August 2015

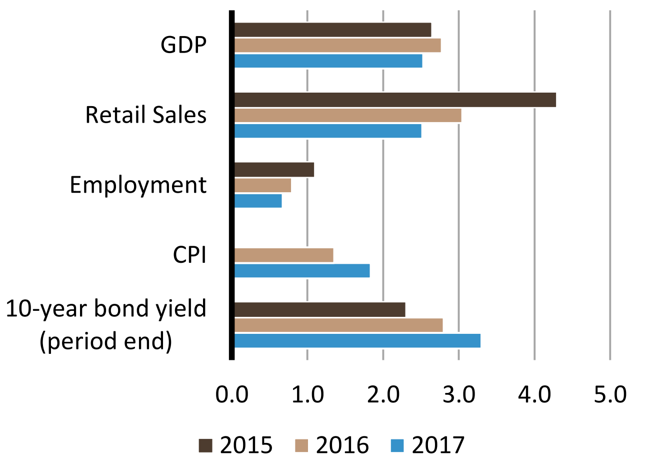
UK real estate market outlook 2H15

Demand for UK real estate is showing no signs of slowing, but as pricing approaches pre-recession peaks how much further growth will there be?

The economic environment

In general terms for 1H15, the UK economy has continued its positive trajectory with 2Q15 GDP growth figures of 0.7% following a surprisingly weak 1Q15 output of 0.4%. This suggests that the weak output numbers for the first quarter were an anomaly rather than the start of a slowdown in economic growth. The economy has now grown for 10 consecutive quarters, and with the stronger output in 2Q15, expectations for annual growth in 2015 are unchanged from the start of the year, at a robust 2.6%.

UK key economic indicators
(% p.a.)



Source: Oxford Economics, August 2015
Note: Past performance is no indication for future results.

Beneath the headline numbers, however, the economy has re-emerged as "two-speed", with the services sector surging ahead, particularly in those areas closely related to the buoyant consumer sector. The tightening labour market has started to exert upward pressure on nominal wages, which combined with an inflation rate of around 0%, has resulted in annual real disposable incomes growing at their fastest pace since 2001. Consumer confidence peaked in mid-2014 and has remained around this record high level, translating into annual retail sales growth of 4.3% in 2Q15, with further strong growth forecast for the remainder of the year.

Conversely, manufacturers have had a much tougher time in 2015, particularly those reliant on exports. The strengthening of the pound against the euro, which has appreciated in value by nearly 9% in 2015, has pushed up the price of UK exports, at the same time as the slowdown in emerging markets has impacted global trade volumes. On a more positive note, the eurozone has been showing some underlying strength in recent quarters, which indicates it may be moving into a phase of sustainable recovery. With the crisis in Greece reaching a solution for the time being at least, one of the main hurdles to a sustainable recovery within the eurozone has been cleared. As the UK's largest export market, a continued recovery in the eurozone should outweigh the short-term negative impact of the weak euro.

In May 2015 the Conservative government won a surprise majority in the general election, which had the initially positive impact of alleviating concerns over an extended period of political uncertainty during negotiations to form a coalition. The outright victory means, however, that the UK will hold an in-out referendum on European Union membership before the end of 2017. The uncertainty in the run-up to the vote is likely to slow both the investment and the occupier markets, and in the event of a Brexit, the impact for UK real estate – and in particular Central London offices – is likely to be overwhelmingly negative.

Office sector outlook

The recovery in UK regional office occupier markets is now well entrenched, and companies have continued to invest in and expand their real estate occupation in the first half of 2015. Total take-up for the Big 6 regional centres[1] reached 2.5 million sq ft, 10% up from the 1H14 total. Particularly strong demand was recorded in Birmingham, where take-up reached a record half-year level for the market, while Leeds recorded a 40% increase on 1H14.

Continuing the trend from 2014, professional and business service firms continued to be active in the regions with signs that occupier demand is becoming increasingly widespread. Illustrating this, the largest regional deal in 1H15 was to HSBC, who pre-let 220,000 sq ft in Birmingham for their new retail and commercial function HQ to physically ring fence these functions from the investment banking arm remaining in London. This follows on from Deutsche Bank signing for 134,000 sq ft in 2014 to facilitate a significant expansion in their operations in the city. There have been a number of other examples in recent years of firms setting up offices in regional markets to relocate non-core functions from London, and as the rise in occupational costs in London has continued to far

[1] Big 6: Birmingham, Bristol, Edinburgh, Glasgow, Leeds and Manchester

outstrip those in the regions, this trend may increase over the next few years providing a positive boost for the office markets and economies of the regional centres.

