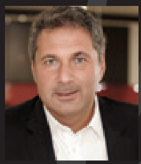
Lambert Smith Hampton

TOP HEAVY

UKIT Q317

UK INVESTMENT TRANSACTIONS BULLETIN



Ezra Nahome
CEO

For what is usually the quietest part of the year, Q3's impressive volume has really changed the complexion of 2017. The year is now certain to break the £50bn mark for only the fifth time in history, a result few would have predicted at the end of 2016

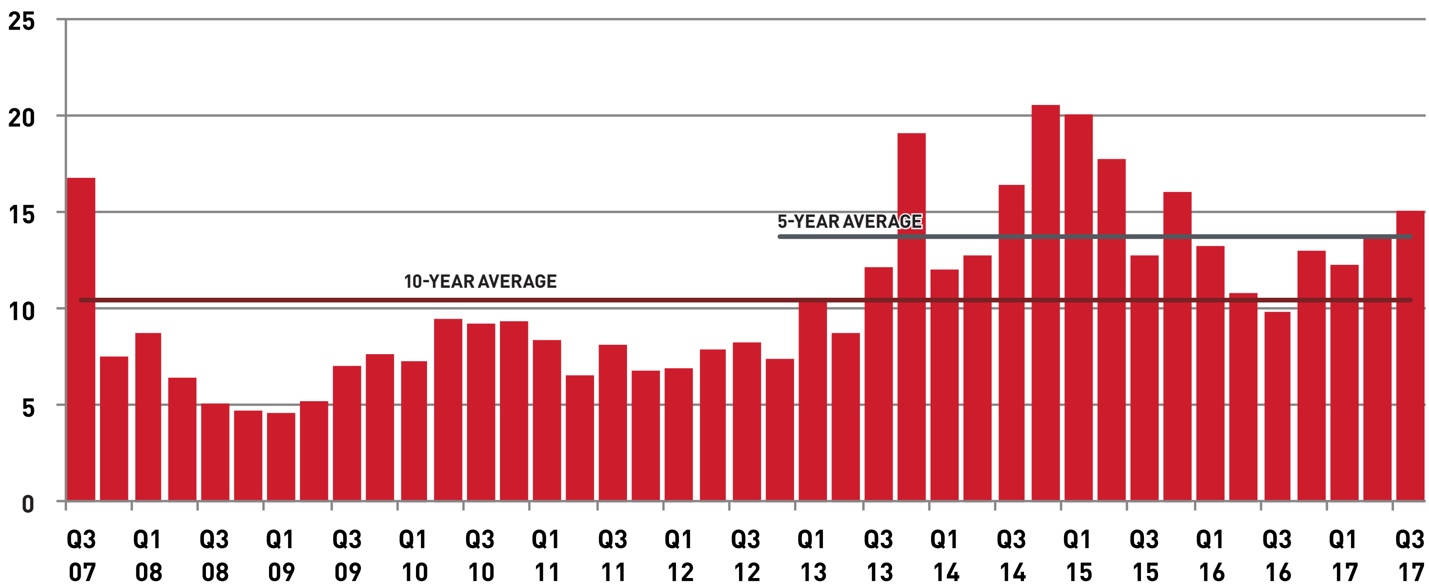
The quarter was admittedly very top heavy, reflecting the sheer scale of some of the deals we saw. Crucially, however, activity at the smaller, busier end of the market has also rebounded from last year, pointing to a healthy depth of demand.

In spite of the all the political wrangling and uncertainty over the UK's eventual divorce from the EU, 2017 has surpassed expectations for both activity and performance. The case for UK real estate remains compelling; returns are relatively attractive, supply is generally tight in the occupier markets and sterling's weakness has fuelled overseas appetite.

Understandably, forecasts of subdued growth in the UK economy and the prospect of a further hike in interest rates suggest that 2018 is looking more challenging. However, while no-one can predict the future, I am convinced that the fundamentals in the property market are sufficiently sound and that the risk of an economic shock is remote.

If anything, with a wall of capital looking to be deployed, the main challenge surrounds stock levels, particularly so for longer income, annuity-type product for which demand is insatiable. However, if rental values continue to hold up well as they have been doing, arguably the best prospects will be found elsewhere in the market where value can still readily be found.

