Standard Life Investments

Real Estate Update Q2 2017

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Global real estate themes

Anne Breen
Head of Real Estate Research and Strategy

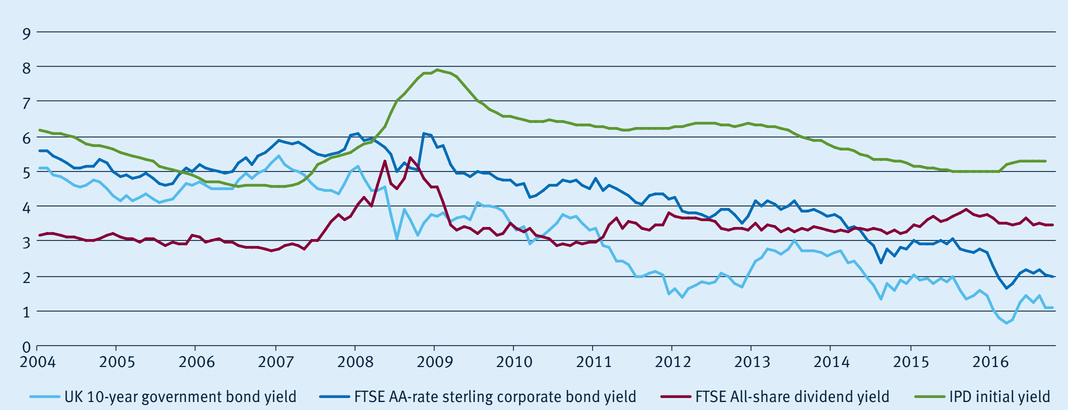
Real estate is a safe haven in an uncertain world

So far, President Trump has failed to implement some of his key election policies, while some of the political uncertainty in Europe has dissipated following elections in the Netherlands and France. What remains is a degree of ambiguity around the UK's exit from the European Union (EU) and the election outcome in Germany. In the midst of uncertainty, real estate has been something of a safe haven, underpinned by the nascent recovery in the global economy and accommodative monetary policy. This is borne out by the minor, short-lived correction in the UK real estate market following the referendum. Low interest rates and elusive inflation underpin the alluring real estate yield margin over other asset classes and investors are looking through the uncertainty to deploy their capital. Capital flows from China to the US are particularly strong, as investors look for security and a robust legal framework for capital preservation. Japanese pension funds shifting allocations into real estate assets are also favouring the US. Downward pressure on yields has eased somewhat as investors keep their risk appetite in check and income growth continues to drive performance.

Market fundamentals remain healthy

The performance of the real estate market has been steady. Economic recovery has translated into healthy office occupier demand and modest but sustained rental growth. Rents in a number of office markets are still below previous peaks and have room to grow. Commercial real estate development has been relatively muted this cycle and vacancy rates have reached historic lows in a number of global office and industrial/logistics markets. Despite the sustained ultra-low interest environment, lenders have been cautious, thus keeping supply in check and rental growth on a steady course. The rapid development of multichannel retailing has blurred lines between the retail and logistics sectors. This has led to a shift in demand for traditional retail space to locations most suited to 'last mile delivery' – to the detriment of secondary retail locations. Retail's pain, however, is offset by robust performance in the office, industrial and alternatives sectors, where the outlook remains favourable.

Real estate offers a sustainable yield



Source: Thomson Reuters Datastream, IPD, Standard Life Investments, as at 31 March 2017

Simon Kinnie
Head of Real Estate Forecasting

Lulu Wang
Real Estate Investment Analyst (UK)

David Scott
Real Estate Investment Analyst (UK)

Craig Wright
Real Estate Investment Analyst (Europe)

Markets in detail

UK real estate

- **UK real estate performance has recovered after the referendum upheaval.** Performance has been nuanced since the EU referendum, with industrial and long-income type sectors generating the strongest returns. The weakest returns have been recorded by poorer-quality secondary offices, offices in the rest of the UK, and retail-warehouse fashion and bulky-goods parks. The warehouse sector continues to benefit from the transition to online shopping and the reconfiguration of supply chains to meet consumers' changing buying preferences. Due to historically low new development and limited availability in the sector, rents are rising sharply, particularly in the land-constrained South-East market. As a corollary to the distribution sector's robust performance, retail is still suffering. Overall, UK real estate continues to provide an elevated annual yield of more than 5%. This compares favourably with the current low yields in most other asset classes.

