UK CAPITAL MARKETS BRIEFING

Q2 2019

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SUMMARY

Investment volumes came in at ***£12bn***, ***down 23% on Q2 2018***

Average net initial yields were ***5.6%*** for transactions this quarter, ***up 15bps on Q2 2018***

Alternatives are now the largest sector in the UK investment market with a ***37%*** share of year-to-date investment volumes

MARKET REVIEW

A NEW WAVE OF FOREIGN INVESTMENT HAS BEGUN, LED BY INVESTORS FROM FRANCE, SOUTH KOREA AND ISRAEL

New money

Investment volumes came in at £12bn in the second quarter of 2019, taking the rolling annual total to £58bn. If momentum continues to slow, £45bn is likely for 2019.

Institutions have decreased their investment activity. A slowing UK economy and a fast-approaching Brexit deadline has made those already heavily invested in the UK more cautious.

Meanwhile, private equity investors have been increasingly active as buyers and sellers. As buyers, they had a 28% share of all investment in the second quarter – their largest share since 2008.

The main sources of foreign capital are changing. Top investors from the United States, China and Hong Kong have either been net sellers or absent from the market.

In their absence, other investors have stepped up. Persistent buying by French investors over the last 12 months has launched the country back into the top 10 rankings for net investment into the UK since 2006.

Investors from South Korea and Israel have also been buying in large volumes. Both countries are now top 20 net investors into the UK, displacing traditional European sources like the Netherlands.

Big just got bigger

The top three deals this quarter were a third of all investment – the highest share since 2013.

Vinci, an infrastructure operator based in France, bought a major stake in Gatwick Airport, classified as an Alternative asset, for £2.9bn.[1] They announced the deal in 2018 and completed it in May 2019, making it the largest deal in the quarter.

The second-largest deal was over £1bn for a London office bought by an owner-occupier. This deal highlights the trend of large corporates preferring ownership to leasing large amounts of space on long leases. For many companies, buying may be a cheaper option over the long term since the IFRS 16 Leases accountancy standard became effective at the start of 2019. Lessees must now recognise leases as assets and liabilities on their balance sheet.

The third-largest deal was the sale of 12 supermarkets to Realty Income Corporation at a 5% net initial yield. The sale was part of British Land's drive to have a "a smaller, refocused retail business."[2] Long-income portfolios, such as this one, attract buyers looking for low-risk, long-term income. With further declines in government and corporate bond yields this quarter, demand for these portfolios should continue.

1 https://www.vinci.com/vinci.nsf/en/press-releases/pages/20190514-0700.htm

2 https://www.britishland.com/news-and-views/press-releases/2019/23-04-2019

MARKET REVIEW

ALTERNATIVES ARE NOW THE LARGEST SECTOR IN THE UK INVESTMENT MARKET WITH A 37% SHARE OF YEAR-TO-DATE VOLUMES

The appetite for long income has also driven growth in ground rent and income strip deals. The largest of these deals last quarter was £206m of ground rents secured on over £1bn of London Hotels bought by Alpha Real Capital.[3]

Alternatives lead the mainstream

Alternatives[4] have a 37% share of year-to-date investment volumes, making them the largest part of the UK investment market. All other property types have seen their share of investment decrease in 2019 – offices' share is down to 33%, for example.

This collection of specialist real estate, infrastructure and long-income deals has steadily grown its share of the investment market since the Global Financial Crisis. And in the last few years, we have seen this trend accelerate as retail and office performance has weakened.

Investors like alternatives for different reasons. For some, the abundance of long leases is the appeal. For others, the high returns associated with operational responsibility is the draw. Tellingly, investors are willing to invest at scale when they find the right opportunity irrespective of the property type.

Quarterly retail volumes were down over 50% year-on-year, as fewer deals completed (48 vs 72 deals). There were also fewer office deals. But the average value for office deals was higher (£18m vs £13m), suggesting low-value offices are transacting less often compared to last year.

