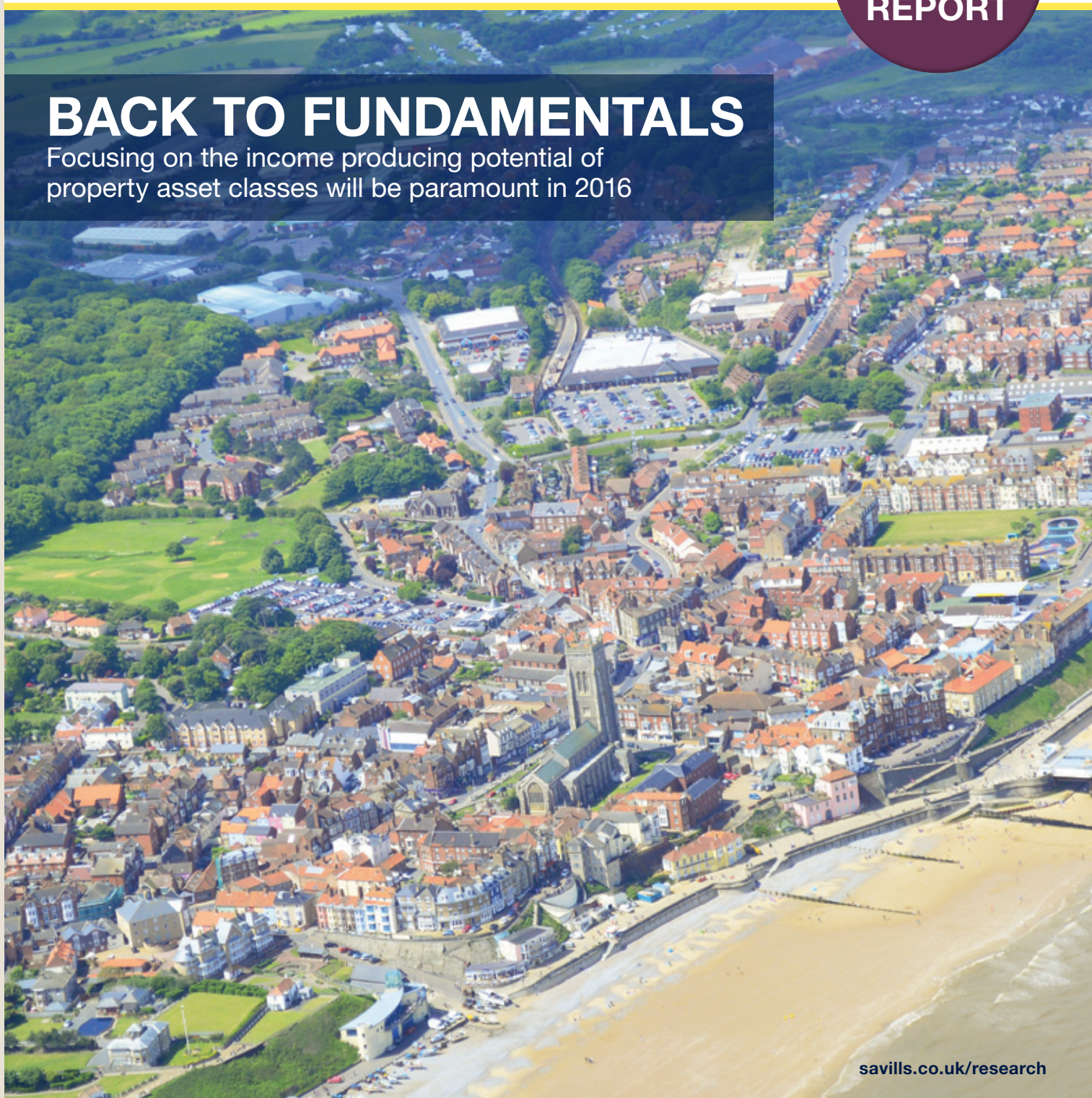


Spotlight **Key Themes for UK Real Estate in 2016**

**CROSS
SECTOR
REPORT**

BACK TO FUNDAMENTALS

Focusing on the income producing potential of property asset classes will be paramount in 2016



THE UK REAL ESTATE MARKET IN 2016

BACK TO FUNDAMENTALS

The investment fundamentals of property are expected to become paramount in 2016, with much greater focus being placed on the income producing potential of the various asset classes and the ability to unlock the latent value of individual assets through management action.

