

Investment case

Enhancing value in U.K. Real Estate

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note this is not a guide to future performance.

Six months to Brexit: take cover or take advantage?

- Quick capital deployment essential to effectively time entry into different submarkets
- Early signs of greater investor confidence in the U.K. reappearing
- Political uncertainty heightened, but business-as-usual approach from occupiers
- Office and industrial sectors provide income and growth potential
- Retail sector faces structural headwinds, but selective mispricing opportunities can be found

As negotiations over the U.K.'s exit from the EU enter the more decisive stages, is a wait-and-see investment approach the best option at a time when occupier markets continue to beat expectations? Alternatively, should investors take advantage of heightened risk aversion and follow a more direct strategy that could capture this upside performance? It appears that the days of market-driven yield compression are over, at least for now. Maintaining and growing income, while unlocking rental growth through expert asset management, will be key to driving returns. We believe active investment strategies, with a focus on bottom-up analysis of asset, sector and underlying submarket strengths, will be best-placed to drive outperformance.

Capture mispriced opportunities through quick capital deployment

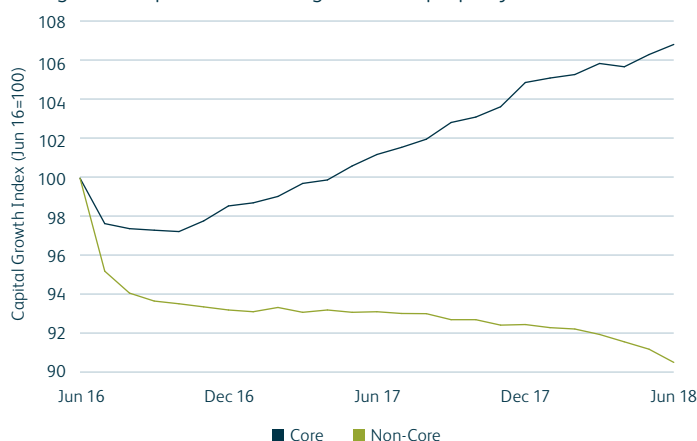
As negotiations regarding the future U.K.-EU trade deal progress, an opportunistic investment environment has

emerged to selectively target real estate over the next 12 months. Recent valuation movements of perceived “non-core” assets support this, at some 10% discount to pre-referendum levels. Office and industrial capital values appear to have stabilized, offering upside potential as occupier markets strengthen. Retail assets have seen further declines, as negative sentiment continues to impact the high street. Investors targeting currently out-of-favor assets with either short-term income, vacancy, or capital expenditure risk, are well-positioned to benefit from this compelling window of opportunity.

The headline risk of a “No Deal” Brexit outcome is still a possibility, and we expect the volume of “noise” surrounding this scenario to increase over the next six months. The EU's agreement to a transitional period extends the U.K.'s access to both the single market and customs union until December 2020 – we hope that this allows for a smoother exit once the future trading relationship with the EU is agreed.

It should be noted that the U.K. economy entered Brexit discussions from a position of relative strength and many of these positive macro drivers are still present. Interest rates are still low and are expected to remain so for a while; corporation tax at 19% is one of the lowest in Europe and will fall to 17% by 2020; unemployment at 4.0% is the lowest since 1975, and with limited spare capacity in the labor market, wages and household incomes are expected to rise. Moreover, population growth forecasts are some of the strongest in the G7 economies, adding more pressure to land use and supporting supply and demand fundamentals. These factors all point towards attractive long-term economic growth.

Figure 1. Capital value change (%) – all property



Source: CBRE, June 2018.



Charter Court

Charter Court

CHALVEY PARK

Charter Court, Slough

Figure 2. Brexit timeline



Increased volatility at a time of major political events, such as Brexit, is customary and we expect the current levels of risk aversion to continue in the short term. However, investors with the ability to deploy capital quickly, will be best-placed to take advantage of the pricing dislocation throughout this process.