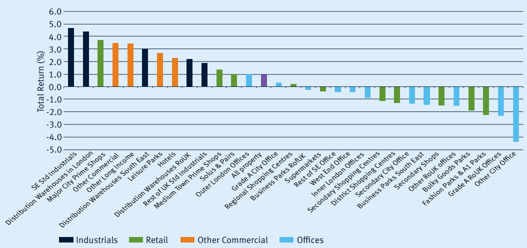
- **Overseas investors remain the largest net investors in the UK.** Total investment activity in Q1 2017 was £9.5 billion, according to Property Data, which is below the long-term average since 2000. Overseas investors were responsible for total purchases of £5.2 billion, representing just under 55% of the total. These figures were fuelled by major transactions and London offices took a 40% share of total volume – its highest level since 2012. Far Eastern investors have emerged as the dominant source of overseas demand, boosted by CC Land's £1.15 billion purchase of the Leadenhall Building in London. UK institutions, meanwhile, remained net sellers, albeit at a more moderate level following three consecutive quarters of significant selling. Listed property companies, however, made their largest divestment since Q3 2009. They were net sellers to the tune of £1.3 billion, although this was driven by a small number of large deals. At the sector level, with the exception of high street, transaction volumes in Q1 were below the longer-term average, particularly for regional offices, shopping centres and the alternatives sector.

European real estate

- **There is less political uncertainty and stronger fundamentals.** European real estate has continued to perform well in a global context – perhaps hard to believe in light of political news headlines. Political influence has worked its way through Austria, the Netherlands and France. Attention now turns to Germany's general election in August 2017, with Italy set to follow. When you consider economic performance and market fundamentals, it is not surprising that real estate has been relatively immune to political concerns this far. Eurozone GDP growth was a healthy 1.8% in 2016 and is likely to have started 2017 strongly. The Eurozone Composite Purchasing Managers' Index reached a six-year high in April, suggesting economic momentum. Office demand is about 20% above the long-term average, driving vacancy rates to their lowest levels in eight years. A lack of development activity in constrained city-centre locations has restricted the amount of available grade-A space. This has forced net-effective rents higher in most markets and prime-headline rents up in the likes of Stockholm, Paris central business district (CBD) and Madrid CBD, as well as in the German cities of Munich, Berlin and Stuttgart, among others.

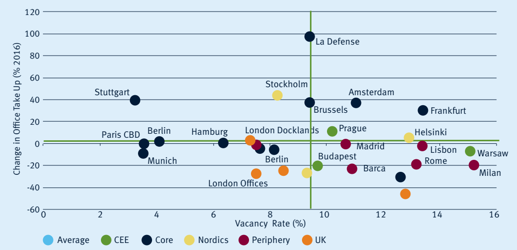
- **Drivers shift from yield compression to income growth.** Three key elements anchor the outlook for direct real estate in continental Europe: the cyclical economic recovery underpinned by domestic demand; accommodative monetary policy; and the need for sustainable income. The current prime-office yield margin provides an attractive buffer for real estate pricing, particularly given investor appetite for income and growth. However, we believe performance will be increasingly driven by income as opposed to yield impact. While attractive risk-adjusted returns are forecast in core markets such as France, Germany and the Nordics, the recovering markets of Hungary, Spain and the Netherlands are expected to produce some of the strongest absolute returns. Offices still offer growth potential in the near term, as economic recovery and low supply should support income growth. In the medium term, we expect higher-yielding sectors, such as logistics, to outperform. Certain retail segments remain challenged by emerging consumer trends. We typically prefer dominant shopping centres and major-city high-street retail shops, due to stronger income-growth prospects.

