DTZ INVESTORS

UK Property - Good buy or goodbye?

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Private & Confidential

UK property in 2016 and beyond: A fund manager's view

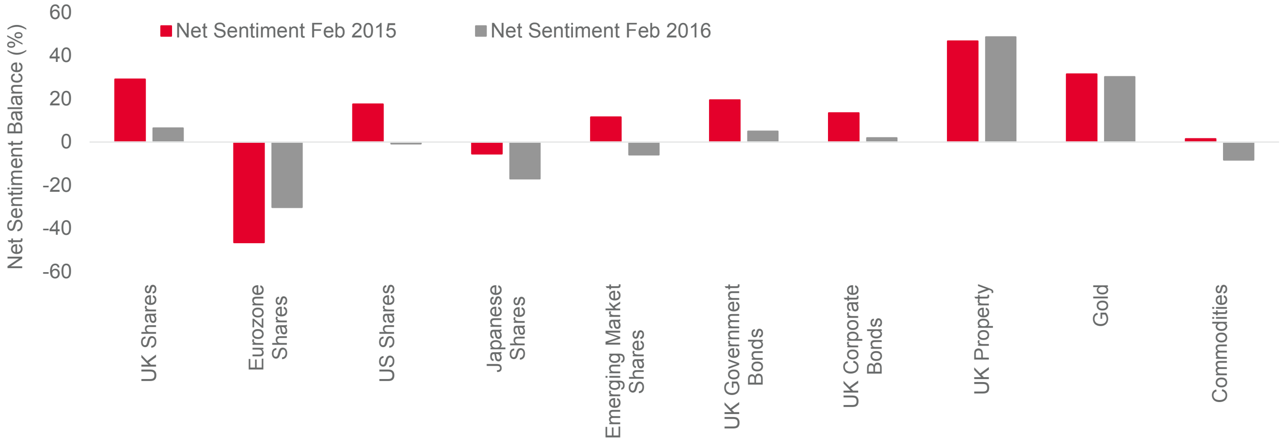
2016 has already started with increased uncertainty over the direction of the global economy which has raised volatility in financial markets. Despite this uncertainty we believe the UK property market remains well placed to deliver attractive returns, albeit lower than the double-digit returns seen over the past three years.

There are a number of reasons why UK property still looks attractive for both domestic and international investors.

Despite the potential for negative external influences **the UK economy is in relatively good shape.** Job creation and falling unemployment should result in rising real wage growth, resulting in growing consumer expenditure, which is a good environment for property rents to grow in real terms.

In the current financial market turmoil, **UK property (especially central London) is still considered a safe haven for investors** and for overseas private investors. This is reflected in sentiment surveys, which are not only positive but still improving (see figure 1).

Figure 1. Lloyds Private Banking UK Investor Sentiment Index



Source: Lloyds TSB

Yields on fixed-income investments and interest rates are likely to stay low over the next 12-18 months, therefore the income yield provided by UK property still looks attractive. As at Dec-15 the equivalent yield for UK property, as measured by the MSCI All Property Quarterly Index, stood at 5.8%, compared to a nominal 10-year bond yield of 2.0%, and a yield of -0.9% on 10-year inflation-linked bonds. This margin over fixed income yields is in-line with property's long-run risk premium and provides adequate compensation for investors in the current low-inflation world of lower investment returns.

With the exception of the office and retail sectors in central London, **rental levels have not moved on over the past 5 years and in many sub sectors real rental values are either below or close to levels first achieved in the late 1980s!**

Very low levels of new development outside of London has resulted in declining availability for quality space across all sectors. Even in London the development pipeline has been more muted than previous upswings, with permitted development rights resulting in a reduction of space due to the conversion of office space to residential.

So given the reasons to be positive about the state of the UK property market what do we believe 2016 has in store for investors?

Capital values to broadly hold their ground, with the negative impact of uncertainty in the global economy being offset by the relative strength of the domestic labour market and the attractive yield provided in a relatively safe market.

Low availability of quality space resulting in **lower incentives for tenants and a higher probability of tenants renewing their leases** (and not taking breaks). Net effective rents therefore improving quickly.

Steady growth in rents across the regions, with prime performing better than secondary. Rental growth rates in central London starting to slow, as tenants in London are more aligned with the global economic prospects.

Potentially limited upside for rental growth as low inflation and uncertainty over the global economy and Brexit prevent the full effect of supply constraints impacting rents.