UK INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, Property Archive

Q3 ACTIVITY

Sector focus

A flurry of major deals propelled Q3 volume to £15.0bn, one of the highest seen for a summer quarter and 52% above the same period in 2016, immediately following the Referendum.

Major deals drive Q3 volume

Q3 saw nine transactions in excess of £400m, which together accounted for a record 33% share of volume. This included the UK's largest ever office deal, LKK Health Products Group's £1.28bn acquisition of 20 Fenchurch Street (the Walkie-Talkie), London from Land Securities and Canary Wharf Group.

Meanwhile, activity was also healthy at the smaller end of the market, with Q3 volume for sub £50m lot sizes volume standing 8% above average. Indeed, despite Q3's 'mega deals', much of the larger end of the market was quiet, particularly lot-sizes ranging £100m to £400m.

Industrial set for record year

Reflecting the considerable weight of demand, industrial recorded another strong quarter of activity in Q3. 2017 year-to-date volume stands at £5.5bn, putting it firmly on course to eclipse the previous record of £6.7bn in 2014.

Rest of UK industrials took the leading share of Q3 volume, albeit more than half of this comprised Blackstone's £559m portfolio acquisition of 140 light industrial assets from Brockton Capital.

Ditto for the specialist sectors

The specialist sectors are also collectively on track to see record volume in 2017, reflecting strong demand for long-leased index-linked assets. Q3 volume of £2.2bn took the year-to-date total to £6.5bn, only 15% short of 2014's record with a quarter to spare.

Q3's headline specialist sector deal was Tristan's EPISO 4's £439m acquisition of a 90% stake in a student accommodation portfolio comprising six assets.

Major portfolio deals drive office volume

Office volume of £6.6bn in Q3 was its highest since Q4 2015 and, while, this was spurred on by the Walkie-Talkie deal, record office park volume of £1.8bn was also key.

This included two substantial portfolio deals; Frasers Property International's £686m purchase of four business parks from Oaktree Capital Management and TPG Real Estate's £450m purchase of the Arlington portfolio from Goodman and L&G.

Q3 INVESTMENT VOLUME (£BN)

SECTOR	Q3 2017	VS Q2 2017	VS Q3 2016	VS 5-YEAR AVG
Shops	£0.61	-30%	-69%	-44%
Shopping Centres	£0.46	-42%	290%	-52%
Retail Warehouse	£0.47	-23%	-21%	-31%
ALL RETAIL	**£1.54**	-32%	-42%	-44%
Central London Offices	£2.89	-25%	62%	-26%
Rest of South East Offices	£0.97	231%	190%	63%
Rest of UK Offices	£0.92	42%	70%	22%
Office Parks	£1.85	531%	304%	239%
ALL OFFICE	**£6.62**	31%	113%	14%
South East Industrial	£0.38	74%	102%	59%
Rest of UK Industrial	£1.08	143%	278%	154%
Distribution Warehouse	£0.39	-67%	-27%	-48%
ALL INDUSTRIAL	**£1.85**	1%	83%	31%
Hotels & Leisure	£1.64	7%	139%	30%
Specialist	£2.24	-5%	29%	74%
Mixed-use (single assets & portfolios)	£1.11	81%	79%	-7%
ALL PROPERTY	**£15.00**	10%	52%	9%

Source: LSH Research, Property Data, Property Archive

Retail suffers lack of large deals

In contrast with other sectors, a lack of major deals was a drag on retail volume in Q3. At £1.5bn, retail volume was the lowest quarterly total in five years, with notably subdued activity in Central London. Q3's largest retail deal was Royal London's £155m purchase of a 7.5% stake in Bluewater Shopping Centre, Kent from Hermes IM.

