For Professional Clients and/or Qualified Investors only

UK Real Estate Overview

Q2 2021

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UK Economy

- The economic recovery is underway as the last restrictions were lifted on 19 July 2021, providing a boost to the economy with GDP growth of 7.3% forecast for 2021 and pre-pandemic levels of activity returning towards the end of the year.
- Consumer-facing services continued to grow with demand shifting from food stores to restaurants and pubs as hospitality restrictions eased. Consumers have saved over the past year, leaving them in in a strong position to support the recovery by taking on new credit and spending some of their excess savings.
- Manufacturing stalled due to supply issues of key components and higher NHS test and trace activity impacting supply chains, which will take longer to resolve.
- Headwinds remain, and the rising number of COVID cases poses a downside risk to the outlook, and even though the link between hospitalisations and case numbers is weaker due to the vaccination programme, consumer confidence could be damaged by rising numbers which may slow the return of leisure spend.
- The labour market continues to improve, with latest employment figures rising for the sixth consecutive month in May 2021. The unemployment rate edged down to 4.8% in the three months to May and job vacancies are back at pre-pandemic levels, with concerns of labour shortages in some sectors now emerging.
- Most government support schemes are in place until the autumn, a couple of months

Key Risks

Our review and outlook is a marketing communication providing an overview of the recent economic and property market environment. It should not be considered as advice or a recommendation to buy, sell or hold investments. Nor is it investment research and has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. As with all investments, capital is at risk.

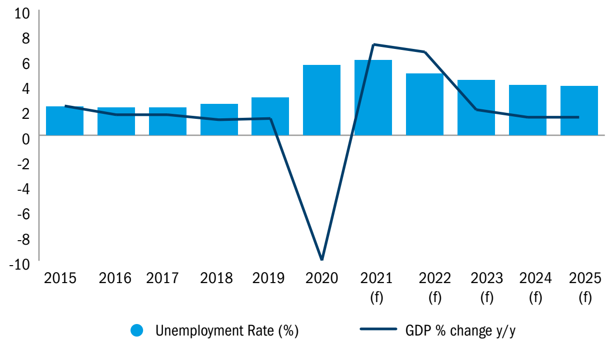
The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

The value of directly held property reflects the opinion of valuers and is reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

beyond the end of restrictions, giving the economy time to adjust before support is withdrawn.

- Inflation rose to 2.4% in June as sectors previously closed reopened and have started to raise prices. The expectation is for these effects to only have a temporary impact on inflation and it will gradually return towards the Bank of England's 2% medium run inflation target. The expectation is for the BoE to look through the temporary increase in inflation, keeping short-term interest rates on hold.

GDP growth & unemployment rate (%)