Early signs of greater investor confidence in U.K. market

U.K. institutions have returned to net positive investment in U.K. real estate, indicating that confidence is starting to build again. Regional markets deemed more resilient to Brexit uncertainties were the first to experience an uptick in transactional volumes. Central London looks likely to follow suit, as sentiment towards the market shifts and investors look for compelling re-entry points.

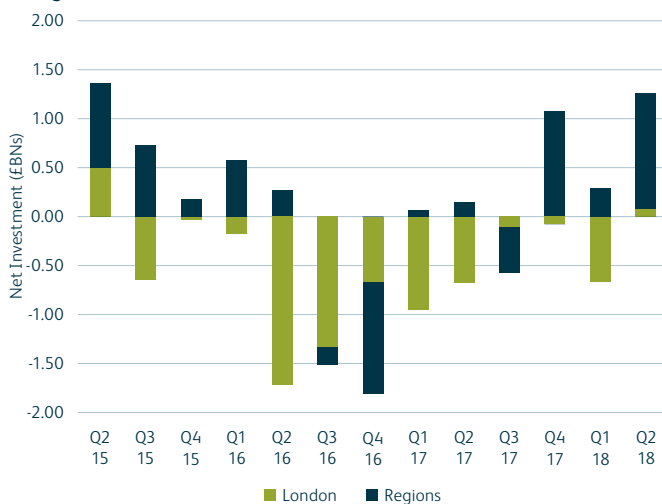
The U.K.'s transparent, liquid and diverse characteristics continue to appeal to a number of global investors. The relative value of U.K. real estate remains highly attractive on a global basis, with the spread of 440bps over 10-year gilt yields still well above average. This continues to underpin investor demand and create opportunities at a time of Brexit-driven risk aversion.

Political uncertainty heightened, but business-as-usual from occupiers

The contrast between heightened political uncertainty and a business-as-usual, resilient occupier market has been a key factor behind rising investor confidence. There are wide variances across the office sector, underlining the importance of understanding occupier demand, trends and supply. The South East and "Big 6" office markets have all performed well, with take-up above five-year averages. The availability of "Grade A" best quality space is now less than 2% in most regional cities, which has not occurred in over a decade. This supports strategies focused on creating quality space through refurbishment and repositioning assets.

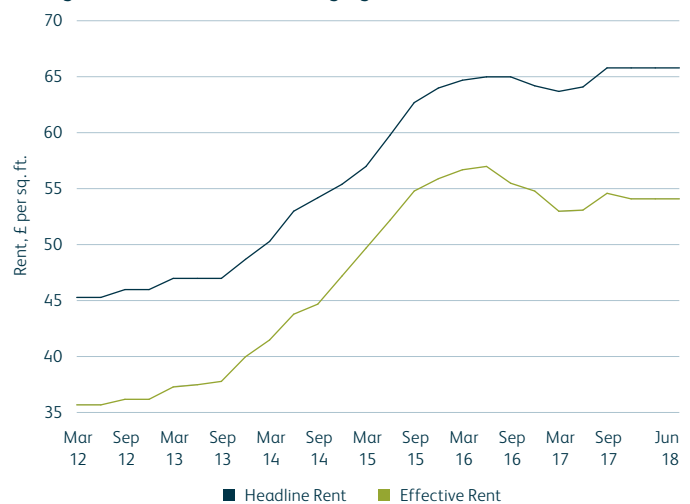
Central London has similarly proved much more versatile. The number of financial jobs expected to relocate outside of Britain or created overseas by March 2019 has fallen to just 5,000, a small fraction of the total employed, according to a Reuters survey. Headline rents in Central London have now stabilized, with emerging fringe submarkets such as Farringdon and Kings Cross offering significant potential to capture upside growth, alongside ongoing regeneration and wider occupier appeal to global technology firms.

Figure 3. Net U.K. investment volumes



Source: Property Data, July 2018.

