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Key themes in UK real estate

Savills Cross Sector Report | 2016/17

savills

WELCOME

Remaining resolute

What a 12 months we have had, a Brexit referendum, a Trump election and the prospect of real uncertainty in the European elections next year. “Expect the unexpected” is now the normality, not the exception.

Despite all this uncertainty, property remains a fundamentally safe asset class, giving strong income returns and in many cases is a refuge for capital preservation in the longer term, its appeal remaining resolute.

In the lead up to the EU Referendum, markets were strong, the drop in transactional volumes primarily down to lack of liquidity as opposed to waning investor appetite. Some market sectors were experiencing head winds with the absorption of higher stamp duty rates as well as concerns on rental growth in some sectors which would be hit by the rating revaluation.

The seismic shock of the Brexit vote brought transactional activity in many cases to a juddering halt, a pause at least to reconsider pricing as opposed to pulling out of deals. The much heralded run on the retail funds was headline news for several months, but after the shock, the realisation that “life in the property world goes on”, with all the retail funds now re-opened and trading.

Nationally, the markets continue to appear robust in all sectors, although there remains some hesitation on what Brexit will mean in the financial markets, around Biomed and also in an Agricultural market place without EU subsidies.

The sterling devaluation has made UK property very attractive for international investors pegged to the US Dollar or Euro, with activity in central London likely to be dominated by Asian investors, with American and Pan-European investors also strong nationally.

In a world of uncertainty, it is more than ever important to seek expert opinions. I hope our experts’ “top picks” prove both interesting and accurate. I am sure they will!

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OUTLOOK

A QUESTION OF RISK & RETURN

Political and economic uncertainties will dictate the patterns of property investment over the next five years

When we prepared our cross sector outlook last year, few would have forecast that 12 months later the UK would have voted to leave the EU - prompting a change in leadership of the country - and that Donald Trump would have become president-elect in the US.

Though not nearly on the scale of the global financial crisis, these events have heralded much greater domestic uncertainty on both political and economic fronts.

UNDERLYING DRIVERS

At a macro level this means more caution and risk aversion among investors. This is expected to reduce the prospects for capital growth across all three sectors.

It means more secure income streams will become more highly prized among core investors. This plays towards the UK long commercial leases where the rental covenant is strongest. For the same reason we expect the momentum for investment into large residential portfolios to continue to grow among institutions.

Risk premiums are likely to increase. This is likely to push commercial yields out slightly in the short term, presenting investment opportunities, particularly given the low returns available from sovereign bonds and cash.

The changed attitude to risk is likely to mean a less crowded market place for the value-add investor, particularly if lender caution results in tighter borrowing criteria in the development sector. Greater risk will mean a strong focus on sectors where the fundamentals of supply and demand are most insulated such as retirement housing, logistics and energy.

For opportunistic investors the continuation of the ultra low interest rate environment is likely to limit the extent to which distressed assets hit the market. This is likely to mean they look instead to the development markets, particularly mixed use opportunities linked to infrastructure improvements.

FIGURE 1

Cross sector forecasts and figures

4.4%
Average annual income return from offices

13%
5 year capital growth forecast for UK residential

32%
5 year capital growth forecast for GB forestry values

1.6%
5 year capital growth forecast for office values

19%
5 year rental growth forecast for UK residential

5.5%
5 year capital growth forecast for GB farmland values

Source: Savills Research

Against this overarching picture, there are a number of sector specific factors, that will influence the pattern of investment in the run up to and immediate aftermath of Brexit.

COMMERCIAL

In the commercial market the position of London as a global financial centre will be under close scrutiny. The comparative costs of staffing and office space among the pretenders to London's crown are likely to protect it from any fall out.

Though we expect to see a downturn in office leasing activity in the capital, this is likely to be offset by a fall in development activity that will limit new supply coming to the market to support rents.

Elsewhere in the office market, we expect lack of dependence on cross-border financial services, low supply, and a very restrained development pipeline to support the major regional city office markets.

"The changes in government has led to a shift in housing policy, with a much greater emphasis on delivering more housing across a much wider range of tenures"

Savills Research

In the retail market, while some investors remain concerned about the impact of the internet on traditional retail, most retailers are now fully entrenched in an omnichannel world. Our rule of thumb for the best buys in retail is to make sure it offers shopper experience, or convenience.

Logistics property will remain highly sought after, due to its long and often indexed leases, as well as the landlord-friendly dynamics in the occupational market.

