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AVIVA INVESTORS
UK REAL ESTATE: EMERGING SUBMARKETS

BY JONATHAN BAYFIELD AND DAN BRIGHT

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AVIVA
INVESTORS

JONATHAN BAYFIELD

SENIOR RESEARCH ANALYST, GLOBAL REAL ESTATE

Main responsibilities

Jonathan manages Aviva Investors' Real Estate Research Team thought leadership and insight program. He is also responsible for developing a house view on the attractiveness of specific UK and Irish property sectors and investment strategy for our UK and Ireland focussed real estate funds.

Experience and qualifications

Prior to joining Aviva Investors, Jonathan worked in JLL's Retail Research and Consulting team, in the UK and Europe. Jonathan holds an MSc in Real Estate from University of Reading's College of Estate Management and a BSc in Geography from University College London. He is a member of the SPR, Revo and the ICSC.

DAN BRIGHT

GRADUATE ANALYST, REAL ESTATE

Main responsibilities

Dan currently works in Aviva Investors' retail asset management team, focussing on locations in south east England. Previously, he was responsible for analysing transactions in the real estate portfolio analysis team, as well as contributing to the origination of new opportunities. He has also spent some time in the real estate strategy and research team, developing a house view on the attractiveness of specific UK property sectors and investment strategy for our UK-focussed real estate funds.

Experience and qualifications

Dan joined Aviva Investors following an internship in the Real Estate Long Income team in the summer of 2016.

He holds a BA in Economics and Management from Oxford University and is a member of the Society of Property Researchers.

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INTRODUCTION

This paper seeks to examine the emergence of new locations around established real estate markets.

For investors and occupiers, established markets have the highest levels of liquidity. They also have the largest number of players. These might include investors, advisors, lawyers as well as public bodies. As a result, they will garner the most attention and consequently are the most informationally efficient.

This means there is less scope for investors to identify mismatches in pricing. Investors seeking core or core plus products will often be rewarded fairly for the risks taken and the income will be fairly secure in core office locations. Yet, any capital growth is likely to be muted on a relative basis and potentially priced in from the outset.

Emerging locations on the other hand are less transparent. There are fewer actors participating and assets may have greater letting risks. Urban change and mixed-use redevelopment in these locations, however, gives investors an opportunity to deliver outsized outperformance. Ongoing cultural and technological changes are affecting the ways in which we live and work, blurring the boundaries of traditional office markets. Consequently, expert investors who can create assets that are fit-for-purpose and can cultivate a sense of place in emerging neighbourhoods have greater potential to deliver alpha over the longer term. This potential outperformance is especially relevant as the end of the cycle nears.