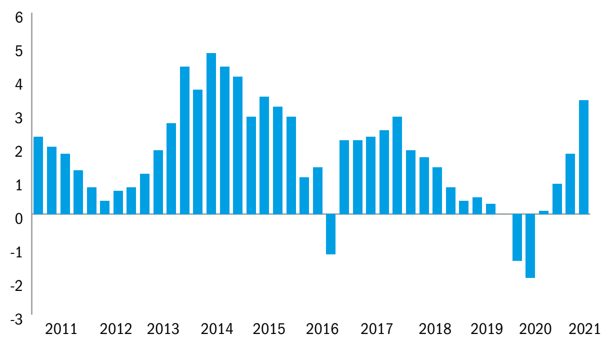


Source: Oxford Economics as at 14-Jul-21

Total returns performance strongest in six years

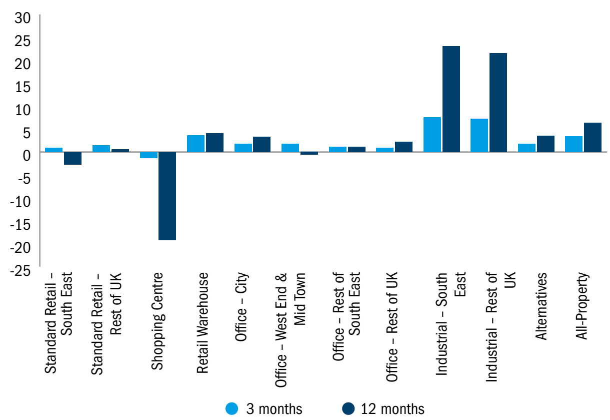
- The all-property total return improved dramatically in the three months to June 2021 posting 3.4%. This is the strongest return performance for six years, since June 2015.
- The 2.3% yield impact, which is the highest quarter-on-quarter performance since September 2014 is supported by positive investor sentiment. Meanwhile, rental value growth at the all-property level, appears to have turned a corner and is positive at 0.2%, the first time in positive territory since late 2018.
- The industrial sector was the driving force behind the quarter's performance with a total return of 7.5%, the second highest quarterly return ever recorded for the sector, with the last three quarters seeing two of the best quarterly performances on record.
- There are no marked differences between standard industrial and distribution, although the latter continues to outperform standard industrial. There are also no meaningful regional disparities with all areas of the UK showing improvements in Q2 over the previous quarter, with the North East posting the strongest total return of 9.2%, followed by Yorkshire & Humberside (8.4%).
- Retail posted a positive 1.7% quarterly total return, the first positive performance of the sector for three years, driven by retail warehouses with a total return of 3.7% for the quarter. Shops and shopping centres are still both negative but there are more meaningful signs of stabilisation.
- Looking forward, the all-property total return moves out of the negative territory of 2020, and looks to remain relatively stable over five years to 2025. The high is expected to come in 2022 with a 7.8% all-property total return, slowing to 4.5% in 2024. There is however a masked divergence between sectors with industrial and supermarkets expected to be the best performing over five years to 2025.

Three month all-property total returns to June 2021 (%)



Source: MSCI UK Quarterly Property Digest as at Jun-21

Total returns 3 & 12 months to June 2021 (%)

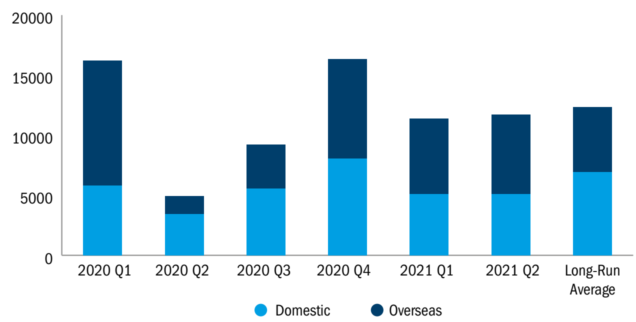


Source: MSCI UK Quarterly Property Digest as at Jun-21

Investment Market

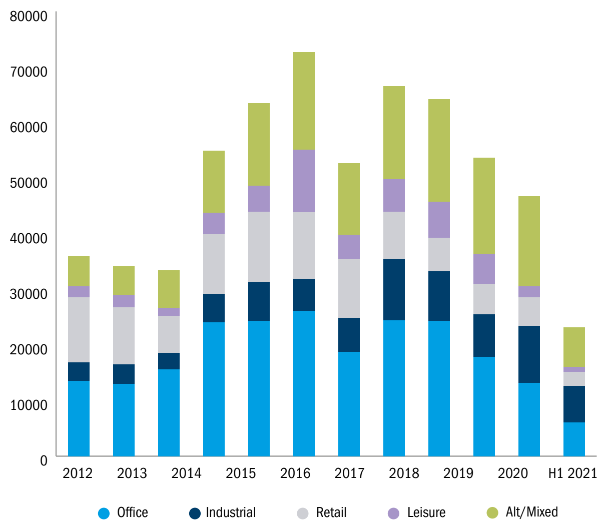
- Second quarter 2021 investment volumes reached £11.7 bn demonstrating the continued resilience of the UK commercial property market to the pandemic. While this is around a fifth under the five-year quarterly average, it is over double the £4.9 bn recorded during the first national lockdown in Q2 2020.
- There continues to be a clear preference for certain sectors, those that are underpinned by their ability to offer long-term, defensive income plays such as industrial, supermarkets and residential.
- Industrial continues to be the most sought after sector with £3.3 bn exchanging hands in Q2, bringing the half year volume to £6.9 bn – the strongest half year volume on record, re-enforcing the seemingly unabating appetite for the sector despite the generally tighter pricing, especially for core. Some investors are looking to assets with a level of risk, be that location or leasing risk or a need for improvement/refurbishment/future proofing of stock in order to drive higher returns.
- Not all retail has been affected evenly by the pandemic and divergence within the sector continues. Supermarkets are most sought after and the defensive nature of retail parks makes them attractive too, especially those well-let and with potential alternative use angles. Of note, while investor appetite is limited for shopping centres, some recent interest has been driven by repricing rather than the repurposing of late.
- Cross-border investors, having learnt to navigate the pandemic related restrictions accounted for a 57% share of second quarter deals, up from the 30% seen in the equivalent quarter in 2020 when lockdowns were first introduced in earnest and strict travel bans were in place.
- Looking forward, the all property yield will compress by around 20 – 25 bps this year driven by supermarkets and the industrial sectors, with mild compression expected or offices, but at the core end, while leisure, hospitality, shopping centres and shops are struggling and further outward movement in yields is widely expected.

