UK Real Estate:
Riding the Wave

Report

UK real estate: opportunities, trends and politics

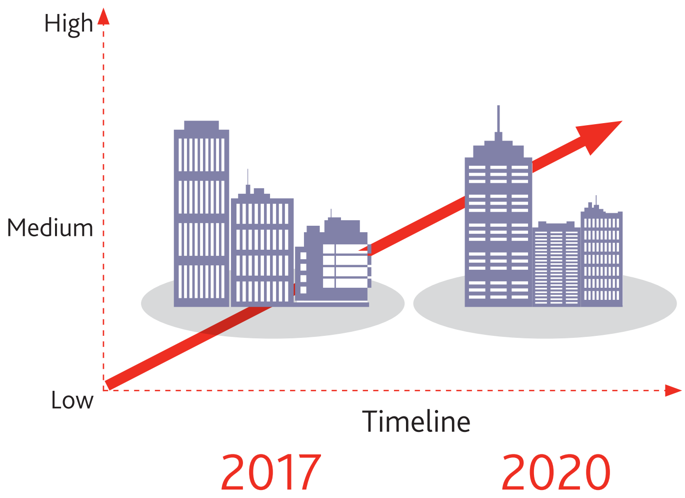
Post-election, the UK now has the certainty of a majority government and it's a buoyant time for the real estate market. This is opening up exciting opportunities in our industry, but we now face new questions about our future in Europe and further political change in Scotland. Which trends will shape UK real estate over the next five years and will the current optimism continue?

Portfolios worth more than £400bn

Our **271** survey and interview respondents are together responsible for portfolios worth more than **£400bn.**

Levels of optimism

Chances of a downturn



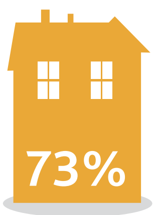
77% are more optimistic about the UK real estate market compared to last year.

74% feel the chance of a UK real estate downturn within two years is low or very low.

However, this changes in the longer term. **85%** feel there is a medium to high risk of a downturn within five years.

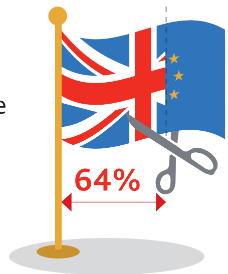
Red hot real estate

73% find residential property to be appealing/very appealing for investment. Overtaking industrial and logistics, it is second only to offices.

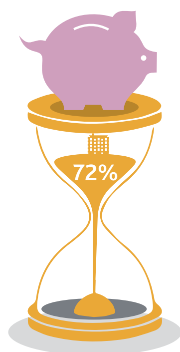


The European question

64% of respondents believe a UK exit from the EU will have a negative effect on UK real estate.

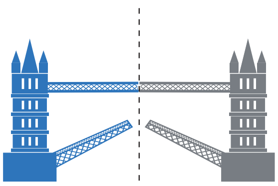


Despite the uncertainty, **72%** will not delay their investment decisions ahead of the referendum.



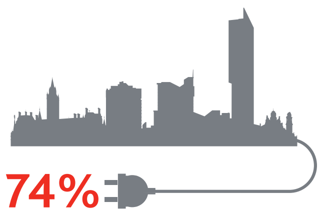
The UK picture

When it comes to London real estate, respondents are evenly split over whether it's fairly valued or over-valued.

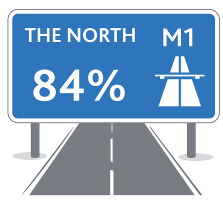


65% are less likely to invest in Scotland as a result of the rise of the SNP, making it a bigger negative factor than the EU referendum.

74% see the devolution of further powers to major UK cities as positive or very positive.



The real estate market is behind the Government's Northern Powerhouse Initiative. **84%** believe it will have a positive or very positive effect.



Regional players

Manchester's popularity continues to soar with **79%** singling it out as the most appealing regional city. Birmingham follows with **52%**.

Manchester

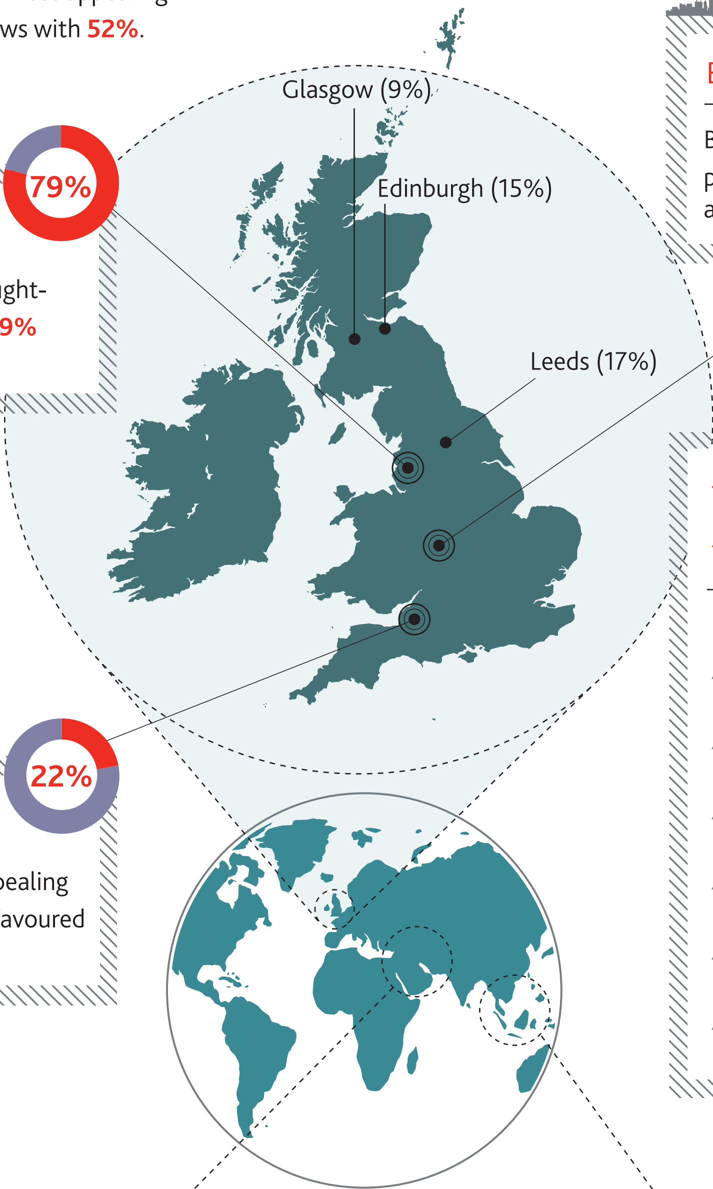
79%

Manchester is the most sought-after regional centre with **79%** preferring this location.

Birmingham

52%

Birmingham is the second most popular with **52%** finding it an attractive investment prospect.



Bristol

22%

Bristol is the third most appealing with **22%** choosing it as a favoured investment prospect.

The top 6 "cities or towns to watch"

- Cambridge
- Reading
- Liverpool
- Newcastle
- Oxford
- Sheffield

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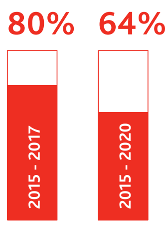
Overseas investment

Of the major geo-political factors affecting UK real estate, terrorism and escalating conflict in the Middle East are the most pressing concerns (**33%** and **25%** respectively).



80% predict that global investors will be more acquisitive than UK investors in the medium term, although this drops to **64%** in the longer term.

62% of respondents see Asia as the top region for UK inward investment and it is expected to be one third more acquisitive than the Middle East.

How optimistic are you?

To explore the opportunities in UK real estate, contact Nabarro's expert legal team.

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About the research

Nabarro, in conjunction with FTI Consulting, created and ran a poll of 263 property investors, developers and agents, and conducted eight interviews with leading market figures. Those surveyed and interviewed have combined assets worth more than £400bn.

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 and former Editor of Property Week, undertook the in-depth interviews during May 2015.

Surfer’s paradise

With the economic tide firmly in the UK’s favour, there are substantial waves of capital available in the market. Nabarro’s third thought leadership report *“UK Real Estate: Riding the Wave”* considers the current buoyant conditions and the undercurrents that may alter the balance.

Our latest market analysis draws on a survey of 263 property professionals and interviews with eight key market players controlling real estate portfolios worth over £400bn. Our research shows a very positive outlook, with 77% of those polled more optimistic than last year and 74% expecting the strong market to continue for at least another two years.

Overseas capital continues to flow into UK shores, but our research identifies a shift in focus to Asia with 64% predicting it to be the main source of future UK investment; this supersedes the Middle East which led two years ago in our first report *“Global Investor Appetite: Who’s Hungry for UK Real Estate?”* Falling oil prices are clearly affecting investors’ view of this region.

