M&G Real Estate

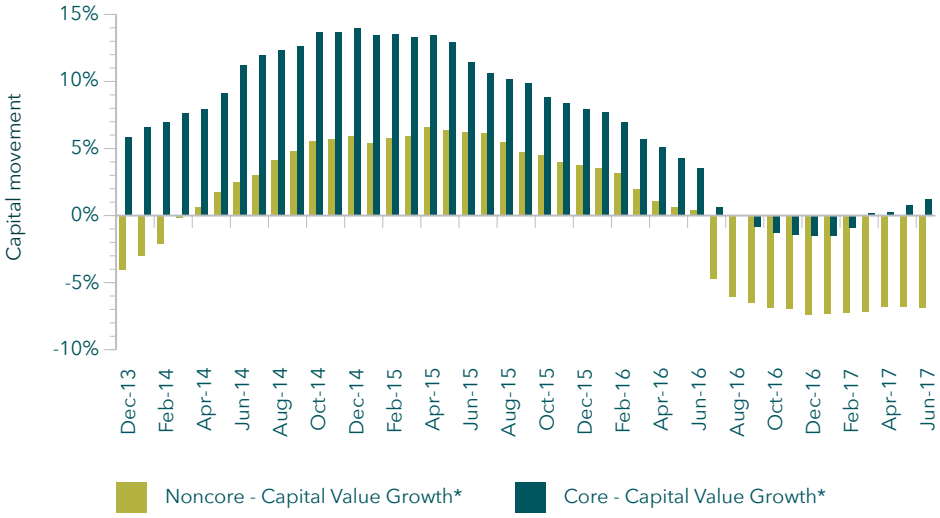
Tackling the low-yield conundrum

Record low yields across asset classes and markets create the conundrum of potentially lower returns, a persistent challenge facing many investors across the globe. Returns from property have been driven by yield compression and, consequently, capital growth driven by falling yields is unsustainable over the long term, as yields cannot harden forever.

Unlike in the past, no longer can returns be safely derived from high yields, a bit of growth and some moderate leverage. It will require more than a core strategy to achieve this. Higher returns can be achieved by taking on more risk, through adding leverage, or by strategies requiring refurbishment or development. Adding leverage at a period of elevated values, however, carries higher risk, and preferences are to keep leverage at very modest levels. Hence, in a lower-return environment, active asset management is increasingly necessary to achieve strong rental and capital growth. This should be considered and factored into the yield that investors are willing to pay for an asset.

In the United Kingdom, the "lower for longer" interest-rate environment is not likely to change in the near term, as the Bank of England has signaled that a rate rise is not in the cards until 2019. Furthermore, structural changes to the U.K. workforce and economy mean we are unlikely to return to the consistently high periods of inflation witnessed in previous decades. We should, therefore, expect that bond yields — and, therefore, the risk-free rate — are likely to rise only to a lower "new normal," while a world of low inflation continues. This, in turn, has pushed yields on U.K. prime assets lower, propelled by overseas buyers diversifying away from their domestic markets, attracted by weak sterling and the relative pricing discounts available compared with other global markets. In contrast, yields on noncore assets with risk attached have come under increasing pressure. The lack of clarity surrounding Brexit negotiations has heightened investors' risk perception, despite attractive U.K. economic fundamentals and relative stability in demand across the majority of the occupational markets versus their long-term averages. This is reflected in the pricing weakness of noncore assets, which have fallen 7 percent a year on from the June 2016 U.K. referendum.

Noncore capital values have already fallen



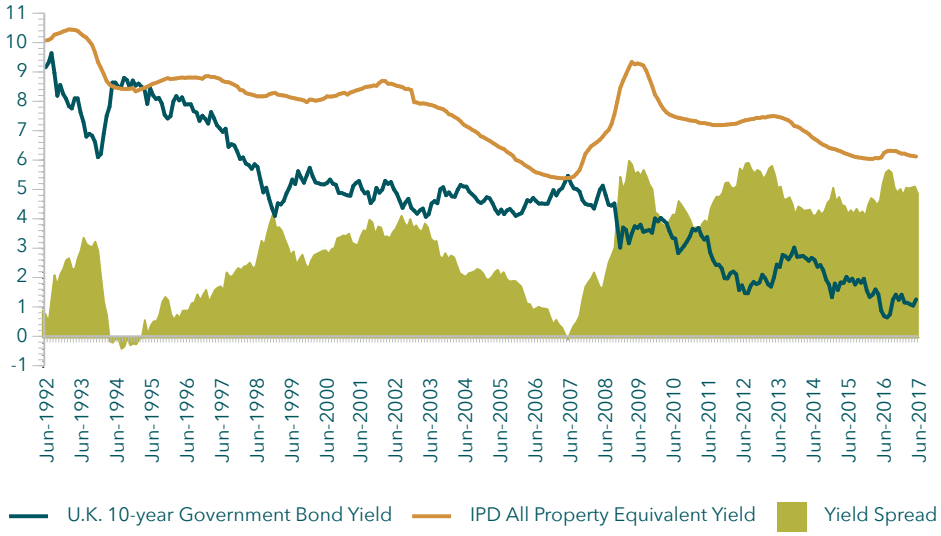
Sources: M&G Real Estate, CBRE June 2017
**Refers to top and bottom 10% of dataset, based on equivalent yields*