Investment activity £m



Source: Property Data as at Jul-21

Investment activity by sector (£m)

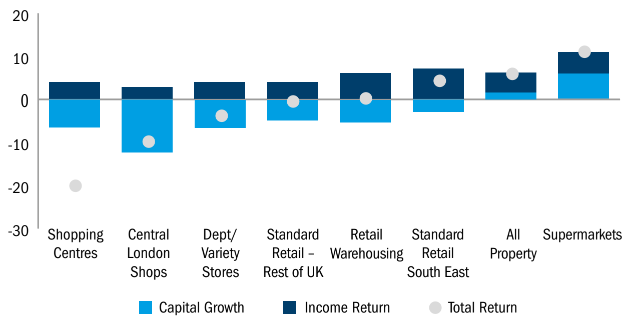


Source: Property Data as at Jul-21

Retail

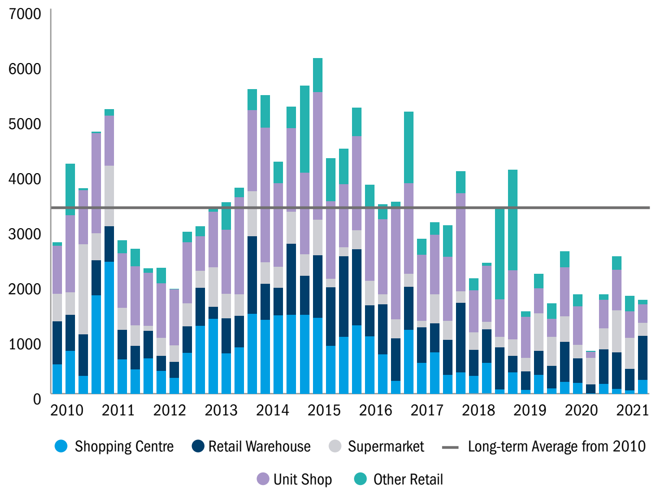
- The retail market turned a corner in the second quarter posting a 1.7% total return, and turning positive for the first time since mid-2018. The annual total return is negative at -2.6% but with signs of stabilisation emerging, and a significantly better performance than the -12.7% in the year to June 2020.
- The headline figure masks not only a divergence within the sector, but a geographical one as well. Across the UK retail appears to be improving, albeit from a low base, with the Eastern region posting a quarterly total return of 2.9% supported by positive income return and capital growth.
- London is still struggling, and while the City is slowly improving, although still with a negative quarterly total return of -0.7%, the trend in the West End reversed in Q2, after posting a positive first quarter total return.
- Retail warehouses are bouncing back, attractive to occupiers and investors and was the only retail segment to outperform the all-property total return, while supermarkets are the fourth best performer against all asset segments.
- Investment levels in Q2 were on par with those of Q1 with £1.7 billion of retail assets trading. Supermarkets and retail warehouses are favoured given their ability to offer secure, long income. Combined they accounted for 31% of second quarter activity at £236 mn and £805 mn respectively.
- Repurposing will continue to be a key driver of investor demand, especially for shopping centres, but there has been a rise in opportunistic purchases, although they remain limited at the moment. For now, local authorities, developers and private investors will be where the bulk of capital comes from.
- The high street universe is likely to shrink with prime-pitches seeing rising demand as it becomes increasingly difficult for retailers to trade at historic margins from off-prime, with a widening pricing gap between the two.

