BMO REP forecasts show positive total returns, averaging 4.6% per annum over five years, underpinned by the income return.

BMO REP has upgraded the 2018 all-property total return forecast to 5.2%, reflecting the strength of investor demand in the property market. The upgrades have been most marked for Central London offices and standard industrials. Forecasts for 2019 have been slightly downgraded, reflecting the possible impact on sentiment from interest rate rises and the Brexit negotiations. We are projecting a modest recovery thereafter.

**Components of BMO REP Forecast All-Property Total Returns – per cent**

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implied Income Return</td>
<td>6</td>
<td>5</td>
<td>4</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Capital Growth</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Total Returns</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: BMO REP July 2018

Forecasts are provided for illustrative purposes; are not a guarantee of future performance; should not be relied upon for investment decisions; and are subject to change without notice.

**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.

Past performance should not be seen as an indication of future performance. 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.
Economic and Property Market Overview

The UK commercial property market is continuing to deliver steady positive total returns but may be at a plateau.

### Market Snapshot Q2 2018

<table>
<thead>
<tr>
<th>Segment</th>
<th>Total Returns</th>
<th>Income Return</th>
<th>Capital Growth</th>
<th>Rental Growth</th>
<th>Gross Rent Passing</th>
<th>Net Initial Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>2.2</td>
<td>1.3</td>
<td>0.9</td>
<td>0.2</td>
<td>1.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Retail</td>
<td>0.5</td>
<td>1.4</td>
<td>-1.0</td>
<td>-0.5</td>
<td>-0.3</td>
<td>5.7</td>
</tr>
<tr>
<td>Offices</td>
<td>1.6</td>
<td>1.2</td>
<td>0.5</td>
<td>0.5</td>
<td>2.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Industrial</td>
<td>5.1</td>
<td>1.2</td>
<td>-1.0</td>
<td>1.2</td>
<td>1.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Alternatives</td>
<td>2.6</td>
<td>1.3</td>
<td>0.5</td>
<td>1.3</td>
<td>0.0</td>
<td>4.9</td>
</tr>
</tbody>
</table>

Source: IPD Monthly Digest June 2018. The definition of Alternatives is the Portfolio Analysis Service definition of “other” which includes hotels, residential, leisure etc.

The economy is showing signs of improved growth after a weak start to the year, but it remains lack-lustre. Concerns about Brexit remain as the March 2019 deadline approaches, with seemingly little agreement within the UK government, and much to be finalised with the EU.

At the all-property level, property delivered a 2.2% all-property total return in the second quarter compared with 2.3% in the previous quarter. The income return has remained stable and was 5.4% in the year to June 2018, with annual capital growth of 5.3%. Rental growth was 0.2% in the quarter compared with 0.4% in the previous quarter. The quarterly growth in gross rent passing, at 1.0% was the highest in almost three years.

The industrial and distribution sectors continue to drive performance, together with alternatives and, in this quarter, City offices. Compared with the previous quarter, standard industrials, provincial offices and City offices delivered an improved performance, with retail weakening.

Most parts of the market have seen a weakening in investment activity in 2018 compared with the like period of 2017, and only Central London offices, leisure and alternatives saw investment levels above the long-run average in the second quarter.
The UK commercial property market continues to deliver a solid performance, underpinned by an annual income return of more than 5%. There is polarisation with industrials pulling further ahead and retail struggling. Given the economic and political headwinds and a move to higher interest rates, the market may have reached a plateau.

Overseas investors bought almost £5.5 billion of property but sales levels also increased to reduce net investment from this source to its lowest level since the global financial crisis. Institutions are becoming net investors in property once again, but this reflects a lack of disposals rather than a renewed appetite to buy. Inflows to retail property funds were positive in the second quarter.

The yield gap between property and the risk-free rate was broadly stable during the quarter and well above the long-run average. Demand is strong for prime property with a long income stream, but some parts of the market, such as industrials and Central London offices, may be starting to look expensive, and there are major concerns about the retail sector. There is a search for yield and genuine value-add opportunities, and growing interest in alternatives.

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The Economic and Property Market Outlook

BMO REP forecasts show performance driven by industrials, distribution, alternatives and offices outside London.

