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ADVISORY

UK Real Estate Update

Autumn 2015

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2015 anticipated to be record year as UK real estate continues to attract overseas and domestic investors

The fundamentals underpinning the UK property market remain strong and confidence continues to grow as investors and lenders alike are buoyed by the positive outlook.

A decisive result in the May General Election, and disarray in the opposition, suggests that a sustained period of stable government is likely. With some investors holding back in the period of uncertainty leading up to May's election, this result already seems to be acting as reassurance and Q2 showed a pick-up on the start to the year. One area lagging behind the anticipated resurgence, however, is the high end residential market, which is still adjusting to the tax changes brought in at the end of last year.

The UK remains an attractive property investment destination, evidenced by the continued high levels of overseas capital reaching our shores. Whilst there are a number of factors pulling in investors (high occupier demand, low interest rates and short supply, as well as our geographic position, transparent markets and economic stability to name a few), the UK continues to benefit from the comparative lack of stability in the Eurozone. We have seen cities like Madrid, Milan and Lisbon moving up the ranks of top investment markets this year, and these will likely become more viable alternatives to London's overcooked market if the euro stabilises, however London remains very much on top for now. How the major European countries react to the migrant crisis currently dominating headlines will also certainly have implications for investor confidence in the continent, which in turn may reinforce the relative attractiveness of the UK. Furthermore, as the occupier markets continue to recover in the UK regions, the search for better value than London's expensive offerings may not lead to a diversion away from the UK market as a whole. Indeed, we are seeing some investors (both domestic and overseas) increasingly turning their attentions to the UK regional hubs.

The impact of a UK interest rate rise remains a topic of debate, but the decision date has been repeatedly pushed back and current estimates are looking at Q2 next year at least, and likely even Q3. Even when rates do start to rise, it is questionable if a 1-1.5% increase spread over 9-12 months would have a significant detrimental effect on real estate investment activity. There may be a slight (and arguably much needed) price correction, particularly in the steeply priced London market, but with other market fundamentals still so positive it would likely take more than a rate rise to deter investors.

With no let-up in demand and an ever-present supply issue, investors are finding it increasingly difficult to obtain suitable assets. Perhaps an inevitable response to a frustration amongst investors with deep pockets who are repeatedly outbid at auction is the current rise in interest in corporate activity we are seeing in the real estate sector. Indeed, recent news of UK listed property companies being the target for stakebuilders with an eye to take private deals could pave the way for an alternative route into the market. Further deals could well be on the horizon, with interest likely to be focused on property companies with geographically concentrated portfolios.

In summary, London continues to outperform its European peers, with record sale values and low yields apparently yet to deter investors. The regional markets are also continuing to see increased interest, and looking forward the UK overall appears set to have a record year for real estate investment.

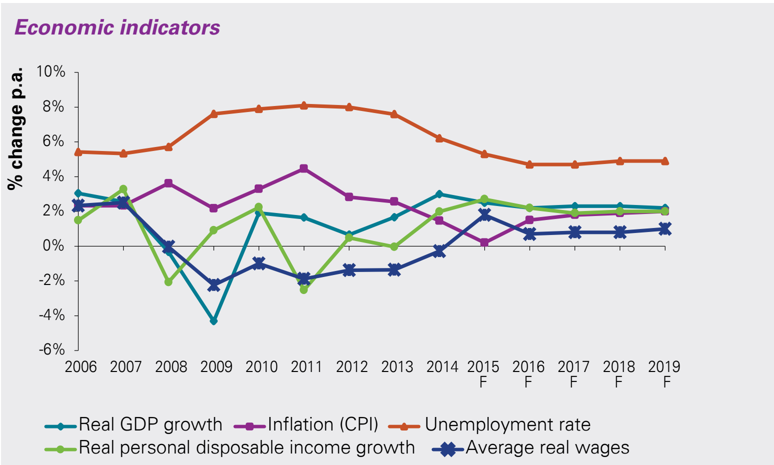
Macroeconomic overview

According to the Office for National Statistics (ONS) UK GDP grew by 0.7% in Q2 2015, contributing to a 2.6% increase over the last twelve months. This represents a slight slowing in growth, with 2014 experiencing a 3.0% rise. However, the UK is still likely to be the fastest growing of the G7 countries this year and the economic outlook remains markedly positive.

Whilst the decisive result in the May General Election brought stability, news of late has been dominated by challenges in the global economy, and there remains uncertainty on home soil over the EU referendum due in 2017 and increasing nationalist sentiment in Scotland. On top of the list of concerns for investors currently is the turmoil in the Chinese markets, which is having clear effects on the UK stock market. According to the recent Bank of Merrill Lynch European fund manager survey, concerns over Greece's economic situation and potential exit from the EU have been replaced by the risk of a recession in China. However, many now feel that the UK, and indeed the Eurozone, is in a far better position than a year or two ago to handle such challenges.

With food and energy prices remaining low, inflation has continued to hover around zero. The appreciation of the pound and the resultant drag on import prices has also kept inflation from rising. However, the outlook for the medium term remains positive and the Bank of England (BoE) anticipates meeting the 2% target within two years. Expectations that the BoE will start to increase interest rates from the current record low of 0.5% at the turn of the year are now being pushed out to Q2, or even Q3 for some. Any rise is still likely to be very gradual once it does commence.

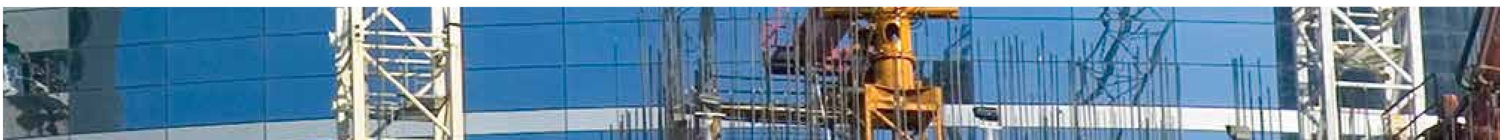
Business and consumer confidence remain high and credit conditions continue to improve. Whilst consumers may be tempted to hold out for cheaper prices in this low inflation environment, spending patterns do not seem to reflect any change in behaviour and the economy continues to be underpinned by strong consumer spending. Rising household incomes, and the expectation of further increases for many, have also resulted in strong consumption growth. In addition, the outlook for business investment is positive. A recovery in productivity is also anticipated over the coming quarters, although this remains vulnerable and well below average.



Source: Economic Intelligence Unit. F = Forecast

Though the latest data shows an uptick in unemployment rates, many observers believe this rise could reflect a mismatch in supply and demand, as companies are finding it increasingly difficult to recruit new employees with the appropriate skills. This tightening of the labour market has also resulted in increased competition between firms for the best staff, which is likely to materialise in increased wages. The Conservative government's announcement of a National Living Wage in the July Budget, to be introduced from April 2017, will also contribute to rising wages, however there may be negative implications for how some firms in traditionally lower-paying sectors deal with this increased cost of labour. Unemployment levels may rise if the solution is cut back on staffing numbers, and firms may seek a younger workforce with the minimum rates only applying to over twenty-fives.