Retail total returns by selected segments annual to June 2021 (%)



Source: MSCI UK Quarterly Property Digest Jun-21

Retail investment activity (£m)

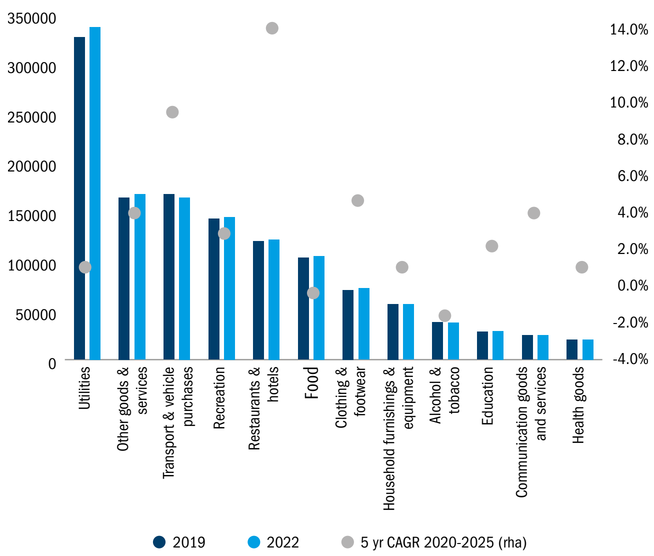


Source: Property Data as at Jul-21

Retail occupier market

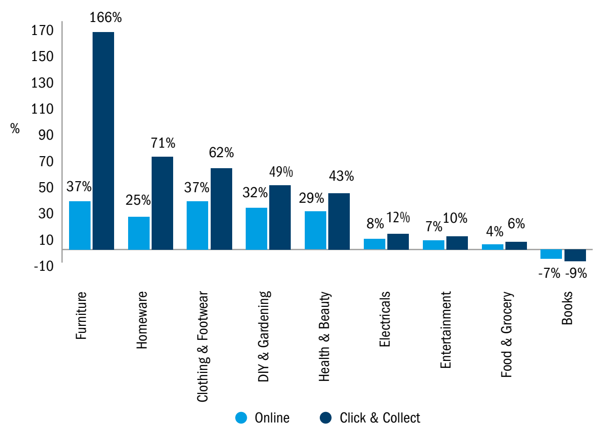
- Consumer confidence improved in line with the continued vaccine rollout, heightened household savings and pent-up demand, as retail and leisure reopened, supporting significant improvements in footfall. But, the forced closures of shops during lockdowns put pressure on revenues and will continue to impact retailer performance even as restrictions are lifted.
- Physical footprints come under great scrutiny as pressure mounts on margins, with some retailers restructuring their supply chains to facilitate structural changes. Those who continue to embrace change and new trends, and who have re-worked their real estate networks, will be in a stronger position as demand returns to physical retail.
- Vacancy rates have inevitably risen, but ongoing governmental support packages such as extension of the eviction moratorium to March 2022 will help to protect struggling operators and limit significant jumps as CVAs slow.
- The offline to online commerce shift will continue, highlighting the importance of an omni-channel approach. In June online sales reached 26% of total UK retail sales, and while dipping from the 36% peak in January 2021, the long-term trend is for rising online spend. However, growth in click & collect are forecast to outpace online over the next five years according to Global Data.
- Retail parks are proving popular, with vacancy sub 6%, and will continue to outperform given the flexibility of format and outdoor setting with the convenience of parking. In some instances they also offer underlying alternative use angles.
- Rents remain under pressure, but the pace of decline is beginning to ease and there are now signs of stabilisation in some stronger locations where, albeit at much reduced rental levels. Turnover rents are also becoming more commonplace.