This not only reflects the stage in the property cycle but also the medium term prospect for interest rate rises, regulation and tax policy in the residential sector and the outlook for commodity prices in the agricultural sector. In the commercial and residential markets we expect a shift towards investment in the markets beyond London, given where recent capital growth has left yields.

The referendum on Europe probably presents the greatest uncertainty for 2016/17, the outcome having potential implications for all three sectors. 2015 teaches us that the prospects for a pre-referendum investment slow down may well be dependent on how close the pollsters believe the outcome will be not to mention their ability to accurately predict the result.

COMMERCIAL

2016 will be a very different year for commercial property investors than 2014 and 2015, with the strong capital value growth story of recent years starting to tail off. We expect to see an increased investor focus on rental growth and income returns, as well as on value-adding strategies such as refurbishment and development.

While we are predicting that the average total return on UK commercial property investments will slip into single digits in 2016 (7.5%), this will still be high enough to ensure that it outperforms many other asset classes.

As such, we expect that investor demand will remain strong, and the overall investment volume in the UK is likely to be slightly lower than the record highs of 2014 and 2015 at £60bn, but well ahead of the long-term average.

Income is King

Institutional investors are increasingly focused on the income-producing aspects of commercial real-estate as an asset class, and we expect to see a rise in demand for longer-income, asset management and alternative asset classes in 2016. However,

there are still opportunities out there for opportunistic and short-cycle investors, particularly outside London. Two examples of areas where capital values are yet to correct significantly are small lot sizes across all sectors, and retail property in general.

Typically the average yield on lots of £5m-£15m is 100-200bps higher than it was in 2000 and 2007, and we believe that this is a reflection of a perception that smaller lots are higher risk or lower return. We expect this margin to close in 2016, driven by opportunistic investors buying smaller lots to combine into larger portfolios for eventual sale to an institution. This end of the market also represents a rich opportunity for the private investor.

Retail therapy

Retail property outside London is probably the segment of the market that has seen least yield hardening over the recent recovery. On average retail property yields outside London are just under 200bps higher than they were back in 2007. Clearly there has been some structural change in this sector due to the rise of internet retailing, but we believe that the risks have generally been overstated.

Retailers will experience a strong omni-channel Christmas this year, and the number of new stores being opened by existing retailers and new entrants to the UK market is likely to rise in 2016. Furthermore, the rents in many of the UK's town and cities have now rebased down to a level where retailers can trade profitably, and this means that the rental growth outlook may well be more solid than some investors imagine.

Beyond the capital

Towns and regions outside London generally look like a strong story for 2016, with recovering local economies, northshoring of jobs from London, and low levels of development likely to combine to deliver better than normal rental growth over the next two to three years. For office investors we expect the best prospects to be the top seven major city markets, with opportunities both for refurbishment and redevelopment, and for industrial investors the best prospects will remain in the under-supplied middle of the country. Local market differentials will be significant, with the best locations for investors being those that combine a low availability of good quality property and a solid and expanding labour force.

Investors in commercial property are undoubtedly going to have to be more forensic in their stock-picking from 2016, and a deep understanding of local supply and demand fundamentals will be the key to outperformance.

RESIDENTIAL

Despite continued growth in the UK economy and record low costs of borrowing, annual house price growth stood at just 3.9% at the end of October, with annual housing transactions appearing to have peaked at 1.2m per annum (still a long way short of the levels seen prior to 2007).

As we predicted last year mortgage regulation appears to have cooled the market by restricting how much mortgage debt borrowers are able to take on and consequently their ability to get on and trade up the housing ladder.

London

Regionally London has continued to see the strongest levels of house price growth, although that market is increasingly restricted to more affluent buyer groups who are having

to spread their search further across the capital. As a result there has been a shift in the pattern of growth in the capital, towards those less expensive boroughs which have seen less price growth over the past decade and remain more affordable.

In particular, the top end of the London market has been held back by the stamp duty changes introduced in the 2014 Autumn Statement which have further increased transaction costs for properties over £1m. Given the price growth which preceded these changes, that market is currently left looking both fully priced and fully taxed which suggests a further delay in the return to trend rates of house price growth.