The July Budget was also notable for its tax raising reforms and significant cuts in the Government's welfare bill. Further fiscal consolidation and austerity measures expected from the Conservative majority government are likely to dampen economic growth in the short term, however the outlook for the UK remains largely positive and the hope is that these will improve the country's resilience to future shocks



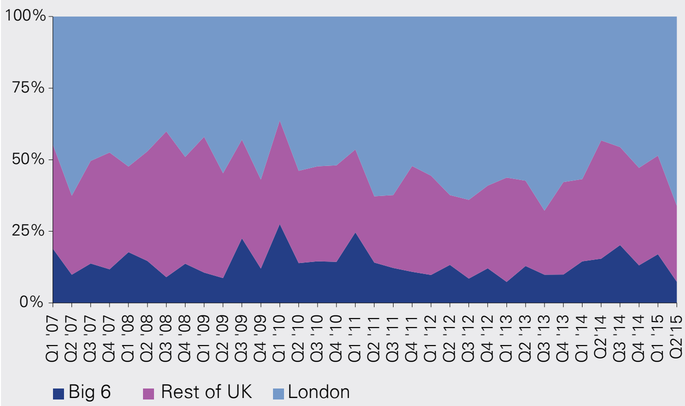
And back to the real estate!

Investments for the first half of the year increased 11% on the equivalent period last year, although this still represented a drop of 16% when viewed against H2 2014. This drop is largely owing to the slow start to the year in Q1, possibly due to hesitancy in the run-up to the May general election. Nonetheless, Q2 picked up and total commercial real estate (CRE) transaction volumes totaled £23.3bn for the first two quarters of 2015, putting the market 12% ahead of its 2007 peak[1]. The underlying fundamentals of the UK commercial property market continue to strengthen and the outlook for further transaction and rental growth, as well as rising capital market values, remains positive. However, with supply an ever-pressing issue across the UK CRE markets and yields continuing to compress, investors will need to look harder to find attractive assets offering fair value.

According to the Q2 2015 RICS UK Commercial Property Market Survey, occupier demand has now risen for the 11th consecutive quarter – the longest run of occupier demand growth since the survey's inception in 1998. Notably, this extends beyond London and we continue to see an improving regional market. With this solid occupational performance, both UK institutional and overseas investors in search of better value are increasingly being attracted to prime regional assets, albeit investment levels dropped slightly for H1'15. Manchester retail and Newcastle industrial assets have been identified by DTZ's UK Fair Value Index as offering the best value in the UK market. There remains room for further rental growth and yield compression in the regions, with the expectation that investors will be increasingly priced out of the flourishing London market, and those willing to move higher up the risk curve in the hope of better returns will shift their focus outside of the capital. Well-located quality secondary assets are also getting a look in.

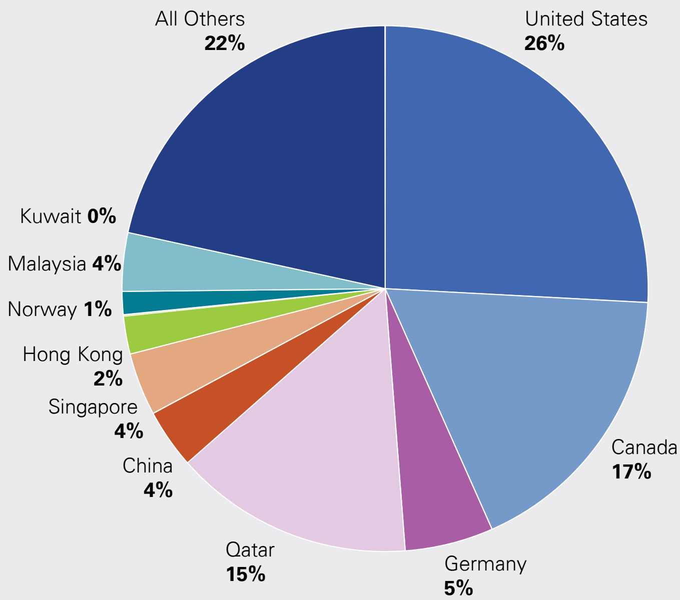
London does however remain on top in terms of investment activity. In H1'15 the UK's capital "received investment equaling the next seven cities combined, and exceeded levels recorded in its only global rival New York".[2] Despite record low yields and high sale values, investors continue to be attracted to the London market. Overseas investors dominate activity, in particular US, Middle Eastern and Asian, with the European cross-border investors net sellers. Domestic investors have also been active and our conversations in the market suggest that pressure to invest is intensifying. Whilst some investors are lured into eye-wateringly high prices, others are considering peripheral and secondary markets in search of better value.

Commercial real estate - Transaction volume composition



Source Real Capital Analytics, rcanalytics.com

Cross-border capital sources (H1 2015)

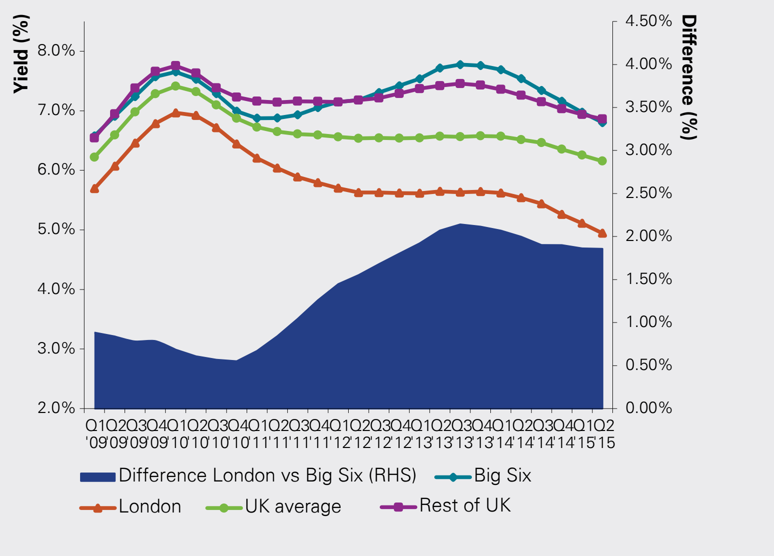


Source: Real Capital Analytics, rcanalytics.com

The supply/demand imbalance remains an issue across UK CRE, both in terms of asset type and location. As such, some slowdown in the market, for example the West End office market, is more a result of lack of supply rather than diminished demand. This is likely to be one the biggest hindrances for investment and occupier activity as attractive assets are snapped up quickly and pre-letting continues to rise. The rise in portfolio transactions for H1 is also a reflection of the lack of larger assets coming to market.