Post-referendum performance



Sources: MSCI/IPD, Standard Life Investments

Office demand and vacancy rates



Source: PMA, Standard Life Investments, as at Q4 2016

Donald Hall
Real Estate Investment Analyst (Americas)

North American real estate

- **Store closures are accelerating but fundamentals remain healthy.** In Q1 2017, at least ten retailers filed for bankruptcy – more than the number of filings during the whole of 2016. Nearly 3,000 store closures were announced before April – much more than in 2008. Overall, retail sales growth remains positive, but department store sales have been stagnating since 2000. America has more retail footage per capita than any other country and a correction is inevitable, particularly given burgeoning online sales. However, the retail sector is not as unhealthy as headlines would suggest. Vacancies are 76 basis points (bps) below last cycle's trough and 132bps below the long-term average. Retail rents, meanwhile, have increased 4.6% year-on-year, higher than the national aggregates for offices and apartments. Retail is the only property sector where rents have not reached pre-recession peaks, but well-located assets continue to do well. Secondary and tertiary malls will be the most negatively impacted by store closures and secular trends. However, prime retail assets will continue to attract high-end stores and foot traffic.

- **Developers and bankers are cautious.** While there are pockets of oversupply, particularly in luxury CBD apartments, in aggregate, there is little supply growth in other sectors. Retail and offices are adding less than 1% of new inventory per year, about half as much as in previous cycles. With less new demand this cycle, less supply is sensible. However, vacancies are well below average and at or below last cycle's floor. Logistics is growing new supply at slightly below last cycle's peak and well below 2000 levels. Vacancies are at all-time lows in modern distribution space and rents are growing. The apartment sector delivered more new supply than in the past few cycles, but a wave of new renters provided historically high demand. While apartment vacancies have increased, they are still slightly below last cycle and below average. Development and land-sale activity is down, and banks are tightening their lending standards on commercial real-estate loans. Despite supply and vacancies at such low levels, it seems both developers and bankers are determined to be more cautious, providing support for a longer-than-usual cycle.

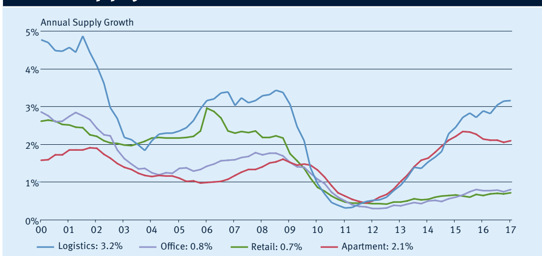
Violet McDonald
Real Estate Investment Analyst (Asia Pacific)

Asia Pacific real estate

- **The end of the yield cycle in Asia Pacific?** The current yield cycle for prime Sydney and Tokyo offices is in its tenth year. Yields in Sydney are below their historic low, in Tokyo they are still above their historic low point, while the margin over long-government bonds remains elevated in both markets. Fundamentals in Sydney and Tokyo are healthy, with vacancy and net additions well below long-term averages. However, in 2017 and 2018, Tokyo will see a significant amount of new supply delivered while Sydney will experience a dearth. In Singapore, meanwhile, the current yield cycle for prime offices is in its fifth year, slightly below the average over five cycles. The yield is above the historic low, but the margin over long bonds is shrinking. Elevated new supply has pushed the vacancy rate to slightly below the long-term average in Singapore, but significant new additions this year are expected to put upward pressure on vacancies. Based on these indicators, we suggest that yields have further to fall in Sydney and perhaps Tokyo. However, the slim yield margin and less healthy fundamentals suggest that Singapore office yields may start to move out.

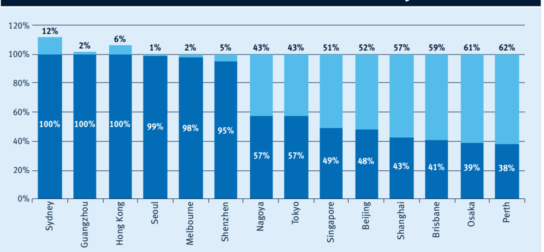
- **Office rents have room to grow in select markets.** Office rents in Sydney and Melbourne have grown rapidly this cycle, as the Australian economy rebalanced away from commodities, and given demand from the services sectors. As a result, prime-office rents in Sydney have risen 12% above their historic peak. In Hong Kong, the withdrawal of investment banks from large floor plates has made way for an influx of financial-services occupiers from mainland China, who are taking smaller spaces and are willing to pay for a prestigious address. This has pushed rents in Hong Kong to 6% above their historic peak. In Japan, prime-office rents are between 40% and 60% off the levels of the early 1990s. However, a significant uplift in the quality of stock, in the Tokyo office market in particular, is expected to support further growth. Singapore and Perth office rents, meanwhile, have been in decline since the financial crisis and the end of the commodities supercycle. However, the recovery in global trade and renewed activity in emerging markets bode well for the lagging office markets.