Almost half those polled think London is fairly valued and see opportunities there, particularly in fringe areas. However, continuing the trend highlighted in our 2014 report *“Growing Opportunities: A New Outlook for UK Real Estate”*, investment is also flowing to dominant regional centres. Manchester and Birmingham continue to lead the pack and the tech boom means that Cambridge and Oxford have now joined as cities to watch outside of the “Big Six”.

In 2013, our report reflected a mood of financial uncertainty as the UK emerged from recession. Two years on, we face a different uncertainty, this time largely political. The general election provided the conviction of a majority government. However, a Conservative term raises questions about Britain’s future in Europe and emphasises the political divergence between Scotland and the rest of the UK.

81% of investors told us in the run-up to the Scottish referendum that they would be less likely to invest in an independent Scotland. Despite the “no” vote, this year 65% still are less likely to invest because of the rise of the SNP. In contrast to what happened ahead of the Scottish independence vote, the majority of those polled would not delay investment decisions due to the forthcoming EU referendum, with most experts discounting the likelihood of a Brexit. Whether this changes as the poll nears remains to be seen. The market is decidedly against a break, with 64% saying it would be bad for UK real estate.

Our survey provides a fascinating snapshot of a market awash with opportunities, rounding off a trilogy of vibrant reports over the past three years (details on page 30). We’d like to thank all those involved, in particular our interviewees whose views have added colour to our research. To take advantage of the current “surfer’s paradise” for UK real estate, please get in touch with our expert legal team.

Ciaran Carvalho.

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

Interview
Bill Hughes, Head of Real Assets, Legal & General

"I'm optimistic because I sense the universe of opportunities for property investment is expanding in proportion to the amount of money available. Increased interest in investing in property related to social infrastructure is a trend that will manifest itself more."

When Bill Hughes's role was expanded from Head of Property to Head of Real Assets at Legal & General last year the fund manager was at the forefront of the trend he pinpoints.

With growing interest in long-term, stable income and an increasing desire to invest in improving national infrastructure, fund managers like Legal & General are growing into residential property through the Build To Rent sector and other fields like healthcare, as well as other forms of social and economic infrastructure such as renewables.

For Hughes this trend will help to act as an escape valve, helping to ensure that property prices don't rise to stratospheric levels.

London, he believes, is fairly valued, but he continues: "It's become very commonplace for people to generalise about London, and that's dangerous. Very prime retail is stretching valuations, and it is clear that prime office investments are being over-bid.

"However, for regeneration opportunities there is tremendous potential: we have recently let buildings in Shoreditch at £60 per sq ft which would have been leasing at £20 per sq ft five years ago."

As well as "alternative" property or infrastructure assets, Legal & General has also set the pace in diversifying out of London and, when asked which two core cities outside the capital he favours most he names Birmingham and Bristol.

"Birmingham as an early High Speed 2 station is already shaping investment thinking, while Bristol has great regeneration potential with electrification of the rail connection and the arrival of its Arena alongside local infrastructure improvements." Hughes also sees strong potential in Leeds and Newcastle.

On asset classes to watch, he not surprisingly names healthcare as appealing as private capital becomes more involved with supporting the NHS, and says that we have reached a "tipping point" in terms of the Build To Rent sector becoming an established asset class.

But Hughes also cites logistics as a sector to watch, due to the way that it cannibalises the role of traditional retail by offering retailers the opportunity to send goods direct to people's homes.

Hughes also sees some clouds on the horizon, and says the chances of a property market downturn within the next two to five years are at a "medium" probability, with the most likely disruption being caused by a shock rise in interest rates.

While he finds it hard to see an immediate reason for interest rates to rise, Hughes does believe that the impact of a rise in base rates of up to five per cent would have a "material impact" on the economy.

Likewise, he says a rise in interest rates would have a more significant impact on the UK's prospects than a Greek exit from the European Union, a significant oil price rise or even a British exit from the EU. This scenario would be "slightly bad, but could be nearer neutral, depending on the terms of our exit".

For its part, Legal & General remains committed to the UK, and won't imminently be investing in other markets abroad: it positions itself as an expert in local markets and, by diversifying its portfolio believes it can still find plenty of opportunities within the UK.

Right now, Scotland is causing Hughes some concern, and on the prospect of growing devolution or even independence he says: "The Scottish National Party needs to understand that political reasons for creating change in Scotland will materially affect investors' thinking.

"Scotland must not make itself appear too different as an investment destination." And on devolution to English cities? "Well-enacted localism is a positive, and good governance can make this work. But equally, with poor governance there is a danger of a policy vacuum."

A swell of optimism

The UK real estate market in the summer of 2015 is divided between those who believe in a new economic paradigm leading to a long-term boom, and those who believe disaster still lurks around the corner.

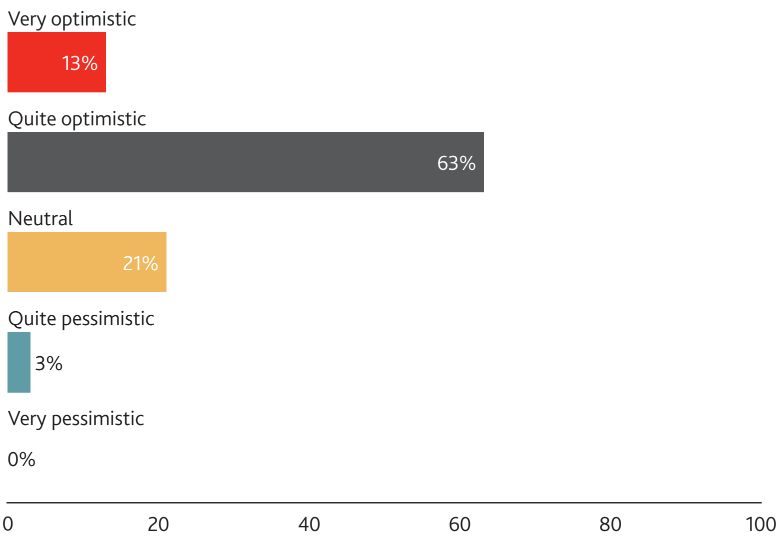
Some consider that low interest rates create an unbeatable arbitrage between yields on property investment and rival investments like government bonds; there are others who stand by the inherent volatility of the property market.

The participants in the 2015 Nabarro poll, however, are mainly in the optimistic camp, with more than three-quarters either optimistic or very optimistic about the market's prospects.

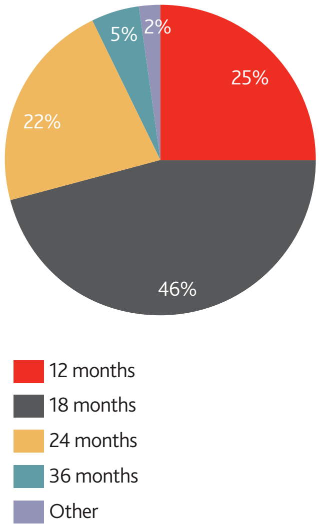
This is a mood which appears to be in line with other sectors. For example, the construction industry has enjoyed a post-election bounce with confidence levels now at their highest since 2006. Even the UK's slip into deflation, rather than concerning economists, has resulted in consumer confidence almost returning to where it was before the financial crisis.

However, with interest rates certain to rise one day, and the European Single Currency as shaky as ever, could this prove to be the high water mark of the current boom?

Compared with 1 year ago, how optimistic do you now feel about the UK real estate market?



When do you expect interest rates to rise?



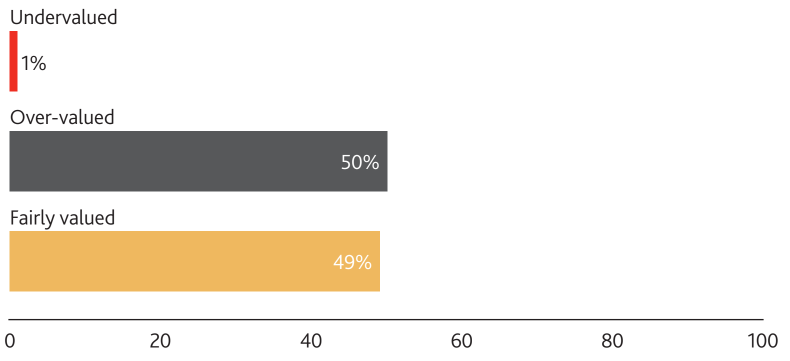
London: surf's up!

London's prospects inevitably dominate discussion, with half of respondents seeing the capital as over-valued as billions pour in from mainly overseas investors.

According to PropertyData, £15.5bn of commercial real estate had been traded in London in 2015 by 5 June, at an average yield of 4.76%. This compares with £26bn in the whole of 2014, at an average yield of 4.87%. Given that the second half is traditionally stronger for the property investment market and that yields have edged in, this indicates that the market is continuing to strengthen.

In 2015 rental records for both the City and the West End have been broken. At 8 St James's Square, Green Property leased the 3,000 sq ft top floor of the new development to Helly Nahmad Gallery at £185 per sq ft, and British Land and Oxford Properties achieved a new City record at The Leadenhall Building (aka The Cheesegrater) by leasing 6,600 sq ft to Affinity Shipping at £90 per sq ft.