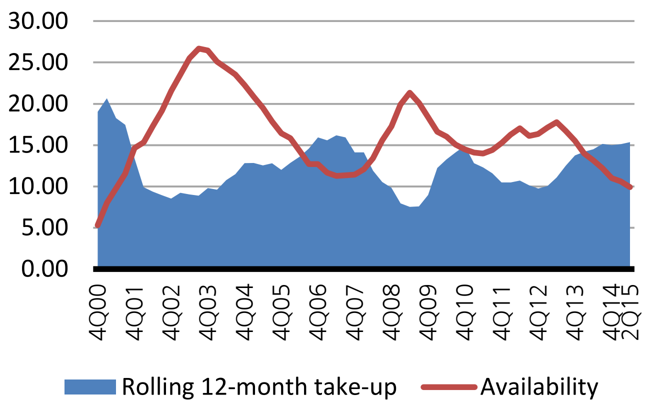
Availability of office space in the Big 6 markets has been on a downward trend, with the weighted vacancy rate for the centres falling from a peak of 15.8% in 2012 to 12.4% in 1H15. This has been driven by the improvement in occupier demand combined with a very low level of speculative development activity. Although construction activity has increased in recent quarters, a large proportion of this has been due to pre-let developments, the prominence of which are reflective of the constrained supply of Grade "A " CBD office space, particularly in the larger size bands.

A handful of speculative schemes are now moving forward; however, these are not expected to be able to meet the growing demand for high quality office space. As a result, prime rents in the regional markets started to increase last year, and growth is forecast to accelerate in 2015 and 2016 in Birmingham, Bristol, Leeds and Manchester. Although the overall market is now improving too, poorer quality space, particularly in buildings located in less desirable areas, still face significant challenges. An increasing number of these types of buildings are being converted to alternative uses as there is very limited demand for this type of office space.

Large scale transactions to the banking and finance sector have returned to the Central London market, and supported by a 388,800 sq ft letting to Deutsche Bank in Canary Wharf, this sector accounted for the largest proportion of demand in 1H15. With the other prominent sectors including TMT and professional services continuing to provide strong levels of demand, take-up in 1H15 strengthened even further to reach the highest first half-year level since 2001. There are no signs that the pace of active demand for Central London office space is slowing, reflected by the volume of space under offer increasing by 20% in 2Q15 to 4.0 million sq ft, and at 47% above the 10-year average it is likely leasing activity in the second half of 2015 will maintain the positive momentum from the first half of the year.

Central London take-up and availability

(mio sq ft)



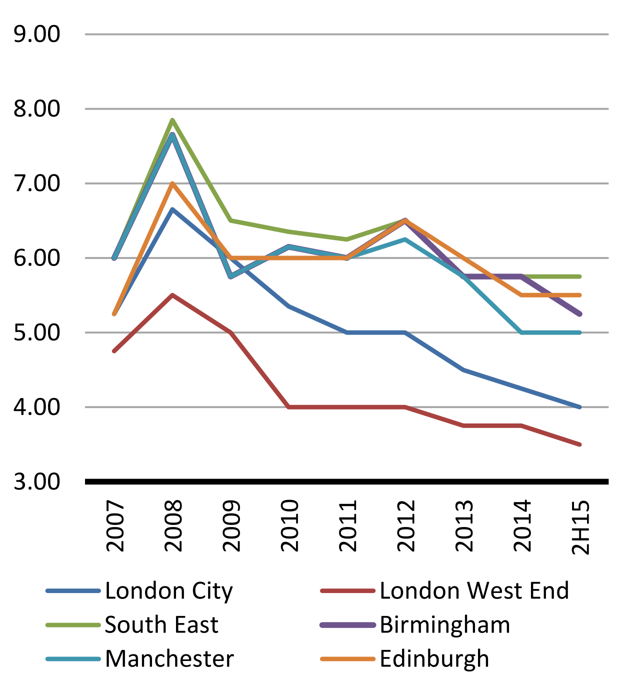
Source: CBRE 2Q15

As this exceptional level of demand has coincided with a period of relatively low speculative office completions, availability has fallen for eight consecutive quarters to stand at 9.9 million sq ft, 34% below the 10-year average. Developers have been responding to the supply-demand imbalance; however, due to the scale of some of the key projects in Central London the lag time for completion is several years, and completions are not forecast to peak until 2018/19. Completion levels in 2015 will only just exceed the 10-year average, and although more new space will come onto the market in 2016, it is likely that the market will continue to be undersupplied given the current pace of demand, placing further significant pressure on prime rents which are forecast to reach GBP 142 per sq ft per annum (p.a.) in the West End and GBP 72.20 per sq ft p.a. in the City by the end of 2016. At this level they will both be significantly above previous peaks and with average rents also recording significant increases, issues of affordability may start to develop, while the pace of rental growth is expected to moderate before declining in 2018/19.

