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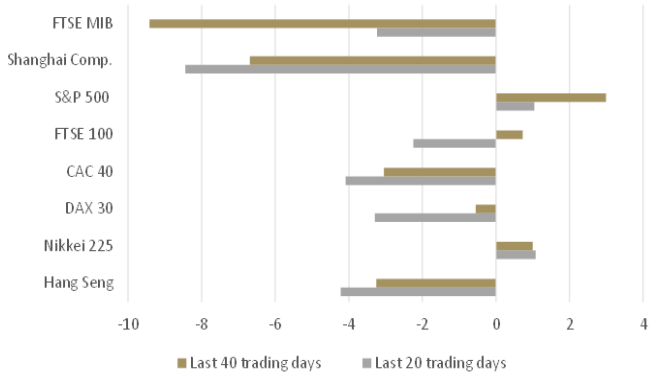
Update - June 2018

Global Factors

Political developments have been the driving force behind equity market movements over the past month. Uncertainty about government actions in Italy, Spain, and Germany have acted as a drag on European equities. Further, the recent announcement that the US will place at least a 25% tariff on selected Chinese goods from the 6th July has reignited concerns about protectionism globally and has added to the headwinds facing equity markets (see Chart 1).

1.0 Changes in selected market indices (%)



Source: Thomson Reuters

For now, however, a reciprocal increase in tariffs from China looks unlikely to throw the US economy off track. First quarter GDP growth in the US was 2.2% annualised, and so far the readings from business surveys and retail sales data point to even stronger growth in Q2 of perhaps 4% annualised.

In the UK, data shows that the economy is recovering, albeit perhaps not as rapidly as hoped. There have been few signs of improvement in the industrial and construction industries. Developments in the consumer sector have been more positive however, with the economy adding 146,000 jobs in the three months to April. Furthermore, the annual rate of growth in retail sales volumes increased to a 13-month high of 3.9% in May, helped by the fact that real incomes are no longer being squeezed.

An Overview

Britain's economy has bounced back from a weak start to the year with companies in the dominant services sector reporting increased activity in May. Businesses are catching up with work lost or delayed in the snowy weather of late February and March.

Rates were left unchanged at 0.5% following the last meeting of the Monetary Policy Committee. However, with the Fed raising rates again, and with the ECB signalling its intention to begin tightening policy, an August rate hike wouldn't surprise. Keeping the rates where they are could well see further downward pressure on the pound. Whilst UK inflation is not particularly high, another fall for sterling would soon change that, leaving investors to look for higher yielding assets, which the property market can deliver.

June Top 5

1. Fears of a trade war escalation creates headwinds for equity markets;

2. Investor appetite remains strong but lack of supply is starting to hamper demand;

3. The positive interest for UK real estate will continue, with high-quality stock likely to trade at a premium;

4. Strong pre-letting activity continues for City offices. Over 70% of scheduled mid-2018 completions are let;

5. Demand for long-term, stable cash flows is helping to drive strong hotel property performance.

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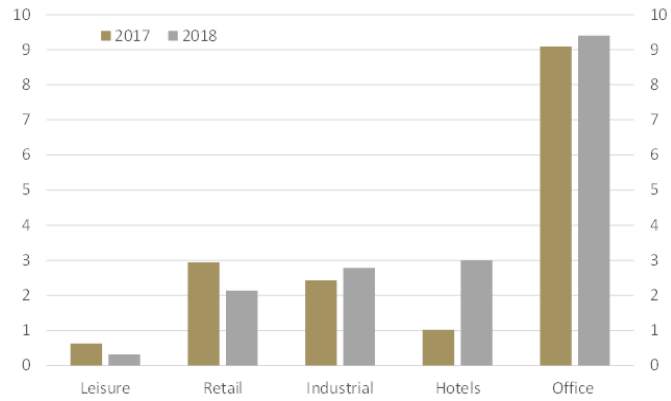
Nevertheless, headline CPI inflation was flat in May, at 2.4% y/y, and the Monetary Policy Committee did not raise Bank Rate at its June meeting. However, with the number of members supporting a rate hike increasing from two to three, a rise looks likely to come sooner rather than later.