A more even balance between buyers and sellers. Many investors have reached their target allocation to the sector and others will be tempted to take the profits. The result is a **more balanced market place** in which it will be harder to dispose of deficient properties, but will also offer more potential for the patient investor to find value.

Property outperformance will be predominantly driven by asset management. Properties where leases are expiring should see the strongest returns as landlords are able to take advantage of more favourable leasing conditions and capture uplifts in net effective rents. Likewise, given the relatively supply constrained nature of the market those investors that are prepared to take on refurbishment and development risk are likely to be well rewarded.

Projected total returns for 2016 are likely to be in the range of 5-10%.

What's in store for 2017 & beyond?

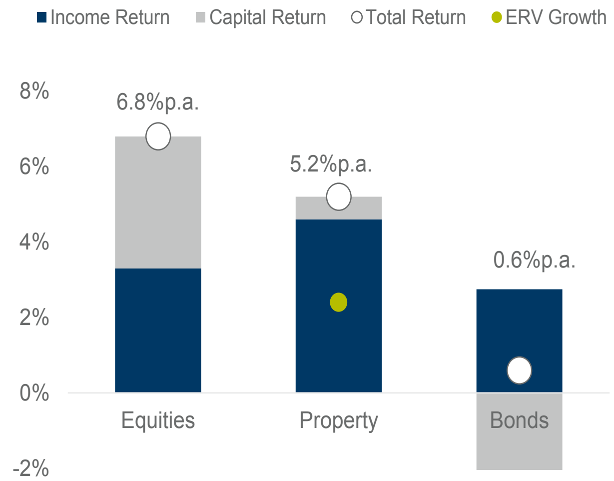
There is limited potential for further yield compression. At some point bond yields and interest rates will move out. This could ultimately lead to an upward pressure on property yields, should the sector's yield premium be maintained. However, property should be partially protected by the fact that interest rates are only likely to increase if both inflation and real wages are at or above trend levels, which is likely to be a favourable environment for property rental growth.

Depending on economic conditions we would expect to see a mini property cycle over 2017-20, which will be slightly more exacerbated in more volatile central London markets. All property returns are likely to average around 5% p.a., but more likely to be -5%, 0%, 10%, 15% (in some order) than a constant 5% p.a.

Given our outlook for the future we have outlined a number of strategic recommendations for investors to consider when investing in UK property.

Be realistic about return expectations – there is a risk of investors taking on more risk than anticipated in search of higher returns. Figure 3 outlines the level of ungeared returns we believe an investor in UK property should be targeting over the next 5 years.

Figure 2. DTZ Investors All Property 5 year Forecasts (2016 - 2020) vs. Equities and Gilts



Source: DTZ Investors

Figure 3. Target 5yr Returns by Investment Type

Core	**4-5% p.a.**
Core-plus	**5-7%p.a.**
Value-add	**7-9% p.a.**
Opportunistic	**9-12%p.a.**

Source: DTZ Investors

Beware of over-paying for rental growth / implied reversion. Yields across some markets are at very low levels in anticipation of future rental uplifts, particularly in central London and to a lesser extent in south east industrials. However, it is important to consider what will happen to a property's yield once growth has materialised. If some outward movement in yield is not factored in then an investor will end-up paying too much for growth up front.

Be prepared to take leasing risk in core assets. Strong tenant demand for well-located properties should result in favourable leasing conditions and rising rents. Therefore, shorter leases will provide investors with the opportunity to add-value through leasing activity and enable rental uplifts to be captured.

Existing investors should look to take profits in assets where future growth is already priced in. This is effectively the flip-side of the last point in that investors should consider disposing of ex-growth assets at today's low market yields. This could well be the case for some core London office assets.

Patience is likely to be rewarded. To a certain extent any property acquired three years ago would have gone up in value as a result of market wide yield shift, regardless of its underlying fundamentals. This will no longer be the case going forward, therefore investors need to be more cautious when investing as it is better to wait for the right asset given that the opportunity cost of being out of the market is now lower. With a better balance between buyers and sellers opportunities to find value should emerge over time.

Sector strategies we would recommend focussing on in 2016 include:

Prime retail shops / leisure in dominant centres - Destination retail locations, with a mix of retail, leisure and beverage use should remain resilient to the expansion in e-commerce. Retail rents across most centres remain affordable having moved sideward since the financial crisis. However, a lack of new development is starting to put upward pressure on rents within the best retail pitches.