Costs of borrowing

The outlook for the mainstream market is much more dependent on what happens to costs of borrowing. Current indications are that rate rises are still a little way off, which gives more short term capacity for price growth and increases the prospects of a ripple effect gaining a foothold. However, the stress testing of affordability for mortgaged owner occupiers is likely to prevent a debt driven housing market boom.

Over the medium term, rate rises are likely to put a squeeze on affordability particularly in the capital, making

house price growth dependent on earnings and the pace of economic growth both at a national and regional level. This indicates the strongest potential for house price growth in London's hinterland, feeding further north later in the cycle.

Private renting

These two issues of mortgage regulation and interest rates will impact on people's ability to access the housing market. Despite a series of government policies focused on boosting housebuilding and homeownership, we expect levels of demand for private rented sector accommodation to continue to rise.

Recent stamp duty changes and the restriction in the tax relief given to mortgaged buy to let investors are likely to limit the ability of this group to extend their portfolios to meet this demand. This may add to the upward pressure on private rents. It is also likely to result in a shift in the focus of this type of investor towards higher yielding sectors of the market, though not those which are heavily dependent on welfare payments.

Industry issues

All of the indications are that the house building sector will continue to benefit from government support, though at this stage it is unclear as to how policies

such as Starter Homes will work in practice and whether they will result in a step change in housing delivery.

Similarly many questions remain unanswered as to how Housing Associations will be affected by a raft of new policies, most notably the proposed cuts in social rents.

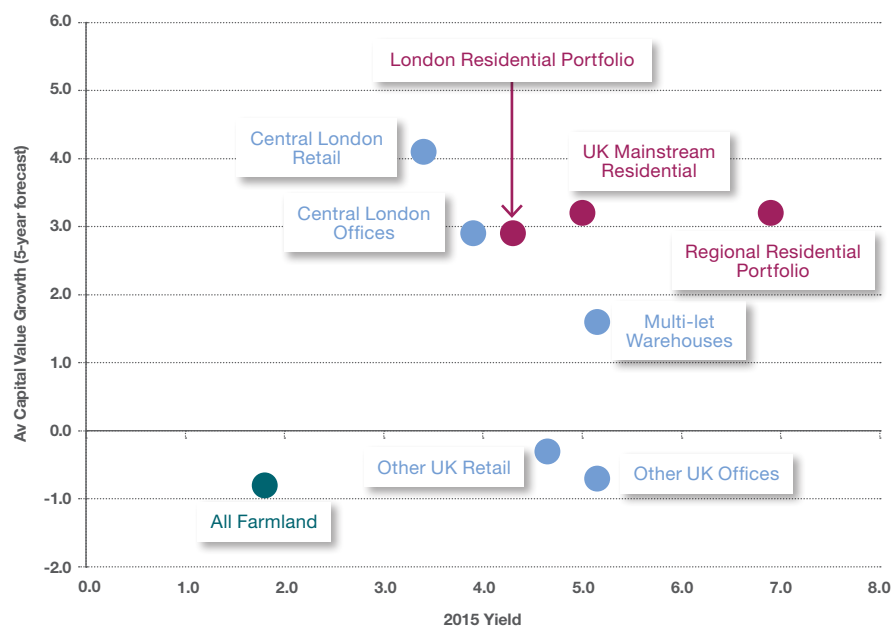
AGRICULTURAL

Forecasting future values for the farmland sales market is far from easy, particularly following a year when a wide range of sale prices were achieved.

Agricultural incomes are under pressure as some commodity prices are back to 2008/2010 levels. The key global forecasting organisations, including the FAO, USDA and IMF, have all cut their already pessimistic forecasts for commodity prices in the medium-term to 2020. Lower energy and feed costs will partially offset lower output prices but the strong pound makes exports less competitive.