EXECUTIVE SUMMARY

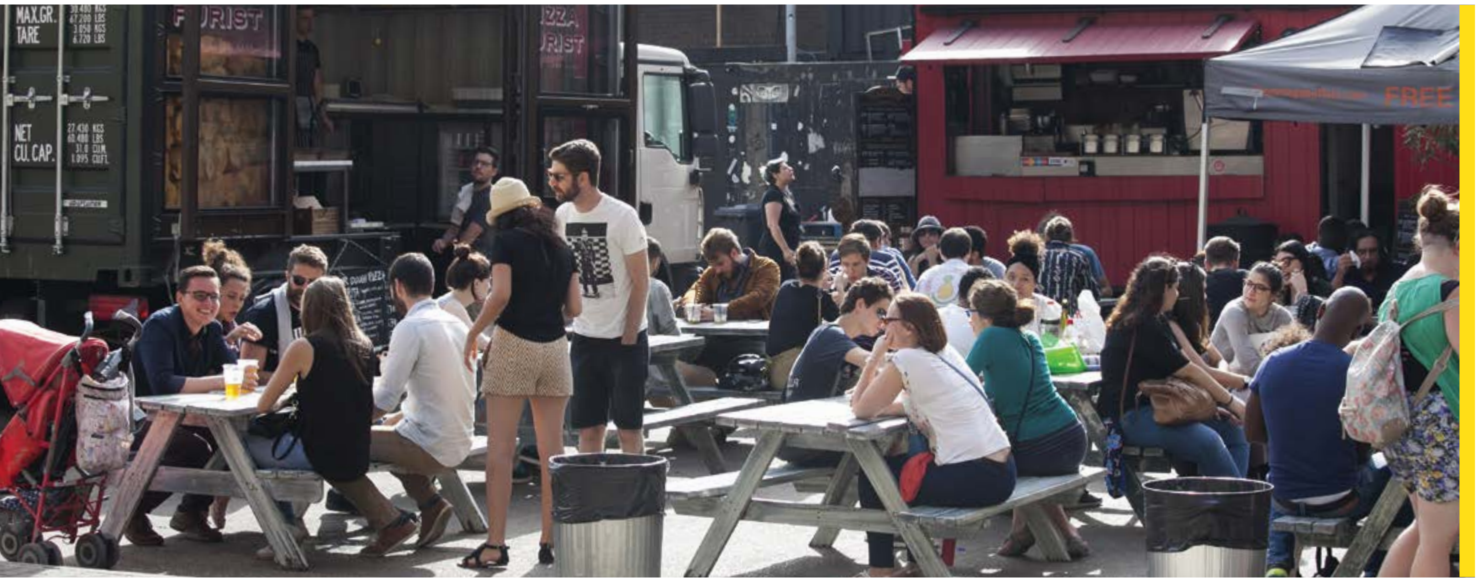
Transformational change: an opportunity

We begin by looking at urban regeneration and the role that skilled labour as well as public and private investment, plays in prompting urban change. The agglomeration effects that come from the clustering of knowledge-based employment often means that companies want to locate close to one another in city centres. Of course, there is only a limited amount of space available. This drives rents higher in core locations. In turn, this means that some companies are forced to locate elsewhere – perhaps simply due to where they are in the corporate life cycle. Where do they go and why? Is it likely that a pattern will develop?

Next, we identify a number of indicators that could form a framework to detect this phenomenon, using London as an example. A low value location in close proximity to a high value location may be an obvious place to start for office development. There are numerous examples across the world's major cities. Indicators of change within such a location might include increasing incomes per capita, or other positive demographic trends like falling crime rates. We then dig deeper into the analysis and explore factors that might act as catalysts for change.

Strategic Implications

We conclude by looking at the implications for real estate investors. Firstly, while some indicators such as wealth or income growth are likely to be common to most emerging areas, the framework as a whole is not a rigid and inflexible tool. Each city is unique and analysed on a case-by-case basis, with the framework amended as necessary. Secondly, it is essential to bear in mind risks round letting and liquidity that are often taken on when investing in less established locations. This is especially the case if the hope of regeneration is already priced in. Finally, commercial real estate is a local asset class. Expert investors who have a holistic, thorough understanding of the micro-location will be well-placed to make greater conviction calls on emerging markets.



URBAN CHANGE AND REGENERATION

Successful cities: those that act as a crucible of ideas

The rise of service-based economies globally has meant the role of cities has changed. Urban locations have become more important. They are now centres of interconnected knowledge networks. Thriving cities are those that create agglomeration effects through the sharing of information. Historic concentrations of tacit knowledge and recognised knowledge networks give certain cities, like London, clear benefits. Size, density and good connectivity help too.

Knowledge based industries and skilled labour drive change

The rise of knowledge-based industries will remain a crucial growth driver. Along with technological change, this trend will combine to remodel office demand. Ultimately, skilled labour is attracted to higher value economic activities. Educated people increasingly have the desire to live in the vicinity of similar people and close to centres of work[1]. Historically, higher birth rates have also put pressure on housing in many cities globally[2]. In the UK, when the proportion of people working in professional services and purchasing power increased, an alternate to suburban living emerged[3].

Residential locations re-emerge

Subsequently, across the world, people have continued to move to previously neglected inner city areas. Previously low value residential locations are increasingly in demand among more affluent groups, spurring redevelopment. A clear preference of the group is to live in pleasant environments close to work, and reduce the hassle of commuting[4].

Businesses move back to core

As a result, businesses are increasingly focussed on locating within urban cores. Long-term access to a skilled workforce is a critical component to decision making. Companies are seeking to attract talent which increasingly prefers to be located in vibrant downtown locations. As traditional core locations have reached capacity and employees have wanted more mixed-use environments, emerging locations have come to the fore. These locations, often located in high proximity to high value core locations, have seen dramatic increases in land values.