RESIDENTIAL

In the residential market it is the indirect implications of the Brexit vote that hold the key. The changes in government have led to a shift in housing policy, with a much greater emphasis on delivering more housing across a much wider range of tenures.

This means greater opportunity to unlock development potential of strategic land for the opportunists and value-adders. For the core investors, who have gained more traction in the Build to Rent sector, it is likely to mean a more accommodating policy backdrop.

By contrast, private buy to let investors face a combination of higher stamp duty costs, less income tax relief and greater mortgage regulation. This is likely to mean a continued imbalance between supply and demand in the private rented sector that pushes up rents.

In contrast to the commercial sector that is likely to marginally improve income yields. Debt backed private investors, faced by these challenges, are increasingly likely to look to higher yielding, lower value markets to deliver cash returns.

Taxation is also likely to be a key driver in the prime housing markets, where stamp duty rates are highest. Overseas investors also face higher exposure to capital taxes, which is likely to mean that they will want to be confident that residential investments offer value in sterling terms, irrespective of a potential currency play.

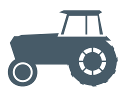
RURAL

In the rural sector, the £3 billion of subsidies provided by the Common Agricultural Policy each year can no longer be guaranteed to underpin farm incomes over the longer term. They are, however, secure until 2020 and in the short term, the depreciation of sterling will boost their value in sterling; underpinning demand for farmland.

Over the longer term, they are likely to be gradually eroded and increasingly weighted away from production towards public goods such as the environment.

This means that buyers will increasingly differentiate between the underlying commercial value of farmland, its amenity value and, in the case of strategic land, its development potential.

With 60% of UK food exports worth £20 billion going to the EU and 17% in addition going to the US, the first impact on farming incomes will be dictated by the trade deals that are struck. This is likely to mean diversified income streams will be an increasingly important hedge on those farms occupying the middle ground.



£3bn

Value of subsidies provided by Common Agricultural Policy

SPECIAL ISSUES FOR NON-DOMESTIC INVESTORS

Opportunities and risks for overseas investors

Currency

- Sterling expected to remain weak, offering instant savings to non-domestic purchasers.
- Yields on some sectors may not be high enough yet to look attractive, compared to other domains for investors who have to hedge currencies.

Tax and Legislation

- High stamp duty costs and greater exposure to capital taxes will mean overseas investors seek value in sterling as well as foreign currency on residential property.
- Commercial property investors to continue to be taxed in the same way as domestic buyers making the UK more attractive than some markets with extra non-dom taxes.
- Political threats need to be carefully watched. These include FDI regulations, trade policies and reducing support from subsidies.

Other issues

- Lower levels of domestic demand, particularly at larger lot sizes will give non-domestic investors a clearer playing field.
- Comparatively low trading volumes may raise questions about liquidity, but the high levels of transparency in the UK should compensate for this.

FIGURE 2

Risks and opportunities in 2017 by investor type

	CORE INVESTORS	VALUE-ADD INVESTORS	OPPORTUNISTIC INVESTORS
DRIVERS	**Heightened risk aversion due to geo-political risk** **Increased demand from long term income security** **Low returns from sovereign bonds and cash**	**Low income yield and market led capital growth increases focus on value add activities** **Diminishing occupational concerns in some sectors make voids an opportunity**	**Search for contra-cyclical investment** **Government drive for greater house building** **Infrastructure-led development opportunities**
COMMERCIAL	**RISK:** Downward pressure on yields for prime assets **OPPORTUNITY:** Specialist assets with secure income streams, e.g. data centres	**RISK:** Economic shocks lead to longer than expected voids **OPPORTUNITY:** Bulky goods retail warehousing is internet-friendly but looking cheap	**RISK:** Hunt for higher returns takes investors too far up the risk curve **OPPORTUNITY:** Less competition in this space due to risk aversion
RESIDENTIAL	**RISK:** Taxation and regulation of buy to let **OPPORTUNITY:** Expansion of institutional build to rent	**RISK:** Reduced turnover curbs demand from private house builders **OPPORTUNITY:** Government focus on housing delivery across multiple tenures	**RISK:** Lender caution makes raising development finance more difficult **OPPORTUNITY:** Ability to 'white knight' stalled development projects
RURAL	**RISK:** Short term pressure on land values and continued low supply **OPPORTUNITY:** Ability to unlock residential development potential on strategic land through planning	**RISK:** Economic pressures a threat to certain grassland farms in northern regions **OPPORTUNITY:** Demand for UK timber as housebuilding and biomass use forecast to increase	**RISK:** Constant change in government support for renewables or other grid supply/storage related projects **OPPORTUNITY:** Battery storage and off grid energy parks – ability to create/supply a range of Cooling, Heat and Power (CHP) on demand

Source: Savills Research

INVESTMENT

WHAT ARE THE TOP PICKS FOR 2017?