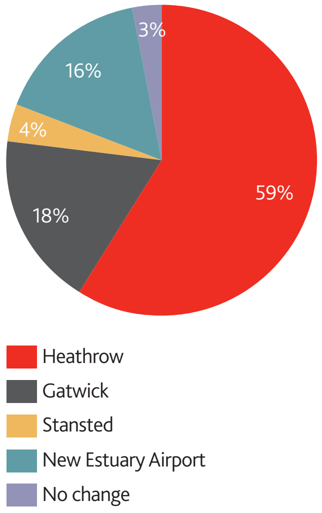
What is your current view of the London real estate market?



With the central London market hot, many believe that by turning to development and refurbishment opportunities in fringe areas there are still good returns to be made. The International Quarter, a £2.1bn development on the former Olympic site at Stratford, is a good example.

Meanwhile, with inadequate airport capacity, London's status as a global city may come under threat. The need for expansion is a pressing issue. Whilst the Davies Commission is due to report this summer there is concern over speculation that ministers will not respond to its recommendations until late in 2015 or early in 2016.

What would be the best option regarding airport expansion?



In one of the year's biggest pre-lets **425,000 sq ft** was recently secured by the Financial Conduct Authority for its new HQ in Stratford.

Interview
Hideto Yamada, Managing Director, Mitsui Fudosan (UK)

Mitsui Fudosan has built up a strong portfolio of London projects, ranging from the £800m Television Centre White City development, in partnership with Stanhope, to a number of City and West End office buildings.

Whether it is providing new residential units, studios for the BBC at White City, or building in the heart of the City at Moorgate or Mark Lane, Mitsui has become an established part of the London development scene. Its current projects will cost £1.3bn and have an end value of £2bn.

Its UK Managing Director Hideto Yamada is well-placed to discuss trends among UK and overseas investors. He is cautiously optimistic, but foresees a rise in interest rates in 18 months because "at some point we will have to tighten such an extremely liquid market."

Asked if he views the UK market positively or negatively, Yamada replies "neutral".

"The market has been hot since 2010, and since 2013 the occupational market has been strong as well. Rents have been moving up and we are now at a good level, but we can still see growth for a year or two. But we are coming to a high point in terms of values."

He believes London is "fairly valued", but aside from a project in the capital's satellite city, Reading, Mitsui doesn't invest in other cities in the UK. As a global player it deploys the 30% of the capital it spends outside Japan in "gateway" cities like New York, San Francisco, Shanghai and Singapore.

Asked what real estate sectors Mitsui favours, Yamada explains that its focus in developed countries like the UK is on offices, where it foresees growth in creative industries, biotech and IT. Its White City project, for example, will play on links to Imperial College nearby.

In the Asian market Mitsui invests more in shopping centres and residential, where rapid consumer spending and population growth is driving demand in both sectors.

Yamada expects more investors to arrive from Asia for two reasons: Far Eastern investors have an affinity with the UK market due to historic links; they also relish the liquidity of London, which allows them to access prime property at transparent prices.

He believes that to maintain Britain's competitiveness, infrastructure investment is important, and favours an expansion of Heathrow above other options for increasing airport capacity.

As a global investor, Yamada's views are pertinent: "Everyone from a business point of view prefers an expansion of Heathrow. It has good connections with Europe, but also cross-continent, and airport connectivity to us is vitally important.

"As a global player we look at ratings in different fields for all cities. London is well rated overall, but transport comes up as an issue. That's why we are big fans of Crossrail, which the Government was right to press ahead with despite its austerity plans."

He is also cautious about Britain cutting itself off from the world by exiting the European Union, believing that following a "Brexit" not only might manufacturing businesses hold back, temporarily, from investing in London, but also London could suffer a fall in its status and levels of office occupation.

Overall the message from Yamada is "London is strong and growing, Mitsui is a committed investor, but don't tamper with the successful formula."

"London is strong and growing, Mitsui is a committed investor, but don't tamper with the successful formula."

Positioning, timing and balance

As in our 2013 report, when it comes to asset choices, offices remain in first place. Traditionally offices are appealing to the overseas investor and this is now also bolstered by increasing occupier demand. Retail has grown in appeal, but remains the least attractive of the asset classes. Whilst recent IPD research found that the retail vacancy rate is almost half that of the all commercial property average and tenant default is below average, this is clearly having little impact on investor sentiment.

Our survey highlights the appetite for alternatives as part of a wider portfolio. However, how much longer before certain alternatives truly become mainstream?

The drive towards alternative real estate really started to gather momentum last year. In our 2014 report, interviewee Alex Jeffrey (CEO of M&G Real Estate) predicted that 20% of M&G's portfolio would be invested in alternatives over the next five years. In line with this, it recently acquired six Priory Group hospitals as part of a sale and leaseback transaction.

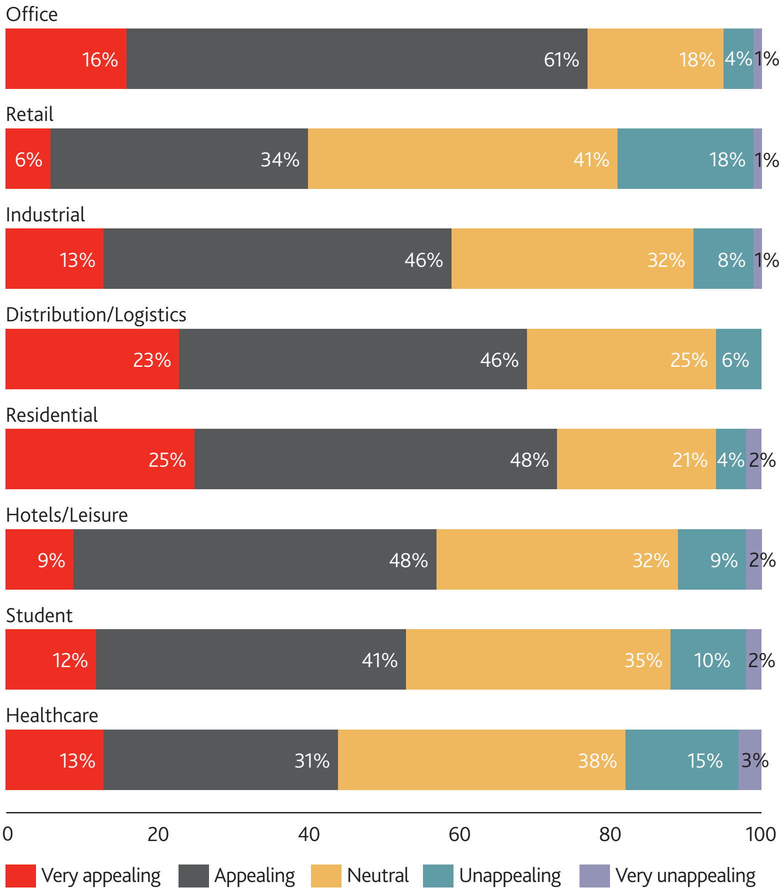
77%

find offices and

73%

find residential appealing or very appealing.

Rate the following asset classes on their level of appeal

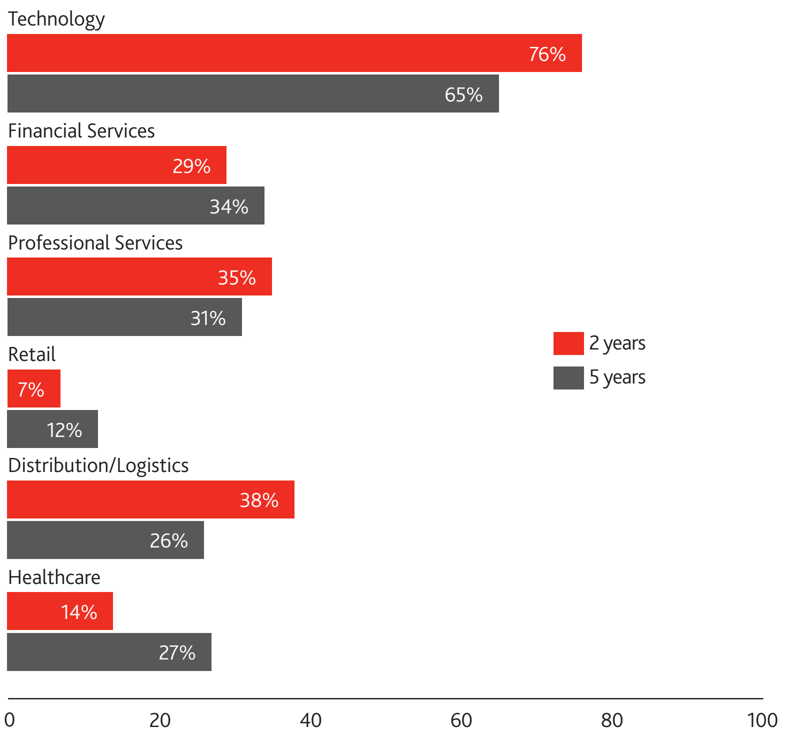


The residential sector continues to lead the alternative charge. Despite doubts over the prime residential market in London (with many believing that there is insufficient demand to take up the flood of £2m apartments planned), residential continues to appeal to investors due to the demographics in the sector's favour. London's outer boroughs and northern cities with a growing private rented sector market are also now catching the eye of investors.