Average transaction yield edges inward

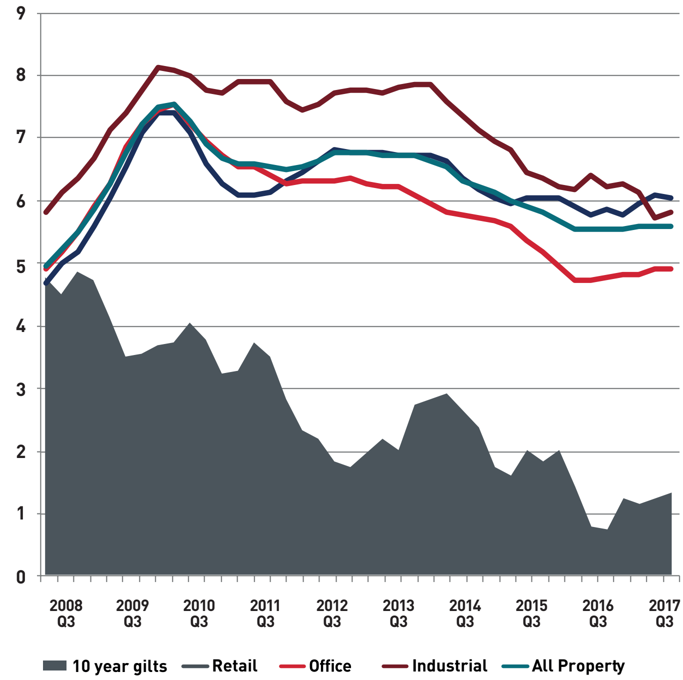
The All Property average transaction yield was 5.57% in Q3, seven basis points keener than Q2's level and the first meaningful movement in average prices since Q2 2016. Yield movements diverged between the main sectors, with office and retail yields moving in by 29 and 17 bps respectively and industrial yields moving out by 36 bps.

Growing appetite for risk in industrial

With prime industrial yields at record lows, the outward shift in the sector's transaction yield during Q3 likely reflects confidence in the sector's growth prospects and a willingness to move up the risk curve in search of stock.

Meanwhile, the inward movement in average retail transaction yields is arguably indicative of a growing flight to quality among investors. This is supported by market sentiment, with notional prime yields for shopping centres under outward pressure. That said, we have witnessed evidence of improving sentiment towards retail warehouses over the summer.

ROLLING ANNUAL TRANSACTION YIELD & 10-YEAR GILTS (%)



Source: Source: LSH Research, Experian

Q3 2017 YIELDS

	Transaction yields			Prime yields			
SECTOR	**Q3 2017**	**3 MONTH MOVEMENT (BPS)**	**12 MONTH MOVEMENT (BPS)**	**Q3 2017**	**3 MONTH MOVEMENT (BPS)**	**12 MONTH MOVEMENT (BPS)**	**YIELD SENTIMENT**
Shops	5.08%	60	63	4.00%			
Shopping Centres	6.31%	-104	-28	5.75% *			
Retail Warehouse	6.63%	14	19	4.75%		25	
ALL RETAIL	6.09%	-17	9		-	-	-
Central London Offices	4.12%	-22	-33	3.50%			
Rest of South East Offices	6.15%	-10	18	5.00%			
Rest of UK Offices	5.80%	-132	-25	5.00%			
Office Parks	7.26%	50	223	5.25%			
ALL OFFICE	4.93%	-29	2		-	-	-
South East Industrial	4.99%	51	-37	4.25%		-50	
Rest of UK Industrial	6.91%	-45	86	5.25%		-75	
Distribution Warehouse	6.35%	66	94	4.25%			
ALL INDUSTRIAL	5.77%	36	24		-	-	-
Hotels & Leisure	4.94%	26	-100	4.50%		-25	
Specialist	5.64%	3	-16	4.50% **		-25	
Mixed-use (single assets & portfolios)	4.24%	-240	-353	-	-	-	-
ALL PROPERTY	5.57%	-7	-8	-	-	-	-

Source: LSH Research, Property Data, Property Archive

*Sub regional centres **Student accommodation (Regional, direct-let)

Regional focus

With investment in London at its lowest level for a year,
Q3's healthy volume was underpinned by a revival of major portfolio deals.

Quiet quarter for the capital
At £5.5bn, Q3 volume for single asset deals in Greater London was down 18% on the previous quarter and 10% below the five-year quarterly average. This was in spite of the Walkie-Talkie transaction, the UK's largest ever office deal.

