UK Property Market Trends

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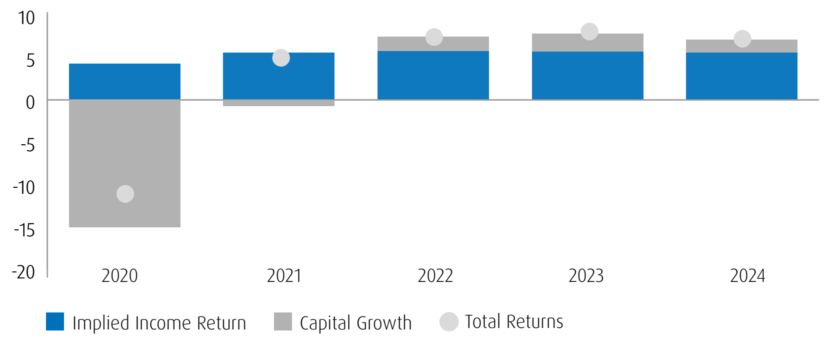
Property market performance is expected to improve after 2020, as the shock from lockdown eases.

The recovery is likely to be gradual and with downside risks. After a poor 2020, BMO REP anticipates all-property total returns to average 6.8% pa in the four years to end-2024.

Components of BMO REP All-Property Total Return Forecasts per cent



Source: BMO REP Jul-20

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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.

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.

In March 2020, a material uncertainty clause was imposed by valuers due to the impact of coronavirus on property performance.

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Economic and Property Market Overview

The property market has been deeply affected by the pandemic but some clarity is emerging.

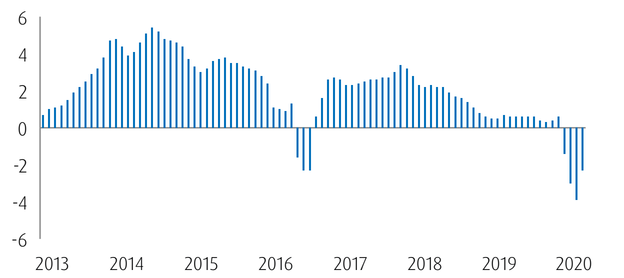
Market Snapshot three months to June 2020	All	Retail	Offices	Industrial	Alternatives
Total Return	-2.3	-5.0	-1.4	-0.6	-3.7
Income Return	1.4	1.8	1.2	1.2	1.3
Capital Growth	-3.6	-6.7	-2.6	-1.7	-4.9
Rental Growth	-1.0	-3.0	-0.3	0.2	-0.7
Gross Rent Passing	-0.6	-1.2	-0.4	0.6	-2.6
Net Initial Yield	5.2	6.9	4.6	4.6	4.9

Source: MSCI UK Monthly Property Digest Jun-20. The definition of Alternatives is the Portfolio Analysis Service definition of "other" which includes hotels, residential, leisure etc.

Past performance is not an indication of future performance.

The economy was characterised by lockdown, as the authorities attempted to contain the pandemic. Restrictions eased in the UK as the quarter progressed, but UK GDP is estimated to have fallen by 19% in the three months to May. Massive fiscal support has limited the immediate impact on employment and the Bank of England has dramatically eased monetary policy and cut interest rates. However, a recession is unavoidable and this has inevitably affected sentiment towards property.

All-Property Total Returns – Three Month Rolling Average to June 2020 per cent



Source: MSCI UK Monthly Property Digest Jun-20

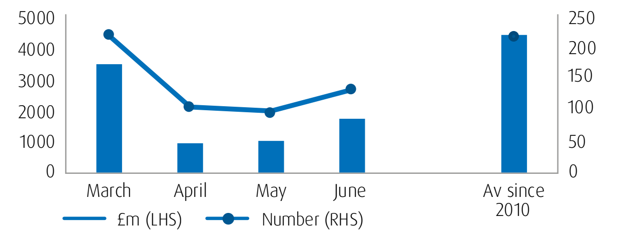
Past performance is not an indication of future performance.

The UK property market went into sharp reverse in March as lockdown was imposed but monthly total returns, although negative, have been on a consistently improving trend since then. The material uncertainty clause was applied by valuers in March. However, some segments have now seen this relaxed, including all industrial and logistics, institutional quality healthcare, supermarkets and build to rent housing, plus Central London offices and some student housing.

This downturn has been notable for weakness in the occupational market and reduced rates of rent collection, but there has been some outward yield movement as well. The impact on performance has been particularly severe for retail, leisure and hospitality. Industrials, supermarkets and residential have been relatively resilient.

After a reasonable first quarter, investment activity dropped sharply as sentiment was hit by the scale of economic dislocation. There has been no flight of capital or mass distress selling, but some transactions have been aborted, others put on long-term hold and very little new stock released. Some deals have gone ahead, especially for long lease indexed supermarket stock and industrial/distribution assets.

UK Property Investment in the COVID-19 Era



Source: Property Data as at 27-Jul-20 Non-confidential deals.

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The Economic and Property Market Outlook

The outlook for UK commercial property remains highly uncertain. Industrial/distribution and offices are expected to out-perform.

