Global real estate themes

Anne Breen
Head of Real Estate Research and Strategy

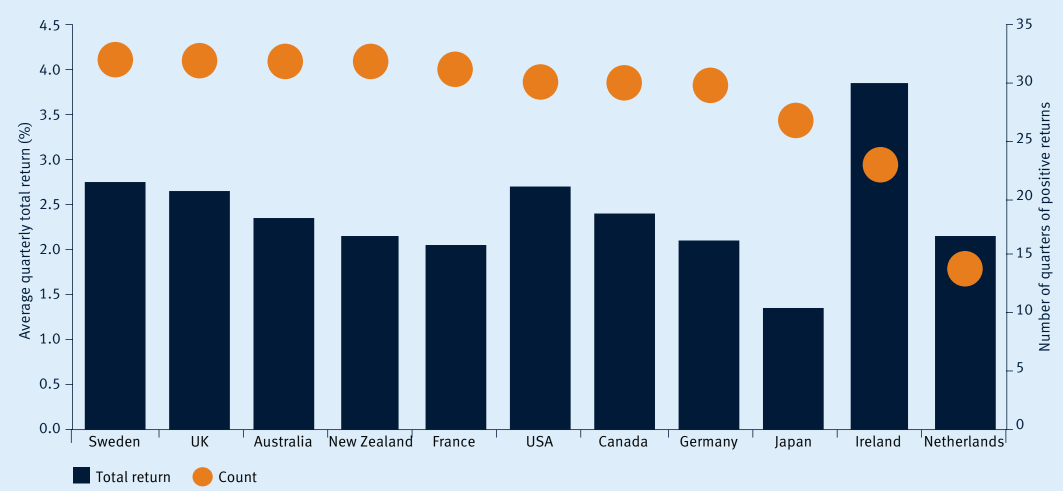
Political events have failed to derail real estate markets

The shock result in the EU referendum led to one quarter of negative real estate returns in the UK, but the market has swiftly recovered. Soon after came Donald Trump's presidential election win and, despite twitter wars and high turnover in his administration, the real estate market continued to perform well. In Europe, the economy strengthened further during elections in Germany and France, with both countries returning an average 2.1% per quarter since the bottom of the cycle. Even Brazil's economy started to recover after a deep recession, exacerbated by, or perhaps because of, political scandals. However, the real estate market has some way to go before recovery in this instance. More recently, Japan's Prime Minister Shinzo Abe's snap election resulted in a landslide victory for the coalition and secured continued reforms – the lifeblood of the Japanese real estate market. In China, Xi Jinping cemented power and rhetoric changed from a focus on economic growth to building an affluent society, the benefits of which will be felt across the globe. Looking ahead, the full impact of Brexit remains unknown, but it has proven possible to navigate the uncertainty. The outcome of current political uncertainty in Catalonia, on the other hand, could be different.

Real estate performance continues to positively surprise in what has turned out to be a prolonged cycle

Comprehensive quarterly data is limited to a handful of countries but we can observe distinct patterns. Sweden, France, Germany, the US, Canada and Australia all managed positive total returns over more than 29 consecutive quarters. Total returns averaged between 1.4% (Japan) and 3.9% (Ireland), with most countries posting returns between 2.1% and 2.4%. Low interest rates, depressed inflation and a modest construction pipeline have driven demand from both investors and occupiers. Real estate yields have compressed to historic lows and rental growth has been remarkably buoyant despite low inflation. The industrial sector has performed particularly well and the emergence of the alternatives sector, encompassing hotels and different parts of the residential sector, has been another key feature. The alternatives sector now represents 25% of total transactions in the UK given strong demand, while the private rental sector presents a particularly attractive growth opportunity.