Industrial investment was healthy, but volumes were down as the quarter lacked the notable, large deals seen this time last year – the same was true for hotel investment.

Polarised pricing

Average net initial yields were 5.6% this quarter, up 15bps on Q2 2018.

Most deals had yields between 4.5% and 7.5%. But more deals completed below this range compared to earlier quarters, as appetite for long-income assets continued to drive their yields down.

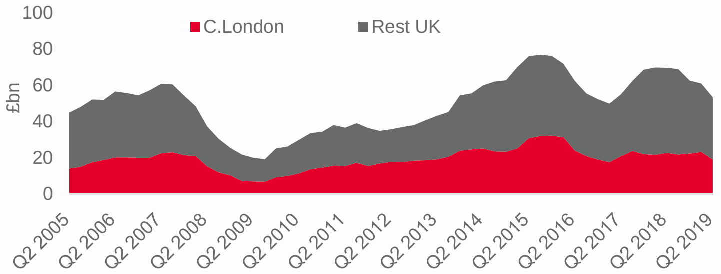
In contrast, there were fewer high-yielding deals. Opportunistic investors are keen to buy higher-yielding assets, but these deals need extra work to assess the risks and financing them is increasingly difficult.

Lower economic growth and higher credit risk are applying upward pressure to real estate yields. However, government and corporate bonds fell this quarter, allowing spreads to increase without making a material impact to real estate yield levels. Overall, real estate prices are steady, with lower prices becoming common in the challenged parts of the retail sector.

3 https://alternativerealcapital.com/docs/2019-04-08%20ARC%20ground%20rent%20transaction%20on%20%C2%A31billion%20hotel%20portfolio.pdf
4 Alternatives – includes hotels and other property types. Excludes offices, retail, industrial, residential and development sites

INVESTMENT MARKET AT A GLANCE

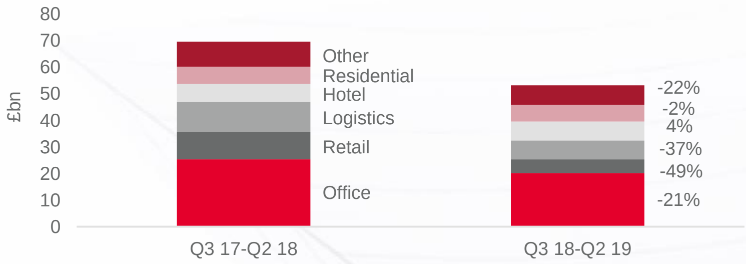
UK Investment Activity (Rolling Annual)



Source: Real Capital Analytics, Cushman & Wakefield

Q2 2019 had a rolling annual investment total of £58bn. Central London was a third of this total.

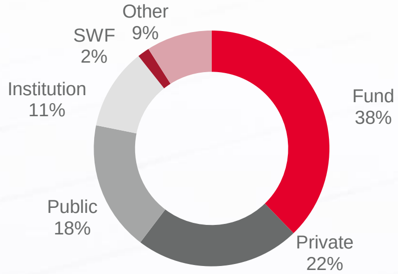
Investment by Property Type



Source: Real Capital Analytics, Cushman & Wakefield

Hotels saw a 4% rise in annual investment versus the previous 12 months. All other property types saw volumes lower between the two periods.

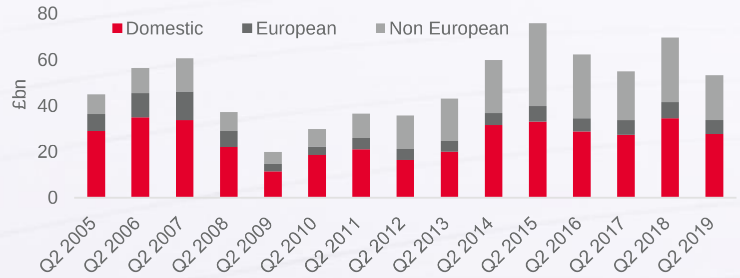
Investment by Purchaser Type (Q3 18-Q2 19)



Source: Real Capital Analytics, Cushman & Wakefield

Private investors had a 22% share of investment over the last 12 months, although their share increased to 28% in Q2 2019.

