Standard Life Investments

Real Estate Update Q3 2017

Global real estate themes

Anne Breen
Head of Real Estate Research and Strategy

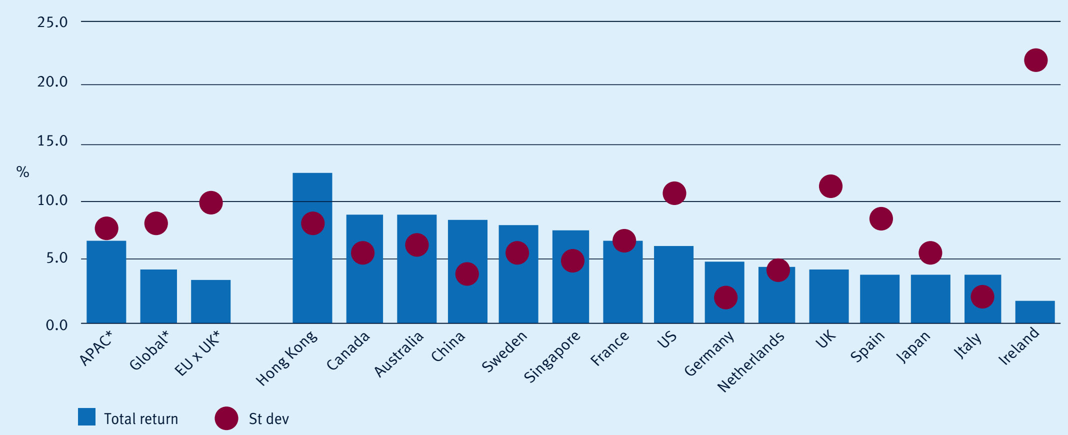
Technology change is impacting real estate

Traditional commercial real estate sectors are morphing into new alternatives, but there are similarities and disparities in how this manifests itself around the world. Demand for flexible office space is gaining momentum and the response from stakeholders ranges from addressing the need for flexible design and flexible leases, to sustainability and well-being. In the retail space, e-commerce is driving polarisation, as consumers increasingly prefer to shop online. However, larger shopping centres are well placed to respond to consumer preferences for malls as leisure destinations. Meanwhile, two high-profile partnerships in the flexible office space were recently announced in Asia, while e-commerce has spawned giants like Amazon and Alibaba. The industrial sector benefits from increased demand for industrial space because of multichannel retailing. At the same time, it provides the optimal location for the vast data centres required by the masses of data generated by mobile devices and industry. The response to technological changes is not always clear-cut: should parking spaces be provided if autonomous vehicles are on the horizon? Design flexibility has become central to the success of the buildings of the future.

Real estate is performing well across sectors and locations

The asset class is benefiting from broad-based acceleration in global activity and healthy market fundamentals. In the UK, commercial real estate continues to record solid returns and industrial sector performance is particularly strong. In Europe, Spain, the Netherlands and Ireland lead performance. Returns there are second only to Asia, where diversification between individual countries' real estate market cycles is central to performance. There are isolated areas of weakness in the US, but caution from banks will go some way to insulate the market from a major downturn. Yield compression has stalled in a number of markets, but rental growth is sustained, albeit muted. The attractive fundamentals are reflected in sustained investor demand around the world as the search for yield continues. Caution exercised during this cycle in the lending space and in conservative new development is paying off, and there is still a fair amount of momentum in real estate markets around the world. The real challenge in this cycle has been the impact of changes in technology.

All property performance 2007-2016



Source: Standard Life Investments, MSCI, as at 31 December 2016 *USD returns

Markets in detail

Simon Kinnie
Head of Real Estate Forecasting

Lulu Wang
Real Estate Investment Analyst (UK)

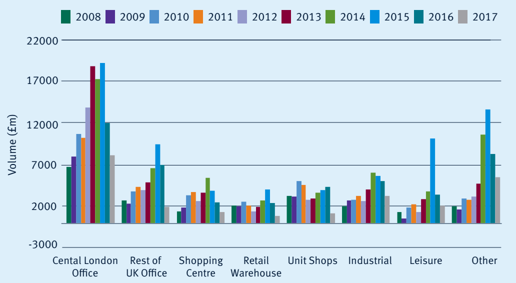
David Scott
Real Estate Investment Analyst (UK)

UK real estate

► **Industrials lead the way.** UK commercial real estate recorded a solid 2.5% return over the second quarter, according to MSCI/IPD performance data. Capital growth remained reasonable at 1.1% and rents grew by 0.4%. Industrials remained the strongest-performing sector, in line with strong fundamentals and ongoing supply-chain reconfiguration by retailers, reflecting moves to online distribution. In doing so, it continued to outperform offices and retail by some distance. Industrial assets remain in demand and investors are paying higher prices to benefit from robust expected growth. Capital values rose by 3.2% for industrials, compared with a 1.1% rise for All Property. At a subsector level, City of London office returns were better than anticipated, largely driven by strong capital growth. This reflected the large amount of overseas capital chasing a limited number of assets. Shopping centres continued to lag, underperforming all other sectors. Industrial assets in the southeast recorded the strongest rental growth at 1.3%, closely followed by rest of the UK industrials at 0.7%. Rental growth for southeast offices was also reasonably strong at 0.5%.