2015 has so far been another strong year for the student accommodation sector. For example, in one of the largest student accommodation deals of recent years, Canada Pension Plan Investment Board acquired the Liberty Living UK student accommodation portfolio from the Brandeaux Student Accommodation Fund for £1.1bn.

> "For everyone logistics is proving difficult to buy. In the current retail revolution, moving goods around is a very good business to be in."
> David Partridge, Argent

Where do you see occupier demand coming from?



Future occupier demand is seen as coming most strongly from the technology sector (76%). Distribution and logistics come in second, which may account for the fact that 69% of respondents see investing in distribution and logistics as appealing or very appealing. Interestingly this is up from 35% in our 2013 survey, perhaps reflecting the growing impact of the internet revolution on this sector.

Interview

David Paine, Head of Real Estate Investment, Standard Life

Last year was a very good year for investment in real estate in the UK, so should investors have concerns about the prospects this year? It's a resounding no from David Paine, who has over £17bn of real estate assets under his management.

"I remain optimistic about the market. This year will be a good year but it will not be as strong in terms of performance as 2014 - but that is a reflection of the fact that we are moving further through the market cycle."

He cites rental growth as the deciding factor. "The capital side of the equation is still playing out as we anticipated so there will not be the same extent of yield compression as we saw last year. What we are seeing is rental growth, emerging as expected with the recovery underway, in a number of markets."

Paine sees the geo-political situation as one of the reasons London attracts so much overseas capital. "London is a global city that will attract investor flows. When there are uncertainties around you see more elevated levels of demand for what is one of the most liquid, transparent and low risk global markets. That has got a lot of appeal and makes it one of the most straightforward markets to deal in around the world."

But Paine is always looking for the right opportunity: "Many of our funds have UK wide mandates and have been moving out of London to the rest of the South East as well as regional centres around the country. So moving out of 'core London' has been a theme as we look to find value."

Standard Life is actively developing new stock and improving assets in regional centres and looking at a wide variety of asset types.

The appeal of regional markets can be enhanced where infrastructure improvements are being realised, and he sees Reading as a good example. "Once infrastructure commitments are made, there is a degree of certainty that things are starting to unfold and happen. Investors will respond fairly rapidly once the plans begin to crystallise in order to try to unlock opportunities."

One of the trends that has been a growing feature for real estate investors in the UK is "alternative real estate". This now represents 12% of the money that Paine manages. "This trend is underpinned by more of an outcome focus amongst investors in real estate with an allocation used for different things."

An example would be where real estate investors have sought out inflation protection and long-term high quality income streams. "You can get that in traditional UK real estate but you can also get that in student accommodation, in healthcare, in hotels and other segments. This outcome focus has broadened the appetite for a wide range of real assets. Other examples would be a desire to preserve capital or focus on growth."

Paine also wants the new Government to make a decision on the ongoing London airport debate:

"As I've already mentioned, infrastructure improvements can be major drivers of economic growth and investment will be attracted where there is greatest clarity. The Government, having evaluated the arguments, needs to take a decision which permits others to act."

"London is a global city that will attract investor flows. When there are uncertainties around you see more elevated levels of demand for what is one of the most liquid, transparent and low risk global markets."

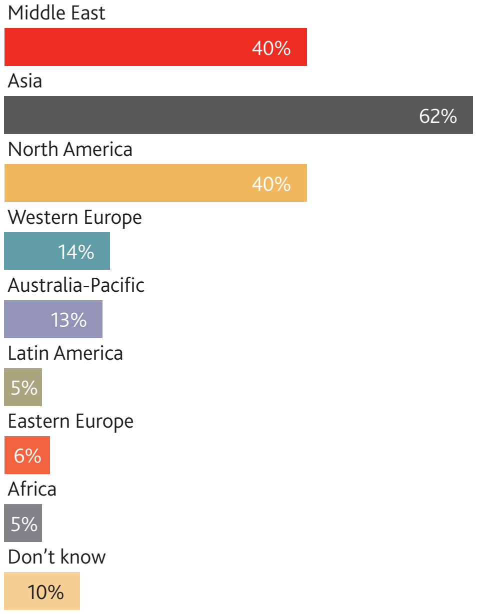
Inflows of capital

Soaring investment from Asia has dramatically altered perceptions of who will have the greatest appetite for UK real estate from overseas, compared with the poll we carried out in 2013. China's Dalian Wanda, Japan's Mitsui Fudosan and a plethora of other Singaporean, Malaysian and Indonesian investors are leading the way.

Two years ago, Middle Eastern investors were seen as the likeliest source for new overseas property investment in the UK with the impact of the Arab Spring increasing the attractiveness of the UK as a safe haven.

Those polled in this report appear to have doubts about the continuation of high levels of investment from the Middle East. The region was ranked top by 75% of respondents in our 2013 report but has dropped to just 40% this year. This is hardly surprising with the price of oil, its main source of income, falling sharply causing fiscal pressure on governments and casting doubt on sovereign wealth fund investment. That said, Middle East investors are still active in the market with, for example, Qatari buyers teaming up with Canadian investor Brookfield to buy Canary Wharf in the first half of 2015.

Which two regions will increase investment in UK real estate in the next 2 years?



80%

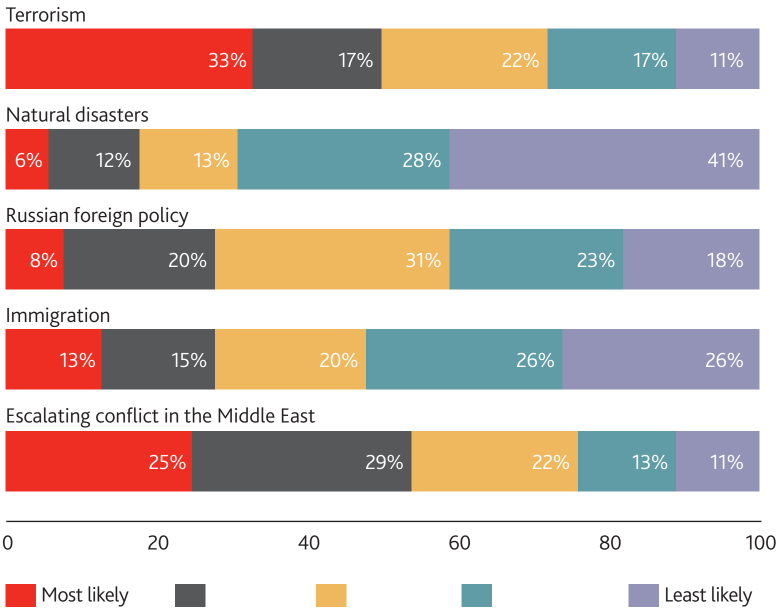
of respondents say that global investors will be more acquisitive in the UK market than domestic investors in the next 2 years.

Dangerous waters

Terrorism, and conflict in the Middle East have both had a major impact on the property industry for recent generations: the fallout from the September 11 terrorist attack affected the market badly in 2001, and the very severe mid-1970s crash was triggered by conflict in the Middle East. These remain our respondents' biggest geo-political concerns today by a significant margin.

Meanwhile, tension between Russia and the West is at its highest since the Cold War. If Russian aggression spreads to the Baltic States there could be severe repercussions for real estate. Germany, for example, is heavily dependent on Russia as an export market, and if this causes an impact on Europe's biggest economy the chill could spread across the continent.

Which of the following geo-political factors is most likely to affect your UK investment decisions?



Whilst immigration remains a hot topic politically, 72% of investors **do not** consider it is likely to have a major impact on their investment decisions.

Interview
David Partridge, Managing Partner, Argent

"For everyone logistics is proving difficult to buy. In the current retail revolution, moving goods around is a very good business to be in."

In predicting that Australian and American investors will step up their involvement in UK real estate, Argent's boss David Partridge is speaking from first-hand experience.

Fund manager Australian Super agreed in March to take a 25% stake in Argent's King's Cross scheme, in its first London investment and only its second investment in the United Kingdom.

Australian Super has joined the King's Cross Central Limited Partnership alongside Argent itself, Hermes Investment Management, DHL and London & Continental Railways.

Also in March, Argent announced that it had teamed up with American developer Related Companies to undertake UK development projects, targeting mixed-use and residential schemes with a focus on homes that are built-to-rent.

Both Australian Super and Related Companies are attracted to a partnership with Argent after its stellar performance at King's Cross, with the promise that it will be a world-class partner in large-scale, mixed-use development projects.