Meanwhile, the European economy has struggled to recover following the slowdown in GDP growth in the first quarter of the year. Despite some improvement in consumption data, the composite PMI is consistent with GDP growth in Q2, remaining at around Q1's pace of 0.4% q/q. Industrial production also slowed in April, from 2% y/y to 1.7% y/y, and the decline was broad-based across member states. Despite lacklustre economic developments, annual inflation increased from 1.2% to 1.9% in May. As such, the ECB confirmed at its June meeting that it will reduce the monthly pace of asset purchases to €15 billion after September, and that asset purchases will finish at the end of the year. However, the ECB made it clear that interest rates are likely to be on hold until at least autumn 2019.

Property Overview

Over the past month, there has been nothing in the available data to suggest that the generally healthy picture for UK commercial property has deteriorated. Investor appetite for UK commercial property remains robust although the lack of buying opportunities is curtailing transactions. Annual investment transaction value for the UK commercial market levelled off at £65 billion in the 12 months to Q1 2018. According to Property Archive, the cumulative total for commercial property investment to date in 2018 has only been 0.7% lower than over the same period of 2017. But the divergent prospects for the sectors has meant that stronger investment in the office, industrial and hotel sectors has offset weakness in retail and leisure investment (see Chart 2).

2.0 Cumulative investment by main sector (Jan to May £bn)



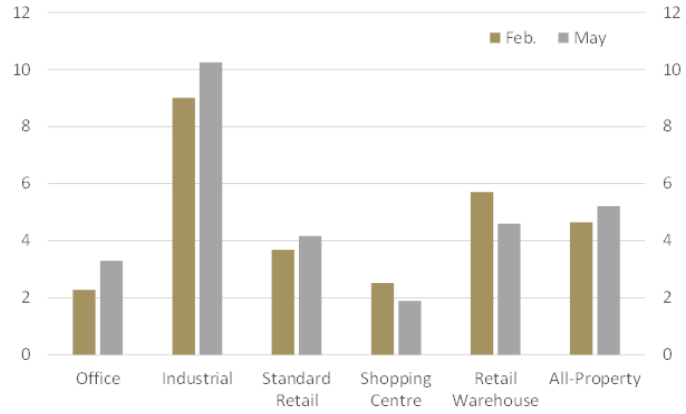
Source: Property Archive

However, questions remain about whether the market can repeat the strong rates of investment growth seen in the second half of 2017. Investment data paints a consistent picture. Viewed in aggregate, the combined value of investment deals for UK property assets is only 2.3% lower than the same period of 2017. But within that total, investment in office and industrial property has risen, while investment in retail property has slumped by almost 40% (see Chart 3).

Yields remain under downward pressure across many parts of the market, including some secondary properties with shorter leases. This reflects the high desirability of UK commercial real estate and limited supply. The positive interest for UK real estate will continue and high-quality stock is likely to trade at a premium, with retail being the exception. The rise in administrations and Company Voluntary Arrangements amongst retailers is likely to shrink the rental income stream from retail assets and investors will be looking for a discount on deals.

The overall outlook for all-property returns has improved relative to what was expected earlier in the year. The May IPF consensus forecast for all-property total returns was revised up to 5.2%, from 4.6% in February. And the big picture is that the commercial property market is expected to experience a soft landing.

3.0 Average total returns forecast for 2018 (%)



Source: IPF Consensus

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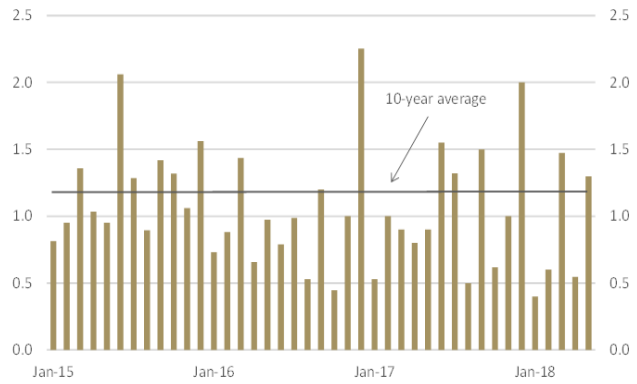
London Property Market

