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UK Commercial

THE IMPACT ON UK REGIONAL OFFICES
Brexit Briefing

BREXIT BRIEFING

WHERE NEXT FOR THE MARKETS?

SUMMARY

UK office price falls will stimulate a rise in opportunistic investment

■ Significant changes in the political environment, in the UK, have dominated the news flow in the past couple of weeks. The appointment of a new Prime Minister has assisted in providing the first stage of stability.

■ We are expecting that investment volumes will fall over 2016-2020, as the total returns being produced by commercial property reduce.

■ We think that the regional office occupational markets will be more 'cushioned' compared to the London markets as they are less reliant on inward investment and more reliant on local economic dynamics.

■ The reason why we see pricing correction to be much smaller than in previous cycles is that it will be a function of the relationships between buyer and seller, rather than a collapse in the occupational markets, which has been the driver of the larger cyclical movements in yields that the UK has experienced in the past.

"The initial reaction will be for company management to take stock of the impact and then decide on their growth plans - this will certainly stall property decision making in the short-term"

Savills Research

The impact of Brexit on all sectors of the UK commercial property market will be very dependent upon the macro-economic impact and the Government's and consumers' response.

This paper provides our first analysis of how Brexit may affect the regional office markets across the UK. Other papers are available, for the key sectors, including Central London offices, retail, residential, rural and industrial/distribution, which will be updated on a regular basis as new data, news, forecasts and analysis.

Economic outlook

The impact of Brexit on all UK property markets is very dependent on the macro-economic background, and this in turn is dependent on how the UK consumer responds.

The most optimistic scenario assumes that given the fact that the majority of the UK population voted for the result, then the scale of the economic shock will be less than that felt around an "external" shock such as the global financial crisis (GFC).

The most pessimistic scenario is that the combination of suspended corporate decision making, sharp falls in consumer confidence and other factors leads to a recession in early 2017, followed by a period of much lower than forecast growth. We have discounted the possibility of a Eurozone collapse from this scenario, not because it is unlikely, but because if it were to happen it would probably be beyond a reasonable forecast period.

Our base scenario is that the financial markets settle over the summer of 2016, realising that the possibilities of a chain-reaction leading to other countries leaving the EU is low. Indeed the fact that the UK only represents around 3.5% of global GDP does rather question why so many global markets fell sharply during the week following Brexit. Indeed, the equity markets recovered sharply, but Sterling is still much lower, particularly in the face of a potential cut in interest rates.

The next question is how long it will take the UK to exit from the EU and negotiate its position regionally and globally. David Cameron stated that he did not plan to enact Article 50 immediately, so this left us with a base view that this period is likely to continue until the end of 2018. With the appointment of Theresa May as Prime Minister, it will now take a few weeks for her to announce her plans for the UK in the short to medium-term.

This period will undoubtedly see lower investment in domestic and international businesses in the UK, an unwillingness to make long-term decisions, and a need by some sectors (most notably finance) to enact contingency plans that could see certain jobs moving out of London to Europe.

The response of the major European countries will be important to the prospects for the UK. An aggressive reaction is possible. However, the fact that the UK will become the single largest export market for the EU should temper the likelihood of that sort of reaction. However, the relative weakening of Sterling will not help in the short-term, but interest rates remained unchanged in July.

The key is for Theresa May, as Prime Minister, to move fast and clearly as to the direction of the UK economy and the 'plan of action'. In terms of base macro indicators, our core view is:

- Sterling will rise a little from the initial turbulence but remains weak in the short-term;
- Higher import prices lead to inflationary pressures;
- A cut in the UK base rate as early as August seems likely, though this may not be mirrored by cuts in lending rates (indeed these may rise as the UK's risk rating is drawn into question);
- UK GDP growth will be around 1.5% lower than originally expected in two years' time (i.e. growing at around 1% per annum). London's economy is likely to be impacted by a similar degree, down from 3.5% per annum to around 2% per annum).

Occupational markets

There is a wide diversity of business sectors that take space across the UK office market. One of the biggest opportunities that we have is to reshape the area of regulation and compliance to ensure that products/services come to the market quicker. For example, pharmaceutical is on the 'risk' list, with regards future funding, but we believe that speed of delivery could be increased and this will ensure global companies will want to locate here to benefit from the high quality of science and perhaps in a 'freer' regulatory environment. This sector will benefit the M4 corridor office market, Oxford, Cambridge and Manchester, for example.

We also need to remember that confidence, in particular Chief Financial Officers in UK companies, has been waning for the past few quarters in terms of hiring intentions. The lead up to the EU Referendum had stifled confidence given the uncertainty created. However, there is the potential for the corporation tax level to be reduced. Already, comparatively low compared to other major economies, a reduction would assist in attracting new companies and cancel the effect of companies leaving the UK. We wait to see the influence of the new Chancellor of the Exchequer.

The leasing markets definitely slowed in May 2016, and we expect that this will continue through the next two quarters as those deals that were in the pipeline complete. 2017 will see lower than originally forecast levels of take-up in the office markets. As we stand today, we can see a 5-10% fall in combined take-up levels in 2017 and 2018. In comparison, the key office markets saw over 20% fall in 2008 and 2009.