Public and private initiatives can drive urban change

New urban locations can also emerge in multi-faceted ways, with the organic process being just one of the drivers. Government policy can also assist with urban change. Some have argued that transport or IT infrastructure improvements contributed to the recent emergence of Shoreditch. It is now a high value office, residential, retail and leisure location. On the other hand, purpose-built private sector initiatives have been extremely successful across the world as well. The recognisable example in London is Canary Wharf.

Locations that facilitate people's ability to live, work, play and learn to outperform

Cities that are able to attract and retain highly skilled talent will be further advantaged if they have an international profile and are globally connected. Long term investors would therefore be well advised to discriminate heavily in favour of locations where deep pools of highly skilled labour want to live, work and spend their leisure time.

Emerging submarkets could generate outperformance

Investing in emerging submarkets is likely to generate significant growth and outperformance. As noted above, these locations can be less liquid and less transparent. There are fewer participants. Assets may also have issues around liquidity and letting. Urban change in these locations gives well-informed and embedded investors an opportunity to deliver outperformance through an information advantage. Local specialists with deep expertise are well placed to identify pre-conditions of urban change, or generate it themselves. This change has the potential to deliver alpha over the long term. Generally, locations in cities where highly-skilled workers want to live, work, play and learn are likely to have more robust demand.

[1] Butler, T. and G. Robson (2003a) London Calling: The Middle Classes and the Re-making of Inner London, Berg: Oxford.
[2] Munt, I. (1987) 'Economic restructuring, culture and gentrification: a case study in Battersea, London', Environment and Planning A, 19, 1175-97
[3] Hamnett, C. (2003) 'Gentrification and the Middle class Remaking of Inner London, 1961-2001', Urban Studies, 40, 12, 2401-26.
[4] Ley, D. (1996) The New Middle Class and the Remaking of the Central City, Oxford University Press: Oxford

KEY INGREDIENTS FOR TRANSFORMATIONAL CHANGE

At the quantitative screening stage, a number of different data points could help identify pre-conditions of urban change. The framework below explores data in the context of the London office market. Not all will be relevant (or readily available) in other markets.

Proximity to high value locations

People and companies like to be located near more affluent neighbours[5]. Being close to existing high value neighbourhoods, therefore, is a key ingredient for transformational change. Examples of such locations include the West End, the City of London or Canary Wharf. One of the attractive factors about King's Cross is how close it is to the West End. While Elephant and Castle is a 30 minute walk into the City, its location has clearly been a driver behind its recent redevelopment.

Demographics and data

Troves of data are available to give an insight into a neighbourhood's attractiveness to real estate occupiers. Forward-looking demographic data is perhaps the best indicator of who will be spending time in an area in the long term. Transport connectivity data, such as PTAL scores from Transport for London, measures how well connected a micro-location is. House price data and crime trends also indicate how the local environment might be changing.

QUALITATIVE ANALYSIS

Finding pockets of value in emerging locations requires qualitative analysis too. Initial top level investigations may highlight locations that have already emerged. In the context of London this may be King's Cross or Farringdon. King's Cross has recently undergone significant private sector investment. Farringdon is located at the edge of the City and Shoreditch and will be affected by no fewer than three major rail projects by 2023. Yet despite continued *incremental* improvement in these areas, they are not candidates for future *radical* change. This has already taken place. Investors may therefore struggle to find any mismatches in pricing as any growth may have already happened or already be priced in. A more detailed investigation is necessary.

Looking deeper at the property market dynamics, the degree of public sector support for an area, and evidence of private sector investment may offer more informed insights. If these factors are favourable it has the potential to enjoy future outperformance.

Signs of public sector support

Public sector support can often be a catalyst for urban regeneration. Crossrail, as Europe's largest single infrastructure project[6], has unsurprisingly prompted investment around the stations on what will become known as the Elizabeth line. Planned infrastructure projects in a micro-location, be that High Speed 2 (Euston), untangling the road system (Vauxhall), or extending the tube network (Nine Elms), help to enhance an area's long-term appeal.

If connectivity is not already excellent, improving local transport is fundamental in a city like London. While geographically close to the centre of the city, south east London nonetheless feels somewhat isolated. The Bakerloo line extension, if and when it arrives, will unlock residential and retail opportunities in areas like New Cross and Lewisham.

