12 MONTHS ON
WARNINGS VS REALITY

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Real Estate
for a changing
world

BNP PARIBAS
REAL ESTATE

RESEARCH
On the 23rd June 2016 the UK took the momentous decision to leave the European Union. The lead up to and following the vote saw many warnings surface about how the UK would fair. We take a look at 12 key warnings and 12 months on, we see if they have or are indeed close to becoming reality?

Political uncertainty
Prolonged period of political uncertainty...

Stock market crash
Traders to dump UK equities...

UK tech talent to be lured to other European cities
If freedom of movement is lost, this will negatively impact the UK’s Media Tech sector...

Office demand to slow
Increased uncertainty will result in occupiers delaying making real estate decisions...

Sterling in a free-fall
Investors to sell sterling-denominated assets...

Interest rates to turn negative
Huge negative shock to the UK economy...

Banking exodus?
Banks moving operations to mainland Europe...

Investors to look to ‘safer’ markets to deploy cash
The UK will lose its ‘safe haven’ status...

DIY UK recession
Country on the brink of a recession...

Inflation to exceed Bank of England target
Depreciation will lead to higher inflation...

Capital values to fall considerably
With yield compression and rental growth already slowing, significant further declines expected...

Tenant space to flood the market
Increased amounts of second-hand tenant space will enter supply...
Warning: Stock market crash
Traders to dump UK equities in panic reacting to the prospect of recession amid months of market turmoil.

Reality: Market turmoil contained
It wasn’t a surprise to see the FTSE 100 lurching into the red after the Brexit vote. After the initial post-Brexit sell-off in equities, financial markets were quick to quieten down.

The fall in sterling helped the FTSE post its best week since December 2011, making gains of 7%. Having plunged 8.7% in the immediate Brexit aftermath the FTSE 100 recorded its best weekly performance in its 33 year history, the week ending July 1 is now ranked as the tenth best on record.

Although the focus was on the FTSE 100, it is not a great indicator of Brexit on the UK economy. Collectively the companies in the FTSE 100 make around three-quarters of their money outside the UK.

Those revenues are earned in foreign currencies, which are converted back into sterling for reporting purposes; the weaker the pound, the bigger the relative boost those companies get from those foreign earnings which in effect is the reason the FTSE 100’s slide was stopped in its track.

A much better gauge of the UK economy is the FTSE 250, which includes smaller and more domestic-focused companies, which rely on a strong and confident UK economy. Since the vote the FTSE 250 has almost erased the post-Brexit decline.

UK market turmoil was contained somewhat by a pledge from the Bank of England that it would take any measures needed to stabilise markets and the economy. The Bank of England (BoE) responded with a four-part package of easing measures, which included a 25bp rate reduction. The FTSE 100 and 250 have even moved ahead of its pre-Brexit level as confidence recovered from the initial shock.
ECONOMIC
WARNING VS REALITY

Warning: Political uncertainty
Prime Minister David Cameron to step down if the UK voted to leave the European Union, opening up a nine-week Conservative leadership contest, destabilising the country at a critical time.

Reality: Uncertainty remains
David Cameron announced he was quitting as Prime Minister just hours after the outcome of the vote was known, losing his big Brexit gamble. His campaign to keep Britain in the EU failed, propelling the leavers to a shock 52-48 victory.

Andrea Leadsom did however pull out of the race saying it is in the “best interests of the country”, paving the way for Theresa May to become Prime Minister. Less than three weeks after David Cameron’s resignation Theresa May was appointed as the new leader of the Conservative party and Prime Minister, limiting political risk.

As soon as Theresa May took office, further rumours began to surface about a snap election. Although she was quick to dismiss this, a snap election was announced in April. The election resulted in a hung parliament, with Theresa May losing her majority. Currently political uncertainty remains rife as the Conservative Party negotiate to put a government together.

Warning: Sterling in a free-fall
Investors to sell sterling-denominated assets by taking out contracts that allow them to dump the pound leading to an immediate fall in the value of sterling if the UK votes to leave the EU.

Reality: Sterling stabilises
The value of sterling slumped to a 31-year low on currency markets and was on course for its biggest one-day loss in history as panicking investors came to terms with the outcome of the EU referendum. This left the pound down more than 10% at $1.33, compared with $1.50 just after polling stations closed. That was the lowest since 1985. The pound was down more than 7% against the euro.