Domestic investors continue to focus their investments on safe-haven assets, which demonstrate defensive income or have the potential for further growth. As such, U.K. investment volumes have declined by 33 percent year over year, as risk-off investors shy away from noncore real estate.[1] The resulting divergence in pricing has created a two-tier market with opportunities for property investors that can enhance value through focused, active asset management. This includes assets considered noncore due to near-term income or capital risk, but which are located within a supply-constrained market and, therefore, are still supported by attractive occupier fundamentals.

In the office sector, the weight of capital and strong rental growth have driven up pricing on prime assets. Value can be found through looking at locations that are still well-connected from a transport perspective, but face challenges that can be addressed through asset management. This could be vacant units, short lease lengths or an unfavorable tenant mix. Alongside improving the income profile of an asset through tackling such issues, there is an opportunity for active management to improve its quality through adding floors and upgrading existing space to command higher rents. Better value can also be found in cities outside of central London. Central London,

U.K. real estate offers relatively high yield-spread over government bonds

IPD Equivalent Yield vs. 10-year Government Bond Yield



Sources: Bloomberg, IPD (June 2017)

in particular, faces downside risks from Brexit and has also been the recipient of elevated levels of new office supply. There is a shortage of class A office stock in key cities outside of London (the regions) — particularly in Bristol, Edinburgh and Manchester — which should support rental growth and capital values, while such cities also have a lower concentration of financial services companies. The connectivity of the regions to the rest of the United Kingdom is set to improve with the Government's plan to spend £26 billion ($33.5 billion) on transport and infrastructure. The affordability for occupiers residing in cities beyond London is also clear. For prime class A office space (for a minimum of 10,000 square feet on a 10-year term), rents are £34 ($44) per square foot per month in Manchester, compared with £65 ($84) per square foot in the City of London.[2]

Another opportunity where we can take advantage of attractive pricing is in the retail sector. Weaker consumer and occupier confidence is likely to lead to greater polarization between better-performing retail, including dominant shopping centers with a diverse offering, and poor retail, such as high street shops in oversupplied second-tier towns. Asset managers can, therefore, take advantage of property in good locations that require capex investment or leasing improvements and benefit from this polarization between better and worse assets. The retail sector is likely to continue to evolve to offer the end consumer an experience beyond the traditional shop format and, as an extension of the retailers' logistical supply-chain network, "click and collect" is becoming more common. Adding or enhancing the leisure offering is one route toward extending the customer dwell time. Overall, the growing role of e-commerce and evolving shopping habits provide numerous opportunities for an asset owner to stay ahead of the curve to create value.

This exponential growth of online retailing is driving higher demand for logistics space, where limited supply is underpinning the healthy prospects for rental growth in industrials, which we forecast to perform the strongest out of the U.K. sectors. Options are limited for occupiers, as development starts for distribution warehouses have dropped significantly since last year's Brexit referendum result. In an increasingly competitive market for investors, yield compression has driven up pricing on prime assets, making the search for value more important, whether through speculative development or existing assets needing refurbishment.

In summary, the U.K. property cycle looks to be well advanced, with expectations of further capital appreciation limited, except for industrials. A variety of factors is causing a polarization in the market and the potential for some interesting buying opportunities. The Brexit negotiations have caused a significant fall in investor risk appetite and, hence, buyer interest in noncore assets alongside a decline in the capital values of such assets. In London, the Brexit process is putting some question marks on the resilience of even class A assets, as occupier fundamentals are at risk at a time of rising supply. In the retail and logistics sectors, the growing impact of e-commerce is forcing both sectors to evolve in line with new consumer habits. So, even when the overall market is at a mature point in the cycle, the United Kingdom offers a variety of opportunities for a focused and informed investor.

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[1]CBRE Q1 2017 [2]M&G Real Estate, June 2017