COMMERCIAL

DOMINANT LOGISTICS WAREHOUSES The safety play for times of uncertainty. With availability at record lows and demand unaffected by Brexit uncertainty, this sector looks likely to continue to outperform. Key locations remain the Midlands and M25, though high rents may stimulate some drift to their edges.

James Williams
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HIGH QUALITY REGIONAL OFFICES Generally we see the key regional cities as more defensive to Brexit than London. Availability is low, particularly of refurbished space in the £20-£24/sq ft range. Demand is likely to be supported by continuing northshoring from London.

Richard Merryweather
Head of UK Investment
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RESIDENTIAL

RESTORATION PROJECTS Restoration projects in the commuter belt where you can add value and take advantage of the differentiation between London and the country, which still exist.

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BUY TO LET IN UNIVERSITY TOWNS
Buy to let in university towns where student lets offer good yields and where values have been slow to recover so far.

Jane Cronwright-Brown
Head of Lettings
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Leading Savills experts, across all sectors, select their top picks for the forthcoming year

RURAL

INSTITUTIONAL LAND Where funds and institutions can take time to realise long-term gains, there is a current focus on sites with potential on edge of existing developments and larger sites with strategic opportunities not suitable for short term investors.

Paul Lindon
UK Institutional Land
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FORESTRY An excellent alternative land asset for long-term portfolio diversification and wealth preservation, forestry offers unique attributes in a low risk, tax efficient environment. Investors have opportunities to structure for capital growth or tax free income depending on objectives.

James Adamson
Head of UK Forestry Investment
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DEVELOPMENT

URBAN MIXED USE Urban mixed use development sites in Birmingham, Manchester and Leeds on the back of potential HS2 and general resurgence of UK core cities.

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INSTITUTIONAL GRADE MULTIFAMILY AND STUDENT DEVELOPMENTS IN CORE UK CITIES This underdeveloped sector offers potential to investors and operators who align high quality construction with consumer service. Look to towns and cities with core fundamentals such as employment, transportation, infrastructure and established educational centres.

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COMMERCIAL

MAT OAKLEY'S SIX KEY THEMES FOR 2017 AND BEYOND

1 Brexit uncertainty will not stop decision-making

Occupiers in all sectors are still assessing the impact of the referendum on the future paths for their businesses. As the realisation grows that the negotiations on how we exit and then trade with the EU will be long and bumpy, businesses will need to continue making staff and property decisions. Tenants will definitely demand greater flexibility when signing new leases, but occupational demand will not collapse.

2 Wellness as the new sustainability

While some people still view the debate around wellness in the workplace as a fad, the fact that 55% of the typical office-based businesses costs are related to their employees means that minimising the productivity toxins in the workplace will become increasingly important to employers of all sizes. Recent research by Savills and the BCO found that 31% of workers said that their workplace has a negative effect on their physical health, and 28% on their mental health.

3 Development activity declines from an already low level

Commercial development activity has barely recovered from the post GFC slump, and the next five years will see lender and borrower risk aversion leading to a 30-40% fall in development activity across all sectors and regions. This will be most acute in central London, where up to half of the planned developments could be delayed. This will make life much harder for tenants who are looking for new space, and will present an opportunity for those developers who hold the line and proceed with projects.

4 Shape of the rental cycle will change

Prior to the referendum we were predicting that some kind of shock would slow the occupier markets towards the end of the five year period. This shock has come earlier than expected, which means that some markets and sectors will see rental falls in 2017 and 2018. However, the corresponding declines in development activity that are likely to be most intense in 2019-2021, will lead to falling Grade A vacancies and rising rents at the back-end of our five year forecast period.

5 Non-domestic investors will become increasingly active in the UK

We expect that the pound will remain comparatively weak throughout and after the Brexit negotiation process. This, combined with the income security that the UK lease offers, will stimulate a steady rise in non-domestic interest in commercial property in the UK. This will not just be confined to London, where 75% of the purchases in 2016 were non-dom. The next five years will also see record levels of non-domestic investment outside London.