A closer look at the London office market shows that, following weakness in April, letting activity improved in May. CBRE report that take-up increased to 1.3m sq. ft. in May, ahead of the 10-year average of 1.1m sq. ft. (see Chart 4). In part, take-up was bolstered by an owner-occupier deal for the Chinese Embassy at Royal Mint Court. However, occupiers continue to show interest in the central London office market, with under offers at a three year high.

4.0 Central London office take-up (million sq. ft.)



Source: CBRE

In any case, the outlook for the central London office market appears better than what many expected earlier in the year. The IPF consensus forecasts for City and West End office total returns have been revised up, reflecting both better expected rental value growth and a modest cut in yield forecasts.

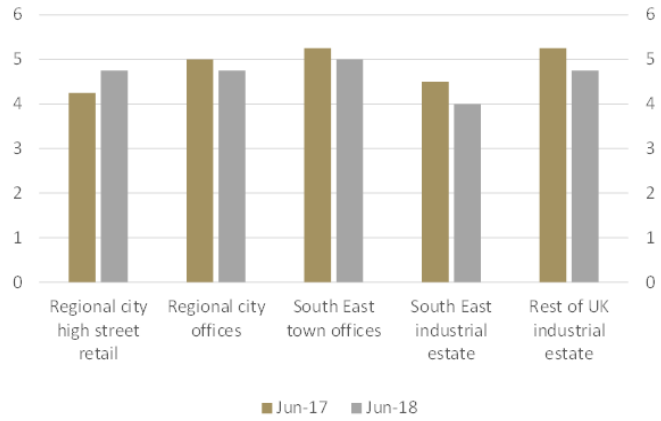
Headline rents in some submarkets have started to respond to an acute shortage of Grade A space. Locations such as Mayfair, St. James's (both have reached £120 psf) and Paddington all saw prime rental increases in Q1 2018. Strong pre-letting activity continues in the City where over 70% of the 800,000 sq. ft. scheduled for completion by mid-2018 is already let. This positive outlook for occupier demand continues to provide support for our investment case for our latest investment opportunity on Cannon Street, Sherborne House. Following a deterioration in the outlook for retail, the vacancy rate for Bond Street retail increased from 2.8% in 2017 Q4 to 5.7% in 2018 Q1.

Regional Property Market

Investor interest continues to be greater in the regions than in London. According to Property Archive, in the year to May the share of investment in the regions increased to 59.2%, the highest share since 2010. This reflected an increase in the value of investment from £1.1bn in April to £2.3bn in May, driven by stronger investment in the South East and Scotland.

However, data from Knight Frank show that investor interest in regional retail property is notably weaker than that for office and industrial. Over the past year, yields for regional high street retail have increased from 4.25% to around 4.75%, whereas yields for South East and Rest of the UK office and industrial estates have fallen (see Chart 5).

5.0 Selected regional property yields (%)



Source: Knight Frank

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Sector Spotlight

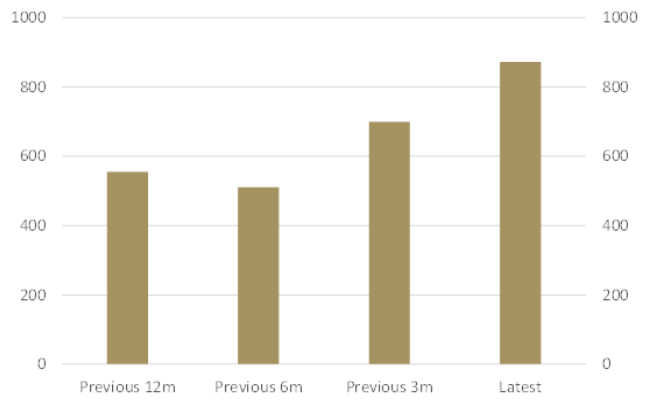
Hotels

Against a backdrop of Brexit uncertainty that has subdued the growth of some other commercial sectors, the hotels sector has continued to grow both in London and the regions and has become an increasingly popular choice with investors. Demand continues to grow for long-term stable cash flows on premises that are critical to a tenant's business. Income streams with fixed or indexed linked leases provide an excellent hedge against inflation in a low rental growth environment and their demand has noticeably increased following the Brexit vote.