Demand is also outstripping supply in the investment market in Central London, with strong competition emerging from a range of different investors for office assets which come onto the market. Investment volumes for Central London offices increased to GBP 6.7 billion in 1H15, a 16.5% increase on the first half of 2014. The market continues to be a key focus of foreign capital, which accounted for 68.5% of the volume in 1H15. The strength of the economy, low government bond yields and positive occupier fundamentals have all been key drivers of this. To foreign buyers and particularly those from outside of Europe, the status of London as a global centre, high levels of liquidity and transparency, sizeable investment opportunities and presence of trophy assets have been key in attracting large volumes of capital.

Driven by the weight of capital targeting Central London offices, prime yields have continued to come down in 1H15 in all sub-markets. The South Bank saw the sharpest contraction of 35 bps to stand at 4.4%, while the City (4%), West End (3.5%) and Midtown (4.25%) all recorded an inward shift of 25 bps. All these sub-markets are now at or below the record historic yield, while Docklands is just 10 bps above the record low after falling 15 bps to 4.5% in 1H15. Despite reaching this level and with investor appetite for Central London offices showing no sign of slowing, it is likely that further inward yield movements will be recorded in the next 6-12 months.

Prime office yields
(%)



Source: CBRE 2Q15

As yields in London have fallen to record lows, investors have increasingly targeted higher yielding regional office property, with the total volume outside of London in 1H15 reaching GBP 3.1 billion, a 19.2% increase on 1H14. Prime yields in the Big 6 centres have been moving in as a result, and now range between 5% in Manchester to 5.75% in Glasgow. Although yields have already moved in significantly from the levels seen at the peak of the crisis, based on the spread between prime yields in London there is still scope for further inward yield movement over the short term.
The occupational markets in both London and the regions are likely to continue to strengthen in the remainder of 2015 and into 2016, and with the supply-demand balance firmly pointed in favour of the landlords, further rental growth is forecast to come through to the markets. While the outlook for the short term continues to be positive, there are a number of downside risks emerging in the medium term. The first interest rate rise is now expected to come early in 2016, and if it continues to rise gradually from this point record low office yields will start to look expensive by comparison in the middle of the forecast period. This would coincide with the first wave of the major supply response which is expected to come through, primarily in London but also in some of the key regional centres, which would limit rental growth prospects. The biggest risk to the outlook for UK offices remains the looming EU referendum, and although there are currently no signs of it slowing the market as we come closer to the date, the potential for a slowdown in leasing and investment activity remains and the consequences of a Brexit for pricing – particularly in Central London – are likely to be severe.

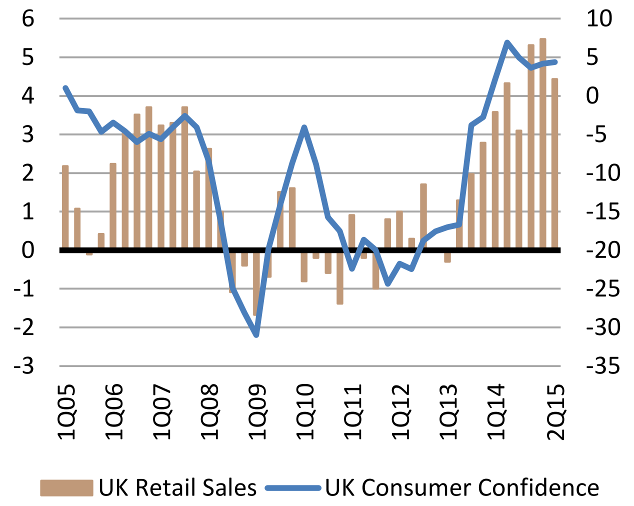
Retail sector outlook

The macro-economic data for the UK retail sector has continued to strengthen in 2015. Nominal wages are growing at their fastest annual pace since 2007, which combined with very low inflation drove disposable incomes up 4.5% in 1Q15 year-on-year (YOY). With further support for spending coming from a buoyant housing market and availability of cheap credit, UK consumer confidence has remained at a historical high level. The boost to real incomes from low inflation is set to retract from 4Q15 as the impact of lower oil prices comes out of the annual equation and inflation is set to return to between 1.3-1.7% in 2016. The underlying strength of the employment market is, however, expected to continue to push robust wage growth which is forecast to outstrip inflation and maintain positive real wage growth. The retail sector will continue to benefit from the higher spending power of

UK households, and sales are forecast to grow by 3.1% in 2016 and 2.5% in 2017.