All property performance in the current cycle



Source: IPD/MSCI Global Hybrid Benchmark Data, Q2 2017, local currency returns

Simon Kinnie
Head of Real Estate Forecasting

Lulu Wang
Real Estate Investment Analyst (UK)

Craig Wright
Real Estate Investment Analyst (Europe)

Markets in detail

UK real estate

- **UK real estate has fully recovered the capital losses incurred following the EU referendum.** Having fallen close to 4% immediately after the vote, prices are now back to their pre-referendum levels. Furthermore, All Property performance over the year to date has been stronger than analysts initially anticipated (7.6% total return over the year to end-September) and double-digit returns are likely for the year overall. Capital values have risen by 3.4% over the last nine months. Meanwhile, the All Property yield of around 5% continues to compare favourably with low yields elsewhere. Although rental growth is moderating, it remains positive so far this year. According to MSCI/IPD, rents rose 1.3% over the year to end-September. The industrial sector (13.8%) continued to provide the strongest returns so far in 2017, with retail (6.6%) lagging behind.

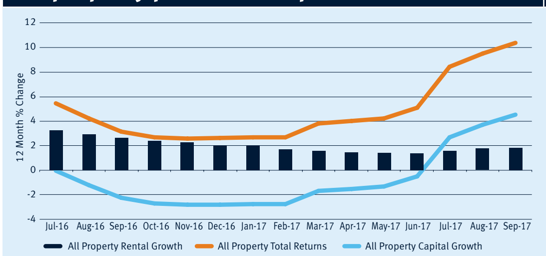
- **UK investment volumes continued to hold up well, driven by overseas demand.** UK real estate transactions totalled £12.3 billion in Q3 2017, which was once more above the long-term average since 2000. Overseas investors remained the largest net investors, with purchases of nearly £4 billion. They were also the sole net buyers, with Chinese and Hong Kong-based investors accounting for a significant share. Private property companies were the largest net sellers. At a sector level, London offices remained dominant, attracting £3.4 billion of inward investment, followed by the rest of UK offices. Demand for industrial assets was still buoyant, as favourable fundamentals and the security of long-lease income continued to attract investors. Activity in the retail sector stayed subdued, although retail warehouse transactions have picked up lately. However, both retail warehouses and shopping centres are likely to end the year below the long-term average.

European real estate

- **Political events have not derailed European real estate but Catalonia could be different.** Europe has been through an unprecedented period of political events, coinciding with global political change. While uncertainty levels have been high; the European economy has marched on. The Eurozone economy grew at an annualised rate of 2.3% in Q2 and forecasts for 2017 have risen from 1.4% in January to 2.1% in September. As a result, European real estate has ridden the wave of political instability and performed extremely well. At 11.5% over the year to Q2 2017, according to the MSCI/IPD Global Property Funds Index, total returns exceeded other global regions. The Netherlands, which at one point was the focal point of political uncertainty, returned 11.8%. Spain returned 11.7% but the independence referendum in Catalonia could tangibly impact real estate performance. Barcelona, which has relied on global capital for improving liquidity, could be particularly affected, while international businesses could favour Madrid for longer-term stability.

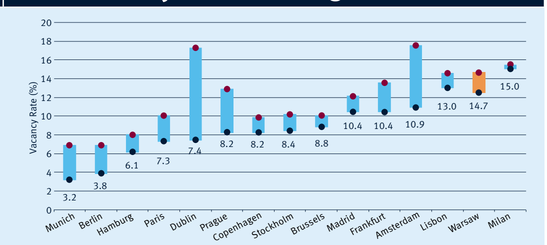
- **Is the long-awaited supply reaction starting to emerge in Europe?** The missing component from the current real estate cycle has been development activity. Finally, after 17 consecutive quarters of economic growth, signs of higher construction activity are now emerging. Construction order books in the Eurozone rose to their highest levels since January 2008, while the construction component of industrial output is now increasing at around 3% per annum. Deeper analysis shows that a large component of development activity thus far has focused on addressing supply shortages in Europe's residential markets. However, this focus is now switching to the office sector, which is starting to experience increased activity. Vacancy rates are at a 15-year low on aggregate and rising rents make development a more financially attractive proposition. At 3.2% of existing stock, office building starts across the key European markets have reached their highest level since 2009. Reassuringly, levels are still modest in the context of previous cycles. However, trends can rapidly change and it is important to watch for over-exuberance.