► **Overseas investors continue to dominate investment activity despite uncertainty.** The latest data showed transactions worth £11.3 billion took place in the second quarter, which is slightly above the long-term average. Overseas investors remained the largest net investors in the UK, with total purchases of £6 billion. UK institutions, as well as property companies and occupiers, were net sellers. At a sector level, London offices continued to dominate, attracting £3.2 billion of inward investment. The leisure sector also experienced increased transaction volumes, driven by a small number of major deals. Furthermore, demand for industrial assets remained buoyant, as the sector's security of long lease income and favourable fundamentals continued to attract investors. In contrast to Central London and the industrial sector, activity in the retail sector remained subdued, particularly for retail warehouses and shopping centres. The 'other' sector, which covers alternative assets, has been buoyant so far in 2017 and looks set for another year of strong activity.

UK transaction activity



Source: Property Data, Standard Life Investments to 31 July 2017

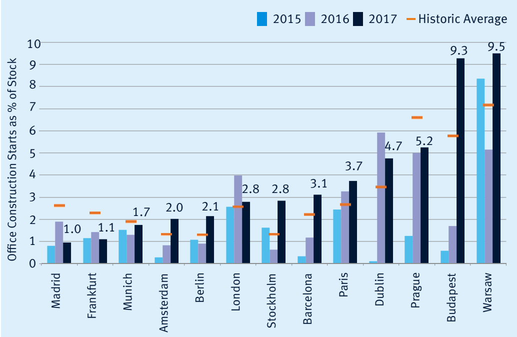
Craig Wright
Real Estate Investment Analyst (Europe)

European real estate

► **Capital values are still rising in Europe, supported by income growth.** The spread between prime office yields and government bond yields fell to 290 basis points (bps) on average. This was a result of increasingly 'hawkish' central banks and further real estate yield compression. As the cycle advances, rental growth typically begins to replace yield shift as the key driver of capital growth. This is in progress. Office vacancy rates have fallen by one-third from their peak, while tenant demand has risen to a 10-year high. On the logistics side, an increasing proportion of demand is satisfied by pre-letting due to a lack of available space, particularly in Germany and the Netherlands. Regionally, conditions have improved fastest in core northern European office markets. Net effective rents have risen sharply, particularly in German office markets. In Berlin, headline rents increased by around 12.5% over the last 12 months, with net effective rents rising around 16.5%. Falling tenant incentives in Paris have also helped net effective rents rise. With the election result well received, confidence in the occupational side of the Paris office market is rising. Rents have been slower to recover in Central Europe and Southern Europe due to structurally higher levels of supply.

► **European real estate performance compares well, but supply reaction could cool future returns.** Q1 2017 was positive for European real estate returns. According to MSCI direct property indices, Germany returned 2.3%, Spain 3.4%, the Netherlands 2.9%, Ireland 2.5% and France 1.3%. On an annualised basis, Continental European Global Property Funds asset level returns reached 9.1%, second only to Asia. This represents very healthy performance, which we forecast to continue through the second half of 2017 and much of 2018. While prime yield compression has begun to slow across a number of markets, rental growth has improved – but for how long? There are signs that increased supply could cool rental growth from the end of 2018. Indeed, in Q1 2017, there was a notable increase in development. The construction component of Eurozone industrial output climbed 3.5% in May 2017, the highest rate in three years and the second-highest increase since 2007. In terms of European office space, 2.7% of total stock was under construction in Q1 2017, an increase from 1.6% recorded in Q1 2015. Crucially, it remains below the 3.3% rate seen at the previous peak in Q1 2008, with very little speculative development at present.