New supply is under control



Sources: CoStar, Standard Life Investments

Prime office rents – current versus peak



Source: Standard Life Investments, PMA, as at Q4 2016

Svitlana Gubriy
Global Real Estate Equities
Portfolio Manager

Global listed real estate

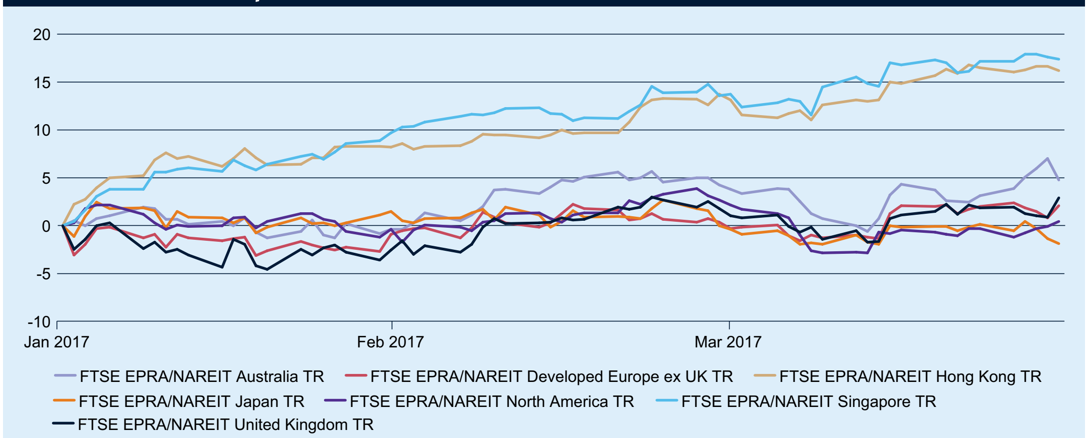
- **Global listed real estate markets posted a positive return during the quarter.** US REITs lost some momentum from the post-election rally, underperforming later in the quarter. Concerns were raised over the government's ability to implement tax reforms and infrastructure spending, which some investors are hoping will help reignite economic growth. At a sector level, healthcare was among the strongest performers as reform concerns looked overblown. Positive momentum continued in CBD office REITs, as investors bet on increased business confidence and potential financial deregulation, which could spur additional demand. Conversely, regional malls and strip centre REITs were the worst-performing sectors, as investors became increasingly concerned about the impact online retail would have on the profitability of retailers.

- **Continental Europe performed in line with the global benchmark but this masked significant volatility.** French stocks underperformed because of political risk ahead of the presidential election while German stocks were buoyed by their safe-haven status. Spain also performed well, given strong trading results from a number of companies. European retail REITs were among the weakest performers, because of the generally out-of-favour nature of the sector and the growing threat from online retail sales.

- **The UK listed real estate market performed broadly in line with the global benchmark.** While political noise around the triggering of Article 50 remained high, events were well anticipated and absorbed by markets, with limited volatility. Those stocks with exposure to the industrial sector performed well, as strong rental growth remains supported by robust online retail sales. More niche sectors, such as student accommodation and self-storage, also outperformed. Those stocks with London office exposure were weaker, despite trading at large discounts to net asset value.

- **Changing expectations around the US economy and the direction of interest rates swayed listed real estate markets in Asia Pacific.** Japan gradually gave back strong gains made at the end of 2016, as the yen strengthened and inflation expectations fell. Hong Kong listed real estate was a big outperformer year to date, as primary sales volumes and prices soared. The entrance of Chinese developers into land auctions have resulted in elevated transaction prices. Singapore has started to show signs of economic improvement and more acutely, an improving residential market. Australian REITs vacillated based upon the volatility of the 10-year government bond yield.