UK property performance post-referendum



Source: MSCI/IPD, Standard Life Investments, as at September 2017

Office vacancy rates declining



Source: PMA, Standard Life Investments, as at Q2 2017

Donald Hall
Real Estate Investment Analyst (Americas)

North American real estate

- **The longest run in US commercial real estate returns should continue.** This cycle has been unique for both the record length of positive returns and the composition. Since NCREIF began tracking US institutional returns, capital growth has never played such a large part in total returns. However, income growth is poised to drive returns from here. As of Q2 2017, capital growth had slowed for three quarters. It now represents just 3.3% of annual returns, compared with 7.8% on average since Q2 2010. Conversely, income added 4.4% to returns, modestly down from 5.2% over the cycle but on a steady footing to continue driving returns. As of late October, all four property types had vacancies below their average for this millennium: apartments at seven basis points (bps), offices at 98bps, retail at 127bps and logistics at 345bps. New construction is tempering rental growth in some markets and rents are not growing as quickly as they were in 2015 and 2016. However, landlords still have pricing power in most markets. With banks continuing to pull back on construction lending, steady rent and income gains should help extend this cycle's record run of positive returns.

- **Brazil's economy seems to have bottomed.** After the worst recession on record, Brazil's economy grew for the second straight quarter in Q2 and notched its first annual gain (0.23%) in three years. While the economy continues to improve, this recovery may be more subdued than previous cycles. Brazil is still struggling with the overhang from the credit boom of the past decade, the continued need for major fiscal retrenchment, the lack of industrial export drivers and high real interest rates. Political uncertainty and corruption allegations also sour the positive trend; but law enforcement, the media and the judiciary are exposing and investigating allegations. In São Paulo, deliveries from projects approved in the last boom are finally slowing and new rezoning should help slow new construction. With Class AA+ central business district vacancies at 26.7% and rents down another 2.1% quarter-on-quarter, it will take some time for the market to be healthy. Net absorption is positive, however, so with the economy on the right track and supply finally under control, the market is beginning to head in the right direction.

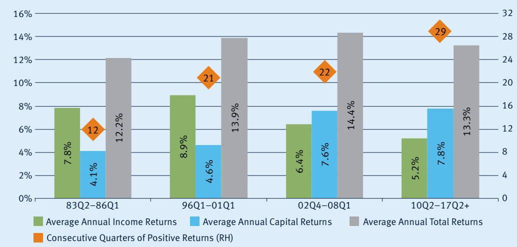
Violet McDonald
Real Estate Investment Analyst (Asia Pacific)

Asia Pacific real estate

- **Political conclusions favour real estate.** Asia experienced its measure of political uncertainty in the run-up to Japan's snap election and China's Communist Party Congress. Under Shinzo Abe's leadership, Abenomics has been central to the firm and sustained performance of real estate, which has benefited from a more stable economy, relaxed immigration and growing numbers of women in the workforce. All Property returns in Japan improved significantly to an annual average of 7% since 2013. In China, a more powerful President Xi Jinping secured his second five-year term and announced a series of goals to achieve national greatness. These are no longer focused purely on economic growth, but instead on building a comparatively affluent society. Growing affluence has been a key driver of the residential sector and the expanding tourism sector, which is driving the hotel sector across the region. Transaction volumes for hotels in the first nine months of 2017 were three times more than the same period in 2016.