Consumer spend (£m) and 5 year annualised growth (%)



Source: Oxford Economics as at 07-Jul-21

Channel Growth 2020-2025

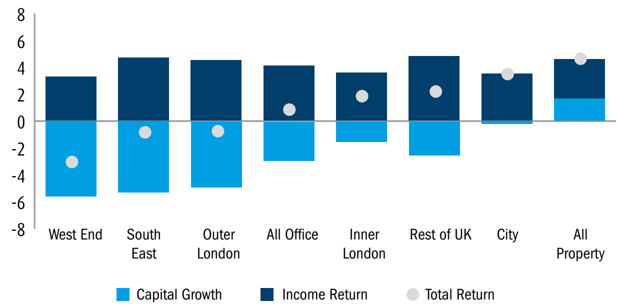


Source: Global Data as at Jun-21

Offices

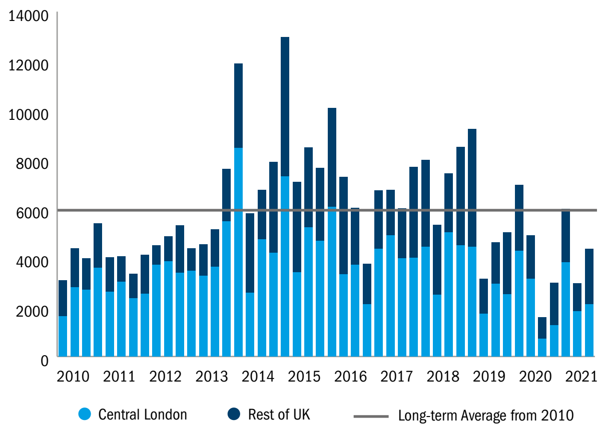
- There was much better news coming out of the office sector which delivered a 1.4% return in the three months to June, building on the 0.5% total return from the first quarter. For the year, UK offices delivered a 1.0% total return, which will gradually lead to improving returns over the next five years as rental activity picks-up, albeit modestly, coupled with some value appreciation.
- As the office sector works through the structural change that was accelerated by the health crisis, investor confidence will be boosted by the phased, albeit slow, return to working practices as businesses start venturing back to the office. The all-office total return for this year is expected to be in the region of 2.5%. The Rest of the UK will outperform (3.0%), compared to the 2.8% increase in total returns for the South East, compared to London at 2.5%.
- The office sector saw a turn around in appetite in Q2. After a slow start to the year trading volumes reached £4.4 bn in the second quarter, bringing the half year total to £7.4 bn with both London and key cities outside the capital seeing a pick-up.
- Boosted by some large transactions, volumes in London reached £2.1 bn in Q2 with a spread of buyers ranging from overseas investors from North America (35%) and European (25%), to domestic purchasers (25%) indicating that confidence is improving despite the slow start to the year.
- With Brexit headwinds easing and the eye of the pandemic hopefully in the past, buyers are sensing a mismatch in pricing between London and other European capital cities reflected in a 25 bps compression in Q2 to 3.25% in the City and 3.75% in the West End – the first inward movement since 2016.
- Across the key regional, prime yields have been relatively stable with a clear focus on core assets offering long income. Assets with an element of leasing risk will be of interest, but to a smaller pool of capital. Institutional capital has been somewhat muted, with overseas investors and UK property companies the most active.

Offices total returns by selected segments annual to June 2021 (%)



Source: MSCI UK Quarterly Property Digest Jun-21

Office investment activity (£m)

