NABARRO

CLARITY MATTERS

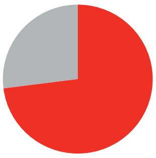
Growing Opportunities:
A New Outlook for UK Real Estate

Report

A new outlook for UK real estate

Most appealing regional cities

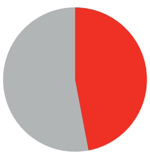
Manchester



73%

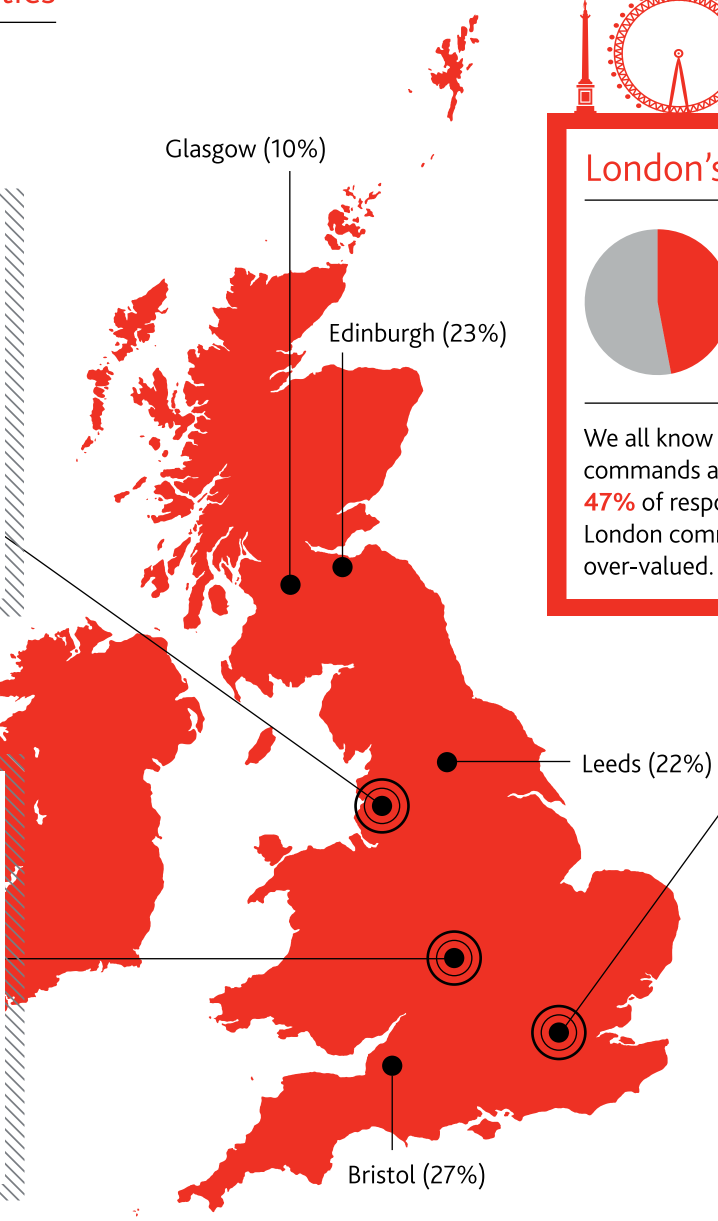
Manchester is the most appealing regional centre with **73%** of people singling it out.

Birmingham



42%

Birmingham is the second most popular with **42%** finding it appealing.



London's value

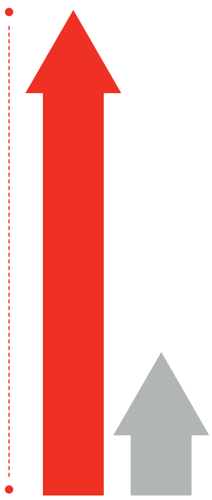
47%

We all know that London commands a price premium and **47%** of respondents now see London commercial real estate as over-valued.

The top 5 "cities or towns to watch"

- Aberdeen
- Reading
- Cambridge
- Liverpool
- Sheffield

86%

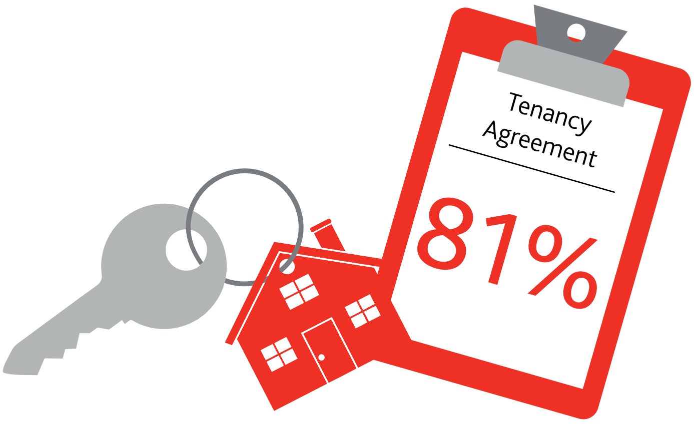


86% think that the attractiveness of regional property will increase over the next **2 years**.

£150bn

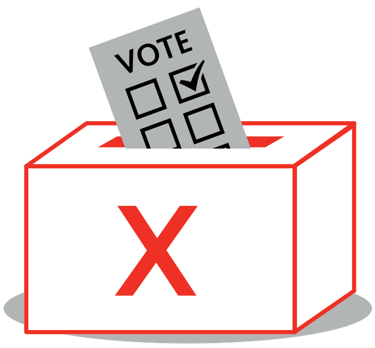
Our **250** survey and interview respondents are together responsible for portfolios worth more than **£150bn**.

34% see alternatives as the most appealing asset class over the usual core areas of office, retail and industrial.



Private rented housing is the most popular alternative asset. **81%** found it appealing.

42% felt that management intensity was the major barrier to investing in alternative real estate assets.



Investment decisions will be most shaped by the UK election in the next **2 years** and UK participation in Europe in the next **5 years.**

81% of respondents would be less likely to invest in an independent Scotland.

Are you ready for the changes in UK real estate?

For advice on how best to take advantage of investment and development opportunities contact Nabarro's expert Real Estate team.

www.nabarro.com

NABARRO

CLARITY MATTERS

Growing Opportunities:
A New Outlook for UK Real Estate

Contents

About the research

Nabarro, in conjunction with FTI Consulting, created and ran a poll of 239 property investors, developers and agents, and conducted 11 interviews with leading market figures. Those surveyed and interviewed have combined assets worth more than £150bn.

Of the survey respondents, 60% work in property investment companies, 22% for property development companies and 18% for property agents. Giles Barrie, Managing Director of strategic communications company, FTI Consulting, undertook in-depth interviews with eleven selected investors during April – May 2014.

Foreword

Over the past year, we have seen the pace of change accelerate in the UK real estate sector. The economy is blossoming and, in response, the market is opening up to opportunities beyond the security of 'prime' and 'core'.

In June 2013 we published 'Global Investor Appetite – Who's Hungry for UK Real Estate?', an in-depth survey of international investors, which showed that their focus was still fixed firmly on London prime property. But while London remains attractive, what started as scattered seeds of interest in the UK regions has now grown into a significant level of demand.

This report draws on a survey of 239 investors and interviews with 11 key market players controlling property worth more than £150bn. It reveals a shift in attitudes toward UK real estate – and, crucially, how this will shape future demand. What emerges is a colourful picture.

86% of respondents say the appetite for regional property investment will grow over the next two years. A mere 2% say it will fall. Asking the same question just one year ago would have produced an entirely different response.

Of the big six cities outside London, Manchester and Birmingham are decidedly the most appealing investment opportunities. Interest in Edinburgh and Glasgow is dampened by the prospect of Scottish independence creating uncertainty over currency, tax and regulation. However, this does not overshadow confidence in Aberdeen, voted our survey's number one 'City or Town to Watch'. Its oil-based economy will drive prosperity and confidence come what may.

With 47% of our respondents seeing prime London commercial real estate as over-valued, attention is shifting to 'non-core' asset classes in the capital and beyond. This shift is accentuated by an improved economy leading many to consider more risky investments with higher potential returns.