Office development across key European cities



Source: PMA, Standard Life Investments

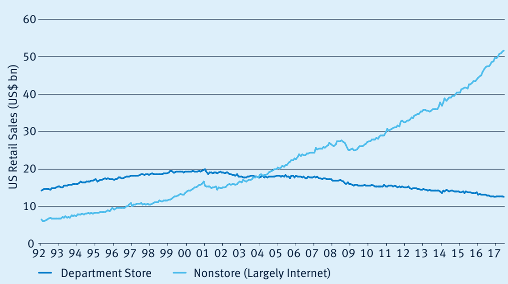
North American real estate

Donald Hall
Head of Commercial Real Estate Research Americas and Asia

E-commerce growth continues while department stores falter. At a high level, US retail appears healthy – vacancies are below the last cycle's trough at just 5.2% and under-construction space equals just 0.5% of total stock. However, the impact of e-commerce is beginning to bite as more traditional retailers fail. A dozen retailers have filed for bankruptcy in 2017 and many plan to vacate space over the next year. Demonstrating the variety and depth of store closures, Gymboree is closing 350 stores, Sears & Kmart 43 more stores after already closing 250 this year, JC Penney 138 stores, Macy's 68 stores and Michael Kors more than 100 stores. Many of the closures are located in less prime centres, but even Class A malls are struggling and are spending more on improvements to keep facilities attractive. Meanwhile, developers cannot build e-commerce distribution centres fast enough. Vacancy for logistics buildings is just 6.6%, 321 basis points below the last cycle's trough, and rents are growing at 7.1% per year due to strong demand and relatively little supply. E-commerce sales continue to grow at dual-digit percentage points. With twice as much distribution space needed to support a dollar of e-commerce sales versus bricks-and-mortar sales, there are plenty of tailwinds for big-box industrial demand and rental growth.

Lenders have generally been cautious this cycle, particularly banks, which should help extend this cycle and insulate real estate from a major downturn. For the first time since the global financial crisis, all 34 major banks passed the Federal Reserve's annual stress test. The most recent test scenario included five quarters of negative economic growth, unemployment doubling to 10%, housing prices falling 25% and commercial real estate prices falling 35%. This proves banks are better prepared, making a 'credit crunch' less likely in the next downturn. Banks are also helping keep commercial real estate fundamentals strong in the first place, making a severe downturn less likely. Despite historically low vacancies across property types, lenders reported tightening standards for commercial real estate loans of all types, keeping a lid on both supply and pricing. However, there is a broader spread of lenders in this cycle and alternative lenders will also need to be monitored closely. There are isolated pockets of oversupply and areas of weakness but, overall, the US commercial real estate market remains in a healthy place as well as having a reasonable floor on downside volatility. It is therefore poised to fare well on a relative basis when this cycle ends.

E-commerce growth versus department stores



Source: US Census Bureau, as at June 2017

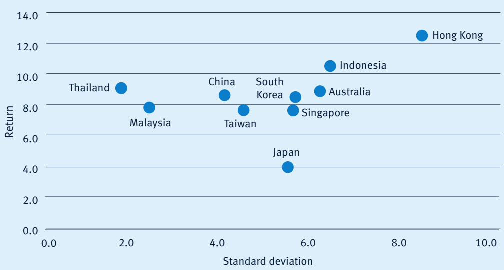
Asia Pacific real estate

Violet McDonald
Real Estate Investment Analyst (Asia Pacific)

Technology and changing real estate space. E-commerce has carried the blame for the erosion of both sales growth and rental growth in bricks-and-mortar retail. Amazon has become the 'sword of Damocles' to retailers, but Asia may be different. Alibaba and Tencent, the largest e-commerce companies, operate with millions of merchants, a model that appeals to consumers in the region as it generates more competition and better pricing. They also offer payment systems to those without bank accounts. Their success lies in responding to the specific needs and preferences of their customers, and the economies of scale they have achieved. But e-commerce is not the only area where technology is changing real estate. Two substantial partnerships in the flexible office space were announced recently in response to increasing occupier demand. Chinese flexible-office provider naked Hub is joining forces with Singapore's JustGroup in an attempt to create Asia's leading operator of high-end co-working space, while WeWork has partnered with Japan's SoftBank on a joint venture, WeWork Japan. The growth in demand for flexible space requires innovative building design and changes to lease structures. As with e-commerce, economies of scale are also central to their success.

The diversity of the region's real estate market cycles is central to its attraction as an investment destination. The core office markets of Japan and Australia are starting to slow, Hong Kong remains resilient and Singapore takes up the growth baton. Both Hong Kong and Singapore benefit from the recent pick-up in global trade and robust financial sectors. The Hong Kong office market in particular is underpinned by sustained demand from mainland Chinese financial firms, as the capital markets in China continue to deepen. About HK$53.6 billion of funds were raised from IPOs in Hong Kong in the first half of 2017, up 23.1% from the first half of 2016. Demand pressure and tight vacancy have driven office rents in the Central district to the most expensive in the world, but decentralisation is expected to accelerate as the rental gap between Central and the rest of the market widens. After two years of decline, Singapore's office market may bottom earlier than expected on the back of healthy take-up in the new office towers at Marina One. The dearth of new office supply in Singapore from 2019 is balanced by elevated new supply in Australia and Japan. The disparate market cycles underpin the diversification of returns within the region.