Economic forecasts for 2020 were sharply downgraded both for the UK and globally as the coronavirus outbreak intensified. These continue to be revised lower. The third quarter may see improvement from a low base, as restrictions ease and businesses re-open. There is, however, growing concern about the impact of the end of the furlough scheme on the unemployment rate, the speed of consumer spending recovery especially for discretionary items, the path back to some fiscal stabilisation, the risk of a second wave of the virus, and the impact of Brexit. A prolonged period of adjustment supported by fiscal and monetary policy is in prospect. Latest consensus forecasts point to a 9.2% fall in UK GDP this year and 5.9% growth in 2021. Consensus forecasts for the longer-term indicate a gradual return to positive, but fairly subdued, growth of around 1.7% pa.

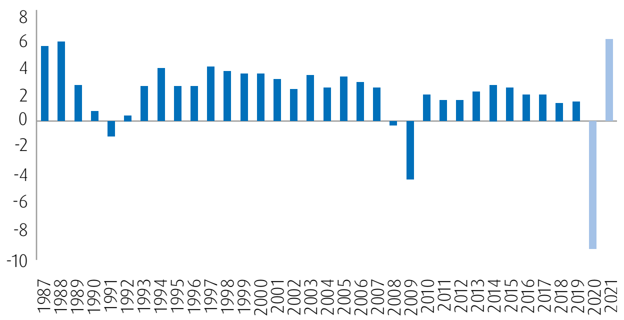
The global nature of the pandemic adds further challenges. Consensus estimates indicate that UK GDP growth will be relatively badly affected in 2020 and recovery could lag other countries thereafter.

The property market outlook is filled with uncertainty and with some significant downside risks. The latest Investment Property Forum (IPF) Survey shows most forecasters predicting negative total returns at the all-property level in 2020 and double-digit falls in capital values could well be in prospect. Inevitably, the BMO REP forecasts for 2020 have been downgraded due to the impact of the pandemic and are minus 10.7% versus a minus 8.1% IPF all-property total return consensus forecast. This largely reflects our more pessimistic outlook for the retail sector.

It appears that this downturn will have a significant and lasting effect on lease structures and income streams. The leasing market is likely to be very quiet while the crisis persists, but with considerable differences by sector. Relative strength for logistics may contrast with extreme weakness in retail and a sluggish office market. Lease flexibility is expected to become increasingly important for occupiers and covenant strength for landlords.

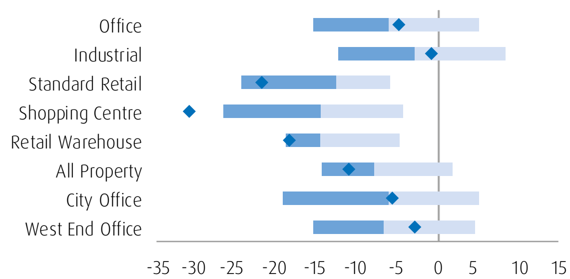
The investment market may also be considerably weaker given uncertainty on pricing. A recent independent investor sentiment survey, indicated mild negativity on balance, but with wide differences by sector. Sentiment remains strong for residential, industrials and warehousing but is extremely negative, and at all-time lows, for retail units, shopping centres and leisure. It will take time for investors to switch to an acquisitive mode.

UK Real GDP – Historic and Forecast per cent



Source: Consensus Economics Jul-20, ONS

BMO REP Forecasts versus IPF Consensus Forecast Range. Total Returns 2020 – per cent



Sources: BMO REP Jul-20 (marked as diamonds), Investment Property Forum (IPF) Consensus Forecasts May-20.

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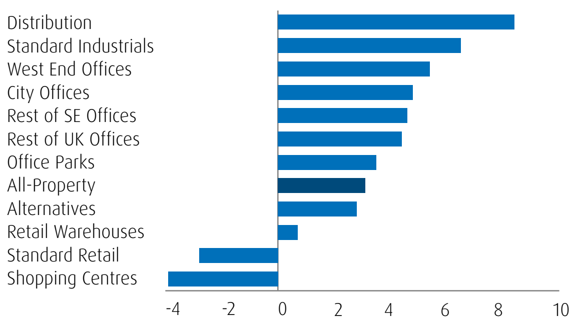
The market could see more corporate activity as investors capitalise on NAV discounts. There has also been some capital raising to fund acquisitions, and greater interest in sale and leasebacks by occupiers to help cash flow.

On a sector basis, the market is expected to remain highly polarised but also more nuanced within sectors.

Total Return Forecasts by Segment, Five Years to end-2024 – per cent per annum



Source: BMO REP Jul-20

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The long-term structural problems affecting retail have intensified due to the pandemic. The weakness has spread to Central London and persists in the regions. It will take time for spending and travel patterns to establish a post-COVID normality. Town centres may be weaker than retail warehousing given their relative reliance on public transport, vulnerability to online competition and problems with social distancing and queuing. Within retail warehousing, food-anchored parks may prove more resilient than fashion parks. Local retail and leisure facilities may benefit from greater home-working and convenience. We expect a permanent shift to greater online spending. There is also likely to be more re-purposing of assets, with residential being a possibility for some in-town retail and last mile logistics among the options for retail warehousing.