Alternative assets now make up 15% of the whole Investment Property Databank (IPD) Index and, according to our interviewees, this figure will most certainly grow. Rented residential property is still seen as 'alternative' by some but, as it continues to flourish, for others it is increasingly considered mainstream.

Retirement living had strong support in our survey, reflecting demographic changes, as did student accommodation, hotels and healthcare. We conclude our report with advice on how to mitigate risk and maximise return in these sectors which institutional investors have shied away from traditionally (page 26).

Our survey captures the growing opportunities in our market, echoed by the thoughts of 11 key industry players. Highlights of these fascinating interviews are included in this report and we hope you find them as insightful as we do.

Ciaran Carvalho.

Ciaran Carvalho
Head of Real Estate
T +44 (0)20 7524 6152
c.carvalho@nabarro.com
uk.linkedin.com/in/CiaranPCarvalho
#NewOutlookforUKRE

"I'm not afraid of 'new'. I am afraid of assumptions that 'core' and 'prime' are always best."
Anthony Shayle, UBS

Interview

Meka Brunel, Vice-President Europe, Ivanhoé Cambridge

With Cdn$7-8bn of its Cdn$40bn+ global real estate holdings dedicated to Europe, Canadian real estate giant Ivanhoé Cambridge is a strong example of an international property investor that is re-evaluating its strategy all the time.

"Obviously London is heating up. On the investment side some prices are crazy. But there are still opportunities."

The company has a new perspective post-downturn in the sense that it is interested in 'alternatives' – mainly through multi-family housing. But it is not tempted to find value in the UK regions, preferring to stick to core global cities instead.

And while London might look expensive to some, for Brunel and Ivanhoé there is still value to be had.

"Obviously London is heating up. On the investment side some prices are crazy. But there are still opportunities, and as we are focused on offices, we are looking in the City, City fringe and Midtown areas.

"We don't have much interest in the UK regions. Seen from Montreal, London and Paris are already regions. We also don't want to buy one-off assets in out of the way locations. Large, dominant retail assets like this are a lot of energy and effort.

"Multi-family housing is something we are really interested in. Since 2008, when a great number of people handed the keys to their homes back to their banks, so many have turned their backs on what I call the 'Desperate Housewives' image of the suburbs.

"They are keen to live in city centres, and we see tremendous growth in this field."

Brunel has some clear predictions for the future. Being Paris-based, she has seen the benefits of high-speed train travel in France and says: "High-speed trains created development in regions that had been left behind. Lyon, Bordeaux and Marseilles all prospered as a result.

"It has really re-shaped the country. Those cities became regional capitals in a country which, until then, had been heavily centralised through Paris."

And in property terms, Brunel has seen, post-banking crash and Euro Crisis, a shift in expectations among property's key customers – its tenants.

She says: "None of us will now put up with living or working in bad environments. I don't believe tenants are bothered with lease lengths. What they do want, after the technological revolution we have just been through, is for the landlord to be a provider of the good space needed rather than just an old-fashioned landlord."

Is there still value in London?

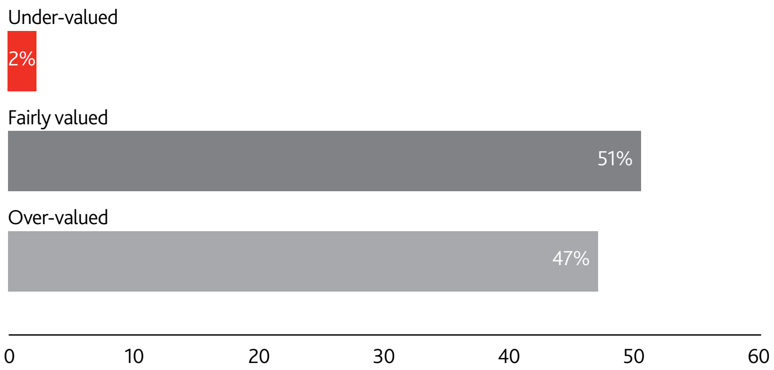
2014 is proving to be a buoyant year for the UK economy and for the London real estate market. There is little doubt that London remains a magnet for both domestic and international investors. Nearly £30bn of assets were traded in the capital last year – the highlight being the £1.7bn disposal of More London.

London's popularity has resulted in increased competition and low yields, which explains why 47% of respondents to our survey now see London prime real estate as over-valued. This pressure means that more investors are being drawn to regions where there is a promise of greater returns.

47%

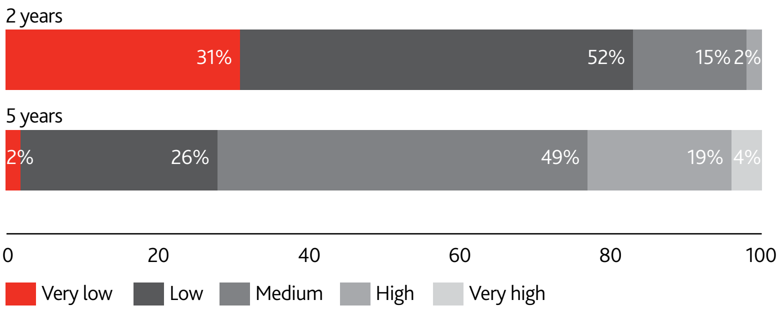
of respondents see London commercial real estate as over-valued.

Do you see prime London commercial real estate as



The strength of the London market and the growing optimism in the regions perhaps explain why 83% of respondents believe there is a low or very low risk of a UK real estate downturn in the next two years. In the longer term 49% feel there is a medium risk – a figure which is unsurprising given that the real estate market is notoriously cyclical.

From your perspective what is the risk of a UK real estate downturn in the following time periods?



The changing regional picture

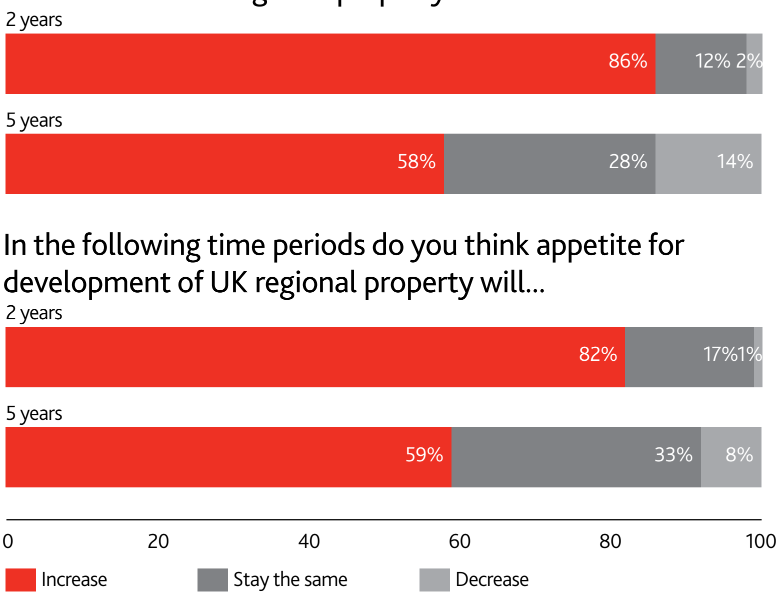
When we spoke to both UK and international investors in 2013, there was a sense that regional property was only for the 'brave', echoing the often-used phrase of an American investment banker when he dismissed "London as a first-rate city in a second-rate country".

More recently, we have sensed greater interest in the regions from both our clients and the general market. Rather than looking to international centres such as Paris, Berlin and Zurich, increasing numbers of investors see the regions as another credible alternative. Indeed this year, just two of the new regional developments we are advising our clients on are worth over £2bn.

Investors are more attracted to the regions than ever before. 86% believe appetite will increase over the next two years and 58% expect this appetite will continue to grow over the next five years. Respondents agree there is similar appetite for regional development – 82% think appetite for regional development will increase over two years and 59% over five years.