Partridge says American investors have a deep appetite for UK property because there is a global trend for diversification, and because they are having to travel to achieve value for money outside the red hot United States market.

The same need for diversification arises with Australian equity investors looking to hedge their bets – and where better to head than for the UK, where Partridge is now "very optimistic".

"Getting the election out of the way made a huge difference to the real estate market," he says. "First we had the Scottish independence referendum, then we had the election, but in the last 12 months the attraction of London has just grown. The weight of capital has increased."

While partners like Australian Super and Related Companies focus their partnership with Argent on large-scale regeneration, mixed-use and the Private Rented Sector, Partridge himself is impressed by the potential in logistics.

Argent is unlikely to take on the likes of SEGRO, ProLogis or Gazeley, but, asked which sectors are most promising, Partridge says: "For everyone logistics is proving difficult to buy. In the current retail revolution, moving goods around is a very good business to be in."

Having built in Birmingham and Manchester with Argent, Partridge is highly enthusiastic about Chancellor George Osborne's "Northern Powerhouse" stretching across the north of England.

"It will reinforce connectivity across those northern cities, giving the UK a much more regionalised offer. All the UK's major cities need to demonstrate they have got real strength, depth and resilience, and ideas like this can only reinforce that perception."

He is less enthusiastic about Scotland, however, describing it as a "whole different proposition" where Argent would be unlikely to break into the local development scene successfully.

With Argent and London in such good health – Partridge puts the chances of a slowdown over the next two to five years as "low to medium" – he is wary of anything that will rock the boat.

Now with a strong exposure to international investors who have bought into the idea of Britain as part of the European Union, Partridge says: "A lot of people investing in the UK see it as a stepping stone into Europe. If we exited the European Union they might think twice about buying an office building with a bank tenant here – because the bank may then move abroad."

Interview

Mark Titcomb, Head of London Representative Office, DekaBank

As one of property's leading bankers, Mark Titcomb was one of the first to see an upswing in UK commercial property after the great crash of 2008-2009. As a result the team at DekaBank lent hundreds of millions of pounds at healthy lending margins just as the sector was recovering.

Having called the upturn correctly, what does Titcomb think are the chances of another downturn in the near future?

He is ever wary of people who predict the end of boom and bust and a "new paradigm". "There's a high chance of a downturn within five years because history tells you that property cycles don't go away, but for now I find myself surprisingly optimistic.

"Investment decisions are in part made on the basis of `how do returns on property compare with the return on government bonds?', and I can't see property's advantage over bonds changing significantly soon.

"Combining stronger occupational demand across the board with a relatively weak development response, we should not be surprised with the lower levels of vacancy we are now seeing; even for shopping centres – the picture is obviously much healthier."

One reason for Titcomb's relative optimism is that property lending has not run out of control this cycle, with loan rating measures like "slotting" putting pressure on banks to set more capital aside to give themselves a cushion against unexpected falls in value. This is helping restrict late cycle increases in LTV ratios.

As an expert who in the late 1980s and early 1990s saw first Japanese, then Swedish, Middle Eastern and German investors arrive in the UK, Titcomb now sees overseas interest as more consistent and "deeper", with Taiwanese buyers the latest to arrive.

While London is red hot, Titcomb and DekaBank are also assessing Birmingham's potential due to the growing investment being made in the city centre, with New Street station undergoing a £550m overhaul which is due to complete this year.

Logistics and dominant shopping centres also appeal – but over 75% of DekaBank's UK lending commitments are in the capital with a concentration inevitably in large lot size offices underpinned by heavy replacement cost.

In the longer run he is expecting London and other cities with critical mass to become "polycentric", with occupational demand distributed more broadly particularly in response to new infrastructure investment. There is plenty to play for as the niche markets of Oxford and Cambridge demonstrate growth as biotech and hi-tech centres and others will similarly also play to their strengths.

For Titcomb, though, Scotland is not of much interest with the Scottish National Party dominant. The SNP appears to be overly critical of business "especially given that business growth is the driver of employment and the capacity to fund its manifesto".

Titcomb is also wary of a British withdrawal from the European Union, arguing that until now the business community has been distracted by the twin challenges of Scottish independence and the General Election. "I cannot see a majority of people voting for greater unemployment and a balance of payments crisis though.

"Now the business community needs to stand up and let people know what the negative impact of a British withdrawal will be," he says. "It would undoubtedly be negative for the global city of London and the financial services industry in particular."

Titcomb now wants the new Conservative Government to press on with expanding Heathrow, and, like many, is sceptical over plans for a new airport in the Thames Estuary due to potential cost overruns.

On the core real estate market, however, Titcomb is bullish, with the huge volume of equity heading towards London showing no sign of abating in the face of a narrower range of globally acceptable investable locations.

"Asian money is becoming more dominant but it has not yet got to the stage of being unhealthy in scale and is conservatively geared in general. With UK GDP growth of 2% - 3% looking well set for several years to come, allocations to the UK are unlikely to dry up soon."

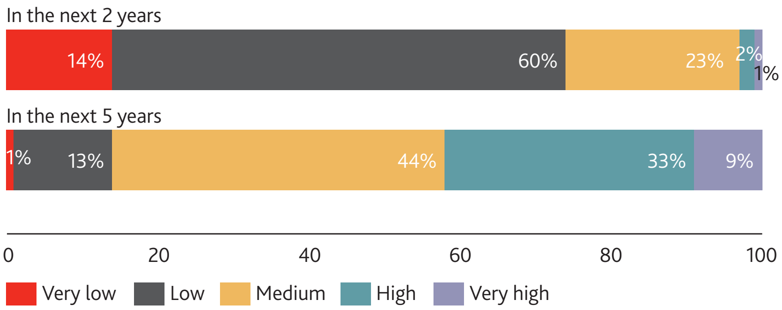
The crest of the wave

With the General Election result widely welcomed by the real estate sector, fears of a downturn in the next two years have receded sharply.

In 2014, 17% of those polled thought there was a high or very high chance of a downturn in the next two years: now this figure is just 3%. However, the five-year picture is very different with 42% saying the chances of a downturn is high or very high, nearly double the figure of the previous year.

This is not surprising given most experts believe we are midway through the current property cycle. If real estate's historic track record is anything to go by, a downturn or major correction at some point is inevitable.

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



"There's a high chance of a downturn within five years because history tells you that property cycles don't go away, but for now I find myself surprisingly optimistic."

Mark Titcomb, DekaBank

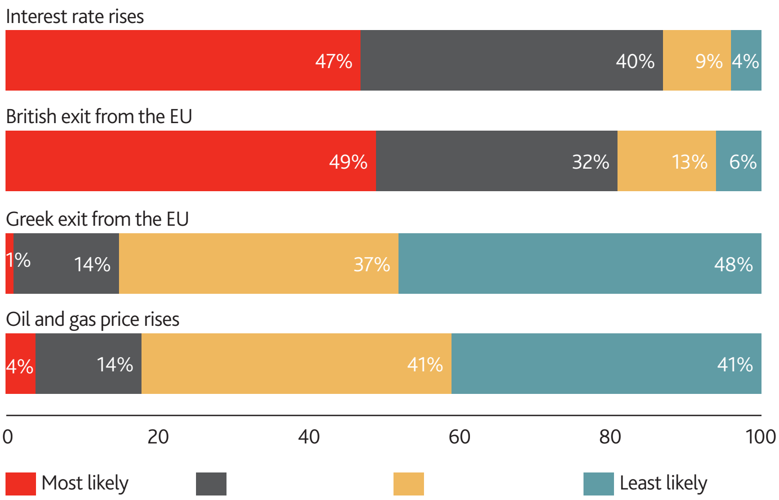
Rip currents

Although most of those polled are optimistic about prospects for UK real estate, there are some undercurrents which could affect the market.

With our survey taking place after the General Election, the prospect of a British exit from the European Union has risen to the top of the agenda, closely followed by interest rate rises with many property companies and developers still heavily in debt.

Whilst it may dominate the news, the prospect of a Greek exit from the European Union now seems to be factored into the calculations of most of those polled. Surprisingly, only one per cent said this is the issue most likely to destabilise the UK market.