6 Global hunt for income will drive price rises in the UK

Uncertainty, rising demands from pension funds, and low bond yields will continue to drive a global hunt for investments that deliver a secure income. This will lead to strong demand for properties in the UK that have such characteristics, whether they are long-let City offices, index-linked warehouses, or the increasingly popular 'alternative' asset classes. Demand for such assets is likely to exceed supply, and thus we expect to see improving capital value growth.

UK COMMERCIAL FORECASTS	2017	2018	2019	2020	2021	Total 5-year growth
Retail capital growth	-3.5%	-0.1%	0.0%	1.5%	2.4%	0.2%
Retail income return	5.2%	5.2%	5.2%	5.1%	5.1%	N/A
Office capital growth	-4.0%	-1.0%	1.1%	2.5%	3.2%	1.6%
Office income return	4.0%	4.5%	4.5%	4.7%	4.5%	N/A
Industrial capital growth	0.0%	1.5%	1.5%	2.5%	2.7%	8.4%
Industrial income return	5.5%	5.7%	7.0%	5.4%	5.2%	N/A

Source: Savills Research

RESIDENTIAL

LUCIAN COOK'S SIX KEY THEMES FOR 2017 AND BEYOND

1 Reduced house price growth in the mainstream markets

The prospect of weaker economic growth and greater pressure on household finances is expected to remove any significant upward pressure on house prices over 2017 and 2018. In this period, fragile consumer sentiment is likely to offset any boost from low interest rates. A pick up in economic growth and confidence from 2019 – as the future political and economic landscape becomes clearer – is expected to underpin a return of house price growth. However, rising interest rates through 2020 and 2021 are likely to limit growth at the back end of the next five-year period.

2 Lower transaction levels including buy-to-let investors

Greater caution among homebuyers is expected to translate into lower transaction levels across the market. Overall we expect transactions to fall by 16% over the period to the end of 2018 before gradually recovering back towards the current level of 1.25 million. We expect mortgaged buy to let investors to be particularly affected given the 3% stamp duty surcharge they now face, the reduced tax relief they are able to get on mortgage interest and the prospect of greater mortgage regulation.

3 Increased rental demand and pressure on private rents

Reduced transaction levels and the prospect of tighter lending criteria are expected to continue to drive demand into the private rented sector from frustrated would be home owners. While demand continues to rise, supply is likely to be constrained by the reduced buying activity of private investors. That indicates that rental growth will exceed household earnings growth, facilitated by greater levels of sharing and more affluent groups of renters.

4 A shift in geographical focus

We expect the strongest price growth to be the South East and East of England over the next five years, with price growth in London curtailed by affordability pressures. Towards the end of this period, markets in the Midlands and the North will show more capacity for house price growth, though much will depend on local economic drivers. Tax changes are expected to cause investors to shift their focus to some of these higher income yielding lower value markets.

5 A broader approach to supporting housing delivery

The changes to Government triggered by the EU vote has heralded a renewed drive to increase housing delivery and a shift in the focus of housing policy. The prospects for subdued transaction levels reinforce the need for a multi-tenure approach to housing delivery to meet current targets. While Help to Buy will continue to play a part in supporting home ownership, there will be much more focus on increasing supply through Build to Rent. This presents much greater opportunities for institutions to meet their aspirations for investment in the residential sector.

6 More opportunities to unlock development potential

With the Government looking to free up the planning system and reinvigorate small and medium-sized house builders, there is likely to be more opportunity to unlock development land opportunities. In the short term this may be inhibited by house builder caution. However, as established and emerging developers respond to improving transactional activity and new markets linked to the rental sector, this will present opportunities to unlock long-term hope value.

UK RESIDENTIAL FORECASTS	2017	2018	2019	2020	2021	Total 5-year growth
House prices	0.0%	2.0%	5.5%	3.0%	2.0%	13%
Transactions	1.125m	1.040m	1.145m	1.195m	1.240m	N/A
Private rents	2.5%	4.0%	5.0%	3.5%	3.0%	19%
Household income*	1.0%	1.9%	2.6%	3.3%	3.2%	13%
Employment*	-0.4%	0.0%	0.4%	0.8%	1.0%	1.8%
Bank of England base rate*	0.1%	0.1%	0.4%	0.9%	1.4%	N/A

Source: Savills Research, Oxford Economics*

RURAL

GILES HANGLIN'S SIX KEY THEMES FOR 2017 AND BEYOND

1 Low commodity prices continue to impact on values

Low commodity prices and patchy local demand are the principal factors affecting the land market. The fall in values continues to be principally driven by pressure on arable land values, especially in the eastern regions of England. Despite the benefits of the weak pound on outputs and subsidies, we expect the average value of 'all types' of farmland across Great Britain to remain under some pressure in the short term as current debt in the industry filters into sales.