However, the main culprit behind a weak quarter for the capital was subdued activity in retail, where volume of only £92m was the lowest since Q1 2009.

Meanwhile, the specialist sectors and mixed-use assets recorded above average volume in the capital, the largest deal being R&F Properties' £470m acquisition of the Nine Elms Square site from St Modwen.

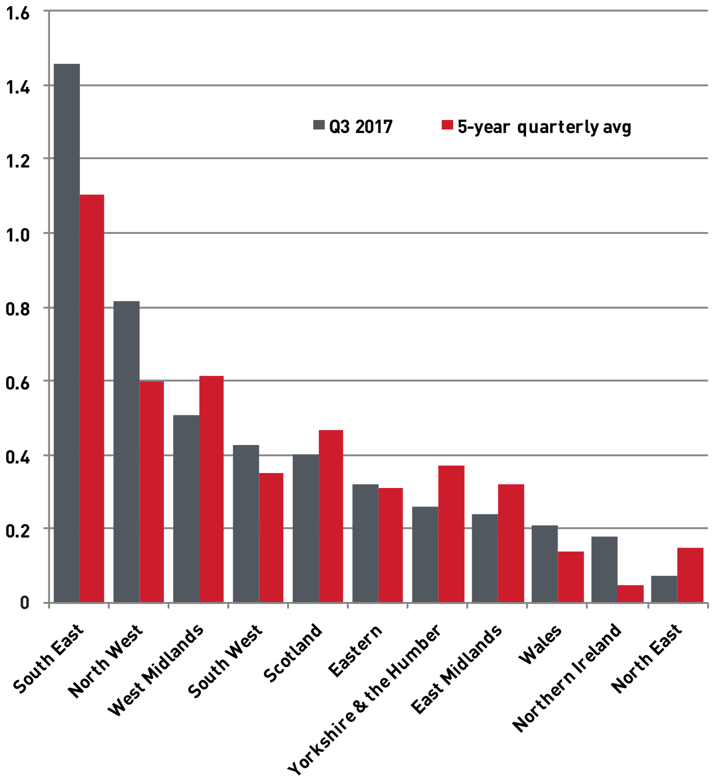
Portfolio deals drive Q3 volume
Following relatively subdued activity over the past 24 months, a flurry of major deals pushed portfolio volume to £4.6bn, equivalent to almost a third of Q3's total volume.

With £1.2bn of assets changing hands, hotels & leisure accounted for the largest share of portfolio volume, the largest deals being Aprirose REI's £525m acquisition of the Q Hotels portfolio from Bain Capital Credit and Canyon Partners.

Decent quarter for regional investment
Volume for single asset deals outside London was £4.9bn in Q3, up 3% on Q2 and 9% above the five-year quarterly average.

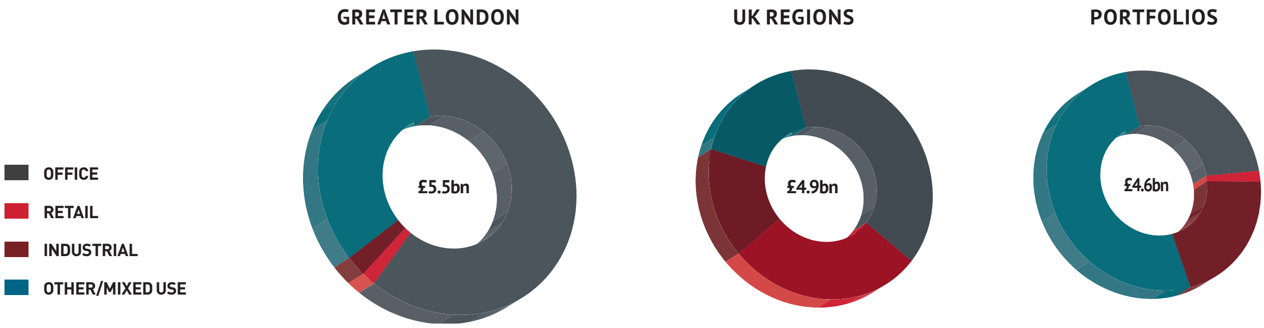
The largest single asset transaction in the regions was CPPIB's £200m purchase of a 50% stake in Milton Park Business Park, Oxford from Hermes IM. This boosted South East volume to £1.5bn, its highest since Q4 2015.