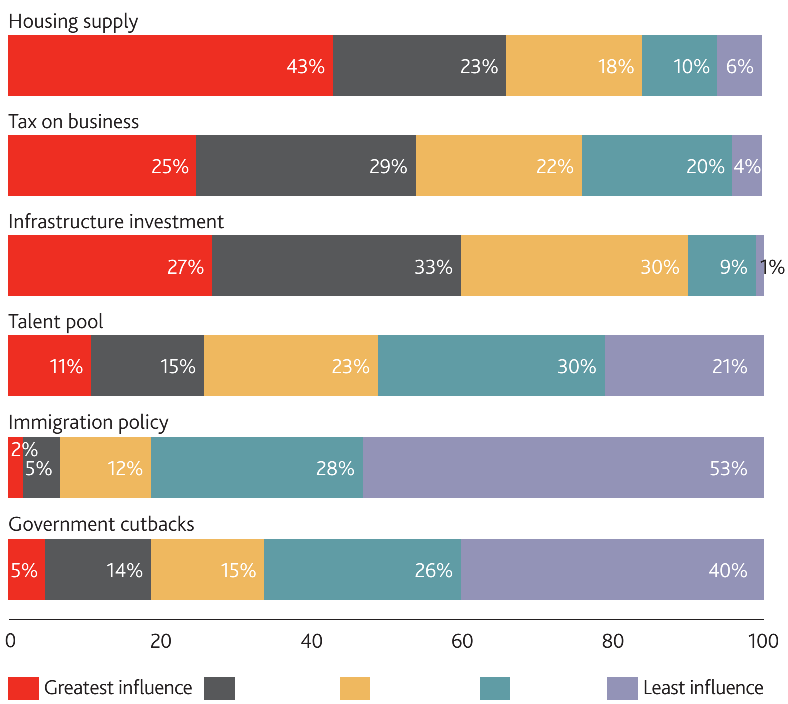
Please rank the below on their likelihood to destabilise the UK property market



> "I am concerned about how interest rates will evolve in the coming years, about how quickly they will rise and the impact that they will have in the property markets."
>
> Amal del Monaco, AXA Real Estate

When we asked our respondents what they felt was the greatest challenge facing the UK real estate industry, 66% said housing supply first ahead of infrastructure investment (60%.) The general consensus is that 200,000 homes a year need to be built to keep pace with population growth, but over the last five years the UK has managed barely half this figure. With major house builders tasked with supplying this market there is little hope that the total figure can be reached without a large-scale publicly-funded house-building programme.

Please rank the following factors in terms of the amount of influence they will have on the future of UK real estate.



66%

of respondents think housing supply is the greatest challenge facing the UK real estate industry, followed by infrastructure investment with 60%.

Interview

Amal del Monaco, Senior Fund Manager, AXA Real Estate

Is the UK real estate market overheated? "To me everything looks expensive!" Having worked in the real estate industry for 18 years Amal del Monaco would know, "especially when compared to what we know or have known in the past, because in absolute terms the prices we are reaching this year are almost unknown to us. This is affecting all the markets and almost all of the segments."

However, she quickly qualifies this assessment, saying "having said that, in relative terms I do believe that the property market remains attractive to other asset classes. However, like a number of investors, I am concerned about how interest rates will evolve in the coming years, about how quickly they will rise and the impact that they will have in the property markets. So, I might say that I am still positive but cautious."

Del Monaco does, though, still see value in the market if you look outside the mainstream. "Most investors are doing the same as us. Not that they are copying us, but they also feel that offices cannot be the only or main asset class to invest in. And they are also taking into account demographic trends and all the other key factors that affect the property market."

The alternative options to watch she names as hotels and student housing but believes that "data centres and healthcare will have a key role from now on in the property market. They will become mainstream assets at some point in time."

As a global investor AXA Real Estate mainly focuses on large cities with strong fundamentals related to a strong labour force working in a wide range of activities and services.

"And which of course benefit from high liquidity which is essential for us." That said, she believes there are other opportunities. "If you look at shopping centres, logistics or healthcare, we would be looking at other cities rather than London. From what I have seen, Bristol and Manchester would be the most attractive cities outside of London."

With international investment into UK real estate still being dominated by Middle East, Asia and Western European money, del Monaco presumes a new dominant player will emerge. "I would expect North America to be back strongly this year, because the currency exchange will help - I think that is their main driver. Also, they will be attracted by the positive outlook that you have in the UK - it is probably the best performing country in the European Union."

So why does the UK remain the home of choice for all this foreign capital? "For me the investment case for the UK is the legal framework, and the availability of market data, which is not the case in all countries, and for London in particular the availability of a talented workforce. The UK market is largely seen as the most transparent in Europe and this is key for newcomers."

> "I would expect North America to be back strongly this year… they will be attracted by the positive outlook that you have in the UK - it is probably the best performing country in the European Union."

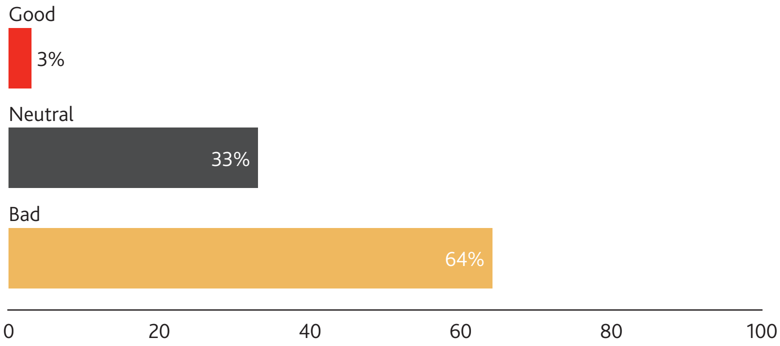
Storms brewing over Europe

Britain's exit from the European Union is considered negatively by 64% of respondents. For most, doubts focus on the short-term disruption of a break with Europe, combined with the signal that this would send to international occupiers. Standard & Poor's has now added to concerns by threatening to downgrade the UK's credit rating due to uncertainty created by the forthcoming EU referendum.

64%

think an exit from the EU will be bad for UK real estate.

What impact will a UK exit from the European Union have on UK real estate?

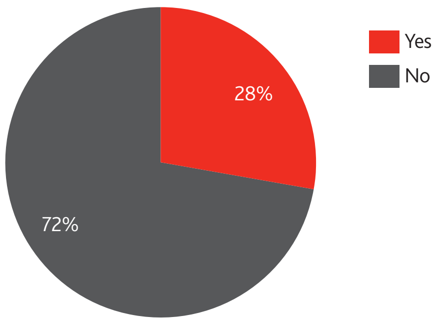


Most of those interviewed are sceptical that Britain will exit the European Union, and as a result do not see the need to delay investment decisions ahead of a referendum. By contrast in 2014, the chances of a Scottish exit from the UK seemed very real and resulted in a marked slowdown of Scottish transactions in anticipation of the vote.

"The business community needs to stand up and let people know what the negative impact of a British withdrawal will be."

Mark Titcomb, DekaBank

Will you delay investment decisions ahead of a forthcoming referendum on the UK's membership of the European Union?



Just as the Scottish Referendum race became closer over time, there is a chance that the campaign for Britain to leave the European Union will gather momentum as the vote nears, which could lead to a slowdown in activity.

Scottish drift

Coming just before the Scottish referendum, our 2014 Report found strong opposition to independence, with 81% saying they would be less likely to invest in an independent Scotland.

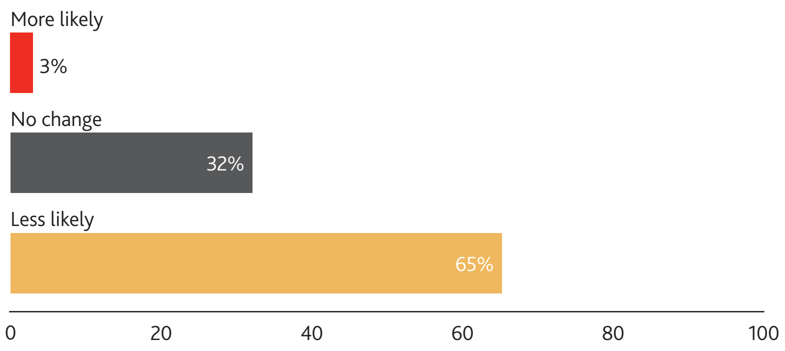
Despite independence no longer being an issue in the short-term, the spectacular rise of the Scottish National Party (SNP) at the General Election has brought some disquiet amongst investors. This is not surprising given the pre-election concerns levelled at some of the SNP's land reform proposals.

An overwhelming 65% said they are less likely to invest in real estate in Scotland as a result of the rise of the SNP. With some commentators predicting a Conservative Government could remain in place until 2025, there is a view that the national Government's policies will diverge from the Scottish Government's. This could lead investors to see England, Wales and Northern Ireland as being led by a right-of-centre government, while a Scotland ruled by a more powerful SNP moves sharply to the left. Investors appear worried that Scotland may become too different in its political and legal framework from the rest of the United Kingdom.

65%

said they are less likely to invest in real estate in an SNP dominated Scotland.

How does the rise of the Scottish National Party affect your likelihood of investing in real estate in Scotland?



> "Scotland must not make itself appear too different as an investment destination."
>
> Bill Hughes, Legal & General

Interview

Ross Blair, Senior Managing Director, Hines

With $85bn under management, global property company Hines is one of the biggest players on the world stage, with assets stretching from the USA to Asia, Western Europe, South America and Eastern Europe.