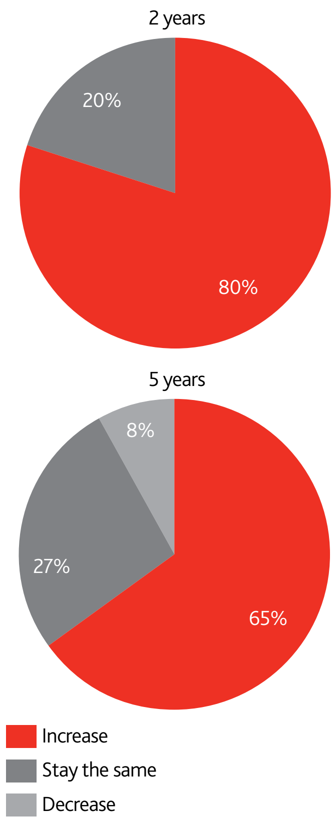
Exciting new regional schemes include the £800m NOMA development – a 20 acre mixed-use scheme in Manchester being delivered by Hermes and The Co-Operative Group.

In the following time periods do you think the appetite for investment in UK regional property will...



The funding picture is equally strong – 80% think it will improve over two years and 65% over five years. Research by De Montfort University states "after several years in the doldrums with very little going on, the UK property debt market has staged a spectacular and vigorous recovery".

In your view, how will the funding market for development in the UK change in the following time periods?



Interview

Alex Jeffrey, Chief Executive, M&G Real Estate

"We see 2014 and 2015 as the years of the regions.

"Parts of the regional market will out-perform London. But it's a story of polarisation: Manchester, Birmingham and Edinburgh will be strong, but other regional markets will continue to fare less well."

"Overall, the economic confidence we've seen in London is definitely spilling out into the regions."

If anyone has an overview of UK property, it is M&G Real Estate Chief Executive, Alex Jeffrey, who oversees combined segregated, retail and long-term income funds worth more than £18bn.

M&G has arguably made a bigger push into the regional and alternative asset markets encompassed by this research than any other investor interviewed.

Foreseeing a downturn, it began to sell property in the UK in 2006. However, it has now amassed a 1 million sq ft regional development portfolio, including schemes in Reading, Glasgow, Edinburgh, Birmingham, Bristol and Aberdeen.

Jeffrey says: "We are seeing rental growth coming through in the regions, as well. We are also cautious about development risk in London right now, particularly in the City of London where the pipeline promises well above average levels of supply."

M&G has also made a strong commitment to residential investment, and Jeffrey argues that the UK will, in the medium-term, see residential as a core rather than 'alternative' asset class for institutions, in line with the German, Japanese and North American markets.

"The lack of supply is creating investment opportunities," he says.

But with Labour Leader Ed Milliband promising rent controls, Jeffrey warns on this potential danger to the market: "Any serious reference to rent controls would have an unwitting negative effect. It would undoubtedly scare off investors and therefore cut off supply and push up the cost of housing for people.

"We at the Pru [M&G's former property brand] were major investors in post-war residential property but we, and our rivals, all got out after the Rent Act of 1974."

Jeffrey is also keen on healthcare property, data centres and student housing, and can foresee alternative investments including residential accounting for 10% of M&G's total property holdings within two years, and 20% within five years.

Last year M&G even strayed into car auctions property, paying £240m for a portfolio after detailed analysis showed that this fringe investment class could represent a strong investment due to the high yield and fixed uplifts embedded in the portfolio's leases.

On prospects for a downturn, Jeffrey cites London as being 'mid-to-late' cycle, and the regions as being 'early-to-mid' cycle, but sees UK property remaining healthy until at least 2017, barring unexpected shocks. His biggest fear? A UK exit from the European Union, which could have a "profound effect on the economy and investors' willingness to come here."

"We are cautious about development risk in London right now, particularly in the City of London where the pipeline promises well above average levels of supply."

Interview

Nigel Hugill, Chairman, Urban&Civic

"Local authorities remain desperately keen to bring people back into their town centres; meanwhile with joint incomes and family orientated spending on the rise, demand for leisure activities will only increase."

Nigel Hugill, together with his long-term business partner, Robin Butler, has arguably originated more value from UK property than any other developer operating today.

While with Chelsfield in the early 2000s, Hugill spearheaded the creation of what is now Westfield London at Shepherd's Bush. He went on, with the help of Sir Stuart Lipton, to lay the foundations for the entire Stratford City project, including a second giant Westfield retail centre, the Athletes' Village and the commercial development now known as the Stratford International Quarter, to which the FCA has recently announced a 430,000 sq ft relocation.

By reversing his and Butler's new vehicle, Urban&Civic, into listed developer Terrace Hill in May this year, Hugill is planning to repeat history, but this time outside London through what many people still see as an 'alternative' asset class.

Hugill's plan is to develop a minimum of five new garden settlements, with planning already secured for two in Alconbury, near Cambridge, and Rugby, near the junction of the M6 and the M1. These projects fit into the template of Hugill and Butler's reputation for mega-schemes, but the Terrace Hill deal also demonstrates an appetite for regional investment and development on a more day-to-day scale and into recovering provincial economies.

Hugill says: "We will look to undertake leisure-based development in the regions. Town centre schemes appeal most because that is where our hearts and our instincts combine. There are a number of local authorities who own suitable sites and might previously have hankered after large-scale retail extensions."

Changed shopping patterns have required them to reassess those aspirations: "Those same local authorities remain desperately keen to bring people back into their town centres; meanwhile with joint incomes and family-oriented spending on the rise, demand for inclusive leisure activities will only increase. Big box out of town leisure, by contrast, has had mixed success and puts less back into local economies."

Looking ahead, Hugill is a fan of Cambridge and believes that the improved rail access, medical research and technical collaborations will only consolidate the already "rock solid" relations with London.

"If you want a proxy for where central Cambridge residential is heading, you might want to start with Wimbledon," he mused.

As chairman of leading urban think tank, Centre for Cities, he has clear views on the UK economy:

"The dynamics are very strong over two years and pretty strong over five."

On Scottish independence:

"If Scotland goes independent you could better make the comparison with Ireland in property terms: stronger romantic investment attachments do not compensate for a reduction in core resilience."

He does not think that Scotland will opt for independence:

"My guess is that the security of ballot box anonymity will reinforce the vote for continued union."

And on High Speed 2, in which he believes most passionately:

"I am a massive advocate, although I concede that the basic case is one of conviction. Ours is a small, imaginative, innovative island: quite the best way to reduce regional differentiations and make a success of the entire British economy is to tighten up connections across the country as much as we possibly can."

Warming to the theme, he continues:

"If we can afford to spend £25bn a year on housing benefit, how can we afford not to spend £50bn on HS2? The structural promotion of economic growth is the only way that we can keep pace with increased public spending requirements elsewhere".

Regional assets – alternative choices

As investors seek more opportunities in the regions, are they playing it safe or looking at alternatives?

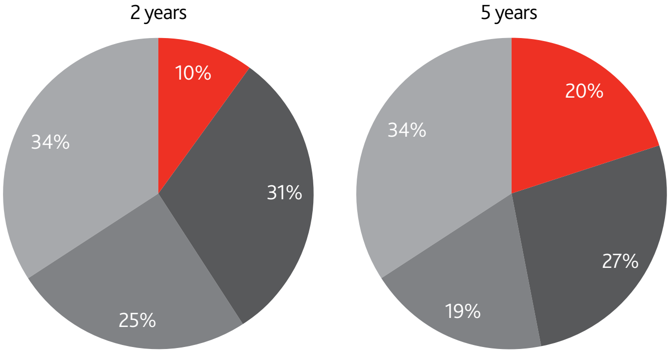
Surprisingly, alternatives (which for the purposes of this survey are classed as data centres, healthcare, hotels, private rented housing, retirement living and student housing), came out the strongest. 34% of respondents think alternatives will be more appealing over the next two years than offices, industrial or retail. This commitment remains strong over the longer term – 34% think it will appeal over the five year period.

Conversely, investors are sceptical of retail in the short term. In our 2013 survey, of the eight asset classes polled, retail ranked a lowly fifth. In 2014, just 10% feel regional retail will offer value over two years. The relentless rise of online retailers continues to place huge pressure on the high street. However, as the economy continues to improve, so too does consumer confidence and spending. This may explain why over five years a surprising number of investors (20%) find favour again in the retail sector.