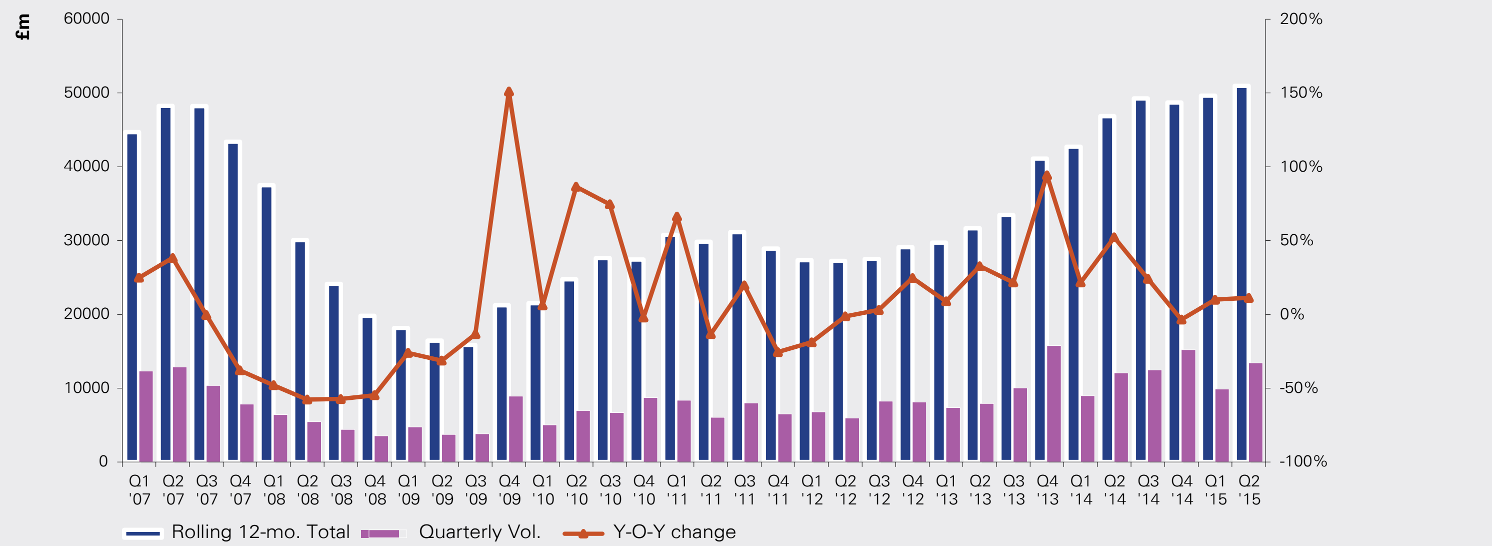
With continued strong investment activity and 2015 anticipated to be a record year for CRE, yields have compressed further and the UK, particularly London, whilst still a very attractive investment location, is likely to be increasingly viewed as fully priced, or indeed overpriced. As interest rates start to rise next year it is possible we will see a slight stabilisation of the UK property market, albeit at a comparatively high level against other countries. The UK does however remain a stable political and economic environment for investors with the current Eurozone and global issues, and thus its attractiveness is likely to persist, at least in the medium term.

UK property yields: London vs. the 'Big Six' vs. the rest of the UK



Source: Real Capital Analytics, rcanalytics.com, KPMG analysis
Note: 'Big Six' includes Birmingham, Manchester Metro, Edinburgh, Bristol, Glasgow, and Leeds

UK Commercial Real Estate Sales



Source: Real Capital Analytics, rcanalytics.com

1 Office market

The UK office market continues to experience thriving occupier demand and strong investment activity, underpinned by growing employment and rising business confidence. With a buoyant first half of the year, the office market is expected to be the stand out performer in 2015, led by the Central London market. However, whilst the London market dominates, investors, particularly UK institutions, are increasingly turning to regional locations for greater value and volume of opportunity. With the flurry of activity outside of London, the yield differential between the South East and the regions has started to narrow and cities like Manchester, Birmingham and Bristol are seeing yields creeping nearer to those in the capital.

The Central London office market experienced its strongest first half year since 2001 in terms of take-up at 6.3 m sq.ft.[3] Though this was largely led by the City, the Docklands and East London market has also come into the limelight, aided by the first major transactions at The International Quarter in Stratford. This building's focus on flexible working space and lifestyle (with childcare facilities, green space and an abundance of shops and restaurants) also highlights the rising demand for serviced office facilities. In the West End market, demand is less forthcoming, with affordability pushing many occupiers to more peripheral markets. With Crossrail improving connectivity in the capital, this will also add to the attractiveness (and thus rising rents) of markets on the outskirts of the core West End.

The West End is however expected to see a record year for investment in 2015, with UK investors representing over half of investment volumes, particularly UK REITs and institutions in the larger deals. Overseas demand also remains high, and with the consequent weight of capital competing for assets and continued rising rents, pressure remains for further yield compression. The City market, where overseas investors dominate, is also anticipated to see further downward movement in yields. This is compounded by the continued supply/demand imbalance, with vacancy rates approaching record lows across the Central London market and increasingly limited investment opportunities. A number of offices are expected to come to the market in the second half of the year, however supply of new stock has failed to keep up with demand and the imbalance is expected to intensify over the year.

A slightly subdued second quarter for regional office investment has not dampened the flourishing start to the year, contributing to the strongest H1 since 2007. Whilst the South East has seen continued activity and steady upward pressure on rents, the West Midlands and other regional locations such as Leeds and Newcastle have experienced significant growth, building on a positive 2014. With high prices, yield compression and a lack of available Grade A stock in the London and South East markets, investors are seeking value in the regions. Leasing activity has also picked up here as firms look to expand, or even move away (particularly as workers are increasingly priced out of London), from the undersupplied and expensive South East market. Birmingham in particular has had a stand-out year to date, with high occupier and investment demand. Bristol also experienced high levels of activity, though other markets such as Aberdeen have been far quieter, likely due to local factors such as the fall in oil prices impacting the Scottish city's North Sea oil industry.

Availability of floor space is a mounting issue in prime locations across of the UK, demonstrated by the rising interest in secondary assets and core regional locations. In places like Birmingham and other regional hubs, an increase in pre-letting activity is absorbing much of the new Grade A stock. As a result, refurbished space is achieving rents not far off those of new builds and a number of investors are considering joint ventures with developers. Next tiers cities are also seeing greater levels of interest as investors, particularly UK institutions, move up the risk curve for well-located, quality and well-let buildings.