In the UK it has also become a formidable player, with assets in London complemented in the last year by a major push into Scotland, including a large shopping centre in Livingston acquired on behalf of HSBC Alternative Investments Ltd where it will act as asset manager.

Hines has already bought in Birmingham, which Blair names alongside Manchester as one of its cities outside London to watch. "Birmingham's proximity to London helps. It is a bustling city centre but also quite a tight office market. High Speed 2 is good news, but it's not what's driving us to Birmingham now.

"Manchester has a buzzing, thriving city centre that's a fun place to be. It has more scale than Bristol or Leeds, and having that liquidity in the market helps when you are a global investor."

Blair is currently cautious about London, believing some parts of the capital to be over-valued, with the risk of a property bubble being created in fringe areas like Shoreditch and North Farringdon where tenant demand might not match developers' aspirations.

While Hines is best known as an office-focused investor around the world, it is also seriously exploring the student accommodation sector in the UK, where Blair believes demographics and a lack of supply all support the argument that rents will continue to rise annually.

Among office occupiers he names professional services as the sector likely to lead tenant demand. This is based on increased regulation keeping accountants, lawyers and other advisers busy as legislation stemming from the last financial crisis is gradually introduced.

With its global perspective Hines is also well placed to observe international trends, and Blair believes that the biggest inflows of capital into the UK will over the next two to five years come from Asia. However, like many other executives he is nervous about the impact on the UK market of a possible British exit from the European Union.

Blair says: "A British exit from the European Union would be bad for us, even though I think the chances of that happening are close to zero. For an office market like the City of London, an EU exit would create nervousness and slow down take-up.

"When there are many cheaper capital cities than London to locate your European headquarters, would big companies remain committed if we were to exit the European Union?"

On the subject of airport expansion, Blair is a fan of Gatwick. His view is that expanding Heathrow will only lead to a need for a further runway in another 30 years, and that Gatwick is "the best of all worlds" as it has scope for growth and would offer increased competition.

And on devolution to the UK's big cities he is a fan of the idea, but strong leadership is needed, as is the case in Manchester and Birmingham, which have created the framework for Hines to make big investments in these cities.

Strong leadership is crucial as devolving power to weak leaders who will "only make decisions by committee" could hold cities back, he says.

"Manchester has a buzzing, thriving city centre that's a fun place to be. It has more scale than Bristol or Leeds, and having that liquidity in the market helps when you are a global investor."

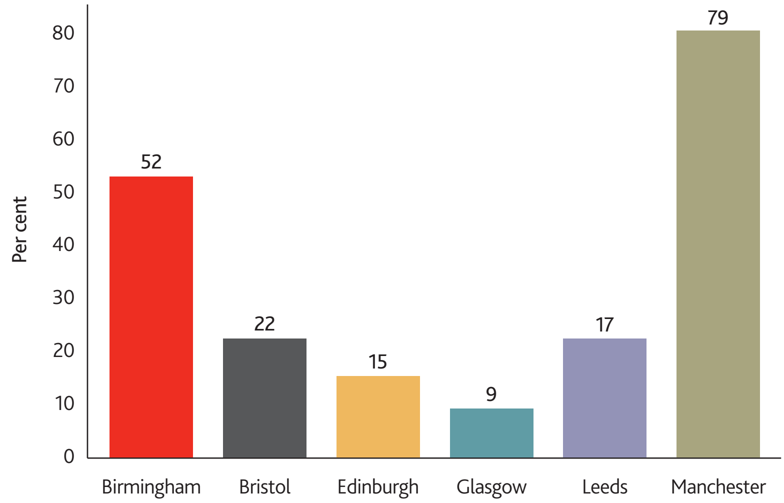
Local squalls

With increasing awareness of High Speed 2, Manchester and Birmingham have gained in appeal over the last 12 months.

In our 2014 survey, asked to pick two from the "Big Six" regional cities which they saw as the most appealing investment prospect, 73% named Manchester and 42% named Birmingham. This year, 79% named Manchester as one of their top two cities to watch followed by Birmingham (risen to 52%).

Doubts about Scotland's future within the United Kingdom and the rise of the SNP continue to impact perceptions of the Scottish cities as investment locations, particularly Edinburgh which is favoured by just 15% of respondents, down from 23% last year.

Of the "Big Six" regional cities listed below, which two are most appealing as investment prospects?



The top six "cities or towns to watch" are Cambridge, Reading, Liverpool, Newcastle, Oxford and Sheffield. The collapse in the oil price has had a dramatic impact on investors' perceptions of Aberdeen. Having been the top "city or town to watch" outside the "Big Six" in the 2014 report, it fell out of the top six to watch this year, with the tech boom helping to lift perceptions of the intellectual powerhouses of Cambridge and Oxford.

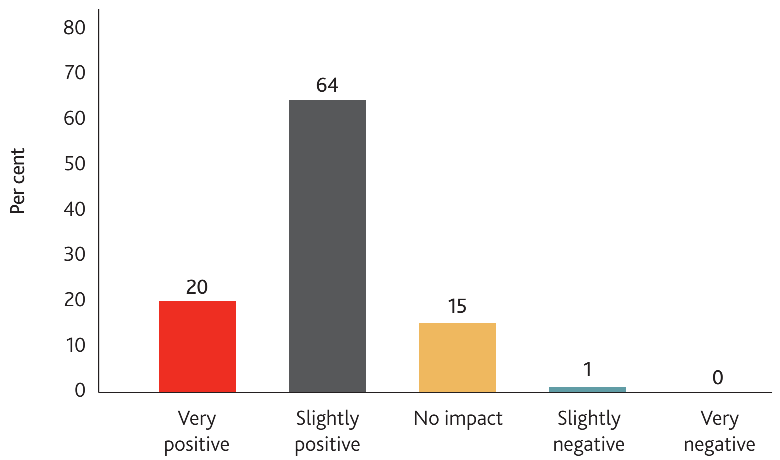
What is your "City or Town to Watch" outside of the "Big Six" cities?

- Cambridge
- Reading
- Liverpool
- Newcastle
- Oxford
- Sheffield

Tidal pulls North

Chancellor George Osborne's Northern Powerhouse initiative – boosting a corridor from Liverpool to Newcastle through improved transport links among other measures – gets a ringing endorsement from the real estate sector.

What impact will the Government's Northern Powerhouse initiative have on real estate markets in the North?



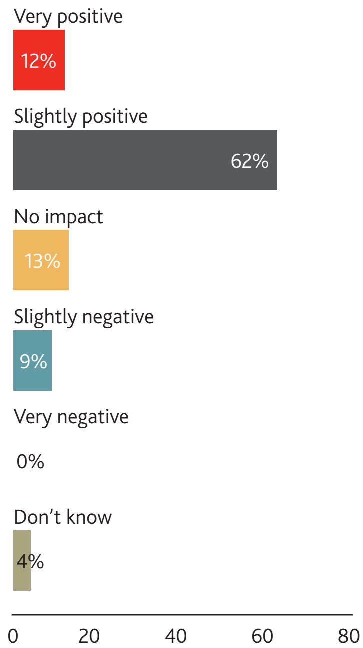
Northern England is now seen as particularly promising for residential development and investment. Apache Capital has this year funded a £1bn programme by developer MODA Living for new rented apartments across Manchester, Leeds and Liverpool. Offices and logistics and distribution are seen as having potential, but retail is still challenging in line with the wider UK market, mentioned on page 10.

Whilst a decision on the Capital's airport awaits the Government's reaction to the Davies Commission, Manchester is investing £1bn in its airport facilities over the next decade. This will maximise its potential as a global gateway to the Northern Powerhouse and allow it to compete with London.

Whilst the general concept of devolution is considered positive by 74% of our respondents, on probing some of our interviewees were more cautious. They are impressed by the strides made by the likes of Sheffield and Manchester City Councils. However, they also believe that for every best-in-class devolved city, there may be a less ambitious and less pro-development council which, given greater powers, could act as an impediment to the real estate sector.

> "All the UK's major cities need to demonstrate they have got real strength, depth and resilience."
>
> David Partridge, Argent

What effect do you think the Government's proposed devolution of more powers to major UK cities would have on the UK real estate market?



Interview

Stephen Down, Head of Central London and International Investment, Savills

Savills was founded in London in 1855, so if anyone knows the investment market it is their Head of Central London and International Investment, Stephen Down.

"London is the destination of choice globally for the majority of international capital that is flowing around the world," he says.

He also cites New York as a competitor for that money and parts of Europe – France and Germany in particular. "However, London is where the majority of global investment flow is currently coming to and will continue for the foreseeable future."

Down manages a team of three dozen professionals and so "has a very good feel for where the international appetite is for London at any one time because we have these people go around the world on a monthly basis".

He has also seen the investors change, "compared to this time last year there is more interest from Asia and there is as much interest still, if not more so, from North America." Interestingly, he has seen a change in who the investors are from the Middle East, "it is not just the Qataris, it's the whole of the UAE and all the other countries in the region."