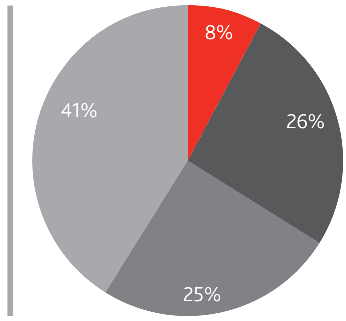
At 41% the preference for alternatives is even more marked when it comes to regional development, compared to the 8% for retail. We are seeing this with our clients; we are currently advising on a number of regional developments including the 'The Studios U-Student Village' development on Newcastle's City Road due to open this September.

41%
favour alternative assets as UK regional development opportunities.

What type of UK regional property investment asset do you think will be the most appealing over the following time periods?



What type of UK regional development appeals most?



Retail | Office | Industrial | Alternatives e.g. data centres, healthcare, hotels, private rented housing, retirement living and student housing

Interview

Cameron Spry, Partner, Head of Investments, Tristan Capital

For Tristan Capital, entering non-core markets was second nature after the property market collapsed in late 2008.

In 2009, Tristan, headed by former Curzon Global Partners chief Ric Lewis, was one of the market's biggest net buyers, having been one of its biggest net sellers as cracks began to show in late 2006 and 2007.

Tristan now has a total of €5bn under management and invests principally in the major property types. But while its head of investments Cameron Spry believes there are "more focused investors in alternatives" than Tristan, the group has led the charge into the UK regions.

Spry says: "We've been active in the regions, focusing on Birmingham, Manchester and Glasgow, where very little has been developed over the last few years, and from which UK institutions retreated to London almost indiscriminately.

"It's wrong to say there is no demand in the regions, because as government and UK plc have cut costs, they've also consolidated into the larger regional office markets at the expense of smaller scattered offices.

"It's also wrong to say there is too much supply outside London, because much of the space that is apparently available actually isn't lettable. These are capital-starved assets that have been in the hands of the banks or other creditors and cannot compete with newly-developed schemes."

While the pool of money chasing UK property has widened, Spry says many new investors are only interested in buying core assets, and that there isn't as much competition for assets that need capital expenditure as people believe.

Tristan Capital may be a fan of the English regions, but Spry sees both sides of the debate on High Speed 2: "I was in Birmingham yesterday and I had an extremely quick journey back – do we really need another 30 minutes shaved off?

"On the other hand, transport investment in the UK is generally positive, and one challenge this country has to face is bridging the north-south divide."

As a counter-cyclical investor, Spry and Tristan are as well-placed as anyone in forecasting future property cycles and, like many expert investors, believe that the cycle will get shorter as information flows more freely.

Having said that, he believes the risk of downturn is greater in Continental Europe with its inherent deflationary pressures, and says it is hard to see right now what the catalyst would be for a downturn in the UK.

He does, however, caution that if interest rate rises happen too quickly, that could choke off the recovery and challenge investors who continue to be over-leveraged.

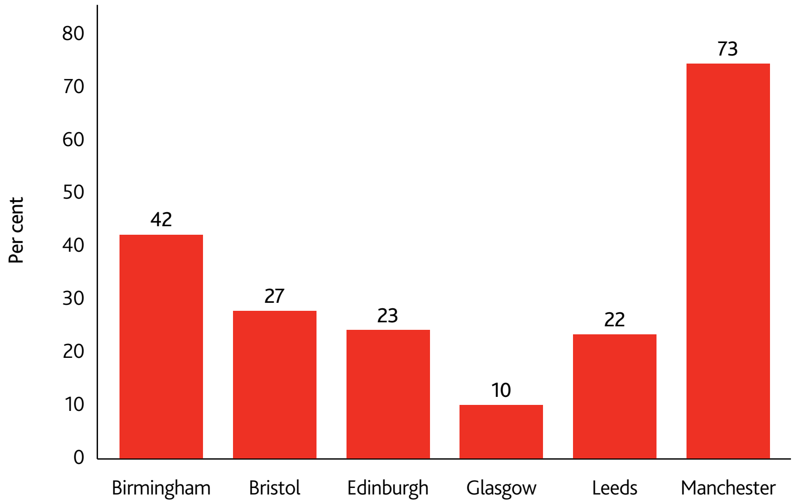
The ‘Big Six’ and beyond

As England’s unofficial second city, Manchester overwhelmingly attracts the interest of investors looking for opportunities outside of the London prime market. The high profile announcement of the £800m investment into Manchester City Airport, a significant portion being Chinese investment, has no doubt boosted the feel-good factor of this city. In our survey, 73% believe Manchester is most appealing.

Leading the rest of the pack are Birmingham (42%), Bristol (27%) and Leeds (22%). Edinburgh and Glasgow have a more modest appeal, reflecting concerns over Scottish independence which we cover later. Aberdeen, on the other hand, bucks this trend by topping the list of cities outside the big six thanks to its oil-related economy.

Indeed, our top five ‘Cities or Towns to Watch’ table favours locations synonymous with a certain industry or service sector. Cambridge is a hub for global research and development and the pharmaceutical industry. Reading has its tech companies straddling the M4 corridor. In addition, whilst it may be difficult for investors to truly quantify the value of HS2, the opportunities that Crossrail will open up for Reading seem more immediate.

Of the cities listed below, which two are most appealing as investment prospects?



What is your ‘City or Town to Watch’ outside of these key cities?

- Aberdeen
- Reading
- Cambridge
- Liverpool
- Sheffield

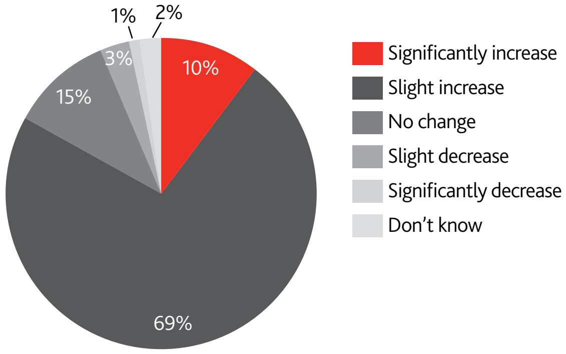
HS2 – different perspectives

The controversy surrounding the HS2 train network from London to Birmingham then onto the northern cities is not reflected in our survey. Despite the cost, profile and backlash, investors appear on balance in favour – 52% are slightly positive whilst 34% are neither positive nor negative about the impact of HS2 on investment strategies. Assuming the project is delivered, the majority of respondents think there will only be a slight increase, if any, in the appeal of UK regional cities as a result.

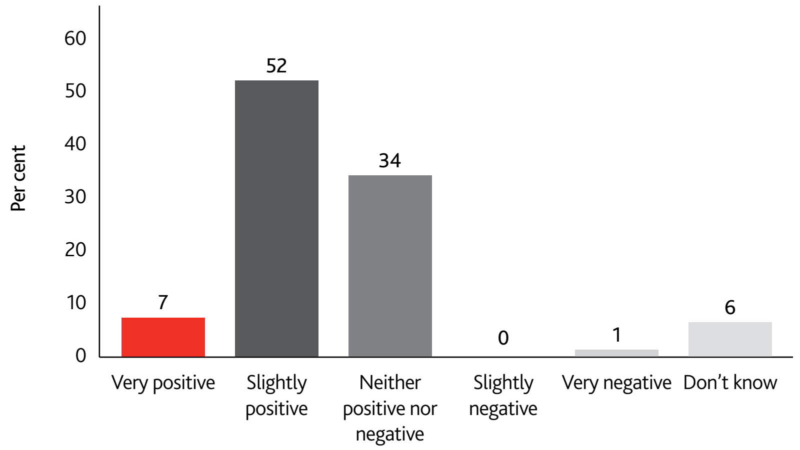
The views of our interviewees varied, with some strongly in favour whilst others were more tentative. They are supportive of infrastructure development as a principle and believe it crucial to maintaining the appeal of the UK regions. However, and probably in light of the fact it is a ten year (or more) development project, they feel that any immediate direct investment gains have already been realised. Clearly this is a debate that will run on.

> "[In France] high-speed trains created development in regions that had been left behind. Lyon, Bordeaux and Marseilles all prospered as a result."
> Meka Brunel

Upon completion, how will High Speed 2 change the appeal of UK regional cities as a property investment prospect?