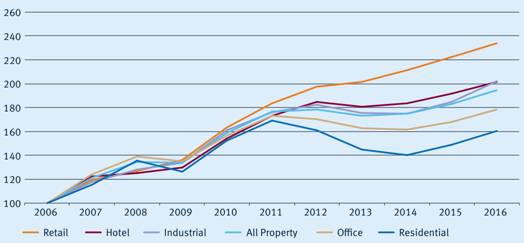
- **Real estate benefits from transport infrastructure investment.** Governments across the region have embarked on initiatives to improve and expand transport links. China's One-Belt-One-Road initiative is the most ambitious, encompassing land and sea routes, the extent of which should cover some 60% of the world's population and two-thirds of global GDP. As accessibility improves, new areas for real estate expansion are created and the benefits are significant across all sectors. E-commerce is booming as the large and increasingly wealthy Asian population takes to online shopping. However, cultural differences and disparities in connectivity lend support to bricks-and mortar retail. The retail sector has, on average, outperformed the other sectors over the past ten years and with less return volatility. Delivery times remain the holy grail of e-tailing, driving demand for well-located, modern logistics space. Low logistics supply has driven both rents and yields, and the sector was the top performer in 2016 at 9.4%, followed by residential at 7.8%.

Long US cycle fuelled by capital appreciation



Source: NCREIF NFI ODCE, as at Q2 2017

Asia Pacific logistic total returns strengthen



Source: IPD/MSCI to December 2016, annual, US$ returns

David Scott
Real Estate Investment Analyst (UK)

Alternatives

- **Investment volumes in the UK alternatives sector have already surpassed 2016 levels.** Overall, the sector has accounted for approximately 25% of total UK commercial property transactions so far in 2017, according to RCA. This is the biggest market share figure ever recorded by the alternatives sector, comfortably exceeding 2016 levels. The increase is partly because of the more modest levels of investment into traditional commercial real estate sectors. Overseas investors have also made a number of sizeable transactions in the student accommodation and hotel sectors. A key driver of investor interest historically has been the ability to access longer leases. As the alternatives sector has matured, investor understanding of the operational business models has evolved. The sector is more about diversification and less about simply long income. The growing share of build-to-rent (BTR) development sites illustrates this point. Development remains the only viable route to market given the severe lack of standing investments in the UK.

- **Structural factors support institutional involvement in the private rental sector (PRS).** The PRS forms an increasingly important component of housing tenure, accounting for 4.5 million households in 2016, equivalent to 20% of the housing market. This figure is forecast to grow to 24% by 2021. The increase in the PRS has been far more pronounced among younger people. In 2005-06, 24% of 25-34-year olds lived in privately rented accommodation in England. By 2015-16, this number had grown to 46%. The sector has been a key beneficiary of stretched affordability and tighter mortgage lending in the home-ownership market. Urbanisation, a change in the cultural acceptance of renting and the desire for city-centre living have also played an important role in the sector's growth. Currently, small-scale landlords dominate ownership of privately rented accommodation. Institutional involvement remains at a nascent stage, but this is set to change as interest in the BTR sector continues to grow at a time when the traditional buy-to-let market experiences more punitive government policies. With £30.3 billion targeting the UK BTR sector over the next five years, according to CBRE, the growth opportunity is significant.

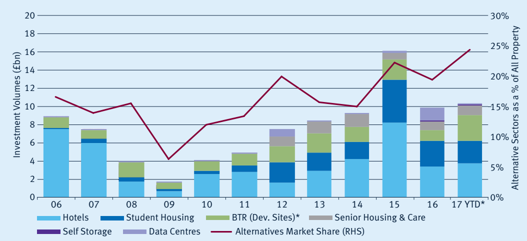
Svitlana Gubriy
Global Real Estate Equities Portfolio Manager

Global listed real estate

- **Global listed real estate markets posted a modest positive return during the third quarter.** Continental Europe continued its recent strong run, with performance broadly based across sectors given increasing confidence in economic growth. Spanish and Irish real estate specialists were the strongest performers, with both benefiting from the continuing recovery from their respective banking crises. German residential and Swedish specialists also performed well following strong economic growth. Meanwhile, the UK market outperformed marginally, largely driven by currency moves, with sterling recovering almost half of its post-referendum losses in September. The London office and UK retail sectors were negative, as investors continued to anticipate capital value weakness. Reflecting this, stocks trade on deep discounts to net asset value. On the other hand, UK industrial specialists delivered significant outperformance, where interim results showed continuing strength in both rents and capital values.