REGIONAL INVESTMENT VOLUME (£BN)



Source: LSH Research, Property Data, Property Archive

LONDON AND REGIONAL BREAKDOWN (£BN)



	GREATER LONDON	UK REGIONS	PORTFOLIOS
VS Q2 2017	-18%	3%	99%
VS Q3 2016	37%	63%	64%
VS 5-YEAR QTY AVG	-11%	9%	47%

Source: LSH Research, Property Data, Property Archive

Buyers and sellers

While UK institutions remained quiet on the acquisition front, strong appetite from overseas investors was fundamental to Q3's healthy volume.

Strong appetite from Far East

Despite ongoing uncertainty over the UK's future relationship with the EU, overseas investors continue to show faith in UK real estate. Responsible for all of the top 15 deals in the quarter, overseas volume totalled £8.6bn, the highest since Q4 2015.

Far Eastern investors continue to command the leading share of overseas volume, accounting for 40% of activity. Purchasing four of the quarter's ten largest deals, Q3 volume of £3.5bn was their strongest quarter since Q4 2013.

Institutions continue sell-off

Institutions were net sellers of UK property for a sixth consecutive quarter in Q3, at £1.2bn. Offices provided the focus of disposals, including a number of prominent office parks sales to overseas buyers.

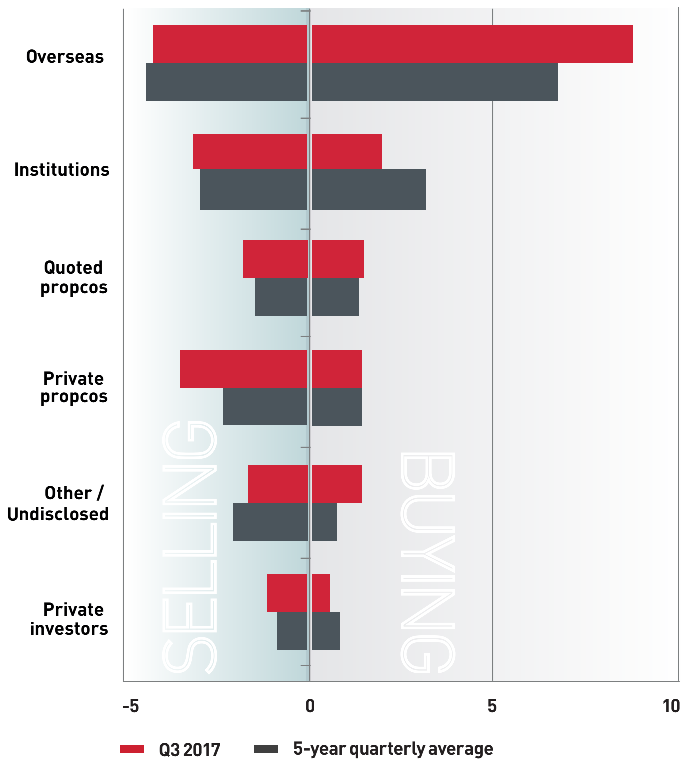
By volume, Q3's institutional sales were dominated by two investors, namely Hermes and L&G, who between them sold c£1.5bn worth of UK property, just under half the total.

Institutions were net buyers of industrial assets, albeit this amounted to a modest £207m. They also remained net buyers of alternative assets for the seventh consecutive quarter.

Local Authority appetite continues

Local Authorities invested £578m into UK property in Q3, closely in line with Q2's level. Offices was the main focus, boosted by Warrington Council's £200m acquisition of Birchwood Park, Warrington from Oaktree Capital Management.