2 No flood of farmland to the market

Debt pressure is the single biggest factor which has the potential to increase supply. We expect debt related sales to be in the region of 20% to 25% of all transactions but the effect will be tempered by the increase in 2016 subsidy and the positive effect of the weak pound on output prices. Over the next five years we expect the area of farmland coming to the market, in the historical context, to remain low.

3 Economic pressure on farm rents (FBTs) tempered by demand

The volume of reviews conducted and the average percentage change in rent have been dropping for three years. We expect, with the current outlook for farm profitability, that the rental market will remain under some pressure, but this will be alleviated by scarcity of land to rent and demand from those looking for efficiencies through economies of scale. Subsidy review in 2020 will cause great uncertainty and affect bidders for new rental opportunities*.

4 Overseas farmland should not be ignored

Investment in global farmland provides the opportunity for good returns, but an in-depth understanding of the market is essential. Extending a portfolio into farmland across the world provides access to land and an opportunity for substantial capital growth, but the rewards depend on the appetite for risk with politics, markets and infrastructure key aspects to consider.

5 Brexit uncertainty – opportunities and threats

In the short term, the downside of Brexit on farmland values is likely to be muted. The weak pound creates a favourable buying environment for overseas buyers and this, along with the potential reduced supply driven by uncertainty, will help support farmland values. In the event of a significant reduction in farm subsidies in 2020 and therefore incomes, the negative effect is likely to be greater on rents than land values.

6 Forestry creates new opportunities

Although UK timber markets will fluctuate from season-to-season and year-to-year, the prospect of a longer term upward trend in timber pricing structures remains very real, making us confident in the future of forestry as an asset. High yield class, well managed commercial spruce forests with good access to timber markets will remain in strong demand, supported by the weaker pound and increasing domestic demand for woody biomass and from construction, with the predicted uplift in housebuilding a key driver.

UK RURAL FORECASTS	2017	2018	2019	2020	2021	Total 5-year growth
GB farmland values	-3.8%	-1.7%	1.8%	4.4%	5.0%	5.5%
GB farmland supply (acres)	0.0%	0.0%	0.0%	5.0%	5.0%	10%
Farm rents (FBTs)	5.0%	5.0%	5.0%	N/A*	N/A*	N/A
Forestry values	4.0%	5.0%	6.0%	6.0%	7.5%	32%
Exchange rates (€/£) aop	1.146	1.185	1.185	1.188	1.190	N/A
Exchange rates ($/£) aop	1.250	1.256	1.286	1.323	1.360	N/A

Source: Savills Research, Focus Economics

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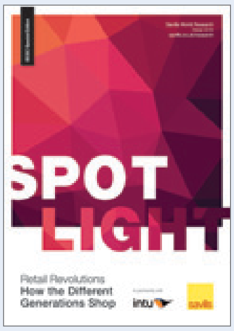

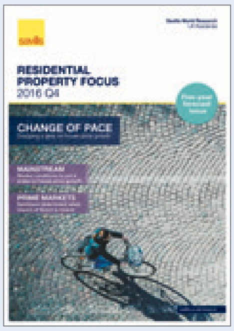

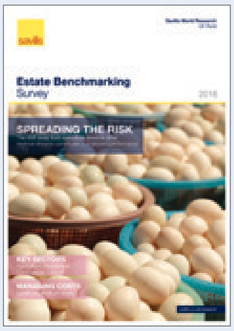

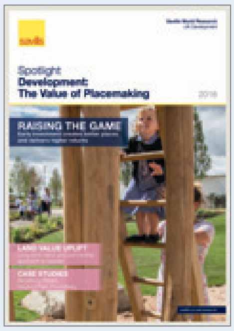

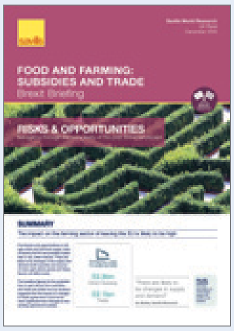

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The Savills research team is unique in providing advice and analysis to clients across all commercial, residential and rural sectors of the property market. The established team has a strong reputation for producing accurate, well-informed and, above all else, independent analysis and commentary. External clients include developers, landlords, investors and occupiers.

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