Q1 listed real estate performance



Source: Lipper Investment Management, as at 31 March 2017

Monitoring real estate's key triggers

Below is an overview of the key triggers we monitor. Our analysis generally indicates a supportive environment for real estate.

Real estate triggers	Trend	Change on last quarter
Economic fundamentals	Stronger	**Fundamentals modestly stronger** Global growth recovering. US recovery sustained; UK recovery impacted by EU referendum; Europe and Japan firming; China stable.
Margin over bonds	Stable	**Margin remains wide against benchmark bonds** Margin narrowing against BBB corporates; wide margin over government bonds remains.
Quantitative easing/ stimulus	Stable	**Modest tightening in US, accommodative elsewhere** US rates rising; additional easing in UK, but not in Europe and Japan.
Flow of capital	Slowing	**Keen pricing curb investment** 2015 looks likely to be the peak of investment this cycle. Allocations persist and increasing in some markets.
Fund flows	Stable	**Moderating** Global funds targeting US and Europe (ex-UK); higher allocations from government pension funds e.g. Japan.
Lending	Slowing	**Modest tightening in standards** Signs of stress in financial markets.
REIT pricing	Fair	**Priced at fair value** Reflecting real estate fundamentals.
Derivatives pricing – UK only	Stable	**Modest trading** Derivative pricing for 2017 indicate single-digit returns.

Sources: Property Data, Morgan Stanley, Bloomberg, IMA, BofE, RCA Q1 2017

Key global real estate market risks

The table below highlights some of the potential risks for global real estate markets.

Global risk factor	Current risk monitor	Outlook for the risk factor
Global stability	**Political environment remains uncertain**	Europe remains a risk while Brexit plays out, German elections are to be decided and US policy is still nebulous.
Economic recovery	**Synchronised pick-up in demand across all major regions for the first time in the current cycle**	A reversal of the economic outlook would hit values.
Bond yields and stimuli	**Markets are pricing in accommodative BoJ and ECB; Fed tightening more pronounced**	Policymakers outside the US intend to maintain loose policies until key economic targets are met.
The income yield on real estate becomes less attractive	**Real estate yields continue to look fair value globally relative to the yield on other assets**	In a low-yielding environment, the elevated yield on real estate remains attractive.

Real Estate House View changes Q2 2017

UK		
Rest of South East Offices	Neutral to Heavy	More optimistic front-loaded yield shift benefiting the office sector.
Grade A Rest of UK Offices	Neutral to Heavy	More optimistic front-loaded yield shift benefiting the office sector.
Medium Town Prime Shops	Heavy to Neutral	Rental expectations downgraded. The sector also moves down a category, due to relativities, because of our more positive expectations for the office sector.
West End & Mid Town Offices	Very Light to Light	More optimistic front-loaded yield shift benefiting the office sector.
Business Parks	Very Light to Light	More optimistic front-loaded yield shift benefiting the office sector.
District Shopping Centres	Light to Very Light	Rental expectations downgraded. Sector also moves down a category, due to relativities, because of our more positive expectations for the office sector.
Secondary/Small Shops	Light to Very Light	Rental expectations downgraded. Sector also moves down a category, due to relativities, as a result of our more positive expectations for the office sector.
Europe		
Hamburg Offices	Light to Very Light	German market fundamentals are generally healthy, but pricing in Hamburg is not compensated by strong income-growth prospects.
Ile de France Logistics	Heavy to Very Heavy	The French logistics market offers a yield premium over neighbouring Germany and Benelux.
Americas		
Vancouver CBD Offices	Light to Neutral	A clampdown on work visas in the US creates demand upside for Vancouver, fundamentals are healthy, and office-to-condo conversion takes out stock and pushes down cap rates.
New Jersey Logistics	Heavy to Very Heavy	Low vacancies and high demand in strong/dense market.
Inland Empire Logistics	Heavy to Very Heavy	Strong demand keeping up with supply to sustain low vacancies and high rental growth.
Chicago Logistics	Heavy to Neutral	Rental growth has softened every quarter for five quarters – landlords seem unable to push rents much more, despite strong fundamentals, which is common in this market.
Boston CBD Offices	Very Heavy to Heavy	Changed purely based on relativity – rental prospects actually increased due to strong demand and low supply.
Boston Apartments	Neutral to Light	Wave of new high-end supply being felt in concessions and stalling rental growth.
New York Apartments	Neutral to Light	One of the first markets to see falling apartment rents and the bulk of the supply has yet to deliver.
Asia Pacific		
China Logistics	Very Heavy to Heavy	Rental growth pared back on high new supply and yields are softening.
Seoul Retail	Heavy to Neutral	Outward yield movement; rental growth underpinned by tourist spending, which is vulnerable to external shocks.
Hong Kong Offices	Light to Very Light	Outward yield movement on rising rates following Fed. Rent affordability is an issue.
Beijing Offices	Very Light to Light	Higher yield driving performance relative to other markets.