Do you think High Speed 2 will have a positive impact on your investment strategies?



Interview

Alan Tripp, Managing Director, UK, LaSalle Investment Management

Running one of the UK's biggest property fund management operations has seen Alan Tripp riding the rollercoaster of the market's fortunes over the last five years.

In 2008, LaSalle's UK business, along with the rest of the UK market had to cope with a 40-45% fall in values. But now, alongside new mandates won in the meantime, its investments are above £10bn.

Clients' wishes have changed, with real estate being back in vogue as investors find the robust income returns compelling. Combined with the higher-return debt funds LaSalle also runs, this creates strong appeal.

Tripp is still interested in investing in London, but on LaSalle's terms: "There is still quite a weight of money from overseas for core London assets – but their requirements are materially different from a lot of UK investors.

"We are still keen to create the stock, which means investing in refurbishments and developments and being clever in capitalising on the Crossrail impact."

LaSalle and Tripp are looking closely at the private rented residential sector, believing that demographics are also in favour of student accommodation and assisted living. What works for Tripp in residential is scale. What frustrates him is the potential for policy changes out of his control.

Funding residential development also appeals, and Tripp is keen to get in early on the private rented revolution, stressing that, as an early cycle developer, first mover advantage is crucial.

He learned the advantages of being first to the party once again in the dark days of 2009 and 2010, when LaSalle was among the few buyers of regional shopping centres.

By including capital expenditure programmes in its bids for centres with voids, LaSalle was able to give them a new lease of life: "Existing retailers are happy to regear their leases if you are spending money on refurbishing a centre," Tripp says.

Looking ahead, Tripp can see LaSalle having 5-10% of its UK holdings tied up in alternatives over two years, and 10-20% over five years.

But as a major investor, he also wants to see improvements in the UK's infrastructure as a whole: "We need the whole of HS2. It has to happen. It's an uncomfortable feeling to see the degree to which London has taken off. Under-investment in the regions is a damaging thing."

Having said that, Tripp believes in-depth specialist market knowledge helps LaSalle navigate many of these challenges.

> "We need the whole of HS2. It has to happen. It's an uncomfortable feeling to see the degree to which London has taken off. Under-investment in the regions is a damaging thing."

Interview

Don Jordison, Managing Director, Threadneedle Property Investments

Threadneedle's reaction to the great crash of 2008 to 2009 was to confront clients' changing demands head on by creating greater alignment between fund manager and client, and well-publicised protocols for flows into and out of its funds.

Now, one of Britain's most highly regarded fund managers is having to restrict flows into its funds to prevent the potentially damaging impact of having too much cash on tap. "The supreme irony," as Jordison, calls the situation.

"The next two years will be extremely buoyant," he says. "And economic prosperity now doesn't stop at the North Circular. Already there is really exuberant demand for 'risk-on' property in London and the south-east, properties without the finest tenancies, covenants or locations.

"And you can't stop developers developing. We don't need to develop ourselves because there's enough for us to buy in the market."

As a Manchester City fan you might expect Jordison to favour the north-west, but as a contra-cyclical property investor he is more interested in outsmarting the rest of the pack.

Bristol is his favourite core city as a property investment, and he also likes Oxford, which he thinks has many of the same scientific and locational benefits as Cambridge but less of the hype.

As an opportunistic investor Jordison is interested in anything – including alternatives – at the right price. But he won't go as far as launching specialist alternative property funds given the risks he still perceives.

"Data centres are good, but it only takes one technological shift and overnight there could be huge over-capacity. Healthcare? Southern Cross [the operator which hit trouble] has given it a bad name.

"Residential? We understand it but it's just too politically and socially charged. Can you imagine? You've built a big infrastructure for residential and Labour come in with rent controls. You'd throw yourself off the top of a building!"

Jordison isn't impressed either with plans to boost the regions through High Speed 2, saying Threadneedle is "pretty convinced" there could be a better way to spend £50bn. An interesting, cheaper suggestion he puts forward is a major Midlands cargo airport.

As a renowned reader of the property market, Jordison is regularly pressed for his views.

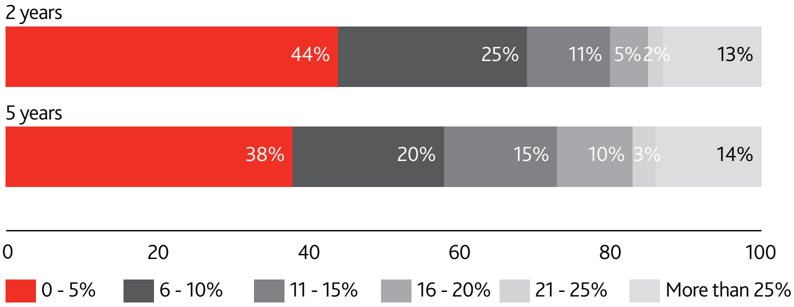
The chances of a downturn? "Pretty low," he says. "There's going to be some exuberance, but things won't unravel. We saw 10% returns last year, and we will see 15% this year. If we see 15% again next year we might give some of those gains back."

From alternative to mainstream?

Our survey highlights a marked shift in investors' attitudes towards real estate.

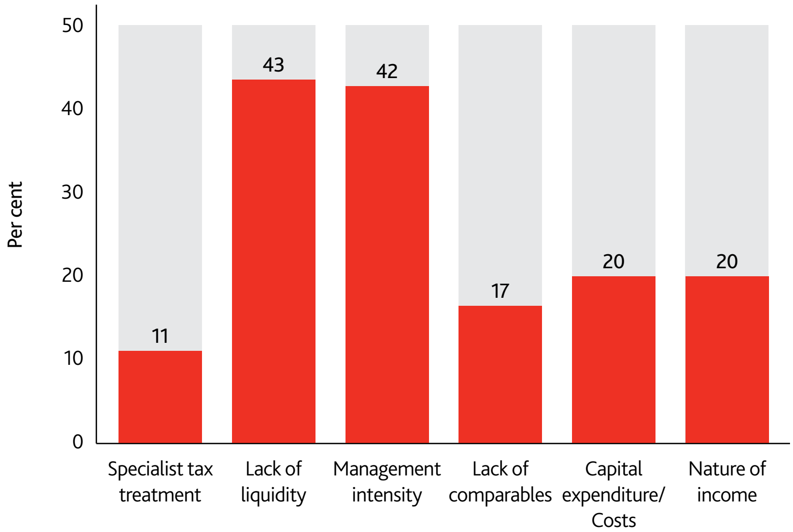
In the future alternative investments will form a notable proportion of portfolios. 48% of investors surveyed believe alternative assets will form 6-25% of their portfolios in five years with a further 14% expecting them to exceed a quarter.

What proportion of your portfolio do you envisage being accounted for by the 'alternative' asset classes in the following time periods?



However, whilst an appetite for alternatives is growing, historic barriers remain. Real estate assets are known for illiquidity. This is heightened when it comes to alternative assets with 43% of respondents being deterred by lack of liquidity. As with all sectors, investors need to make judgements around the risks and gains of alternatives.

Which of the following issues would deter you most from investing in 'alternatives'?



Many alternative assets come with an additional 'hassle' factor: a need for specialist knowledge and hands on management. This may lead to more joint ventures with niche investors, but as our examples on page 26 illustrate, the anomalies of the alternative sector need not automatically dissuade traditional investors.

Alex Jeffrey, Chief Executive, M&G Real Estate, believes 20% of its property holdings will be in alternatives in five years.

Interview

Chris Taylor, Chief Executive Officer, Hermes Real Estate

Urbanisation, infrastructure and technology have rarely formed part of the property fund manager's lexicon. But for Hermes they are key drivers behind its continued push into central London transport hubs and, more recently, regional cities with excellent transport links and the residential sector.

With £6.5bn of assets under management, and a progressive approach to investment that has seen it as a principal backer of Argent and MEPC, Hermes' influence has always stretched far and wide.

Now, having researched how urbanisation is growing, Hermes is betting on the growth of city centres and pulling back from the traditional business park out of town, unless there is a demonstrable economic driver such as biotechnology at Milton Park, Oxford.