Prominent retail parks with affordable rents – The rise of click and collect has been a positive for retail park schemes that are easily accessible. Good schemes benefit from a mixed tenant line-up and a strong (often food) anchor to drive footfall. We have a preference for parks off lower rents as they often benefit from a yield advantage and have greater scope for rental improvement than prime fashion-orientated parks.

Key characteristics of a resilient retail location:

- Cafes satisfy consumers need to shop until they drop, and increase dwell time.

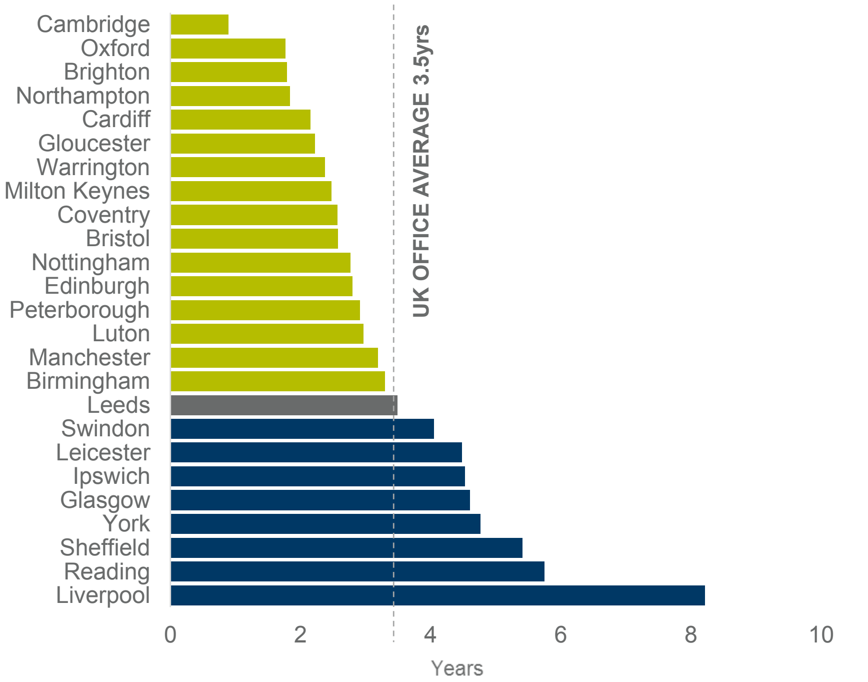
- Towns with a high restaurant offering and a number of tourist attractions should continue to attract consumers, who spend a greater proportion of their disposable incomes on recreational experiences.

- Markets offering a number of big anchor stores that showcase retailers' current fashion lines will continue to attract critical mass and high levels of footfall.

Fringe and emerging Greater London office markets - The combination of population growth, increased employment and infrastructure improvements is increasing the demand for property across all sectors within the London suburbs. These factors are resulting in a structural change in the demand for real estate and therefore should result in a step-change in achievable rents within inner London locations. Growth is likely to be strongest around transport interchanges, where infrastructure investment has been greatest.

Multi-let, mixed use assets in big cities and strong regional locations - Those markets with a diverse occupier base, and rising demand from new market entrants (high growth, small and medium sized enterprises and digital-technology firms), should prosper. However tread carefully! With varied supply conditions across regional markets, we would suggest targeting those locations where the depth in demand has made a satisfactory dent in reducing current availability levels below the UK office average. (see figure 4).

Figure 4. Regional Office Demand v Supply Dynamics
Years to Absorb Current Availability given average 5yr take up



Source: DTZ Investors

Urban industrial and distribution units. The growth in e-tailing is increasing the demand for smaller logistic units within built-up locations to support on-line retailers' 'last-mile' networks. Competing land uses also means that the supply of urban industrial space is likely to remain relatively constrained, particularly around London and the South East, where rents have already started to pick-up.

Key Contacts:

CHRIS COOPER

Chief Executive, DTZ Investors

+44 (0)203 349 0300
christopher.cooper@dtzinvestors.com

RICHARD COOPER

Head of Strategy

+44 (0)203 349 0226
richard.cooper@dtzinvestors.com

DTZ INVESTORS

Capital House
85 King William Street
London
EC4N 7BL

www.dtzinvestors.com