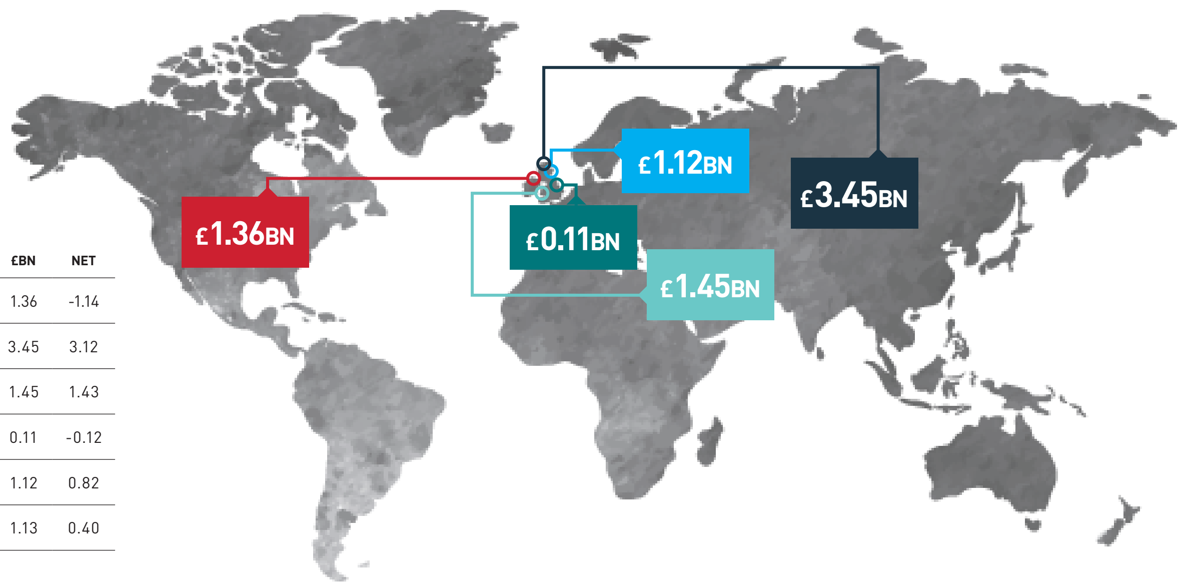
VOLUME BY INVESTOR TYPE (£BN)



Source: LSH Research, Property Data, Property Archive

Q3 2017: GLOBAL INVESTMENT FLOWS INTO UK CRE (£BN)

ORIGIN	£BN	NET
North America	1.36	-1.14
Far East	3.45	3.12
Middle East	1.45	1.43
Germany	0.11	-0.12
Europe	1.12	0.82
Other	1.13	0.40



Source: LSH Research, Property Data, Property Archive

OUTLOOK

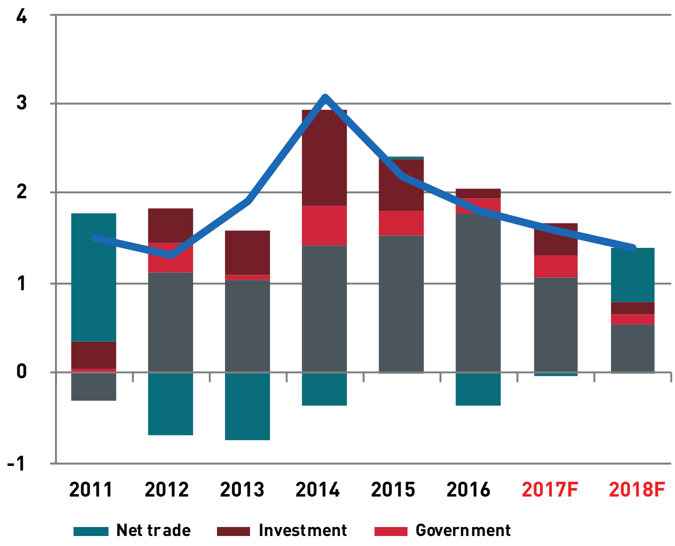
Better than expected economic growth in Q3 recently sealed the first interest rate rise in over a decade. However, with the Bank minded to take a cautious approach to monetary tightening, investors should have little to fear.

UK economy regains some momentum

Momentum in the economy picked up slightly in Q3, with growth of 0.4% running marginally ahead of the previous two quarters. However, despite the uptick, the UK is expanding at the slowest rate of any G7 economy in 2017 to date, a complete reversal of the position in 2016.