Consumer confidence and retail sales volume

(% p.a.)



Source: Oxford economics, Thomson Reuters Datastream 2Q15

While the economics driving the UK retail sector are very positive, there are significant variations in performance of the different segments and geographies of retail property, partly due to the underlying structural changes which have impacted the sector over recent years. The growth of online retailing has resulted in retailers optimising their store portfolios, to concentrate on the large dominant locations which can compete with online offerings. These locations typically have a wide range of national and international brands, with a high provision of amenities including leisure and restaurant facilities which are now an integral part of the shopping experience. While these dominant centres have successfully competed with the internet and increased footfall, secondary and tertiary locations have struggled to attract consumers, in-turn leading to an increase in a number of difficult to re-let vacant units and further decreasing the retail offering.

The retail sector returned to rental growth in the second half of 2014 (IPD monthly index data), and increased by 0.5% over the year to June 2015; however, this has been heavily driven by outperformance of some segments of the market. By far the strongest growth was recorded in south east high street, which recorded annualised rental growth of 3.1%. The strength of this segment has been supported by the affluence of the region, strong employment and population growth, and benefitting those who own property, a substantial increase in house prices. In addition, the volume of tourism retailing which is spent in London provides a further major boost to the retail sector which is unmatched elsewhere in the country. This has driven strong retailer demand, and the overall retail vacancy rate in the south east is 10.5%, below the national average of 11.7%, while the vacancy rate in Central London is significantly lower at 7.3% ERV growth for high street retail outside of the South East remains in decline (-0.4% annual to June 2015). This segment includes the majority of the secondary and tertiary high streets which have suffered the most from the structural changes within the sector. Vacancy rates in the Midlands are generally higher than the national average, and range between 13.5-15%, however in the North East and North West vacancy is above 16%. Dominant high streets have performed significantly better and prime rents in key northern cities including Leeds and Manchester have actually seen rental growth in 2015 of between 4-9%. Attractive historical centres, particularly those with a thriving tourist industry, have also been much more resilient to the changes in consumer behaviour. Examples include Bath, York and Cambridge where vacancy rates are between 6.2-7.4%.

The story is very much the same for shopping centres. Dominant centres across the UK have substantially outperformed secondary and tertiary centres. This reflects their wider range of retailers and higher level of amenities desired by UK consumers, and significantly increases the average dwell time and improve retail sales. The weakness of secondary shopping centres has, however, kept vacancy rates high, and at 13.6% on a national level vacancy has only declined marginally from the peak in 2013. Overall, retail warehouses have performed better than shopping centres, partly due to the improving economic outlook and credit conditions driving stronger sales growth for big ticket items (TVs, furniture, etc.) while the strength of the housing market has been supporting bulky goods and DIY retailers. Vacancy rates have come down accordingly and now stand at 5.5% on a national level, from a peak of 8.2% recorded in 2013.

In contrast to the other sectors of UK commercial real estate, investment into retail property slowed in 1H15, falling by 10% on 1H14 to GBP 5.1 billion. The decline was solely due to a significant drop in shopping centre transactions which fell by 37.6%. High street retail volumes increased moderately, by 3.6%, while retail warehouse transactions increased significantly, rising by 37% on a half yearly comparison. In terms of geography, investment was split 65:35 between the rest of the UK and London and the South East, which is broadly in-line with the distribution of investment in the first half of 2014.