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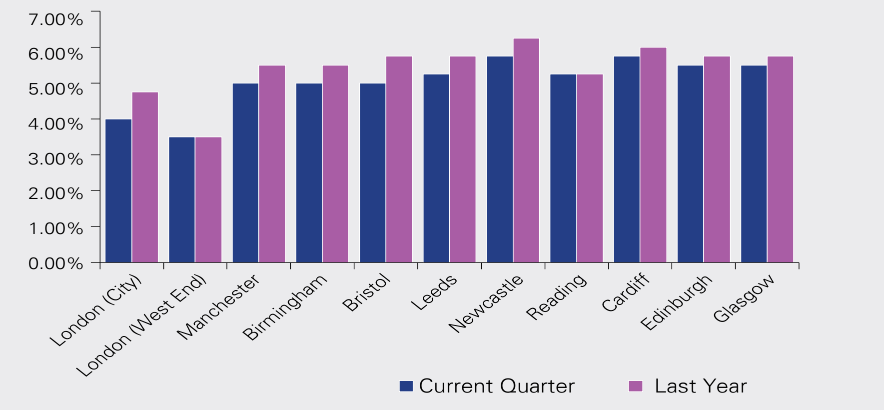
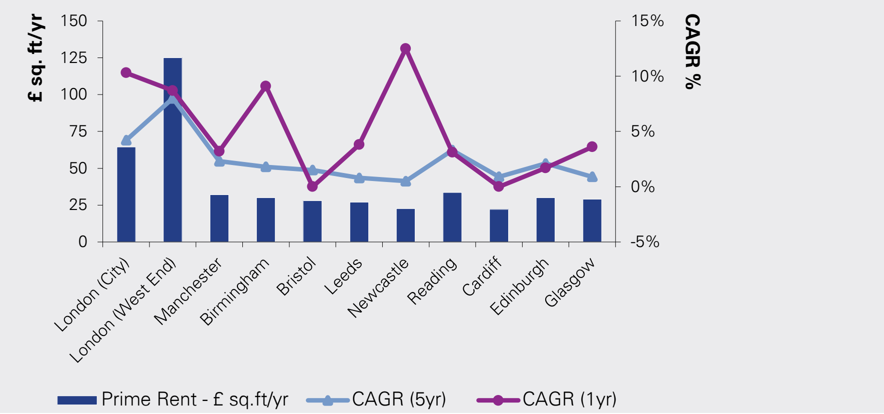
Prime Office yields (net) - June 2015



Source Cushman and Wakefield

Prime Office rents - June 2015



Source Cushman and Wakefield

2 Retail market

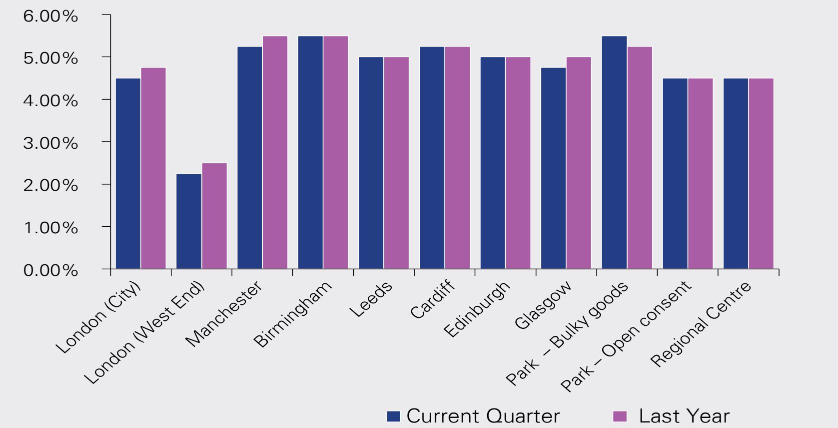
Consumer spending activity improved during the first half of the year due to various factors including low inflation rates, low interest rates, lower levels of unemployment, and a strong economic growth – all of which translated into enhanced disposable income. This trend is expected to continue, backed up by lower fuel and food prices. With a more technologically savvy population, click and collect continues to increase in popularity and is now seen as the main driver behind retailers' growing appetite for more storage space, while also contributing to the drop in footfall in High Street and Shopping Centres, as reported by the BRC/Springboard Footfall Index. An exception has been noted in the case of out-of-town locations where footfall has improved, driven by their ability to provide consumers with enhanced shopping experiences. Food and beverage operators have maintained a stable performance as leisure has become an increasingly prominent aspect of the shoppers' experience.

Though the growing e-commerce sector is moving consumer activity away from the traditional high street, Savills have forecasted an increase in online retailers looking to expand into brick and mortar stores.[4] Competition for space is also growing amongst retailers with a discount strategy, driven by two key elements: firstly, they often demand retail spaces in locations which are overlooked by the typical retailers and, secondly, they have managed to break into a segment historically dominated by the mainstream retailers. However, BNP Paribas reported that in comparison with H1 '14, discount store operators' sales have fallen significantly.[5] Take up in shopping centres, on the other hand, has been largely fragmented across various occupier sectors. Generally, demand for retail space has expanded to a more national strategy, extending beyond the traditionally popular London and South East region, which received the majority of attention a year ago.

In terms of new retail supply, new shopping centres are planned to come on to the market in a number of UK cities. However this pipeline is expected to be insufficient to satisfy demand, even when coupled with the current trend amongst retail developers of expanding and refurbishing existing retail space. Consequently, retailers' expansionary plans are going to be restricted and rents are expected to maintain an upward trend across all types of retail spaces across the UK.

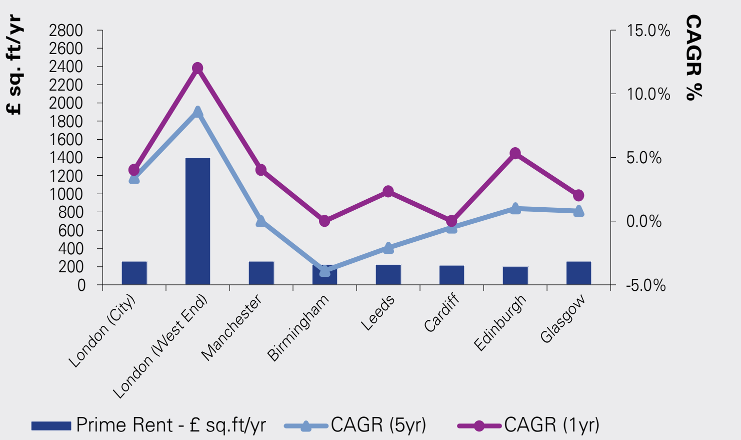
Turning to investment activity, H1 2015 was characterized by high investor demand for shopping centre and well-configured High Street opportunities, but the activity was very much restrained by the available investment prospects. Nevertheless, investors continue to look for suitable opportunities in markets promising rising rents and capital gains. As a consequence, yields followed a downward trend. During the period under analysis, shopping centres took the largest share of total investments with foreign investors comprising 75% of all investors.[6] Investments have also been less concentrated around London with 80% of the investments taking place outside Greater London for the same period.[7] DTZ's Fair Value Index has shown cities such as Manchester, Leeds and Bristol to be the most under-priced cities and, thus, resulting in more value for investors. Moreover, the debt market is optimistic in financing retail investments, evidenced by banks willing to accept high loan-to-value ratios.