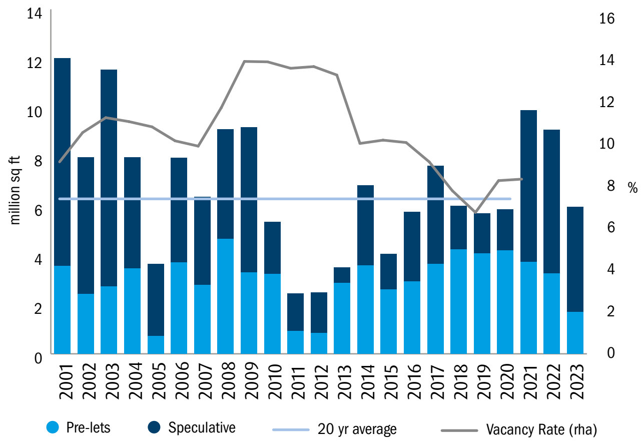


Source: Property Data as at Jul-21

Office occupier market

- Uncertainty remains around how much office space will be needed in the future, but the conclusion that offices are here to stay has been reached, with a focus on quality, collaboration space and location all important and driving corporate decision making.
- While overall take-up figures are lower, there has been a notable flight-to-quality emerge with occupier demand focused on buildings which promote wellness and better support modern, collaborative layouts. This comes at the detriment of older stock, causing rental growth on prime offices to outpace the rest of the market.
- Flexibility is key and smaller floorplates are seeing more activity, where given lingering uncertainty occupier, decision making can be more agile. Larger acquisitions tend to be deferred and take-up here tends to be driven by lease events.
- Availability in Central London is still rising (to 26 mn sq.ft in Q2) but the pace is slowing with vacancy now at 9.3%, and with a constrained pipeline, of which just over 50% of space either pre-let or under offer, will help to limit significant rises.
- Take-up rose for the second consecutive quarter with 1.6 mn sq.ft let in Q2. Leasing activity will gain momentum with 2.7 mn sq.ft of space under offer – the highest since the onset of the pandemic in March 2020, with London's City and West End accounting for circa 80% of under offers in the capital.
- Key regional cities saw Q2 2021 leasing activity reach 1.56 million sq.ft, 26% down on the ten-year average. Healthcare, public sector, TMT and creative sectors are notable for their activity whilst professional and financial services were more muted.
- Central areas drew much of the demand and will continue to do so, which leaves a question mark around the longevity of some, in particular, older out-of-town stock.
- The regional markets are beginning to see the benefit of the commitment of the public sector with the Treasury moving jobs to Darlington and the Home Office to Stoke-on-Trent, while the GPA is in late-phase negotiations in Birmingham.

Key UK office markets – development pipeline

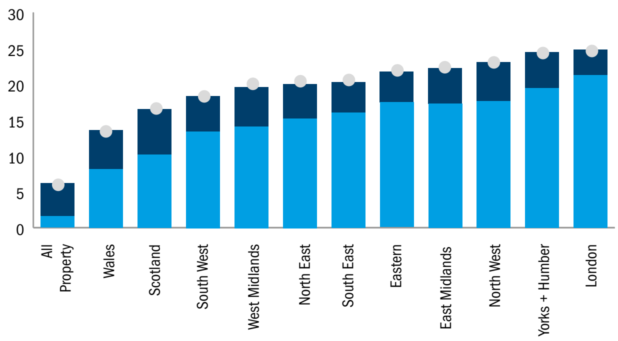


Source: Colliers

Industrial

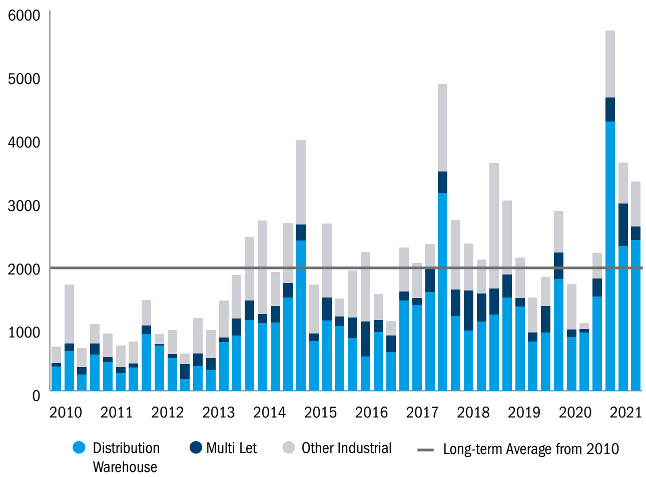
- The all-industrial total return over the quarter was 7.5%, building on the performance seen in Q1 of 5.1%, and is the only sector to outperform the all-property quarterly return of 3.4%. The annual total return was a staggering 22.6% and while both distribution warehousing and standard industrial performed well, distribution leads the way with unrelenting demand for the sector.
- Over the year to June 2021 London was the strongest performer, posting a return of 25.5%, while over the quarter the North West was the best performing region (9.2%).
- Quarter two saw £3.3 bn transact, bringing the H1 2021 investment volume to £6.9 bn, with activity supported by strong occupier market dynamics. The all-industrial total return for 2021 will be in the region of 15% driven on by the ongoing strength of rental growth and firming of yields, before slowing
to a more sustainable rate 2022.
- Investors are eager to increase their allocation to industrial with returns forecast to outpace those of other sectors. With this, a broadening of the investor base is anticipated, including new capital sources, attracted by the favourable structural tailwinds such as the growth in online retail and robust occupier market.
- Traditional office and retail investors are increasingly diversifying their portfolios, diverting capital to the wider industrial sector. International capital is as active as domestic, accounting for just over half of H1 2021 spend. Unsurprisingly foreign investors are more active in 2021 than 2020 when lockdown was more restrictive. Buyers from the US are in acquisition mode, but there has been a notable rise in activity from Middle Eastern investors.
- As investors look to deploy capital and build scale quickly portfolios have become more important accounting for a third of the H1 2021 volume. Strong competition and the weight of money targeting the sector has seen prime yields compress to around 4.00%, a 25bps shift from 12 months previously. Competition for secondary assets has led to yields narrowing over the last year and are now circa 4.50%.