Support from the public sector can take other forms aside from infrastructure improvement. A planning environment that recognises the benefits of development, Opportunity or Intensification Area Status, and the presence of Business Improvement Districts are all positive factors. In one example of public sector cooperation, the councils for Hackney and Tower Hamlets have jointly submitted a bid to host a Creative Enterprise Zone[7]. Such support is a good signal for future growth for places like Dalston, Hackney and Whitechapel.

[5] Guerrieri, V., Hartley, D., and Hurst, E., 2012, Endogenous Gentrification and Housing Price Dynamics, The National Bureau of Economic Research, NBER Working Paper No. 16237
[6] Crossrail http://www.crossrail.co.uk/construction/
[7] Mayor of London https://www.london.gov.uk/press-releases/mayoral/mayor-announces-creative-enterprise-zone-shortlist

Private sector investment

Other real estate investment should be interpreted as a positive sign. An investor does not need to be a first-mover into a location, and evidence of other investment suggests that a micro-location may offer the opportunity for a committed investor to build critical mass. Southwark and Borough, for example, offer buildings of scale that have received interest from a number of investors. That said, too much evidence, as noted with King's Cross and Farringdon, would indicate that the transformation has already happened. The opportunity for value investors has already been missed.

In addition, evidence of increasing general private sector activity is a good indication of an area's trajectory. Broadly the arrival of independent retailers, coffee shops and craft brewers should be seen as a positive. In Waterloo, the steady transition of Lower Marsh is a promising example .

Real estate market dynamics

It is fundamental that an investor take the micro-location's property market characteristics into account. One of the main attractive factors of any emerging neighbourhood will be the discount in rents compared to the nearest higher-value counterpart. The size of this discount is crucial. Moreover, often the urban landscape will have a distinctive form. The benefit of this should not be underestimated. Dalston's street art and Eastern Curve garden are attractive places for residents to spend their time. Local heritage and period buildings can also provide a pleasant urban environment and a sense of place.

An understanding of the property ownership and occupier base is also key. Investors can then use this knowledge to identify any gaps in the real estate provision of a given area. For example, growth in employment without office development or refurbishment to match that demand may suggest a pent-up need for extra workspace. This requires being active in the market and developing those crucial relationships with local stakeholders.

WHAT ARE THE STRATEGIC IMPLICATIONS FOR INVESTORS?

A framework is needed

First, the above framework is deliberately general as the approach will need to change on a case-by-case basis. Usually, the rejuvenation of an area will coincide with growth in the income per capita of the residents or people who spend their time there. The academic literature exploring emerging clusters is vast, however, highlighting the many possible factors that might contribute to a neighbourhood's transformation. It would be too simplistic to apply one approach to any given city. In Manchester, the origins of the Northern Quarter's buzz stem from different factors than those behind Shoreditch's emergence.

The framework noted above should therefore be treated as a lens through which we can gain a deeper understanding about a micro-location. It should not be seen as rigid and inflexible. Identifying transformational change before it happens requires a holistic approach, and this framework offers a way for us to begin that analysis.

No reward without risk

Second, investors should remain conscious of the extra element of risk associated with this approach, particularly around letting and illiquidity. As mentioned, predicting the emergence of an area is a complex business. There are no guarantees that the area will develop as expected, or within the investor's time horizon. In south east London for example, Deptford has been undergoing gradual change for many years now, with new residential and mixed use developments having mixed success.

Nonetheless, the scope for delivering alpha is attractive. Through careful analysis and investing as part of a balanced portfolio, investors can mitigate the specific risk. A distinction must also be made between occupancy risk and pricing risk. If an area is not generally expected to emerge and the pricing reflects this, barring any change in the broader market conditions, divestment will be fairly rewarded if the location does not develop. Additionally, investors do have ability to shape the future themselves through expert asset management and investing in scale.

Success requires significant expertise

Finally, in order to identify emerging neighbourhoods it is essential that investors are expert in their chosen locations. It is impossible to identify a robust location where people will want to live, work, play and learn without truly understanding that market and its physical environment. Real estate is a local asset class, and this point comes to the fore when finding promising micro-locations. Having a deep, detailed knowledge of the local market allows a focussed investor to commit to emerging areas with conviction, allowing them to enjoy future potential outperformance.

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CONTACT US AT :

Aviva Investors
St Helen's, 1 Undershaft
London EC3P 3DQ

www.avivainvestors.com