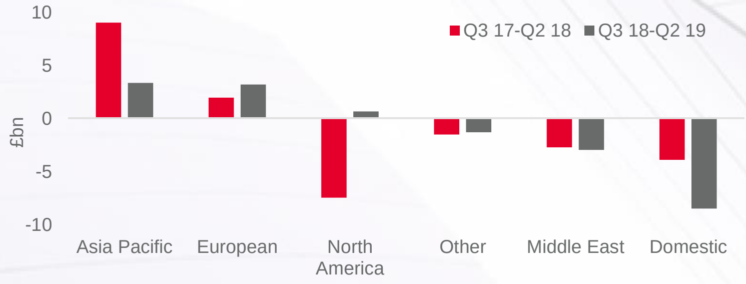
Investment by Capital Source



Source: Real Capital Analytics, Cushman & Wakefield

Domestic investment fell to £29bn on a rolling annual basis. Investment from European investors increased to £9bn, up 29% compared to Q2 2018.

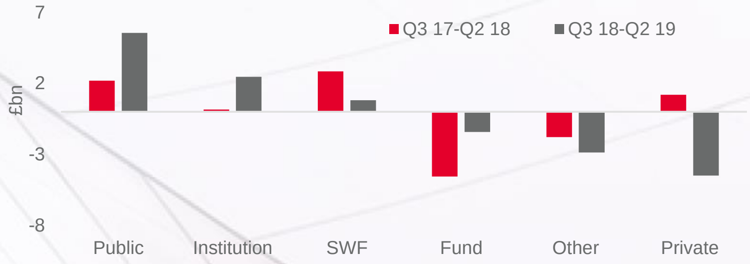
Net Investment by Capital Source



Source: Real Capital Analytics, Cushman & Wakefield

Net investment was positive for investors from Asia Pacific, largely thanks to purchases by South Korean investors. European investment was also positive, led by French investors.

Net Investment by Purchaser Type



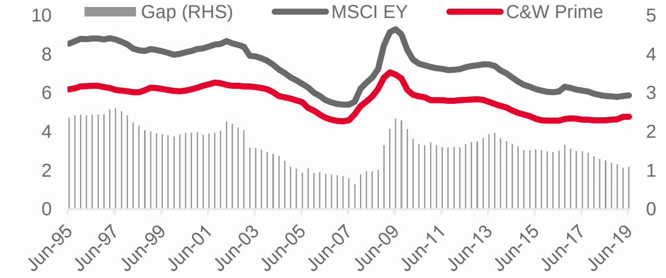
Source: Real Capital Analytics, Cushman & Wakefield

Private equity investors were heavy sellers as well as a becoming more active buyers. Net disinvestment was over £4bn over the last 12 months.

RCA transaction data correct as at 31/07/2019

MARKET PRICING AT A GLANCE

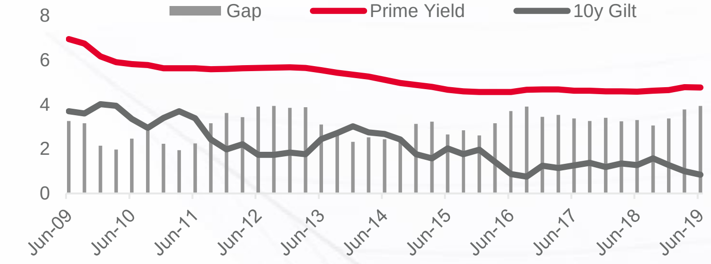
Prime v Secondary Yield gap



Source: Cushman & Wakefield Research; MSCI

Average equivalent yields rose to 5.9% in Q2 2019. Prime yields stand at 4.8%, 20bps higher than they were at the start of the year.