All property performance in Asia Pacific



Source: Standard Life Investments, MSCI, as at 31 December 2016. Data from 2007 to 2016, local currency returns

Svitlana Gubriy
Global Real Estate Equities Portfolio Manager

Global listed real estate

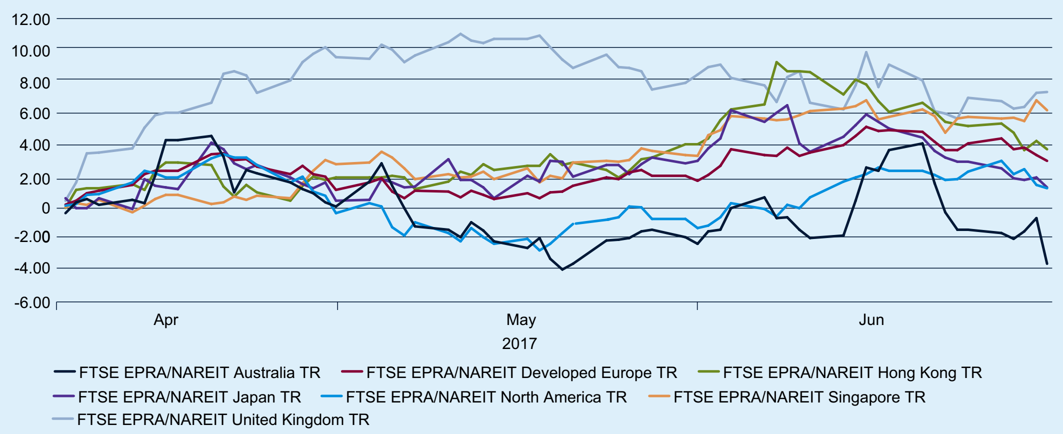
► **Global listed real estate markets posted a positive return during the second quarter.** The UK market outperformed despite a pullback late in the period. Workspace was the strongest performer following strong results that showed rental growth in the flexible office market. Self-storage, healthcare and industrial REITs also performed well. Weaker performance came from larger London office-exposed companies, which guided to future rental declines at their full-year results. These stocks continue to trade on wide net asset value (NAV) discounts, reflecting potential downside to capital values and lack of visibility on a return to growth.

► **Continental Europe performed well as various potentially adverse political events failed to materialise.** There was robust performance across a variety of subsectors, including German residential, French offices and Spanish REITs. Retail specialist REITs were weak given ongoing concerns over the sustainability of rental growth as retail spending moves online. Valuations now sit broadly in line with NAV, except German residential stocks, which are valued at a modest NAV premium.

► **While the North American REIT market posted a modest gain, it lagged both the broader equity market and the global REIT index.** This was almost entirely because of weakness in the retail sector, which was shrouded in negative sentiment. Many other sectors posted gains because of favourable underlying fundamentals. Industrial REITs were the best performers, driven by healthy demand growth because of e-commerce growth and the need for retailers to redesign their distribution chain to accommodate quicker delivery. Meanwhile, Canadian REITs outperformed US REITs during the quarter. The Canadian economy appeared relatively healthy, as business investment re-accelerated, offsetting any slowdown in the Toronto and Vancouver housing markets from policy decisions aimed at reducing speculation.

► **In Asia, the Hong Kong and Singapore markets were the top performers.** Elevated levels of liquidity in the system appeared to be driving this, with the outperformance increasingly decoupling from each market's respective real estate fundamentals. In Hong Kong, residential sales are slowing, while fundamentals remain broadly challenging in Singapore. Elsewhere, Japan continued to underperform. Developers traded according to global macro sentiment, while Japanese REITs slid lower as fund flows turned negative because of a lack of sector catalysts and relatively high valuations.

Q2 listed real estate performance



Source: Lipper Investment Management, as at 30 June 2017

Monitoring real estate's key triggers

Below is an overview of the key triggers we monitor that indicate 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** Likely past 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 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**	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 hit.
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.

Source: Standard Life Investments proprietary knowledge – not traced to a single source

Real Estate House View changes Q3 2017

UK		
Outer London Offices	Neutral to Light	This move is due to relativities and the addition of the build-to-rent (BTR) sectors.
Build to Rent (Rest of UK)	Heavy	This is a new sector, added as Heavy.
Build to Rent (London)	Neutral	This is a new sector, added as Neutral.