Prime Retail yields (net) - June 2015



Source Cushman and Wakefield

Prime Retail rents - June 2015



Source Cushman and Wakefield

3 Residential market

Although UK house prices have continued to rise in 2015, the annual growth rate has eased from 11.5% at Q2 '14 to 4.1% at Q2 '15 according to the Nationwide House Price Index. London in particular has experienced a slowing in growth rate, to the extent that Northern Ireland has now overtaken the capital as the fastest growing region, with average prices up 8% y-o-y compared to London's 7.3%. Nonetheless, London remains the most expensive region in the UK (and 39% more expensive than its 2007 peak) and Northern Ireland the cheapest (45% below its 2007 peak). Confidence is rippling out of London, however, and there has been an uptick in demand outside of the capital as buyers seeks to take advantage of the price gap, particularly in commuter areas. This has contributed to a greater convergence in price growth across the UK, though the South continues to outpace the North with average house prices now almost twice as high.

The slowing growth rate may calm concerns of a potential pricing bubble in the UK to a degree, however pricing is still expected to increase for the remainder of the decade, albeit at a more gradual rate. Furthermore, with the continued low interest rate environment and rising wages driving demand, issues of supply are becoming more critical and have the potential to accelerate price increases if not addressed imminently. Price expectations will likely be impacted by the anticipated rate rise by the BoE next year, however this has not had any significant impression to date and indeed the current global economic situation may further push out the onset of an increase by the BoE.

Lenders appear to have adapted to measures introduced by the Mortgage Market Review (MMR) in April last year and mortgage approvals have now grown every month since the turn of the year. According to the BoE's August Inflation report, mortgage approvals for house purchase increased in Q2 to 66,000 per month on average. There is, however, an ever present issue of affordability, with the greater scrutiny on lending reducing the availability of high loan-to-value (LTV) loans and restricting the ability of those with smaller deposits to enter the market. Nowhere more is this felt than in the first time buyer category, particularly with the continued house price inflation. KPMG published research in April which illustrated that the average wage needed in order to buy a home in the UK was £41,000 – nearly double the actual wage of a first time buyer (the gap being even higher in London, where a £77,000 salary is needed). The emergence of a "Generation Rent", typically the 20-39 age group, is a symptom of this affordability problem as more and more under-forties find they are priced out of the UK housing market. In contrast, more people are owning their homes outright as the proportion of over-sixties increases and mortgages are paid off.

A number of tax changes have been introduced by UK Chancellor George Osborne over recent months, with many aimed at the residential market. One area where the impact of these has been most notable is in Stamp Duty Land Tax (SDLT) and Annual Tax on Enveloped Dwellings (ATED). The tiered SDLT tax structure brought in on 4 December 2014 has reduced the distortions previously caused by clustering of transactions around the tax thresholds, particularly the £250,000 mark. Whilst this is likely to boost the housing market outside of London, the higher prices in the capital mean more will be hit with a higher tax bill, with the impact being felt in the over £1 million market. It was expected that the pre-election slowdown in the market would pick up with the Conservatives winning a decisive majority, and the removal of the threat of a mansion tax. However, whilst Q2 has seen some resurgence in the prime markets, there has clearly been an adjustment period as the influx of sellers have had to respond to increasingly price sensitive buyers taking into account the added cost of transactions. Some vendors have turned to the rental market as they wait for sale prices to bounce back, though this increase in supply is now struggling with reduced demand, particularly in corporate and relocation activity, as a result of the current dip in the stock market.

The higher end of the market has also been impacted by revised ATED rates and other tax regulations aimed at overseas investors. Furthermore, the continued strengthening of the pound against major currencies, and the potential of a 2017 referendum on Britain's EU membership, may put off potential overseas investors. However, the appeal of the UK, particularly London, as a secure investment destination is likely to remain in the medium term and will continue to attract global investors, even if the make-up of these changes. KPMG's recently published London report discusses this further and explores the potential outlook for the capital in the long term.

Other tax measures introduced include the changes to inheritance tax allowances, which may encourage more family homes on to the market as couples downsize without

concerns of passing on the tax burden to their children. However this may also result in high value homes being kept in the family and passed on later in life. This could lead to younger families being priced out of more upmarket areas, which in turn may impact on social mobility given the "postcode lottery" often evident in social provisions in the UK, such as education.

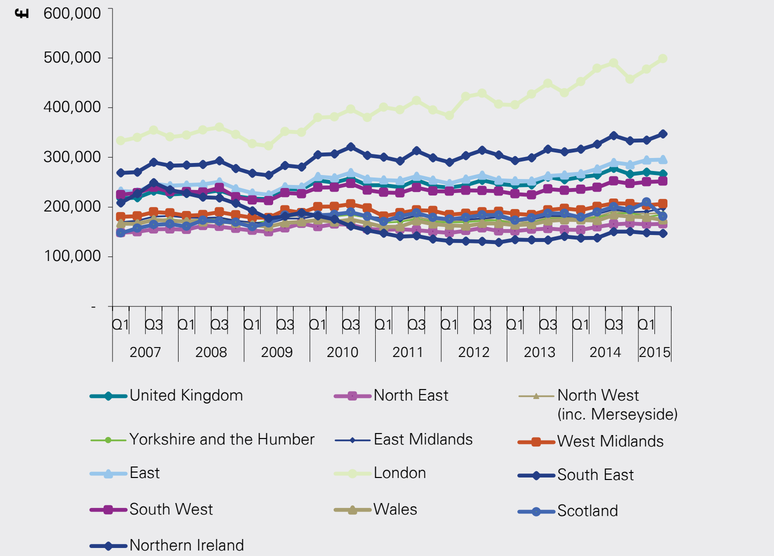
The restriction of buy-to-let mortgage tax relief, which is being phased in from April 2017, seeks to address the imbalance of home ownership and rental tenure. This may also be aimed at counteracting the expectation that the increased freedom of pension access might encourage retirees to invest in buy-to-lets. Whilst this new measure is likely to reduce the attractiveness and affordability of the buy-to-let, opinion is divided as to its impact. Given many pension pots will not stretch to a house deposit in the current environment of house price inflation, and the fact that this is already a shrinking market, it is unlikely to produce any significant uplift in supply.

References to a UK "housing crisis" are ever increasing, and with the latest ONS statistics showing a decline in the rate of new homes started to date this year, it is clear that the government needs to do more to deliver its pledge of making home ownership more available and accessible. The "Fixing the Foundations" policy report published in July offers some promising proposals, with the emphasis on increasing availability of land, and devolving and streamlining the planning process. We noted this time last year that Local Planning Authorities have appeared reluctant to embrace the growth agenda but these new measures seek to address this with leagues tables and government intervention if progress is not made. The commitment to legislate the creation of a register of brownfield sites suitable for development, and further proposals to reduce the number boxes required to be ticked for planning approval for these, will also do much to speed up development.