There will also be a rise in businesses seeking to extend their leases for a short period to allow them to assess the needs of their business in a post-Brexit world.

Northshoring will remain a theme over the medium term, as businesses seek to control costs in a more uncertain world. As London will not see significant rental decline, then the price differential story remains in terms of some companies moving away from London, but this includes

potential relocation, in closer proximity, i.e. to well-connected areas of Greater London and the outer M25 office market areas.

Sector impacts

There will be some winners and losers.

■ Banking – will be the hardest hit in both the short, medium and long term, particularly in Central London. Questions around 'passporting' will combine with pre-existing challenges such as 'ring fencing'. Back-office functions remain attractive in regional office markets, but any reduction in headcount in London is likely to feed through to the office markets nationally. However, from a cost of office and labour perspective, the regional office markets may become relatively attractive.

■ Professional Sector – This is the biggest opportunity as legal and accountancy firms are likely to see higher levels of business due to Brexit. The legal sector in particular will have a considerable increase in workload when the task of reviewing and re-writing the law and regulation books becomes pertinent. There have been a number of corporate moves to new and additional office markets throughout the UK in the recent past and this activity is likely to increase in the short to medium-term.

■ Government-related demand may also increase as promotion agencies and lobbyists, particularly those involved with trade and policy, will re-locate back to the UK. The Government may also look to increase occupation in the regions to ensure a more even level of new employment opportunities. Indeed, the HMRC and Government Property Unit led requirements throughout the UK are significant and will assist in enhancing take-up in the next few years.

■ TMT – Stable demand. This sector is more likely to be challenged by unrelated global questions around valuations than Brexit, particularly as the level of venture capital funding has receded significantly during the past few months. However, companies in the UK should be looking to innovate to develop differentiated offerings to customers.

Following the adaptation period of 2016-2018, we believe that the net impact of all of this will be in the region of 5% lower than normal levels of take-up.

This will mean that the base scenario for the regional office occupational markets will be as follows:

Regional office markets impact

■ Lower levels of leasing activity and rises in lease extensions in 2016 and 2017 as businesses watch the exit process;

■ A reduction in the volume of space in the development and refurbishment pipeline from 2018 as speculative development starts are put on hold or delayed;

■ Gentle rises in the vacancy rates throughout the whole of the next five years, though in both cases these remain low enough that they do not stimulate wide spread falls in the rents being achieved;

■ We think that the regional markets will be more 'cushioned' compared to the London markets as they are less reliant on inward investment and more reliant on local economic dynamics;

■ 2017/18 should be a good opportunity for the refurbishment market with a number of second hand buildings being bought for asset management over the last two years. Now could be the time for landlords to capitalise on this as occupiers are looking to cut costs. With market uncertainty in the UK, potential occupiers are more likely to go for a good refurbishment than one of the brand new speculative developments coming out of the market;

■ Lower cost refurbishment product to accommodate more flexibility perhaps bridging a gap between serviced and 'conventional' office space;

■ Northshoring will support demand levels going forward. With companies nervous about spending capital, there could be even more reason for occupiers to take their back (or middle) office functions to regional cities. Even if London rents start to fall, the gap between Manchester and London is still wide and if you factor in staff costs, the savings will be great.

Of course, European companies could leave London, however, in the short term we believe they will stay put until more is known. Longer-term this could impact of the amount of 'grey' space coming on stream.

Another positive is the development pipeline in the regions, this is still manageable and the majority of regional cities still have an undersupply. Manchester's pipeline up to 2018 for example, is 47% pre-let.

Investment market

Understandably, many investors are currently taking stock while the impact of the Brexit vote is considered.

No doubt, this will mean that some deals will fall through on pricing renegotiation and the recent closure and re-pricing of some of the UK property funds has also impacted on both buyers and sellers views.

We believe that the increased depth of overseas investors in the regions will help to stabilise these markets and we had already seen an increase in regional office investment volumes.

We are also expecting that investment volumes would fall over 2016-2020, as the total return being produced by property reduced.

This diversity of investor types is also likely to impact on any pricing variations from before the EU vote. Although much of the recent focus has been on redemptions within some of the large UK funds, very few of these had been very active earlier in 2016.

Whilst there have been relatively few deals transacted since the vote, indications from bidding are that 'annuity' type deals have largely held their level, whilst at the other end of the spectrum, investors are being more cautious and therefore pricing is likely to have fallen. The rumours

of 'fire sales' from the UK funds seem to have been incorrect, with a number looking at a few, strategic sales where good demand still exists.

Our core view for the regional office investment market is therefore:

- Lower investment volumes in 2016 and 2017;
- More focus on longer term income deals;
- Investors looking for any evidence that Brexit is impacting on occupational markets;
- Expecting range of pricing discount, subject to level of risk;
- Currency will play a key role for the overseas investors – weaker Sterling stimulating interest.

MORE ON BREXIT:
We will be publishing further reports on specific topics, see our website for details

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