Prime Yield v Gilt



Source: Bloomberg; Cushman & Wakefield Research

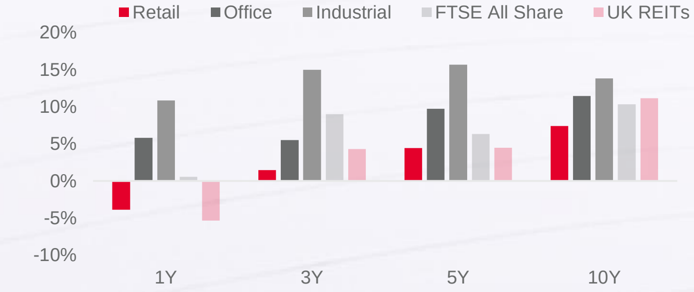
Government bond yields fell to 0.8% in Q2 2019, down 80bps on the previous year. Spreads to prime yields are close to 400bps.

Prime Yields (Q2 2019) and Outlook

	Office		Retail		Logistics	
London	3.75%[1]	→	2.50%[3]	↗	4.00%[5]	→
	4.25%[2]	→	3.00%[4]	↗	4.25%[6]	→
Reading	5.00%	→	5.25%	→	-	
Manchester	4.75%	→	5.25%	→	4.75%	→
Birmingham	5.00%	→	5.25%	→	4.75%	→
Leeds	5.00%	→	5.25%	→	5.00%	→
Bristol	4.75%	→	5.25%	→	5.00%	→
Cardiff	5.50%	→	5.25%	→	5.25%	→
Edinburgh	4.50%	→	5.00%	↗	5.75%	→
Glasgow	5.00%	→	4.50%	↗	5.75%	→

Source: Cushman & Wakefield Research
Note to London Locations: [1]West End [2]City [3]Bond Street [4]Oxford Street [5]Heathrow [6]Enfield
Outlook relates to YE 2019 forecast

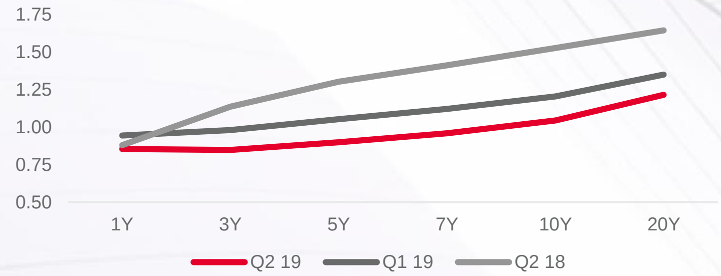
UK Property Returns



Source: Cushman & Wakefield Research; MSCI; Bloomberg

Retail's recent underperformance has tarnished its long-term track record. Meanwhile, industrial has outperformed in all past periods.

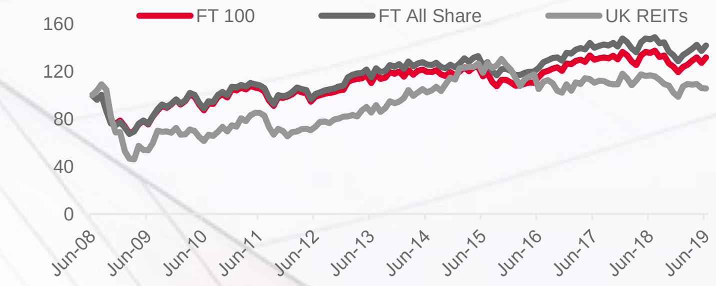
UK Swap Rates



Source: Bloomberg; Cushman & Wakefield Research

Swap rates continue to lower and the yield curve has flattened. Three-year swaps rates are down to 0.8% and their spread to 10-year swaps is around 20bps.

UK Equity Indices



Source: Bloomberg; Cushman & Wakefield Research

UK equities performed well in Q2 2019, propped up by weaker sterling. UK REITs underperformed, as the prospect of falling asset valuations hurt prices.

RCA transaction data correct as at 31/07/2019