The pound has since fluctuated between losses and slim gains against a slew of currencies. Currently there is no market consensus on the outlook for sterling post Brexit vote. The most common prediction is that sterling volatility is far from over, especially as various Brexit scenarios are explored.
ECONOMIC
WARNING VS REALITY

Warning: DIY UK recession
Pre-Referendum, many analysts predicted that Britain’s decision to leave the EU will leave the country on the brink of a recession that will reverberate around the world; this was based on fears of a drop in investment and turmoil on global markets. George Osborne (at the time UK Chancellor) issued a pre-referendum warning of a year-long “DIY recession”. The Treasury’s best case scenario where the UK seeks membership of the European Economic Area (EEA), like Norway, estimated that UK GDP will be 3.8% lower after 15 years; the worst alternative would see UK economy 7.5% lower.

Reality: UK growth
Despite the shock Brexit vote, activity data for the UK has been better than expected. Two months after the vote, the initial shock to business and consumer confidence almost disappeared. It was largely expected that the uncertainty would feed through to the real economy through a fall in business investment and hiring. However, business investment actually rose in the quarter following the Brexit vote. Although this might be explained away as existing planned spending in the pipeline long before the vote, we have actually had a fair bit of good news on investment. Google, Facebook and Apple all announced their commitments to the UK post Brexit vote. Not only that, the Q4 GDP figure came in at 0.7%, bringing annual growth for 2016 at 1.8% - similar to what Germany posted and ahead of France which grew by 1.1%.

Warning: Inflation to exceed Bank of England target
The effects of exchange rate depreciation will lead to higher inflation, with inflation likely to exceed the Bank of England target.

Reality: Inflation exceeds target
The UK’s inflation rate is currently at its highest since September 2013. Inflation now stands at 2.7% - up from 2.3% in March - and above the Bank of England’s 2% target. These increases can all be linked to the cost of importing goods into the UK as a direct result of the fall in the value of sterling since the referendum. The Bank of England has warned that inflation as measured by the Consumer Prices Index (CPI) would peak at just below 3% this year.

While the fall in sterling will clearly boost inflation, it will also help support the rebalancing of the UK economy towards the external sector. Furthermore, the sterling devaluation has made London more attractive than ever - presenting a buying opportunity for international investors willing to step into the market.
ECONOMIC WARNING VS REALITY

Warning: Interest rates to turn negative
The vote to leave the EU will result in a huge negative shock to the UK economy. The Bank of England could try to offset the effect of higher risk premia by reducing the Bank Rate to 0 or even lower - at least in the short-term.

Reality: 25bp rate reduction
The expectation of lower rates marks a sharp turnaround from the mood in the months before the EU referendum when the focus was on trying to predict when the Bank’s key rate, at 0.5% since 2009, would rise rather than fall. The markets had expected no rate increase until at least 2018 for much of the first half of this year. Now markets do not expect rates to even return to 0.5%, after the expected cuts, until the summer of 2020. The Brexit verdict has dealt a shock to the system. It has increased the need for Bank of England to keep supporting the economy with low rates.

After the referendum the Bank of England were swift in taking steps to boost the economy and reassure markets.

The Bank of England (BoE) responded with a four-part package of easing measures, which included a 25bp rate reduction from 0.5% to 0.25% in August taking UK rates to a new record low; a Term Funding Scheme (TFS) with up to GBP100bn available that aims to ensure lower policy rates are passed on to businesses and households; GBP60bn of additional gilt purchases to be conducted over six months; and GBP10bn of corporate bond purchases to be conducted over 18 months.

Mark Carney the Governor of the Bank of England has ruled out negative interest rates, saying it has other options to provide economic stimulus. Ten months on and the interest rate remains unchanged at 0.25% since the last cut. Looking ahead rates are expected to remain on hold, with one increase being delivered in 2018, and two expected in 2019.

Source: Macrobond
Warning: Banking exodus?

Headlines and news flow centred on London’s financial services industry and Banks moving operations to mainland Europe; this was based on the potential loss of ‘passporting’, the ability for UK based financial service firms to operate across the European Economic Area and vice versa. However, has this reliance on ‘passporting’ been overplayed?

Reality: Contingency plans

Depending on who you talk to, as few as 4,000 or as many as 232,000 UK jobs will be heading to Europe after the UK withdraws from the European Union! As further details of the banks’ contingency plans emerge it is clear job relocations are said to be more in the hundreds than the thousands. Indeed, originally JP Morgan job relocations totalled 4,000, however it now looks closer to 500-1,000.

The truth is no one knows exactly how many jobs will leave the City of London and what a potential Brexit deal will look like. For now, banks are trying to keep their options as open as possible as they try to gauge the scale of their future activities in London.