Note: We do not expect the structure of all our real estate funds to exactly match the above views, as there are stock-specific, transaction cost and liquidity issues that may work against each fund achieving the ideal structure.

Real Estate House View

Q2 2017 - Three-year view

	UK	EU – Core	EU Non-Core	Americas	Asia
Very Heavy	SE Industrial Distribution Warehouses (SE ex London) Distribution Warehouses (London) Provincial Industrial Distribution Warehouses (Rest of UK)	Amsterdam CBD Offices Stockholm Offices German Logistics Netherlands Logistics Ile De France Logistics Munich Offices	Budapest Offices Lisbon Offices Madrid CBD Offices Budapest High Street Retail Lisbon Retail	Inland Empire Logistics West LA Offices New Jersey Logistics Los Angeles Logistics	Sydney Offices Mumbai Offices Melbourne Offices Australia Prime Regional SC Brisbane Industrial
Heavy	Major City Prime Shops Leisure Parks Rest of South East Offices (ex London) Grade A Rest UK Offices Regional Shop Centres (>50k m²)	Sweden OOT Retail Berlin Offices Grade A Dutch Regional Offices Stockholm Logistics Danish Logistics Helsinki Logistics	Portugal Logistics Budapest Logistics Belgium Logistics Madrid M30-M40 Offices Madrid/Barcelona Logistics	Seattle CBD Offices Boston CBD Offices	Brisbane Offices China Logistics Melbourne Industrial Sydney Industrial Delhi Offices Seoul Industrial
Neutral	Medium Town Prime Shops Hotels Supermarkets Retail Fashion Parks Outer London Offices Retail Wareh. Bulky Goods	Stockholm High Street Retail German High Street Retail Paris CBD Offices Germany Dominant Malls Dublin Logistics	Barcelona CBD Offices Prague Logistics Spain Dominant Malls Italy Logistics Warsaw High Street Retail Brussels High Street Retail	Toronto CBD Offices Chicago Logistics Washington DC Core Offices New York CBD Offices Seattle Apartments Vancouver CBD Offices Washington DC Apartments US Class A+ Malls	Perth Industrial Japan Logistics Seoul Retail Hong Kong Industrial Tokyo Offices Seoul Offices
Light	West End & Midtown Offices Solus RW Business Parks Other RoUK Offices	Paris Peri Defense Paris Levallois Frankfurt Offices Copenhagen Offices Dublin Offices Dusseldorf Offices	Milan Offices Prague Offices Brussels CBD Offices Madrid/Barcelona Retail Prague Retail	Boston Apartments San Francisco CBD Offices Houston Offices New York Apartments	Tokyo Retail Shanghai Offices Perth Offices Beijing Offices Singapore Industrial Singapore Offices Guangzhou Offices
Very Light	District Shop Centres (<50k m²) Grade A City Offices Inner London Offices Secondary /Small Shops Secondary Shopping Centres Grade B City Offices	Paris High Street Retail Copenhagen High Street Retail Dublin High Street Retail Hamburg Offices Amsterdam High Street Retail Helsinki High Street Retail France Dominant Malls Helsinki Offices	Milan/Rome High Street Retail Warsaw Logistics Rome Offices Warsaw CBD Offices Poland Dominant Malls	Mexico City Offices Sao Paulo Offices	Hong Kong Offices China Retail Singapore Retail Shenzhen Offices Hong Kong Retail

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