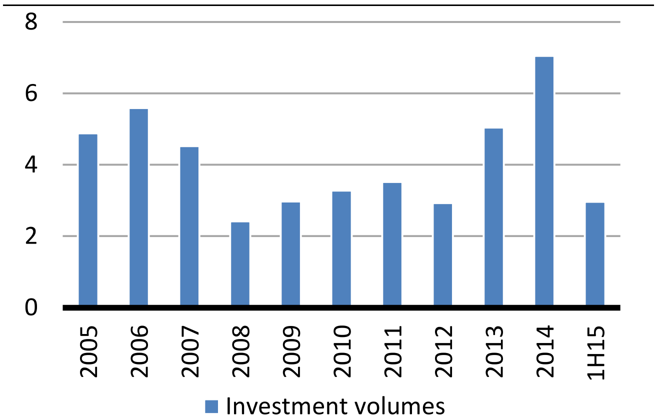
The sharpest average yield movement of the segments in the IPD monthly index in the first half of 2015 was shopping centres, which came in by 20 bps to stand at 7.2% and remains the highest yielding retail segment, 150 bps above the pre-downturn low. Reflecting the polarisation in performance there is a substantial spread between average and prime yields, the latter ranging between 4.25-5% in the main regional markets and 4% in London. The lowest yielding segment is South East high street units, which fell by 19 bps over 1H15 to 5.1%, which is now just 14 bps above the record low recorded prior to the downturn. Prime London West End high street retail yields have already fallen well below the pre-recession level to stand at just 2.25%. Retail is expected to be the weakest overall performer in the three and five-year forecast periods, however South East retail and retail warehouses are expected to continue to outperform the sector average in both rental growth and capital value growth terms. Yields across all segments are expected to continue to compress in the remainder of 2015 and into 2016 as the weight of capital keeps pressure on pricing. As retail has become the most polarised of all the sectors, investors will need to be highly selective in acquisitions and with consumer behaviour showing no signs of change, the main drivers of performance in the sector will be size, location and provision of amenities. There may be some value-add opportunities to reposition shopping parks and centres by introducing more amenities to improve the overall experience, but dominance within the catchment area is likely to be the key feature in attracting consumers and retailers alike.

Industrial market

The UK industrial market strengthened further in 1H 15, with take-up[1] reaching 9.0 million sq ft, an increase of 9.8% on the volume recorded in 1H14. The market is in an advantageous position of benefitting from the strength of the consumer sector through both online and bricks and mortar retailing, with retailers accounting for 49% of Grade "A" take-up in 1H15. Retailers are continuing to optimise their portfolios to adapt to the change in consumer trends. Many are now consolidating into modern "mega shed" regional and national distribution centres which feed a new network of smaller, often cross-docked delivery centres, which are located in key urban locations close to the final point of consumption, be it either the retail store or home delivery.

Speculative development has been very limited in recent years, partly due to the speed at which developers are able to build a new warehouse and partly as it hasn't been necessary to take on the additional risk of vacancy upon completion, keeping the speculative supply response relatively modest despite the underlying strength of the market. Although there is an increasing volume of speculative space now being developed, with just 3.6 million sq ft under construction this is likely to be comfortably absorbed at the current rate of demand. Logistics availability stands at 11.0 million sq ft, having fallen by 77% from the peak level in 2009, and the vast majority of this space (75%) comprises second-hand stock. Reflecting the limited availability of high quality space, the proportion of take-up which comes from design and build deals has been higher in recent years than was typical historically, accounting for 81% of new take-ups in 2014 and 59% in 1Q15.

Industrial investment volumes
(GBP billion)



Source: UBS Global Asset Management, Global Real Estate Research; August 2015 Property data 2Q15

The strength of demand has continued to put upward pressure on rental values, with IPD rents in the South East and Rest of UK increasing by 4.3% and 3.2%, respectively in the 12-months to June 2015. In the South East in particular, rising land costs and strong competition from other land uses, especially residential

[1] Nationwide, units over 100,000 sq ft only.

property, are contributing to both rental and capital value growth. Some opportunistic investors are purchasing industrial units in predominantly residential areas at exceptionally low yields, with the upside that at some point in the future they will be able to try to change the land-use to residential, justified by the severe housing shortage in London and the South East.

Rental growth in the prime sector has generally exceeded average levels; in 1H15 prime rents for industrial space around London Heathrow Airport increased by 9.8% to stand at GBP 14.00 per sq ft p.a., the most expensive industrial rents in the world. Elsewhere prime rents have increased by 10.4% in the prime Midlands distribution area, 8.3% in Scotland, 5.6% in the North West and 4.5% in the North East. Given the positive outlook for the sector, both prime and average rental growth is expected to accelerate in 2015 and 2016, before slowing towards the end of the forecast period. With the supply-side kept in check by the prominence of pre-letting, rental growth is expected to remain in positive territory throughout.