Debt may increase the number of farms coming to the market although if this is the case it is likely to be smaller farms. Overall, we don't expect supply to increase significantly unless there is a threat to direct farm subsidies from UK exit from the European Union or a significant negative change in

RETURNS MATRIX: The relationship between income and capital returns by property sector



5-year Annualised Returns	Yield	Capital Growth
Central London Retail	3.4%	4.1%
Rest of UK Retail	4.7%	-0.3%
Multi-let Industrial	5.2%	1.6%
Central London Offices	3.9%	2.9%
Rest of UK Offices	5.2%	-0.7%
Regional Residential Portfolio	6.9%	3.2%
London Residential Portfolio	4.3%	2.9%
UK Mainstream Residential	5.0%	3.2%
All Farmland	1.4%	-0.8%

the capital tax treatment of farmland. Both of these factors remain threats to watch but are unknown at present. UK exit could have a significant negative impact on farm incomes and land values, dependent on how the UK Government supports farming, which is currently unknown.

In 2015, our research recorded falls in arable land values in the eastern counties of England, where values have been highest. Grassland values, which have lagged behind arable values, have continued to increase and this land type is still regarded as good value by large livestock and dairy operations which are trying to expand to spread costs. This demand will help support prices in this segment of the market.

Localised demand

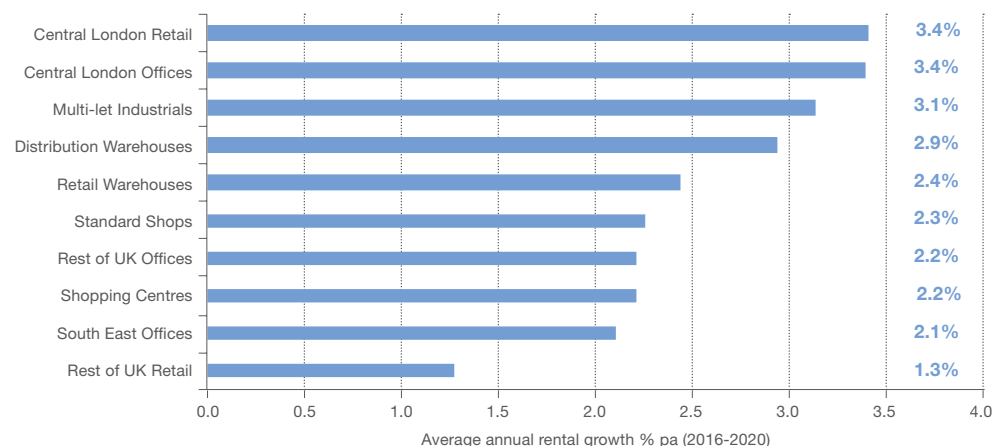
In the short-term, demand for farmland will be more localised, with areas of strong and weak demand, often quite close to each other. Top-performing farmers will continue to be in the market for the right opportunities. Non-farmer demand, and the expected growth in prime country residential markets over the next five years will continue to support prices especially on residential and amenity-type farms but investor demand may weaken as the performance of alternative assets improves. An increase in buyers with rollover cash is likely to follow increased development activity and will add to the mix of local demand.

Downgraded forecast

In the light of recent market evidence, the short- to medium-term expectations for commodity prices and therefore farm profitability, we have downgraded our forecasts for the next five years. We expect values to be much more varied than in the past five years. Exceptional prices may still be achieved if all the right factors come together but conversely it is very likely that there will be more farms where potential sale prices fail to reach expectations or they fail to sell, as illustrated on Figure 3. We expect this market will last three to four years until commodity prices start to recover, following stronger global growth.

However, the fundamental factors driving UK farmland value growth remain. Supply is historically low, the product is finite, competing land uses and ownership motives will all support farmland values growth in the long-term. ■

FIGURE 1
Outlook for average commercial rental growth, 2016-2020 % pa



Source: Savills Research

FIGURE 2
Residential forecasts

	2016	2017	2018	2019	2020	5-year
UK House Prices	5.0%	3.0%	3.0%	2.5%	2.5%	17.0%
Prime Central London Prices	0.0%	2.0%	5.0%	6.5%	6.5%	21.5%
Total (m)	1.245	1.280	1.300	1.300	1.305	