But there will not be an exodus of City of London jobs to the EU after Brexit.

The Bank of England’s deputy governor was the first to dismiss fears of a mass exodus of City jobs after Brexit – insisting the EU does not have the same capacity as London.

Further reassurance for London’s strength as a financial centre came with Goldman Sachs pressing ahead with developing its new 800,000 sq ft headquarters in the City of London. Deutsche Bank has also agreed terms to pre-let a new 500,000 sq ft headquarters at 21 Moorfields.

With the focus on ‘passporting’ a key argument for remainers, was this in fact overplayed? In theory, according to MIFID II, the UK should easily meet the equivalence requirements and is highly likely that the UK will do everything necessary to ensure that an equivalence decision is obtained; meaning very little change to the status quo from a regulatory perspective.

Whatever deal is agreed for the UK, a point to stress is how Central London has increasingly become less reliant on Banking & Finance to drive demand. As a percentage of total take-up over a 10-year period, the Banking & Finance sector’s share has diminished, see graph opposite.

Overall, UK Banks are keen to regain the status quo, not only because of the cost benefits but because of the intricate financial services eco system in the City which will be hard to replicate anywhere else.

Indeed, Central London has retained its title as the world’s top financial centre in the Z Yen Global Financial Centres Index.

![Graph: Central London take-up by sector as a % of total](source: BNP Paribas RE Research)
REAL ESTATE
WARNING VS REALITY

Warning: UK tech talent to be lured to other European cities
As an international City, London’s workforce hails from all over the world including the EU, particularly within the Tech sector. The potential loss of freedom of movement could have a negative impact when attracting the best and brightest talent. Berlin and Dublin were primed to be big winners.

Reality: UK remains top tech hub
The weeks after the Brexit vote were defined by Media Tech giants expressing their commitment and confidence in the capital. Google and Facebook both committed to increasing their headcount in Central London and Apple signed a 500,000 sq ft pre-let for their European HQ in Battersea.

Major Media Tech occupiers are also looking outside of London, notable examples of this include Co-op Digital who acquired 45,000 sq ft in Manchester, Cirrus Logic’s 45,000 sq ft letting in Edinburgh and Nokia who took 35,000 sq ft in Reading.

According to a survey conducted by Silicon Valley Bank, the majority of start-ups (62%) intend to keep their headquarters in the UK, despite the Brexit risk. This is positive news for the capital as it is smaller to medium sized businesses that drive office demand making up 64% of all deals done over the last 10 years. Furthermore, the survey found that 89% of UK start-ups intend to hire more staff this year.

Growth in this sector is expected to grow by 7.5% over the next six years in comparison to the Finance & Insurance sector which will experience a fall in headcount.

UK DIGITAL TECH INVESTMENT VS EUROPE (2016)

<table>
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<th>Country</th>
<th>Investment (bn)</th>
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<tr>
<td>UK</td>
<td>£6.8bn</td>
</tr>
<tr>
<td>France</td>
<td>£2.4bn</td>
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<tr>
<td>Germany</td>
<td>£1.4bn</td>
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<tr>
<td>Netherlands</td>
<td>£1.3bn</td>
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<tr>
<td>Denmark</td>
<td>£0.9bn</td>
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<tr>
<td>Italy</td>
<td>£0.8bn</td>
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<td>Spain</td>
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Source: Tech City UK 2016

EMPLOYMENT GROWTH - NEXT SIX YEARS

Source: Oxford Economics

Growth in this sector is expected to grow by 7.5% over the next six years in comparison to the Finance & Insurance sector which will experience a fall in headcount.

Furthermore, funding for Tech start-ups in the UK shows no sign of abating. According to the latest Tech Nation report, UK digital tech investment reached £6.8bn with London attracting £2.2bn of this, around £1bn more than Amsterdam and Paris.
Warning: Office demand to slow
Occupiers to delay making real estate decisions due to increased uncertainty.

Reality: Down in London
Up in Regions

According to Deloitte’s CFO survey, in the wake of the EU referendum vote levels of optimism amongst Chief Financial Officers dropped to levels not seen since 2007. Since then, positive sentiment has started to increase with business optimism hitting an 18-month high in Q1 2017. Furthermore, the proportion of CFO’s looking to decrease hiring plans has halved from 66% in Q2 2016 to 30% in Q1 2017.