In addition to the Help to Buy initiative (which currently runs to 2020 , although there is some debate as to the positive impact of this), the government has committed to deliver 200,000 Starter Homes built by 2020, at a 20% discount for young first time buyers, and brought forward proposals to help achieve this. However, the constraint of a lack of skilled workers in the construction sector, and thus increasing costs of those who are available, remain. Furthermore, steps need to be made to help local authorities deal with the devolution of planning powers, for example by investing in more planning officers to process applications.

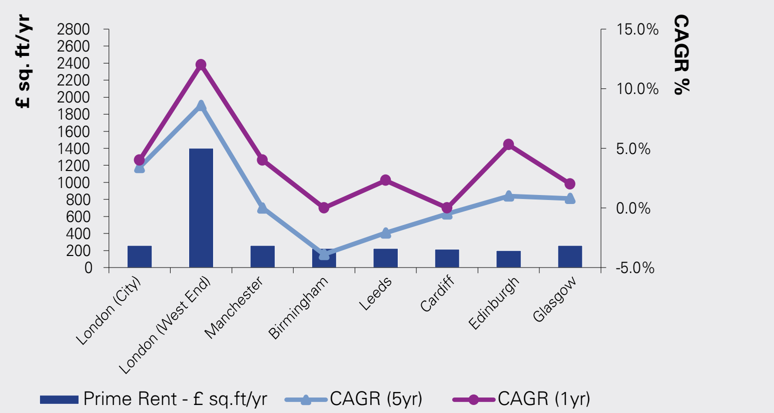
The successful implementation of these proposals will be key to addressing the so-called "housing crisis" and in turn will have a significant impact on future pricing and access to home ownership. In the meantime, "Generation Rent" is reliant on an unsophisticated rental market, which may well develop into the higher quality more long-term solution currently evident in the German and Swiss private rented sector (PRS), but to date has shown limited evidence of changing. The increased interest in PRS by investors could however be a sign of things to come.

Average UK House Prices by Region



Source: Department for Communities and Local Government

GB housebuilding starts and completions



Source: Department for Communities and Local Government
Note: Publishment of data on UK housebuilding is on hold until the conclusion of the Northern Ireland Housing Executive's methodological review. Data for Great Britain housebuilding has therefore been used on this occasion

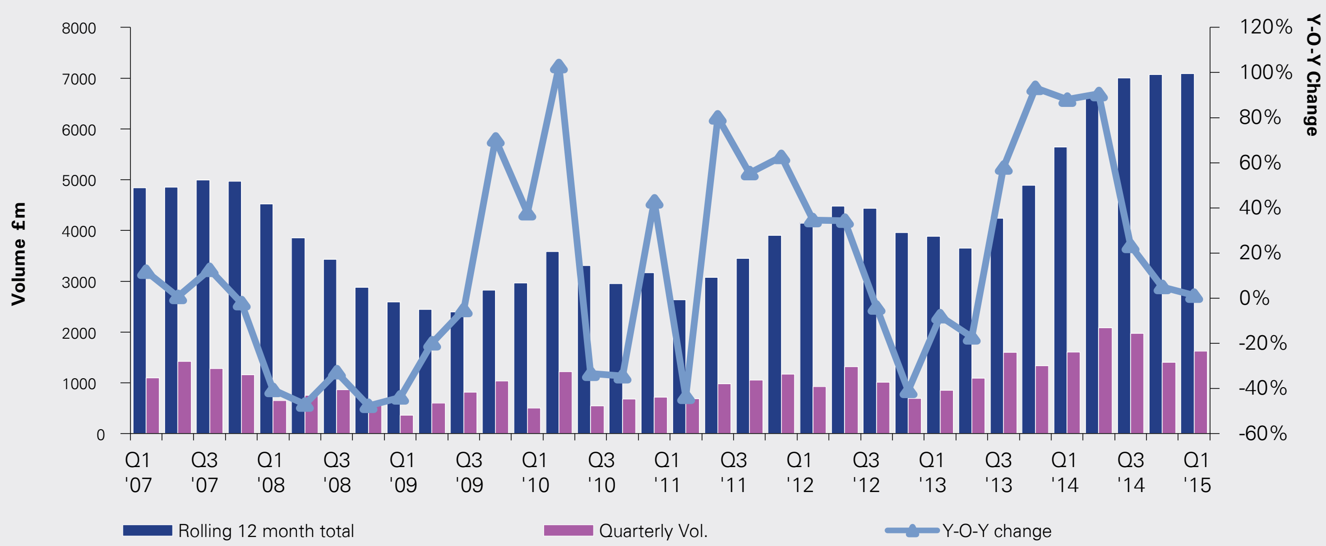
4 Industrial market

The industrial sector has witnessed strong growth in investment and occupier demand in the first half of 2015. With supply still lagging behind demand across the UK, both investors and occupiers are increasingly looking to secondary assets and regional locations for suitable stock. UK investors, particularly those with a focus on the sector, remain dominant in the market. In terms of take up, this has been largely driven by manufacturers and online retailers, with the focus on larger, modern warehouses as firms seek to improve their distribution and supply chain networks. This demand has led to a slight uptick in speculative development in the most active regions, particularly the South and the Midlands, but build-to-suit solutions still dominate elsewhere.

With the highest amount of industrial space of the UK regions, the North West experienced strong take up, recording approximately 3.7mn sq. ft.[8] The growth in the e-commerce sector and some improvement in the market. Demand across the UK for prime and secondary assets continues to strengthen but growth in supply remains modest. Speculative development is witnessing an upward trend and Savills estimate a total of 3.6 sq. ft. to be completed by the end of 2015, yet this is unlikely to be sufficient for the anticipated demand. Consequently, competition between occupiers on the limited space and escalating construction costs are exerting upward pressures on rent and, as estimated by Colliers, further increases of 10% in rental rates are likely to be seen by the end of 2016.

Investments in the sector reached a volume of approximately £3bn[9] within the first half of the year (a 25% drop compared to the second half of 2014) with domestic investors dominating. 2015 has seen a rise in portfolio transactions, reflecting the limited availability of larger assets. With many investors, eager to invest in the logistics sector, in particular investment funds, supply shortages are increasing competition for prime assets and pushing interest to secondary markets. The resultant downward pressure on yields has produced a fall to approximately 5.5% compared to 7.1% in H1 2014.[10]

UK Industrial property market quarterly volumes



Source: Real Capital Analytics, rcanalytics.com

5 European Hotel Market

2015 European Hotel sales volumes shows a surge towards pre-crisis highs

Year to date sales of European hotels show no signs of slowing down, building further on the strong finish in 2014. As the chart below shows, volumes have exceeded the pre-crisis levels seen in Q1 2008 (€19.2 billion) as the rolling 12 month total sales volumes hit €20.3 billion in Q2 2015, according to data drawn from Real Capital Analytics (rcanalytics.com).

London's attraction remains a key contributor to Europe's transactional volumes. However, the UK regions are now well and truly back in business with the volume of transactions equalling those in the highly competitive market of the UK's Capital, delivering a 12 month total volume of €4.7 billion or approximately 50% of the UK's €9.3 billion total sales volume.