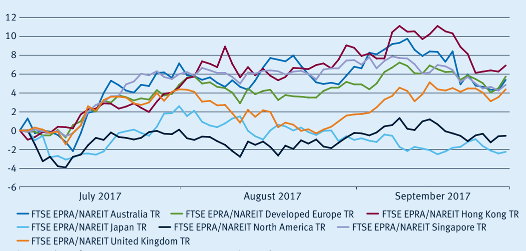
- **The North American REIT market moved ahead but lagged both the broader equity market and the global REIT index.** Volatility in the interest rate environment and a weaker US dollar were the biggest drivers of this underperformance. Canadian REITs outperformed the US market, with the Canadian economy appearing relatively healthy, as business sentiment has reaccelerated. This offset any slowdown in the Toronto and Vancouver housing markets because of policy decisions aimed at reducing speculation. In Asia, rising stock markets in Hong Kong and Singapore also benefited real estate stocks. However, this made many of them appear increasingly expensive in the face of lacklustre fundamentals (Singapore) or building headwinds (Hong Kong). By contrast, Japan and Australia languished. Japan suffered following continued disappointment on inflation expectations and Australia sold off as investors became increasingly cautious about the impact of higher interest rates and weak consumer data.

UK alternatives sector investment is growing



Source: RCA as at 27/9/17

Q3 listed real estate performance



Source: Lipper for Investment Management, as at 30 September 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; comfortable margin over government bonds remains.
Quantitative easing/ stimulus	Tighter	**Synchronised global tightening** US and UK rates rising; further ahead than Europe and Japan.
Flow of capital	Slowing	**Keen pricing curb investment** Likely passed the peak of investment this cycle. Allocations persist and increasing in some markets.
Fund flows	Stable	**Moderating** Global funds targeting US and Europe; higher allocations from government pension funds e.g. Japan.
Lending	Slowing	**Modest tightening in standards** Signs of caution in financial markets.
REIT pricing	Fair	**Priced at fair value** Pricing disparities within sectors and regions, 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 Q3 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	Brexit is the stand out risk for Europe 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 economic outlook would hit values.
Bond yields and stimuli	Markets pricing in accommodative BoJ and ECB; Fed tightening more pronounced	Central banks are becoming more hawkish given stronger economic growth and signs of inflation.
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 Q4 2017

UK		
Build to Rent Rest of UK	Heavy to Very Heavy	We upgraded the sector due to a stronger rental growth profile.
Build to Rent London	Neutral to Heavy	This movement is due to relativities.
Grade A City	Very Light to Light	This movement is due to relativities.
Regional Shopping Centres	Heavy to Neutral	We are more pessimistic on overall rental growth prospects.
West End Offices	Light to Very Light	This movement is due to relativities.
Europe		
Dublin Offices	Very Light to Light	The market is moving through the cycle, but occupier fundamentals continue to look healthy in the near term.
European Logistics	Heavy to Very Heavy	European logistics markets are relatively more attractive, as higher income returns and buoyant fundamentals support the total return outlook.
Americas		
New York Offices	Neutral to Light	Fewer new tenants entering the market, coupled with tenant downsizing and new supply, are weighing on fundamentals and rental growth.
Asia Pacific		
China Logistics	Heavy to Very Heavy	A massive undersupply of logistics space and growing e-commerce support rental growth.
Melbourne and Sydney Industrial	Heavy to Very Heavy	Supply is taken out of the market for rezoning to residential use and/or to make way for new transport infrastructure. The resulting undersupply is driving rents.
Singapore Offices	Light to Neutral	The market has bottomed and rental growth is imminent.
Sydney and Melbourne Offices	Very Heavy to Heavy	These markets are moving through the cycle and starting to peak. Rental growth is slowing and further yield compression is unlikely.
Shanghai Offices	Neutral to Light	Oversupply is putting downward pressure on rental growth.

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

Q4 2017 - Three-year view

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

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Important Information

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