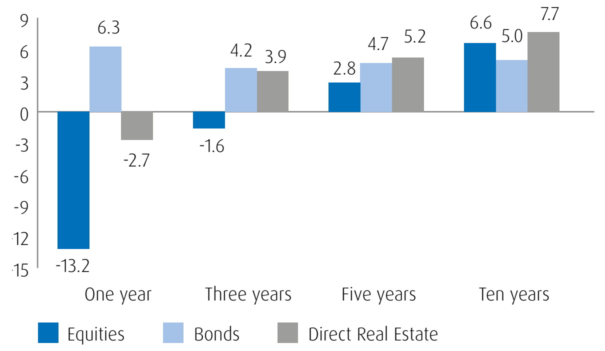
The outlook for the office market is mixed. While there could be some reluctance to commit to new space at present and an overhang of grey space in London, the city is an international hub and is expected to out-perform in the longer-term. Grade A space should prove resilient, although the demand for towers could falter given changed occupational requirements post-COVID. The regional cities could be helped by greater reliance on private transport for commuting but office parks may be held back by lack of amenity relative to city centres.

The industrials market is likely to benefit from the continued growth of online retailing but it could also be hit by retail administrations and the unwinding of lock-down related disruption and stockpiling. In the longer-term, it could benefit from on-shoring and the supply position remains favourable. Edge of town/last mile logistics in thriving areas are expected to do especially well.

The alternatives market is diverse and performance within the sector is expected to reflect this. There are concerns about some covenants in the hotel and care homes sectors in particular. There is uncertainty about the strength of demand for student accommodation post-COVID, especially from abroad. However, demographics and government policy may work in the sector's favour over time, especially for residential property.

UK property benefits from a large mature investment market. In July 2020, JLL rated the UK the world's most transparent property market and London the most transparent city. Property's total return performance has also been creditable against UK equities and bonds over the medium-term. Over the five years to end-2024 we are predicting, at the all-property level, a very difficult 2020 followed by a partial rebound and subsequent recovery.

Multi-Asset Class Performance – Total Returns to June 2020 per cent per annum



Source: Lipper, FTSE 350, JP Morgan United Kingdom GBI 7-10 Years, MSCI UK Monthly Property Index, Jun-20

Key Investment Transactions Data

55 Ludgate Hill, London

Waitrose, Malmesbury bought by LondonMetric

90 Bartholomew Close, London

Some large deals are still completing

At least six transactions exceeded £100m in the quarter, with three in June.

Activity spanned industrials, London offices, residential and supermarkets.

Union Investment bought 55 Ludgate Hill for £139m at a 4.5% yield.

Strong demand for supermarkets

The BA Pension Fund and the Supermarket Income REIT bought a stake in a Sainsbury portfolio for £102m.

Realty Income Corp bought a Tesco unit in Enfield for £70m at a 4.25% yield.

LondonMetric bought five stores from Waitrose for £62m at a 4.3% yield and The Supermarket Income REIT bought a further six for £74.1m at a 4.4% yield in sale and leaseback deals.

There is still interest from overseas buyers

La Francaise bought 90 Bartholomew Close for £48.5m at a 3.92% yield in its first UK fund purchase, and acquired another London property after quarter-end.

20 Farringdon St was sold to a Hong Kong investor for £120m.

Hines bought industrial space in Wakefield for £20.64m.

Industrials/logistics are still in demand

SEGRO acquired Perivale Park for more than £202.5m at a 3.12% yield from Federated Hermes in the quarter's biggest transaction.

Urban Logistics REIT bought the Crown portfolio from L&G for £47.2m at a 7% yield.

Blackstone bought a portfolio of last mile logistics assets for £30m.

Sale and leasebacks are being pursued

Next sold its HQ in a sale and leaseback deal and earlier sold three warehouses.

Topps Tiles has sold its HQ and central warehousing to Ares and Revelan for £18.1m at a 6.2% yield.

Aberdeen Standard acquired industrial space in Biggleswade for £33.7m at a 4.16% yield from City Electrical Factors.

Local authority buying is under scrutiny

Herefordshire and Redditch both bought assets within their boundaries in the quarter but there were no deals above £25m.

Market leader Spelthorne has reversed its policy and the government is investigating the use of cheap loans to buy commercial property investments.

Retail assets are under stress and being re-purposed

The collapse of Intu may lead to sales of its shopping centres in due course but at what price?

Amazon bought a retail park in North London to re-purpose as last mile logistics.

A handful of deals in the regional office market

Tesco Pension Fund bought Finzel's Reach (Halo) in Bristol for £70m in a forward funding.

Tristan Capital is said to have exchanged to buy Reading Business Park for £120m versus a £140m initial asking price.

Continued interest in residential

L&G is to provide £150m to forward fund the West Bar Square office and BTR scheme in Sheffield.

LendLease and CPPIB are to partner to develop BTR units at Elephant Park, SE1.

Sources: BMO REP Jul- 20, Property Data Jul-20

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