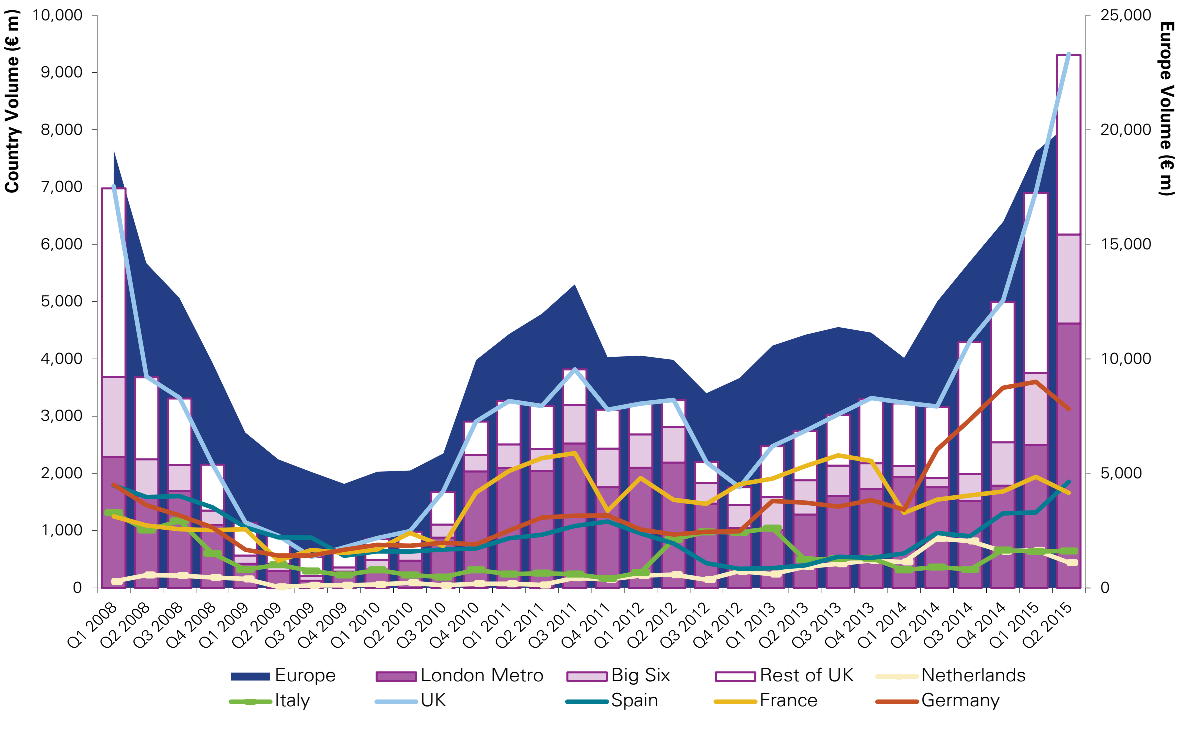
Germany has shown a strong recovery in 2014 with 12 month totals rising from €2.4 billion in Q2 2014 to €3.1 billion in Q2 2015. Volumes are now 73% above those seen in Q1 2008 driven by strong international interest.

Spain is also worthy of note, having seen a return to form with 12 month volumes rising to €1.9 billion having dipped to a low of €0.3 billion in Q4 2012.

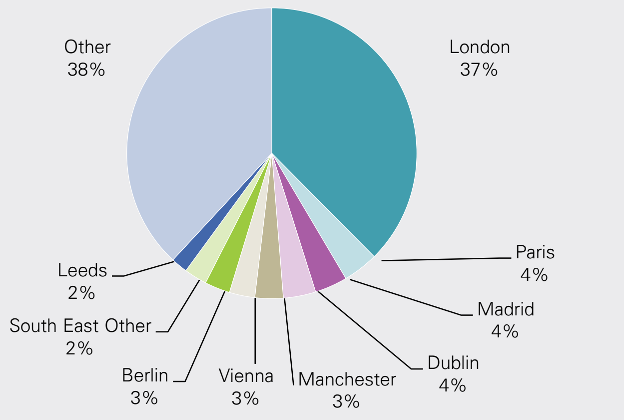
Looking to the key in-country markets London continues to dominate, delivering in excess of €3.6 billion of sales for the 7 months to the end of July. In this same period 30 hotels have transacted, compared with 24 hotels transacted in the 12 months of 2014, however, with QIA's acquisition of 3 of London's prime hotel assets (Claridges, The Berkeley and The Connaught) and with Park Lane's Grosvenor House on the market, 2015 always had the makings of a bumper year and one that may be difficult to repeat due to the lack of supply.

London's dominance is further demonstrated by a dramatic increase in its share of the European market to 37%, 33% ahead of the closest rivals. A clear indication of London's ripple effect is the presence of a further 3 UK markets in the top ten list of European market destinations. Investment capital continues to focus on key gateway cities across Europe, a trend that is expected to continue as political and economic uncertainty rumbles on in the region.

European Market Hotel Sale Volumes (Rolling 12 month totals, €m)

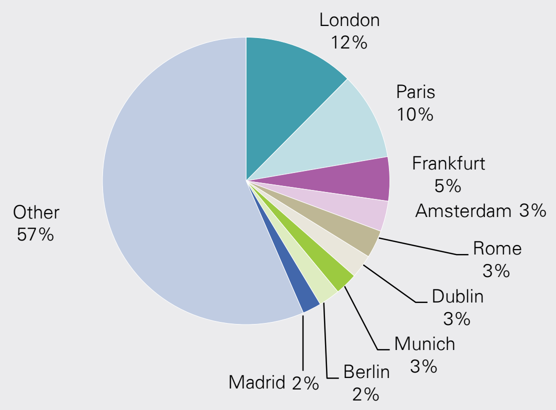


Top European Market Destinations - YTD July 2015



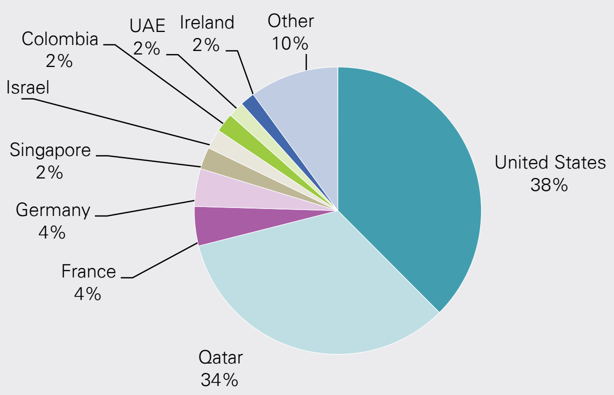
Source Real Capital Analytics, rcanalytics.com

Top European Market Destinations - 2014



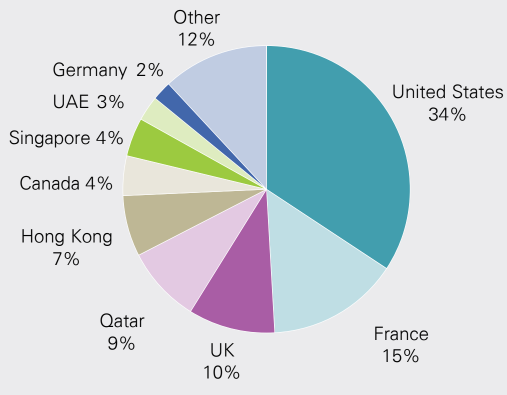
Source Real Capital Analytics, rcanalytics.com

European transaction sources of capital - YTD July 2015



Source Real Capital Analytics, rcanalytics.com

European transaction sources of capital - 2014



Source Real Capital Analytics, rcanalytics.com

5 European Hotel Market- continued

Turning to sources of capital, US and Qatari capital has dominated European acquisitions, as shown overleaf.