Even before an EU referendum was announced, 2016 was forecast to be the year in which demand levels slowed, especially after three consecutive years of above average levels of demand. Take-up in the capital reached 11.4m sq ft, 11% down on the 10 year average. Conversely, in the Big Six regional cities, take-up reached 4.6m sq ft last year, 15% ahead of the 10 year average.

Warning: Capital values to fall considerably
The investment market was experiencing a slowdown prior to the EU Referendum, with both yield compression and rental growth slowing, however many observers felt there would be a further slowdown if the UK voted to leave.

Reality: Not to extent expected
The shock of the vote indeed hampered capital value growth prospects, although not to the scale being forecast. The immediate aftermath saw capital values take a knock of -3.3% in July, with City offices the worst hit with -6.1% declines.

Since then the rate of capital value declines slowed across all sectors and the last seven MSCI Monthly Indices, from October 2016 to April 2017, have all recorded positive capital growth at the ‘All Property’ level, suggesting the worst is behind us and the market has now stabilised. It is worth noting that in the last cycle, MSCI saw 25 months of consecutive capital declines at the ‘All Property’ level.

With investors already moving to an income focussed strategy in preparation for the bottom of this cycle, these declines did not come as a big shock. Having learnt lessons from the past, in particular, the Global Financial Crises, the industry is now better prepared for shocks and so expects current and future cycles to be shorter and less volatile, as our Cycology report published earlier this year explores.
REAL ESTATE
WARNING VS REALITY

Warning: Investors look to ‘safer’ markets to deploy cash
Perhaps one of the most repeated slogans of the leave campaign was to ‘take back control’. Did this deter the flow of capital from overseas targeting UK Real Estate and direct it to other markets?

Reality: UK remains a ‘safe haven’

The depreciation of sterling acted as further incentive for overseas investors to continue to deploy capital in UK Real Estate, in particular Central London.

Overseas investors have deployed £9.2bn in the quarters following the EU referendum and in Q1 2017 accounted for 79% of total investment volumes in the capital. Overwhelmingly, non-domestic investors have targeted core buildings due to the relative low risk associated with such assets.

Commentators have argued that the UK has become more risky, however in the eyes of overseas investors the UK’s safe haven status will very much remain post Brexit, given the solid fundamentals; its simple and efficient legal system, business friendly time-zone, the English language and world class transport infrastructure and education systems.

In contrast to overseas investors, UK institutions have become net sellers, with UK retail funds continuing to be relatively cautious following the swathe of redemptions following the vote. Withdrawals have stabilised and most UK retail funds have seen net inflows in Q1 2017.

The core reasons to invest in UK real estate remain strong, given the low return and growth environment.

According to the latest INREV investor survey the UK, along with France are top on investors most preferred locations list, knocking Germany off its top spot last year.

Source: BNP Paribas RE Research

CENTRAL LONDON INVESTMENT VOLUMES BY ORIGIN

£ bn

0 2,000 4,000 6,000 8,000 10,000 12,000

Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 2012 2013 2014 2015 2016 2017

UK Overseas % share of overseas

50% 40% 30% 20% 10% 0%

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11
REAL ESTATE
WARNING VS REALITY

Warning: Tenant space to flood the market
Due to increased levels of uncertainty, rationalisation of office needs by occupiers would result in increased amounts of second-hand tenant space returned to the market.

Reality: Moderate tenant space rises
The amount of space in Central London available directly from an existing tenant doubled over the course of 2016 to reach 2.1m sq ft representing 17% of total supply. In Q1 2017 it rose to 2.8m sq ft equating to 21% of total supply.

The majority of this is driven by the Banking & Financial sector.

To what extent is this rise Brexit related? Pressure on businesses to cost save and increase efficiency have been on the agenda for some time now. Recent trends include occupiers looking outside of the capital to reduce already rising total occupational costs, consolidating premises in order to bring people under one roof and the introduction of agile working meaning staff hot desk or work from home more often.

The increased uncertainty brought around by Brexit has almost kick started some of these processes which has led to occupiers off-loading additional space.

Tenant space will continue to enter supply this year due to M&A activity and relocations.

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Source: BNP Paribas RE Research

Having learnt lessons from the Global Financial crises occupiers have been careful not to acquire too much space and therefore we do not envisage the same level of tenant returns as witnessed in 2008/9 where levels reached around 35%.
6 BUSINESS LINES in Europe

A 360° vision

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LITHUANIA
MOROCCO
NORTHERN IRELAND

* September 2016
** Coverage via our alliance in Morocco
*** In Transaction, Valuation & Consulting

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