So with all these new investors and vast sums of international money targeting London, has it become overpriced and difficult to make money in? "There are pockets that look expensive," but he puts this in context of a low interest rate environment globally.

Prime real estate yields are being priced against a low bond rate benchmark and if you price in rental growth it is little wonder that we are seeing yields on some product at very low levels indeed. "I think the general consensus is that interest rates will remain relatively low compared with other cycles for a while and therefore, excluding any 'Black Swan' event, I don't see any reason why that trend of lower yields will reverse for the time being.

"Some investors, particularly the Chinese institutions, are struggling to get to the very low yields on the core stock; their preferred initial yield is closer to 5% than 4.5% for stock. The most aggressive institutional buyers from abroad at the moment are the Taiwanese insurance companies. The recent purchase of the Walbrook Building in the City by Cathay Life of Taiwan was close to 4.0% at approximately £575m."

The new Conservative Government has already made noises about devolving more power to the regions. "Devolution is a good idea. I think that people work better within localised and identifiable communities."

And on the Northern Powerhouse initiative, "this is a route that we have to go down. We have to make sure that what is happening in London is spreading out far more quickly into the regions. There is a need for infrastructure improvements - connectivity between cities is important." And here he believes we should take a lesson from Germany and the superb links by rail, road and air they have connecting their regional centres.

Down doesn't believe that London's bubble is about to burst. "At the macro level, for investors, I cannot see anything that is going to change. I don't see interest rates rising significantly, they cannot rise globally because the world is so indebted. I think that even looking beyond the next five to ten years.

"I think that it is only geo-political factors that might shake confidence. The UK is seen as a straightforward place to trade with limited transactional costs and it is open for global business."

"Devolution is a good idea. I think that people work better within localised and identifiable communities."

Surf lessons

Top 3 reasons to invest in the UK

+ Legal framework
+ Tax regime
+ UK as the "gateway" to Europe

Legal framework

It is pleasing to see the legal framework topping the table of reasons to invest in the UK. Our report shows that we are in a fast paced market and investors should be ready to move quickly to capitalise on this. Nabarro led a working party of industry experts which published the Investment Property Forum's Readiness for Sale Guide. It's a useful summary of how to get the legal issues right up front, something we urge investors on the buy or sell side to do if they are to take full advantage of the dynamic opportunities available to them in the real estate market.

Clare Thomas
Real Estate Partner
T +44 (0)20 7524 6906
c.thomas@nabarro.com

"For me the investment case for the UK is the legal framework, and the availability of market data, which is not the case in all countries."

Amal Del Monaco, AXA Real Estate

Top 3 deterrents for investing in the UK

– Planning laws
– Infrastructure investment
– Tax regime

Tax

It's interesting that tax is seen by our respondents as both an incentive and a deterrent to investors. In fact, compared to a lot of jurisdictions, the UK has quite an attractive tax regime for both UK and overseas real estate investors. There is generally no UK tax on capital gains for non-UK resident investors buying property in the UK. Rental income is subject to tax at 20% for both UK and non-UK investors, although this can be reduced by the use of debt (particularly effective for offshore investors) and capital allowances.

UK investors are subject to tax on capital gains at a rate of 20%, however certain investors can benefit from an exemption under the REIT regime. Stamp Duty Land Tax (SDLT) at 4% is often seen as a deterrent to investing in UK real estate, but despite the increase in anti-avoidance legislation it is still often possible to reduce SDLT on real estate transactions by the use of corporate structures.

Kirsten Prichard Jones
Tax Partner
T +44 (0)20 7524 6581
k.prichardjones@nabarro.com

"We have to make sure that what is happening in London is spreading out far more quickly into the regions. There is a need for infrastructure improvements - connectivity between cities is important."

Stephen Down, Savills

Planning

The planning system is complex, but also fair and consistent. The Government has recognised that developers in London, like in the rest of the UK, grapple with one of the most complex development consenting regimes in the world. The Government has responded to this both at national and London Plan level with a programme to reduce red tape for developers and asset managers and to free up more development without the need for permission, for example by expanding permitted development rights (office to residential and retail to leisure).

In the absence of a third party right of appeal, judicial review remains the key threat to development consents. However the new planning court presides over a judicial review system that still makes it relatively difficult to successfully challenge the grant of a robust permission. Overall the perception might be that the system favours those who know it well and are well-advised.

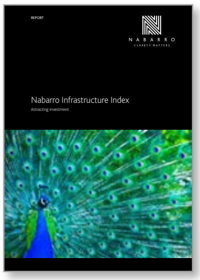
Josh Risso-Gill
Planning Partner
T +44 (0)20 7524 6124
j.risso-gill@nabarro.com

"Once infrastructure commitments are made, there is a degree of certainty that things are starting to unfold and happen. Investors will respond fairly rapidly once the plans begin to crystallise in order to try to unlock opportunities."

David Paine, Standard Life

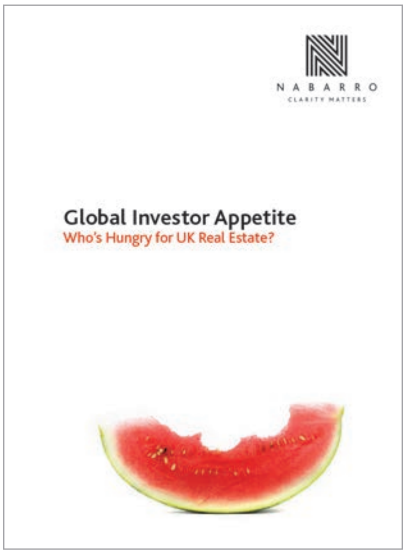
Infrastructure

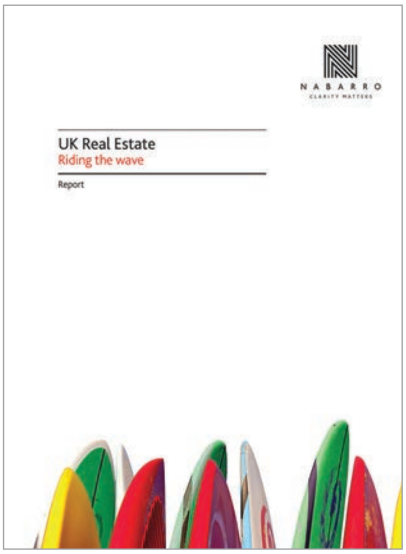
The National Infrastructure Plan 2014 stated that the UK has an infrastructure pipeline of £466bn of infrastructure projects. While this should be encouraging, many investors are of the view that the UK Government is not doing enough to prioritise investment in infrastructure. Lengthy and complex procurement processes, cancelled projects, burdensome regulatory frameworks and a perceived lack of clear political support and direction have eroded investors' confidence in the UK's ability to deliver infrastructure in an efficient and cost effective manner.



The Nabarro Infrastructure Index, which rates the levels of infrastructure across a number of different countries, reported that the UK only spends 6% of its GDP on infrastructure. This compares to 12% by top spender Qatar. Going forward, the UK Government needs to ensure that there is a clear pipeline of infrastructure projects which attracts investors and gives them confidence that the projects will be delivered.

James Snape
Infrastructure Partner
T +44 (0)20 7524 6804
j.snape@nabarro.com





"UK Real Estate: Riding the Wave" is the third instalment in Nabarro's thought leadership series. To receive copies of the first two reports, please email info@nabarro.com.

About Nabarro

We are an international law firm renowned for our positive and practical approach to our clients' business needs. Our commercial real estate group has a stellar reputation for advising on the largest and most complex UK and European real estate transactions and investments 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 acquisition, financing, planning to development, asset management and sale. Our market leading teams also specialise in funds and indirect real estate, environment, construction, litigation and tax.

Our real estate practice is Tier 1 in Legal 500 and was awarded "Real Estate Team of the Year" by the directory.

The firm's headquarters are in central London with offices also in Sheffield, Manchester, Brussels, Dubai and Singapore. For cross-border work we draw on longstanding relationships with a network of selected firms worldwide and via the Broadlaw Group which comprises GSK Stockmann + Kollegen in Germany, Lefèvre Pelletier & associés in France, Nunziante Magrone in Italy and Roca Junyent in Spain, which combined is more than 1,000 lawyers. In 2014 Nabarro was voted "European Law Firm of the Year - Transactions" in the Private Equity Real Estate Awards.

More information can be found at www.nabarro.com.

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NABARRO

CLARITY MATTERS

Nabarro offices

London
125 London Wall
London EC2Y 5AL
T +44 (0)20 7524 6000

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

Manchester
1 The Avenue Spinningfields
Manchester M3 3AP
T +44 (0)161 393 4700

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
Office 105 Level 1
Tower 2 Al Fattan Currency House
DIFC PO Box 506873
Dubai United Arab Emirates
T +971 4302 6000

You can find out more about us at:

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

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www.broadlawgroup.com

Nabarro LLP
Registered office: 125 London Wall
London EC2Y 5AL.

12596