The Q3 figures reveal a mixed picture between sectors. Industrial production posted healthy growth of 1.0% while services sector growth held steady at 0.4%. Meanwhile, however, the construction sector is now in technical recession following a second successive quarterly contraction in output.

CONTRIBUTIONS TO UK GDP GROWTH



Source: ONS, Experian

First rate rise in a decade on the way

Though lacklustre, the fact growth in Q3 was ahead of the Bank of England's forecast was enough to justify a long-mooted interest rate rise. With inflation running to a five-year high of 3.0% and concerns over the growth of personal credit, the Bank was minded to take action. While much of the current spike in inflation stems from the fall in the pound, monetary tightening is seen as necessary to ward off domestically induced inflationary pressures in the future.

Should investors be worried?

Even if only psychologically, the first interest rate rise in over ten years is quite a step. However, the move only restores the base rate from its post Referendum 'emergency' level back to its level a year ago, of 0.5%. By itself, this is unlikely to have an impact on sentiment and is already priced in to investors' expectations.

Further escalation in the base rate over the next 18 months, say to around 1.0%, poses more of a challenge. However, the investment market is relatively well-placed to cope under this scenario; the current cycle is far less debt dependent than previously, while the historically high margin between base rate and property yields offers scope to accommodate small, gradual rate hikes.

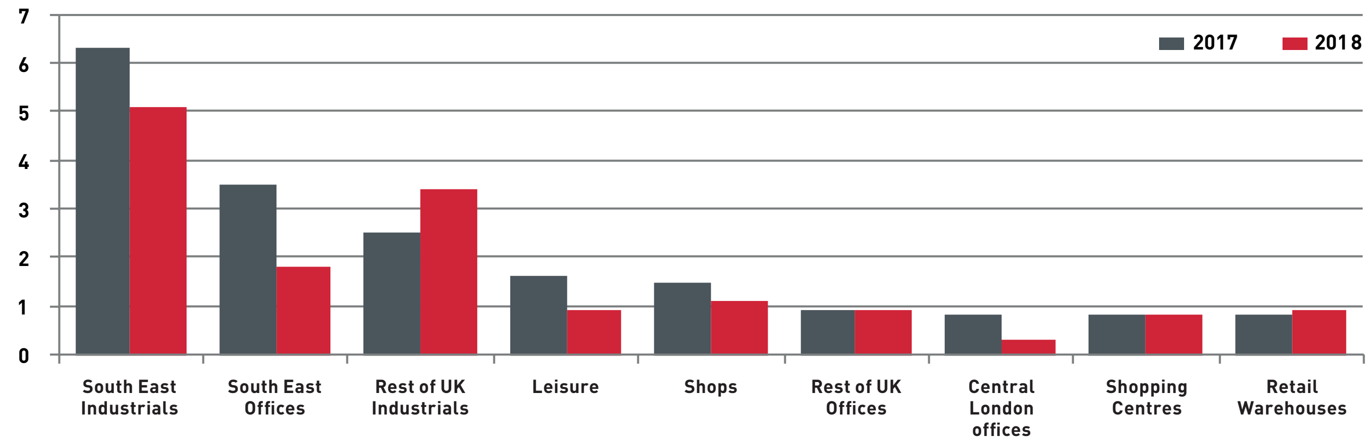
Arguably, the largest risk posed by rate hikes will be to the housing market and in particular consumer spending. Given this makes up a substantial part of the UK economy, further rate hikes will be unlikely should conditions take a turn for the worse during 2018.

Tight supply to support rental levels

In spite of the economic uncertainty, the UK's occupier markets are performing solidly, if unspectacularly. With the current cycle having not seen anything like the levels of development seen on previous occasions, tight supply of quality space is a common theme to a number of sectors and across the UK.

Consequently, while yield compression may be off the agenda in 2018, rental growth prospects are broadly positive. Gaps in supply will continue to offer investors plenty of opportunity to grow income through active asset management and those investors best equipped with knowledge of the local markets stand to benefit most.

RENTAL GROWTH FORECAST (%)



Source: RealFor, LSH Research

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