The UK GDP consensus forecast for 2018 has been revised lower over the last quarter, but the economic outlook is predicted to be fairly benign on consensus forecasts with positive, if modest, GDP growth being sustained. Inflation is predicted to decelerate towards the Bank of England target. Interest rates are expected to move higher, but at a gradual pace. Consensus expectations are for the official rate to be only 1% by mid-2019. Analysts expect some easing in fiscal policy over the coming year.

Sentiment is being supported by the strength of the global economy and hopes that a weaker sterling will boost export prospects. Consensus forecasts are for the UK to out-perform the Eurozone after 2019 and by around 0.5 percentage points per annum in the longer-term. However, the protectionist stance of President Trump and the possible intensification of tariff wars have added an element of uncertainty.

The longevity of the property cycle upswing has been extended by the prolonged period of low interest rates and the weight of money moving into property. Although official interest rates were raised after quarter-end, consensus expectations indicate that upward pressure on property yields is not imminent, although the period after 2020, may prove more challenging.
Industrial, distribution and some alternative assets are expected to deliver superior performance, along with offices outside London. We still expect Central London retail to perform creditably, but we believe that regional shops and shopping centres could continue to struggle. Retail warehousing and regional offices could benefit from their generally higher yields. Despite its recent resilience, we are forecasting that Central London offices will be affected by weaker occupier demand and the return of second-hand space.

There are longer-term issues affecting property. This has been seen most starkly for retail property where a number of administrations, company voluntary arrangements and store rationalisations have combined to turn sentiment against the sector. In offices, the growth of flexible working is affecting the demand for space and while some disadvantages of serviced offices are becoming apparent, the trend towards shorter leases and demand for higher quality space appears more durable. The industrials market remains attractive but is expensive and some rental growth assumptions by purchasers could prove optimistic. Alternative property sectors are expected to continue to grow in importance as investors seek long income or higher yields, but this is a diverse market.

The period of annual double-digit total returns may be drawing to a close, but property still benefits from a relatively high and stable income return, long-term contracted income and an established, large and mature investment market. We are forecasting a period of positive total returns, underpinned by the income return.
Key Transactions Data

Several large deals involving overseas buyers but they are also selling assets

CK Asset Holdings of Hong Kong has bought 5 Broadgate for £1bn at a 3.95% yield from British Land and GIC (Singapore).

Ho Bee of Singapore has bought Ropemaker Place in London for £650m – from a consortium of overseas investors.

A divestment from shopping centres

Hammerson is preparing to sell a 50% stake in Highcross, Leicester to a Japanese bank for £240m at a 5.5% yield.

Lone Star is planning to sell shopping centres in Southampton, Falkirk and Gloucester from its Tiger portfolio.

Alternatives in demand

Student accommodation – Allianz is buying a 40% stake for £350m in the Chapter London portfolio.

Fonciere des Regions has bought a portfolio of 14 hotels from Starwood for £858m.

Strong demand for some regional office assets

Atlantic Quay 1, Glasgow said to be under offer at well above the asking price, at a 5.25% yield, and following strong bidding, to a Middle Eastern investor.

One Park Row, Leeds has been sold to CCLA for £35.6m at a 4.43% yield.

A search for yield

M7, an industrial specialist, is set to buy the Alpha portfolio of retail warehousing at a 7.15% yield.

Regional REIT has bought a portfolio of primarily regional office assets for £35m at an 8.4% yield.

Local authority buying at keen yields

Liverpool Council has bought Central shopping centre in the city from Aviva for £17m at a 4.8% yield.

Portsmouth Council has bought an office building in Queen St, Manchester for £9m at a 4.75% yield.

Forward funding and purchasing

Hines is to forward purchase The Mint office building in Edinburgh.

Tritax is to forward fund a £121m industrial scheme in Darlington, pre-let to Amazon, at a 5% yield.

Industrials still favoured

LondonMetric has bought a portfolio of assets for £35m at a 4.4% yield.

L&G has purchased a £182.3m industrial estate in Dunstable at a 5.02% yield.

Investors attracted to long income but stock is sparse

The Supermarket REIT has bought a Tesco Extra in Scunthorpe for £53m at a 5.1% yield with 22 years unexpired and RPI-linked uplifts.
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