Europe		
Hamburg Offices	Light to Neutral	There was an improvement in the market fundamentals, with vacancy rates falling below 5% overall.
Paris Levallois	Light to Neutral	Confidence is returning to the occupier market and vacancy rates are falling. The yield offers an income premium over the central business district (CBD).

Americas		
Boston CBD Offices	Heavy to Neutral	Tenant demand is not as strong in the CBD as developing areas like Seaport and Cambridge. This is weighing on rents.
San Francisco CBD Offices	Light to Neutral	The market should stabilise after some short-term softness as speculative supply delivers. For existing owners, leases are still rolling up to market rents.
Washington DC Apartments	Neutral to Light	There is existing pressure on rents and much more supply still yet to deliver.
Washington DC Offices	Neutral to Light	Demand has been tepid and fundamentals continue to unwind.
US Class A+ Malls	Neutral to Light	Retailers are under pressure from e-commerce and mall owners have to spend more to keep their centres attractive for customers and tenants.

Asia Pacific		
Shanghai Offices	Light to Neutral	We expect rental growth to pick up at the tail-end of the forecast period.
Hong Kong Retail	Very Light to Light	Chinese mainland tourists are returning and non-luxury retail sales are picking up.
Australia prime regional shopping centres	Light to Very Light	Old stock, limited rental growth and Amazon's threat led to a downgrade to 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

Q3 2017 - Three-year view

	UK	EU – Core	EU Non-Core	Americas	Asia
Very Heavy	SE Industrial Distribution Warehouses (London) Distribution Warehouses (SE ex London) Provincial Industrial Distribution Warehouses (Rest of UK)	Amsterdam CBD Offices Netherlands Logistics Berlin Offices German Logistics Danish Logistics Ile De France Logistics	Budapest Offices Lisbon Offices Portugal Logistics Madrid M30-M40 Offices Madrid CBD Offices	Inland Empire Logistics New Jersey Logistics Los Angeles Logistics	Sydney Offices Mumbai Offices Melbourne Offices Brisbane Industrial
Heavy	Build to Rent (Rest of UK) Leisure Parks Major City Prime Shops Grade A Rest UK Offices Regional Shop Centres (>50 km²) Rest of South East Offices (ex London)	Stockholm Offices Munich Offices Helsinki Logistics Stockholm Logistics Sweden OOT Retail Grade A Dutch Regional Offices	Lisbon Retail Budapest High Street Retail Budapest Logistics Belgium Logistics Madrid/Barcelona Logistics	Seattle CBD Offices West LA Offices	Seoul Industrial Delhi Offices Melbourne Industrial Sydney Industrial Brisbane Offices Perth Industrial China Logistics
Neutral	Hotels Supermarkets Build to Rent (London) Medium Town Prime Shops Retail Fashion Parks Retail Warehouse. Bulky Goods	Paris Levallois Paris Peri Defense Hamburg Offices German High Street Retail Dublin Logistics	Prague Logistics Barcelona CBD Offices Italy Logistics Milan Offices Spain Dominant Malls Prague Offices	Boston CBD Offices Chicago Logistics Toronto CBD Offices Seattle Apartments New York CBD Offices Vancouver CBD Offices San Francisco CBD Offices	Seoul Offices Australia Prime Regional SC Hong Kong Industrial Seoul Retail Japan Logistics Shanghai Offices Tokyo Offices
Light	Outer London Offices Solus RW West End & Midtown Offices Other RoUK Offices Business Parks	Germany Dominant Malls Frankfurt Offices Paris CBD Offices Stockholm High Street Retail Dusseldorf Offices Copenhagen Offices	Warsaw High Street Retail Brussels High Street Retail Milan/Rome High Street Retail Brussels CBD Offices Warsaw Logistics	Washington DC Apartments Washington DC Core Offices Boston Apartments US Class A+ Malls Houston Offices New York Apartments	Hong Kong Retail Beijing Offices Singapore Industrial Perth Offices Singapore Offices Tokyo Retail
Very Light	District Shop Centres (<50 km²) Grade A City Offices Inner London Offices Secondary /Small Shops Secondary Shopping Centres Grade B City Offices	Paris High Street Retail France Dominant Malls Helsinki High Street Retail Dublin Offices Amsterdam High Street Retail Dublin 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

Figures above reflect forecast % annual total returns over the next 3 years. Projected returns are unleveraged, not risk adjusted and do not reflect the inclusion of transaction costs. We do not expect the structure of all our property funds to exactly match the above as there are stock specific, transaction costs and liquidity issues that may work against each fund achieving the ideal structure.

Important Information

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