This means it is backing major office development schemes in Manchester, in partnership with the Co-Op for its NOMA project and through Argent at Paradise Circus, Birmingham, and at Wellington Place in Leeds (through MEPC).

At the same time, it has put MEPC's relatively mature business parks in Basingstoke, Warrington and Hillington near Glasgow up for sale for £400m as it focuses the organisation's efforts on technology-related parks like the emerging £500m Silverstone Technology Park, and continuing to expand the hugely successful Milton Park.

Taylor says: "We are increasingly positioning our portfolio around key cities. When we were discussing terms with Google to lease space at [Argent's] King's Cross, it was clearly the case that it favoured a city centre location with world-class infrastructure, heritage, culture, education and access to a deep pool of labour. We could offer this environment at the 67 acre King's Cross development.

"This leads us to believe that the traditional business park will become a bit passé and will need to reinvent itself."

"At the same time, while nothing has been built for the best part of a decade, we can also see demand for Grade A city centre offices coming back."

The growth of urbanisation is also stimulating Hermes' growing interest in residential.

"If you were the man from Mars you would ask why we haven't got a greater investment in residential", Taylor says, pointing out that the total returns from residential have outperformed commercial property on an annualised basis since records began.

But for Taylor the appetite isn't luxury development, where demand can turn on and off according to global conditions, but in affordable housing where there is an urgent need for supply. Taylor is arguing for parts of London to be more clearly zoned for affordable housing, and points to likely Crossrail Two station, Tottenham Hale, as a typical location where Hermes has holdings that are ripe for development.

Understanding urbanisation trends also, Taylor argues, helps Hermes better understand tenants' occupational needs. "Why is Google coming to King's Cross?" he asks. "Because London can offer the widest talent pool in Europe. By bringing together these key investment themes, we are able to ensure sustainable property investment strategies for our clients."

"The traditional business park will become a bit passé and will need to reinvent itself."

Which alternative?

Almost all of the various types of alternative investments were of interest to our respondents. The only exception to this was social housing – the majority of respondents were either neutral or negative. This is unsurprising given the crackdown in welfare policies and the regulatory changes which mean that private agents now run the risk of payment default. Factor in the inherently low margins as well and it is perhaps understandable that social housing is an alternative too far.

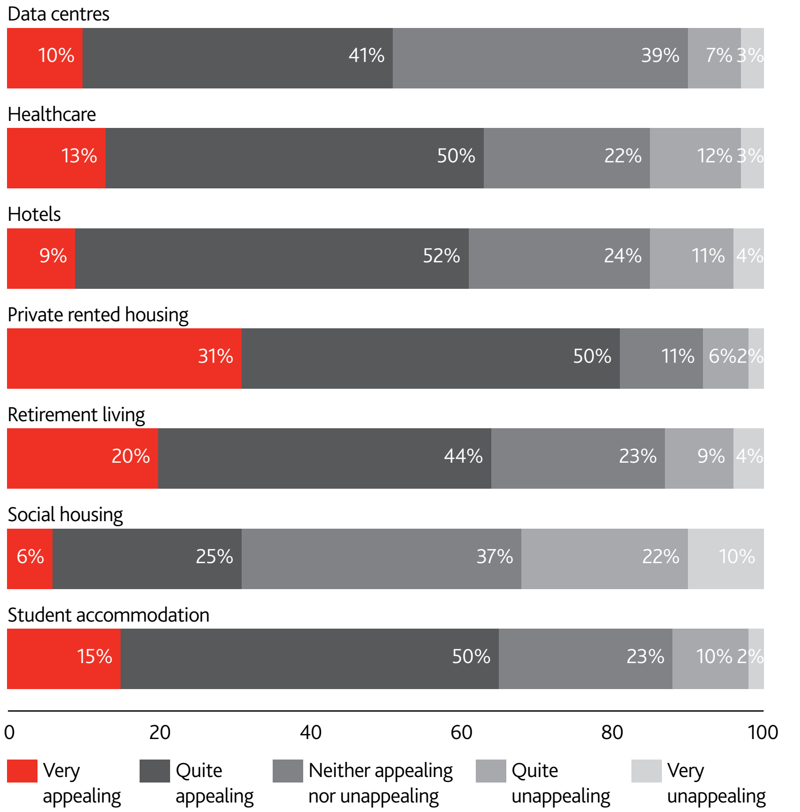
Conversely, the most popular asset class is the private rented sector (PRS) – 81% of respondents think PRS very or quite appealing. Increased house prices, stagnant wages and tightened lending make PRS an expanding market.

Social change is also creating interest in other alternatives. The ageing population makes retirement living an obvious opportunity and 64% of respondents find this appealing. 63% of investors identify the healthcare sector as very or quite appealing. This is likely to be due to demographic changes, the introduction of market forces into the NHS and the growth of the private health sector.

Student accommodation has demonstrated resilience through both the recession and the introduction of tuition fees. With EU and international student acceptances set to rise over the next five years, investors are increasingly attracted to this sector due to competition amongst students for places to live.

Increased house prices, the ageing population, world-renowned universities; these are all contributing to a new UK property patchwork.

Within the context of the UK, how do you view the following 'alternative' asset classes?



Interview

Rob Mills, Partner & Rob West, Partner, Clearbell Capital

Clearbell Capital has a healthy appetite for 'alternative' property investments, but also has its eyes wide open to the potential pitfalls.

The investment management group headed by Manish Chande evolved from Mountgrange Investment Management, seeing the launch of its second fund, Clearbell Property Partners II, in 2013, a follow on fund from its £300m UK opportunistic fund, MoREOF.

It has already invested over £90m of the equity raised, including backing a stretch senior finance platform for residential developers in partnership with Blackstone, and is hungry for further opportunities to invest.

But it is also clear that Clearbell is taking a discerning approach. Partner Rob Mills says: "We have an appetite for looking at opportunities that others haven't considered. But the key question when you are investing outside core real estate is 'is this a real estate business or an operational business?'

"We have always been heavily focussed on real estate businesses, and don't stray into areas which we don't understand. Hotels are on the right side of the line for us; data centres are on the wrong side.

"We see a big obsolescence risk in data centres – what happens if technology changes once again? – and you are mostly selling power, not square feet.

"Healthcare and retirement homes have demographic issues in their favour, but for us the reputational risk is against them."

Clearbell's regional appetite is strong: West says: "On the commercial side we think it's very attractive. There has been a complete lack of development in many big cities over recent years."

The team bought Glasgow city centre's former Odeon cinema site through their first fund, MoREOF in partnership with M&G, and with full planning consent for 143,000 sq ft of offices is seeing "the size of the pre-let discussions getting bigger as supply is getting smaller."

West says Clearbell is also actively pursuing logistics development, with retailers needing to rethink their supply chains on a local, regional and national distribution level. The firm is focusing on meeting the 'last mile' challenges faced by retailers and distributors as customer needs evolve, outpacing current supply. There are opportunities throughout the UK where there is tight supply.

Having made a commitment to Glasgow, their favoured locations for new opportunities now would be Fringe London, Manchester and Leeds. Reading, which is "on the cusp of a major transformation through Crossrail" is amongst others knocking on the door.

"We see a big obsolescence risk in data centres – what happens if technology changes once again? – and you are mostly selling power, not square feet."

Interview

Richard Bains, Partner, Rockspring

"My gut feel is that this cycle has three or four years to run. In two years the chances of a downturn are pretty low, but in five years it's more likely. We always think the cycles have ended, but they haven't."

Richard Bains and the team at fund manager Rockspring should know, as they are currently celebrating 30 years as some of the shrewdest readers of the property market.

So shrewd in fact that Rockspring was among the first out of the traps in 2009 to spot a disconnect between long-term trends and the collapse in values that the UK market had seen at that time.

It made the first investment in its UK Value series in February 2010, when many were still licking their wounds, but Bains says: "The frustration of UK Value One was that we didn't launch it earlier – the ideal timing would have been 12 months prior."

Rockspring struck boldly out into the UK regions through its first UK Value fund, by ploughing 45% of its capital into shopping centres and 35% into higher risk offices.

While regional shopping centres were seen by many as risky at the time, there was method in Rockspring's approach, with the steady income from locally dominant retail offsetting any risk from voids in the offices portfolio.