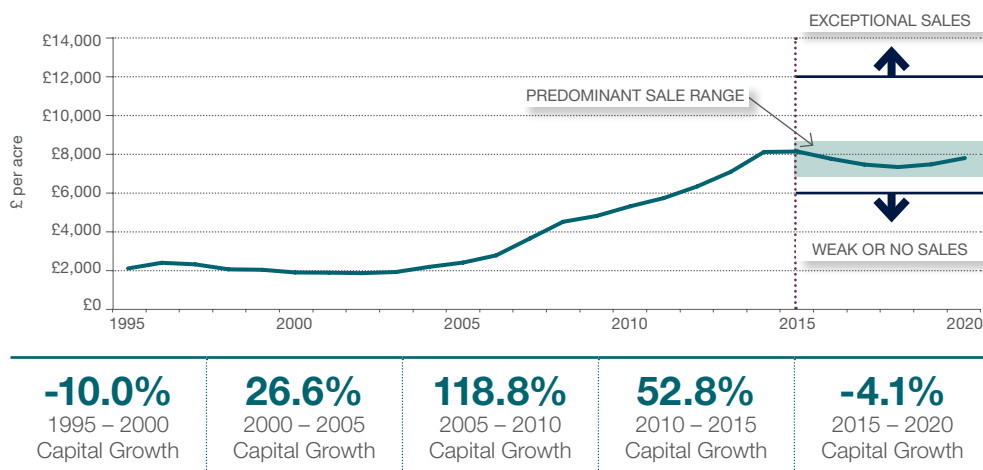
Five-year change to end of 2020

Scotland	14.2%	Yorkshire & Humber	14.2%
North West	13.7%	East Midlands	17.0%
Wales	14.8%	East	21.0%
West Midlands	16.5%	London	15.3%
South West	19.9%	South East	21.6%
North East	12.0%		



Source: Savills Research

FIGURE 3
Farmland value forecasts



Source: Savills Research

WHAT ARE THE TOP PICKS FOR 2016?

COMMERCIAL

■ Office

Good quality refurbishments in the cores of the big seven regional cities will mirror the strong performance that has been seen on similar assets in London in recent years. In London, “future core” development in locations that offer cheaper rents looks persuasive.



■ Retail

Prime West End retail rents to continue to rise at over 6% per annum. The strongest locations will be emerging luxury submarkets rather than the traditional core streets. Outside London the best shopping centre and retail warehouse parks will be those that dominate their catchments.



■ Industrial

Still good opportunities in the core distribution markets if you can find the land. The biggest play in this segment may be in multi-let industrial estates in London and the South where the new permitted development rights could enable conversion to residential.



RESIDENTIAL

■ London hotspots

Though price growth across London as a whole is likely to be limited by mortgage regulation and interest rates, specific areas such as Ealing, Acton, Greenwich and boroughs such as Lewisham and Waltham Forest may buck the trend as they attract more affluent buyer groups.



■ Attractive commuter towns

These continue to offer good medium term price growth compared to more expensive London locations, particularly where travel times are shortened by rail improvements.



■ Graduate hotspots in regional cities

Good second hand stock in centrally located areas of regional cities that are favoured by graduates are likely to deliver higher yields than their London counterparts, without rental incomes being reliant on welfare payments. Improving regional employment markets should underpin tenant demand.



AGRICULTURAL

■ Residential/Amenity farms

These may offer opportunities as the economy improves especially where they are recognised as good value compared to arable land and where improvements will enhance future value.



■ Rural estates

These remain attractive to high net worth buyers as safe shelters for wealth that they can also enjoy; they are also partially protected from commodity price volatility being diverse in their sources of income generation.



■ Commercial farms

These offer the opportunity for top-quartile income potential whilst owning a tax efficient asset for the transfer of wealth and especially for farms in Scotland where values are more affordable compared with areas south of the border.



KEY FACTS: UK Real Estate sectors 2016

COMMERCIAL



Rising interest rates will have little impact on commercial property yields where rents are flat or rising



Strong competition in the debt market likely to lead to increased availability of development finance



Best commercial performance will come from active asset-management and selective development

RESIDENTIAL



Rising interest rates squeeze affordability and limit house price growth



Mortgage regulation suppresses risk of housing bubble and drives demand into private renting



Tax changes restrict private buy to let investors ability to expand in low yielding markets

AGRICULTURAL



Farm incomes are under pressure as some commodity prices are back to 2008/2010 levels



Rising interest rates will squeeze incomes further where debt is significant



UK exit from the European Union remains a significant threat to watch

Source: Savills Research

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