Industrial total returns by selected segments annual to June 2021 (%)



Source: MSCI UK Quarterly Property Digest Jun-21

Industrial investment activity (£m)

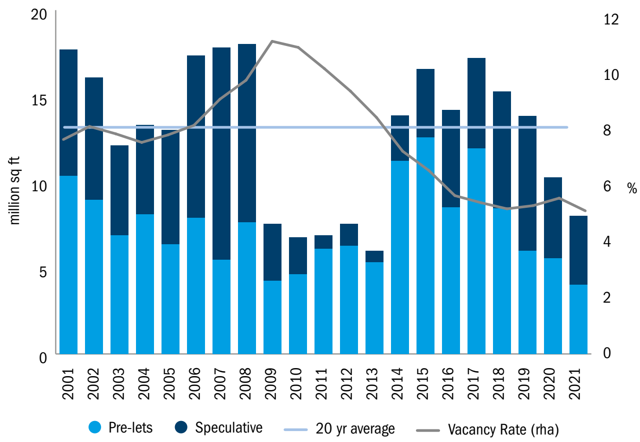


Source: Property Data as at Jul-21

Industrial occupier market

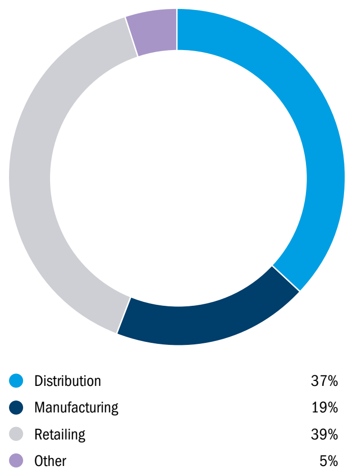
- H1 2021 saw a record breaking 30.8 million sq.ft of take-up (50,000 sq.ft+), double that of H1 2020 with retailers and distribution firms dominating leasing activity as they boost their online and home delivery capabilities.
- Activity will continue as the remainder of 2021 unfolds driven by the continued realignment and structural changes in supply chains as online platforms play an even bigger role in the retail market going forward.
- Robust demand continues to erode availability, which is already low, especially high quality space. There is approximately 43 million sq.ft of available space, much of which under offer or does not meet current occupier requirements in terms of locations or specification
- The lack of availability is becoming an increasing challenge for occupiers, especially those looking for big box units in excess of 350,000 sq.ft. Others are finding that existing standing stock does not meet their requirements and compromises need to be made either in terms of location or specification or delay expansion/relocation plans until more stock completes or secure space via pre-let or build-to-suit.
- The construction pipeline holds approximately nine million sq.ft of speculative space, and underpinned by robust demand, will be absorbed with ease and not expected to negatively impact the vacancy rate which currently sub 4.4%.
- The market dynamics of low supply and strong demand is seeing more development, but the shortages of construction materials and extended delivery times is pushing up costs which is delaying some schemes as profit margins are squeezed.
- The total amount of space under construction, scheduled to complete this year has dropped over the past few months as expected completion dates are pushed forward into 2022, construction starts postponed or schemes are put on hold.