While many wrote retail off at the time, investor demand across the UK has now well and truly returned, with Bains citing a recent competitive offer for a centre in Cumbria's Workington attracting up to 10 bids.

He also likes regional offices: "They are trending more. Occupational markets are tightening, with tenants being squeezed, and space is still very affordable over a 20 year view." Rockspring is in the process of funding a speculative scheme in a major regional city, which, he says, would still be off the radar of many institutions who won't stray beyond the South East.

Rockspring has an interesting take on Manchester, remaining wary of the grip the powerful landlord Bruntwood has on the city. With a large swathe of the city's offices under its control, and the ability to move tenants around its estate, it can be more appealing for newcomers to look elsewhere.

A key candidate for Rockspring is Aberdeen: "We are big fans," says Bains. "It is very affluent, and there's a huge battle for staff. Because of this everyone needs to offer good office space."

"A 'Yes' vote for independence could mean a couple of years when the market is very turgid, but if anywhere bounces back quickly it would be Aberdeen."

Scottish breakaway?

Approaching the referendum on Scottish independence, we were interested to see how investors would view a break with the UK.

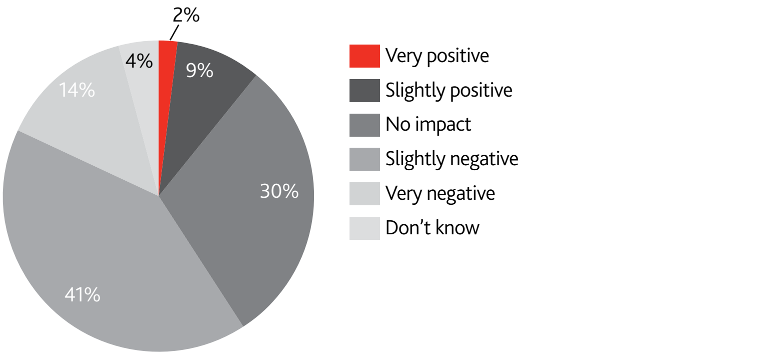
Polls indicate that the political mood is shifting towards the independence movement, suggesting that, even in the event of a 'No' vote, we will see further devolution from Westminster. Few business leaders or economic commentators have shown support for Scottish independence and our survey is no different. In fact there is a clear message: independence will be damaging to the Scottish real estate market.

Not a single respondent said they would be more likely to invest in an independent Scotland. Indeed, recent figures show trading in Scottish real estate has already dropped to just 62% of its peak volume compared to a still healthy 87% in the UK market as a whole. Our research confirms that Scottish independence would have limited impact on the rest of the UK real estate market.

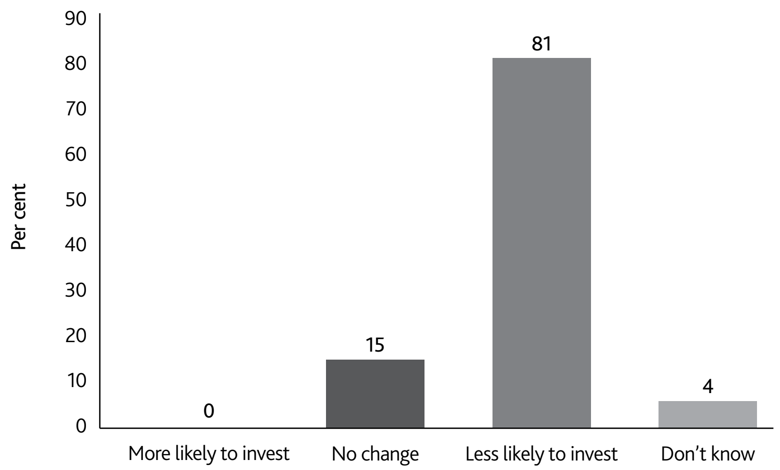
For the Scottish economy to quickly absorb the consequences of full devolution, any newly independent government would have to work swiftly to iron out uncertainty around the currency and membership of the EU. Even if Scotland stays within the UK, it will need to react decisively to restore investor confidence.

> "If Scotland goes independent you could better make the comparison with Ireland in property terms."
> Nigel Hugill

What impact do you think Scottish independence would have on the UK commercial real estate market?



How do you think an independent Scotland would affect your investment appetite toward Scotland?



Political priorities

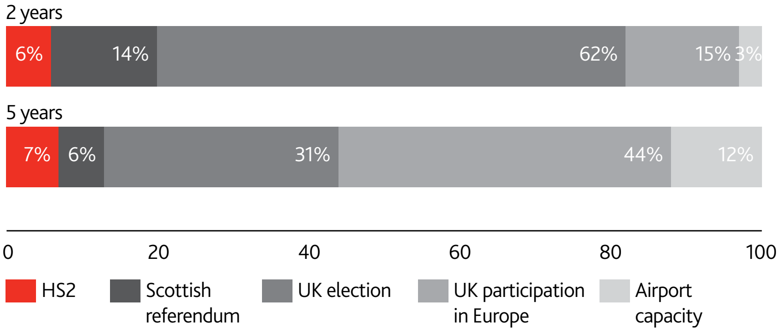
The UK's political destiny is a major concern for investors. With the outcome far from certain, 62% think the UK general election will have the biggest impact on their decisions in the short term.

The results of the EU elections in May 2014 suggest that political concern is due to intensify. Buoyed by its success, the UK Independence Party is set to drive the electoral debate to focus on the UK's relationship with the EU and its immigration policies.

In our 2013 survey, the risk of the UK leaving the EU was frequently (55%) cited as a challenge to business. This concern continues in our current survey: the most significant decision over five years, according to our respondents, will be the UK participation in Europe. Any decision about a referendum in 2017 is eagerly anticipated by investors, many of whom believe it is essential the UK remains a member of the EU.

Despite the media hype, only 3% of respondents said airport capacity would influence their investment decisions in the short term, although this rises to 12% in the medium term.

The outcome of which one of the below will most affect your investment decisions in the UK over the following time periods?



Interview

Anthony Shayle, Head of Global Real Estate – UK Debt, UBS Global Asset Management

"High-speed rail increases economic activity and as a result, national and social mobility. In a macro-economic sense it can only add to what Britain has to offer overall."

After launching a debt fund in December 2013 which will, when fully invested, have put £350m to work, Anthony Shayle is looking for a healthy return.

He is also not afraid of exploring different avenues in real estate: "I'm not afraid of new; I am afraid of assumptions that 'core' and 'prime' are always best. Trying something new, supported by research, doesn't scare me."

For Shayle and his debt fund, both the City and West End are at eye-watering levels, and he cites a sale in 2013 of a retail unit in Bond Street at a 2.3% initial yield.

Like many interviewees for Nabarro's research, Shayle doesn't criticise buyers for paying these prices: but with different targets, they are just not for him.

He does question, however, whether rental growth will justify these transactions on commercial real estate, and believes that central London residential development is now "testing the fullness of the envelope".

Shayle surmises that developers who are quoting £2,000 per sq ft prices for a 1,000 sq ft flat would need to generate a rental income of up to £5,500 a month simply to achieve a 3% yield. Even if investors can afford to pay these prices, will there be enough people to rent them subsequently?

So for Shayle the answer lies in a healthy appetite for the regions and alternative asset classes.

He is willing to lend against residential in the regions and on office development in core locations outside London where there is good demand.

"My watchword is 'if it's good enough to own, it's good enough to lend against'. I never want to be embarrassed owning a property if that situation needs to arise."

He is also interested in lending against central London hotels, data centres, care homes, student accommodation and retirement living, and can see 'alternative' sectors accounting for 25% of his portfolio over five years.

He is a fan of Birmingham, with its strong, defined tenant population and established Central Business District. As an advocate of the city, he is also keen to see its biggest future driver of tenant demand – High Speed 2.

"High-speed rail increases economic activity and as a result, national and social mobility. In a macro-economic sense it can only add to what Britain has to offer overall.

"But the property market impact of HS2 is more complex. Will it erode tenant demand in London? I can't see financial services ever moving too far from the capital."

Investing in alternatives – the legal angle

We've talked about the specialist nature of the alternative sector and here are some examples of assets that certainly fall into this category.