Hotel property was performing well heading into 2018, in part reflecting some bounce-back following Brexit-related concerns. Knight Frank reported that at the end of 2017, yields for prime London hotels as well as prime and secondary hotels in the regions were below their 10-year averages, at 4%, 7.5%, and 9.5% respectively.

Investor interest in hotel property has been strong, particularly from overseas investors and in the regions. Indeed, the value of investment in May was higher than it has been on average over the past 12 months (see Chart 6). Moreover, over the past two months the value of hotel investment has also been greater than investment in many other commercial property sectors, accounting for over 20% of total deals struck, compared to just 5% at the same time last year.

6.0 Value of hotel investment (£m)



Source: Thompson Reuters

International buyers have been prominent and numerous countries such as South Africa and Sweden have increased their presence in the hotel investment market. Overseas investors accounted for 60% of transactions value in 2017, compared to only 20% in 2016.

The outlook for our Travelodge portfolio looks extremely positive. In 2017, investment into UK leased hotel assets (i.e. brands such as Premier Inn & Travelodge) reached £2.57 billion, accounting for 47.8% of total UK hotel transactions (£5.4 billion) for the full year, according to Savills latest data. Already in 2018 we have seen investment volumes for the first quarter reach above 15% year on year, suggesting sustained increased appetite from investors for leased hotel assets.

Over the last 10 years, leased hotels have outperformed some of the other more traditional asset classes in terms of income and capital growth and we expect the sector to continue to perform well.

There have been several key deals so far this year, including the purchase of 76 Travelodge hotels, equating to £246 million, as part of a wider acquisition by Secure Income REIT and the forward funding of the 248-bedroom Premier Inn Custom House in Cardiff by Aviva for £34 million.

UK hotel supply and demand

Brexit has cast a shadow over the UK's economic outlook and has contributed to a subdued development cycle across most commercial sectors – except the hotel sector. Knight Frank report that the supply of new rooms has been strong. In 2017, the number of new rooms grew by 3.1% in London and 1.7% and the regions, with around 60% of these new rooms being in budget hotels. Over the next three years a further 15,000 rooms are in the pipeline in London, while outside of London, an additional 21,500 rooms are expected.

There were approximately 40 million overseas visits to the UK in 2017 according to VisitBritain, up 6% on the 2016 figures. The number of 'staycations' in England during H1 2017 rose to a record 20 million, an increase of 7%. This has largely been driven by the devaluation of Sterling following the EU referendum.

Although the pound has risen from its 2017 lows, it remains below its 2016 levels which could also support tourist demand at the margin. And a weaker pound also entices British tourists to stay at home.

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Both London and key regional cities have benefitted from rising overseas visitors and domestic 'staycations', and indeed hotel performance in the regions improved as overseas visitors looked beyond the capital. Despite market disrupters such as Airbnb and heightened concerns over security, hotel occupancy is now 10% above its 2008 pre-recession peak. According to PwC, occupancy rates in the regional market increased to 76% in the 12 months to December 2017, up by 0.5%. The London market registered an 82% occupancy in the same period, up by 0.3%.

The outlook for hotels is solid. Private, corporate and international investors have shown a strong interest in regional UK hotels, driven by the huge global weight of money, weaker Sterling as well as favourable returns from alternative real estate. Yields are likely to increase in line with marginal improvements in RevPAR (Revenue per average room), albeit modest. Despite ongoing pressure on margins, we expect the hotel investment market to remain strong in 2018, in London and many of the key regional cities.

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