Good quality industrial assets have been highly sought after in recent years, proving resilient in the aftermath of the downturn due to their high income characteristics in a low growth environment, and with the underlying occupier fundamentals strengthening, investor demand has increased further. In 2014 investment in the sector reached GBP 7.1 billion, 25% higher than the previous annual record in 2006. In 1H15, investment totalled GBP 3 billion, marginally above the level recorded in 1H14 and given the increasingly seasonal nature of UK investment volumes it is likely this number will increase in the second half of the year, reaching another annual record.

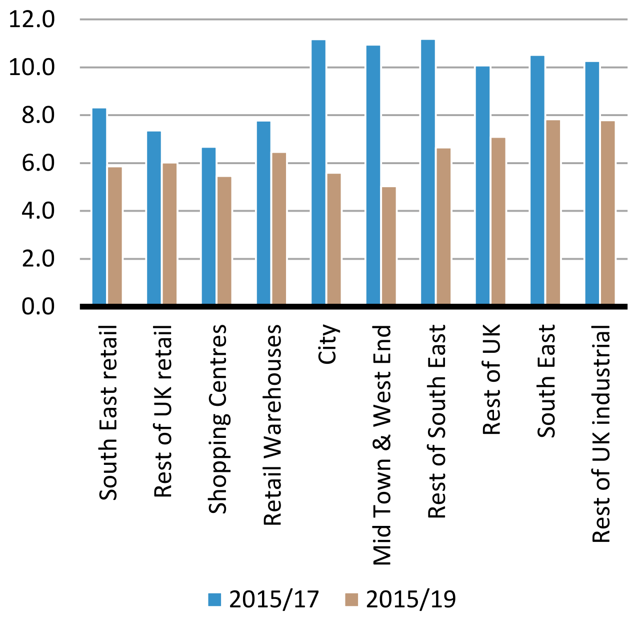
Industrial property has become increasingly expensive and average yields for both South East and Rest of UK property have moved in by 76 and 85 bps in the year to June 2015 to stand at 6.4% and 7.1%, respectively, while prime yields have moved in by between 50-100 bps over the same period. 2015 is forecast to be another year of very strong capital growth in the sector, with the pace slowing in 2016/17 as the property market cools slightly and yields stabilize, before correcting slightly in 2018/19 in a higher bond yield environment.

Summary

UK property will remain in very high demand in the second half of 2015, which will continue to place pressure on pricing even with many segments approaching record low yields. In particular, Central London offices are now forecast to record capital growth which will come close to the exceptional returns recorded in 2014. This front loaded growth will drive performance in the short term, and with occupier fundamentals strengthening even further, it may be another 6-12 months before the momentum starts to slow.
The short-term growth is expected to push total returns over the three-year forecast in the City to first position, followed by South East Offices and Midtown & West End. When the market does turn, however, the cyclical nature of the Central London office market and the exceptional growth which has been recorded in recent years mean that we can expect it to have the sharpest correction to pricing. An additional risk to investors is this may occur at a time when the supply response is kicking in, which will limit the scope for the rental growth which would be required to get value out of any purchase with initial yields which are at exceptionally low levels. Rest of UK offices are expected to follow a similar trend, but with less front loaded growth and a more moderate correction to the back end of the forecast period, whilst South East Offices are expected to be in-between the two, stronger short-term growth than the Rest of the UK with a sharper correction, but not to the same extent as Central London.
Over the full five-year period, the industrial sector has the strongest outlook, with the South East and Rest of UK industrial segments in first and second positions, respectively. The economic fundamentals driving the occupier market are expected to remain positive throughout the forecast period, which will support ongoing moderate ERV growth. The market is expected to see some pricing correction in 2018/19; however, this will be much softer than for the office sector. Supported as it is by strong income return characteristics, it will be in the best position to outperform when capital growth does turn negative.

Data sources: Oxford economics, CBRE, Thomson Reuters Datastream, Local data company, Property data, JLL

Total returns
(% p.a.)



Source: UBS Global Asset Management, Global Real Estate Research; August 2015
Note: Returns based on an IPD portfolio

Retail property still struggles with the structural changes in consumer behaviour, which are expected to continue to polarise performance between the dominant high streets and shopping centres and secondary/tertiary retail areas. Although there may be some scope for improving the retail experience at some parks and centres through repositioning the asset to include more leisure space, size will remain the key driver of retailer and consumer demand. Centres which are dominant within their catchment area are expected to outperform; however, this position is likely to be heavily priced in to any assets which come to the market. Over the five-year period retail warehouses have the strongest expected total returns, reflecting the ongoing strength of the housing market, comparatively low vacancy rates and strong consumer sentiment driving big ticket sales.

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