HOTELS

Whilst leases may form the cornerstone of the UK investment market, they have become increasingly rare within this sector as more and more operators insist on hotel management agreements (HMAs).

HMAs typically run to a hundred pages with many of the big hotel names insisting on their own standard form. That said, there are common themes in all HMAs and with skilful negotiation, it is possible to find common ground between the owner and operator. A detailed explanation is beyond the scope of our report but here is a flavour of the type of issue that will be encountered:

Fees – Investors value the certainty of fixed rental income but this should be balanced with the greater returns often achievable from a well-managed hotel. The operator's remuneration will generally be a combination of base and incentive fee linked to operating profit. As an expense of the business, this will reduce profits distributed back to the owner but encourage the operator to perform well thereby increasing revenue, in theory creating a 'win-win' situation.

Repair – An HMA couldn't be further away from the UK's much cherished FRI lease. An operator will expect the owner to provide working capital whether for fixtures, fittings and equipment (FF&E) (often financed by a percentage of gross revenue being placed in a specific fund) or ad hoc capital improvements. Given that hotels make heavy use of FF&E and operators often have high 'brand standards' this can have a significant impact on returns and should be factored in at the appraisal stage.

Employees – It surprises many that the operator will require the owner to employ staff (albeit that the operator will have day-to-day control of them). Even with appropriate indemnities to manage the risk of this, it still causes issues for certain investors. On a recent transaction, the engagement of employees breached an owner's banking covenants. On another, it went against a pension fund's constitution. Careful consideration needs to be given to these sorts of issues at the outset.

Hotel investments with HMAs may not have classic 'triple net'/FRI characteristics, but with the right asset, operator and commercial arrangement can often deliver superior returns for investors.

RESIDENTIAL

Institutional investors are now seeing the attractions of the private-rented sector and are putting their skills and funds behind PRS and in support of the UK's housing needs.

That said, few of the schemes coming forward now are purely residential. They are often mixed-use schemes driven by planning requirements, the desire to create more cohesive and integrated communities and not to repeat the mistakes of the past.

From a legal perspective UK residential property is subject to a patchwork of legal protections that have been created piecemeal and are often conflicting. Knowing which laws relate to each type of tenancy can be crucial to achieving long-term goals. There are a number of legislative pitfalls, for example, it may be a criminal offence to sell a building without first offering to sell the whole building to any qualifying tenants.

It is important to plan ahead. Key to success is appropriate structuring and flexibility to create a liquid asset (perhaps to allow for the sales of affordable units to a registered provider; commercial elements to a commercial investor; and the income-stream from long-lease residential ground rents) whilst balancing the tax implications and practicalities of managing a dynamic mixed-use estate. By planning an exit strategy at the drawing-board stage, investors avoid falling foul of these pitfalls whilst, at the same time, complying with legal obligations.

STUDENT ACCOMMODATION

Over the past few years we have seen a dramatic increase in activity in this sector, particularly in the major university cities (e.g. London, Manchester and Edinburgh).

One of the major challenges for developers of student accommodation is VAT recovery. As with any residential property subject to short lettings, recovery of VAT incurred on site acquisition and development can be blocked, unless additional structuring is implemented. This will often involve the grant of a lease of the completed building to an entity in the developer's group, which will then grant assured shorthold tenancies to students and/or enter into nomination agreements with local universities. This lease allows the developer to recover the VAT incurred on development and is a common method to maximise returns. It's worth bearing in mind that the existence of the lease can limit the availability of SDLT relief for a future buyer. Developers will need to balance the VAT recovery benefit against any buyer's expectation of an SDLT saving.

Another potential pitfall for investors in student accommodation is the impact that summer lettings can have on VAT recovery. Although the rules have been relaxed recently, it is still often the case that lettings of student properties during the holiday periods can trigger VAT charges for the owner. This is an area where the precise terms of the planning permission and any use restrictions can have a direct bearing on the VAT treatment. Reviewing the planning consents and historic VAT treatment will be an important part of the due diligence process for any investor in student property.

The Government's recent announcement of an extension of UK capital gains tax to offshore owners of residential property has caused concern in the sector, as the Government indicated that the extension would cover certain types of purpose built student accommodation. Key players in the industry, along with the British Property Federation (through its student accommodation committee), are lobbying hard against this as clearly the application of UK CGT to gains realised on these assets will have a dampening effect on investment in the sector as a whole.

HEALTHCARE

The last 12 months has seen a rapid expansion of investment at the mature end of the UK Healthcare market led by the US Real Estate Investment Trusts. After a long run of buoyant returns, share prices, and successful corporate acquisitions in their home markets, the US REITs have diversified overseas to find new markets to continue their growth and performance. They invest in care homes; retirement villages; private hospitals and primary care health centres and are becoming familiar with UK NHS payment structures.

Private equity interest also remains strong with increased investment into healthcare services, social care services, pharmaceuticals and medical technology.

The banks are also back and we are seeing an increasing willingness to invest again across the sector but driven by business cash flows and operator covenant strength.

More and more investors are seeing the opportunities in the £105bn UK market, which is highly regulated and increasingly political, but where the fundamental attributes remain strong. We help investors and operators recover from the over leveraged propco/opco deals of the past with legal restructuring of their public and private portfolios at asset and fund level. We are also seeing recovery in development finance, healthcare sharia finance, a booming healthcare bond market and the forward funding market is also very active.

Speak to one of our experts:

Mixed Use
Deborah Parry
T +44 (0)20 7524 6317

Student Accommodation
Nick Collins
T +44 (0)20 7524 6290

Healthcare
Candice Blackwood
T +44 (0)20 7524 6726

Hotels
Clare Thomas
T +44 (0)20 7524 6906

Tax
Kirsten Prichard Jones
T +44 (0)20 7524 6581

NABARRO
CLARITY MATTERS

Nabarro offices

London
Lacon House 84 Theobald's Road
London WC1X 8RW
T +44 (0)20 7524 6000

Sheffield
1 South Quay Victoria Quays
Sheffield S2 5SY
T +44 (0)114 279 4000

Brussels
209A Avenue Louise 1050 Brussels
Belgium
T +32 2 626 0740

Singapore
Marina Bay Financial Centre Tower 3
12 Marina Boulevard 35-01
Singapore 018982
T +65 6645 3280

Dubai
Level 15, The Gate Building
DIFC
PO Box 506873 Dubai
United Arab Emirates
T+971 4401 9810

You can find out more about us at:

www.nabarro.com
Twitter: @nabarro
LinkedIn: nabarro-llp

About Nabarro

We are a major commercial law firm renowned for our positive and practical approach to our clients' business needs. Our commercial real estate group has an unrivalled reputation for advising on the largest and most complex UK and European real estate transactions and investment for some of the world's most significant investors, developers, funders, occupiers and advisers. Our team consists of more than 200 real estate lawyers, well known for being specialists across the whole real estate life cycle, from financing, acquisition and planning to development, investment and sale. Our market leading teams also specialise in funds and indirect real estate, environment, construction, litigation and tax.

Our real estate practice is highly ranked in Chambers and Partners and Legal 500.

The firm's headquarters are in central London with offices also in Sheffield, Brussels, Dubai and Singapore. For cross-border work we draw on longstanding relationships with a network of selected firms worldwide, with strategic alliances with partner firms GSK Stockmann & Kollegen in Germany, Nunziante Magrone in Italy and Roca Junyent in Spain. More information can be found at www.nabarro.com.

About FTI

FTI Consulting is a global business advisory firm that provides multidisciplinary solutions to complex challenges and opportunities.

We are advisers to 64 of the world's 100 largest companies, 89 of the world's top 100 law firms and 9 of the world's top 10 bank holding companies.

With more than 3,800 professionals located in most major business centres in the world, we work closely with clients every day to address complex business challenges in areas such as business strategy, litigation M&A, policy and regulatory issues, reputation management and restructuring.

Property and Infrastructure capabilities at FTI Consulting includes over 400 professionals who are committed to protecting the enterprise value of our clients.

We deploy property and infrastructure experts from every major financial centre to every corner of the globe so that we can serve our clients wherever challenges arise.

www.fticonsulting.com

@FTI_EMEA

1977