US capital has seen Lone Star investing circa €1.6 billion in European hotels. Acquisitions include Jurys Inn's 31 hotels, located in Ireland and the UK, and also the Mercure Portfolio of UK hotels previously owned by Moorfield.

Approximately €2.7 billion of investments have been rumoured to have been made by Qatari capital sources in the year to date, including the acquisitions in London highlighted above and also the acquisition of InterContinental Le Grand in Paris in February.

So what is driving the appetite for UK hotels?

The strength and stability of the economy, especially relative to Eurozone markets, has been a key factor in attracting investment in the UK hotel and wider real estate markets for some time.

The abundance of debt at low cost coupled with overseas capital sources looking for a safe haven have clearly been key drivers. These factors when combined with strong hotel operating performance, allowing for meaningful returns compared to tenanted properties or government securities, make the UK hotel market an attractive proposition.

While many expected the recovery in regional hotel operational performance, even the most bullish were surprised by the magnitude of recovery in 2014. This is clearly illustrated by the contrast in operational performance between London and the rest of the UK in that period. In London occupancy growth of 0.3% and a 1.7% increase in ADRs drove RevPAR growth of 2% for 2014 (vs 2013). Outside London occupancy growth reached 1.9% and ADR grew by 6.2% driving RevPAR growth of 9%. Of course, these growth rates are from different starting points.

While London's YTD occupancy and RevPAR have both declined by 1.5 to the end of June, as supply has grown, the trend in strong regional performance is continuing through 2015 as the rest of the UK has seen increases in occupancy and RevPAR of 1.6% and 6.5% respectively.

Looking forward, strong performance is expected through 2015 with leisure demand expected to be boosted by the Rugby World Cup. With around half a million visitors expected across nine venues across England and Wales, strong rate growth should be achievable. London should also benefit from the Rugby World Cup, with three grounds hosting games including the final at Twickenham. With new supply broadly in line with recent trends, we would expect continued, modest performance growth in London outside of the Rugby World Cup period.

6 Infrastructure

Why do asset prices keep rising?

We have seen high pricing in recent UK infrastructure deals, highlighted by several landmark transactions at historically high levels of pricing:

- Cheung Kong Infrastructure Holdings Limited (CKI) bought Eversholt Rail for an EV of £2.5bn (9.5x EV/EBITDA multiple) in January 2015 from a consortium of sellers (3i Infrastructure, STAR Capital Partners, Morgan Stanley Infrastructure Partners and PGGM). The deal was the second largest in the sector, after the sale of Porterbrook Rail in October 2014. Reports note that Eversholt's price was approximately 50% above 3i's internal valuation of their stake which was performed five months earlier, and the sale price represented an uplift of £131m for 3i.
- Caisse de Dépôt et Placement du Québec (CDPQ) and Hermes Infrastructure acquired the UK government's 40% stake in Eurostar in March 2015 at an above-market price expectation of £585.1m.
- Hermes Infrastructure and CPPIB acquired Associated British Ports (ABP) from Goldman Sachs Infrastructure Partners (GSIP) and Infracapital for £1.6bn in March 2015. This imlies an EV/EBITDA multiple of around 25x – a record for the UK ports sector. Based on GSIP and Infracapital's 2006 purchase price of £2.8bn (16.6x EV/EBITDA) we understand that GSIP and Infracapital made a multiple of approximately 3 times their initial investment on the sale.
- AMP Capital and PSP Investments both increased their holdings in Angel Trains in August 2015 by acquiring Arcus Infrastructure Partners' 43.4% stake. They now hold 54% and 30% respectively. The transaction pricing is not public, but Bloomberg reported the deal was worth 'about $5 billion'.

We see four key factors which are driving up UK infrastructure pricing:

1. Lower return expectations

Government bond yields are at all-time lows, and are expected to stay low over the medium term and returns on low risk comparable assets (e.g. corporate bonds) are also historically low. However this isn't the full story. We are also seeing evidence of falling return expectations, for example 3i Infrastructure plc recently reduced its return expectations from 10% to 8%-10% in the medium term. It is also worth noting that Hermes GPE (who recently won the competitive auctions for ABP and Eurostar) are reported to be targeting a net internal rate of return (IRR) of 8.0% to 10.0% on 'core' infrastructure investment and a net IRR of 11.0%+ on 'value-add' and 'opportunistic' investment.

2. Changing demand/supply dynamics

Supply of good quality infrastructure assets is traditionally restricted, the infrastructure sector characterised by high barriers to entry and a monopolistic nature of assets and investors have long time horizons which leads to assets trading infrequently (e.g. AB Ports and Eversholt Rail transactions). On the other side, demand has been increasing, both from existing players with increased allocations (the average allocation of investors to infrastructure increased from 3.5% in 2011 to 4.3% in 2014, according to Preqin) and from new players. The buyer universe continues to widen, with pension funds and SWFs, who typically have lower return expectations, also making direct investments. The interplay of limited supply and increased demands is driving prices up.

3. Changing business plan assumptions

Investors are increasingly buying into the importance of asset management, and returns being separated between 'core' and 'active management' (Hermes noted the 'value-add' nature of Eurostar was attractive when making their bid). Recent benign economic conditions and QE have contributed to many infrastructure assets showing strong operational performance, and we have seen a return to a more bullish market with bidders assuming that they will outperform vendor case/IM cash flows, focusing on the upside rather than protecting the downside.

4. Behavioural features

Behavioural features are also helping to intensify demand. In common with other real estate investment classes, asset managers are under pressure to invest given the quantum of dry power available. There are also more strategic drivers for transactions with funds looking to diversify exposure to infrastructure and its various sub-sectors. Infrastructure is now more commonly accepted as an asset class by investors, given the robustness of performance in the period since the global financial crisis.

Sources Infranews; MergeMarket; Bloomberg; Modern Investor; 3i Infrastructure plc presentation "Results for the year to 31 March 2015" dated 14 May 2015; Infranews article "LPs revealed on Hermes infra fund final GBP 1bn close" dated 19 May 2015; 3i Infrastructure plc 2014 annual report

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