Figure 4. London office emerging submarket rents



Source: M&G Real Estate, CBRE, Q2 2018.

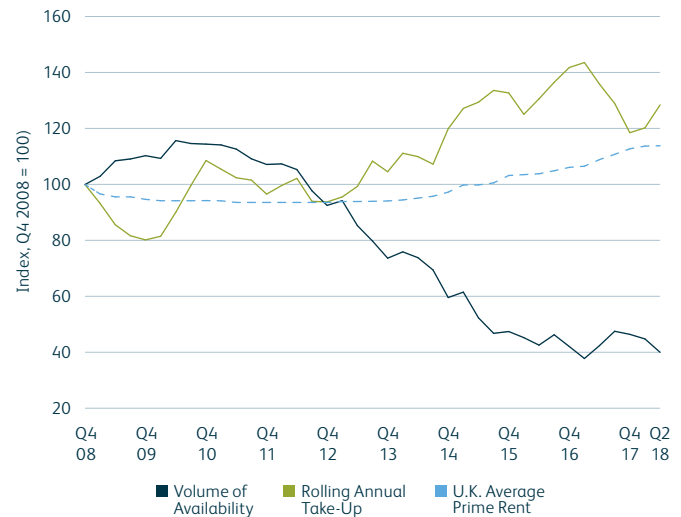
Industrials offer strong market rental growth potential

The industrial market remains occupationally the strongest real estate sector in the U.K. Stepped increases in rents have contributed to 11% prime rental growth over the last 18 months, driven by the need for space close to large populations to service online demand. Strong investor demand continues to put downward pressure on yields, with healthy total returns of over 20% recorded year-on-year. Given the chronic lack of well-located supply in the multi-let sector, there is a strong investment case to take on development or refurbishment risk here, to capture the continued long-term growth potential of this market.

Retail sector facing structural headwinds, but selective mispricing opportunities

Retail remains arguably the most unloved of all sectors, as rising costs and declining in-store sales continue to hinder a highly competitive market. Negative investor sentiment has seen non-core assets fall by 14% to end of June since the referendum. Even core, well-positioned schemes are often disregarded despite strong characteristics. In this distressed environment, investors can take advantage of mispriced assets at significant discounts. However, it is important to be selective in this approach. Assets should be carefully evaluated for the opportunity to drive greater value from these schemes, through repositioning, re-letting or adding to the food and beverage offer. Such active asset management initiatives aim to increase dwell time and consumer spend.

Figure 5. Industrial market fundamentals



Source: Gerald Eve, Q2 2018.

Conclusion

As the U.K. moves closer to understanding its future economic relationship with the EU, we believe active investors with the ability to deploy capital quickly and selectively throughout this period of risk aversion, will be well-placed to capture the greatest potential for future upside performance. Bottom-up investment strategies, with the capability of selecting discounted assets in the best locations, which can be actively managed to drive additional value, are likely to deliver stronger returns on a risk-adjusted basis.





Case studies

Mid-box logistics: Pebble portfolio

- £22.1m portfolio of five units across North West and Midlands
- Let to six tenants, providing diverse income profile

Rationale

- Strong rental growth forecasts driven by supply and demand imbalance
- Less investor competition in this target lot size (£2m to £15m)

Opportunity

- Drive on rents using upcoming lease breaks
- Increase average lease lengths
- Refurbish and re-lease vacant unit

Central London offices: Gate House, Clerkenwell EC1

- £28.5m multi-let office located five minutes' walk from Farringdon station
- 1960s building, acquired off-market at 100bps discount to prime

Rationale

- Supply-constrained submarket with strengthening demand from creative industry
- Connectivity enhanced with opening of Crossrail in 2019

Opportunity

- Refurbish and upgrade reception and common areas
 - Lease up ground and fifth floor and set new rental tone
 - Extend third to fifth floors and add “penthouse” floor with roof terrace
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