UK key industrial regions – development pipeline



Source: Property Market Analysis, Q2 2021 release

H1 2021 take-up by occupier type (%) (units over 50,000 sq.ft)

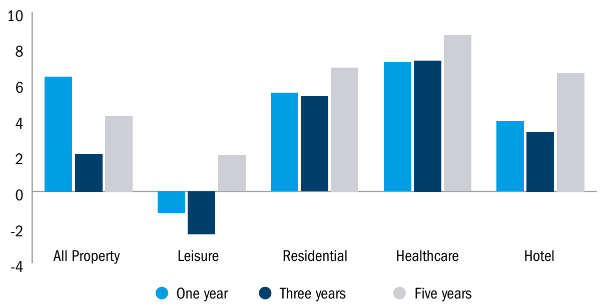


Source: Knight Frank as at H1 2021

Alternatives

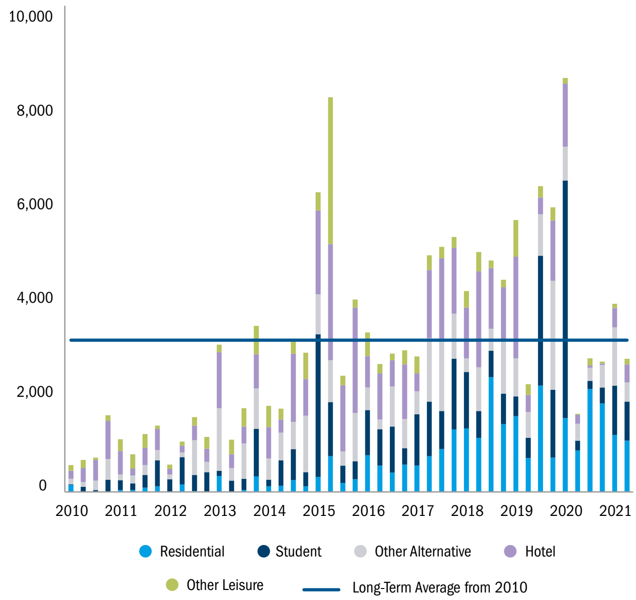
- Alternatives delivered a quarterly total return of 1.8% to June, underperforming the market where the all-property quarterly total return was 3.4%, but outperforming retail and offices. Over the year a significant improvement in performance has been seen as lockdowns are lifted and previously closed sectors, in particular leisure and hospitality reopened – the total return in the year to June was 2.6%.
- There is a distinct polarisation in the subsectors constituting Alternatives, with healthcare the strongest subsector on the quarter and the year with the strength of leasing driving on performance. Leisure meanwhile delivered a negative total return of -1.2% over 12 months to June 2021, but has recorded two consecutive quarters of positive total returns, which to June 2021 was 1.9%.
- Residential is also seeing gains with an improved quarterly performance of 1.9% and is a top performer over the forecast period to 2025 as it continues to produce steady and high returns averaging 4.6% between 2021-2025.
- Hotels showed a marked improvement, with traditional leisure markets expected to bounce back sooner than traditional business locations as confidence returns, boosted by rising levels of domestic travel. The recovery may be too late for some hotels given the length of forced closures and the lackof cash reserves will see some quality distressed assets come to market but limited in number and so bidding could be competitive
- £2.7 bn worth of alternative assets traded in Q2, bringing the half year total to £6.4 bn. Activity was boosted by residential, student housing and hotel deals concluding, which combined accounted for 80% of Q2 deals under the alternative umbrella.
- Select areas of Alternatives able to offer resilient long-term cash flows, supported by underlying robust demand fundamentals, are seeing non specialist investors taking a more active interest. More JVs and M&A activity is also expected as players look at all routes to access stock and take advantage of the growth in the sector.

Alternatives total returns by selected segments annual to June 2021 (%)



Source: MSCI UK Quarterly Property Digest Jun-21

Alternatives investment activity (£m)



Source: Property Data as at Jul-21

Along with BMO Real Estate Partners in-house Research, a variety of sources have been used in the production of this document including CBRE, Knight Frank, Savills, Avison Young, PMA, MSCI and Oxford Economics.

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