

# Real Estate House View

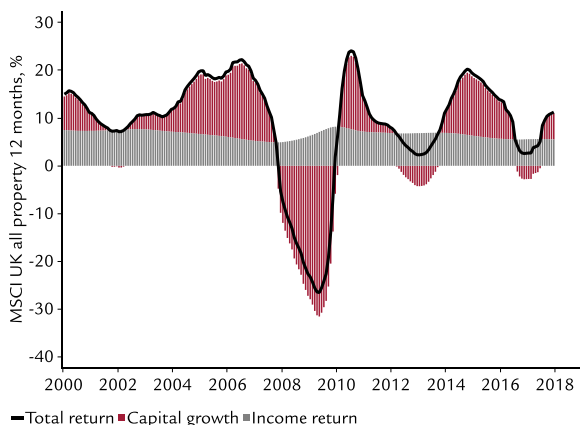
## United Kingdom

First half of 2018

### Key takeaways

- 2017 was a very positive year for UK real estate performance: overall property returns came to 11.2%. The upside was largely due to yield-driven capital growth.
- Yield compression occurred across all asset classes but industrials recorded the most change. Coupled with the strongest rental value growth, industrials were last year's outstanding performer.
- Performance was polarised between and within sectors, reflecting cyclical and structural change. The expectation for 2018 is more of the same and a continuation of the trends seen in 2017.
- Macro-risks exist but with a benign bond environment investor appetite is set to endure. Yields remain attractive on an international basis and the weight of overseas capital shows no signs of abating.
- Occupational demand has been resilient, aided by the lowest unemployment rate for four decades and positive, albeit falling economic growth.
- High street retail is most exposed to the expansion of e-commerce, higher inflation and slower wage growth. We expect occupier and investor demand in parts of the retail sector to soften further this year.

### Chart in focus



Strong UK all-property returns of 11.2% in 2017 comprised 5.5% income return and 5.4% capital growth. The 21.1% overall return in industrials was the strongest sector by far. Returns in the other sectors were lower than the all-property average but still much higher than expected at the start of the year. Offices returned 8.5%, retail 7.7% and residential 7.6%.

According to the latest data published by Consensus Economics, the UK GDP growth forecasts for 2018 range from a mere 0.9% to 2.2%, which is an extraordinarily wide range. Clearly, the ongoing Brexit negotiations cast a shadow on economists' projections for the UK. Further evidence of the uncertainty is that we are lifting our forecast from 1.2% to 1.5% at the same time as the consensus forecast comes down to 1.4% from 1.5%. As a matter of fact and supporting our comparably constructive judgement, the majority of the data covering the fourth quarter in 2017 came in above expectations. Meanwhile, headline inflation eased to 3.0%, confirming our view that the surge in inflation following the EU referendum was temporary. Assuming stable energy prices and no further Sterling devaluation, inflation should drop below 2.5% by mid-2018.

## Strong performance

UK real estate performed strongly in 2017, registering double-digit returns at 11.2%. Aggregate performance masked significant variation between property subsectors. Returns in 2018 are expected to be lower but, barring any macro-shocks, we see potential for capital and income growth in sectors and locations that are aligned with the UK economy's continued structural evolution. Total investment volumes in 2017 for all property investments (including residential) equated to GBP 58.5bn, 10% greater than 2016. This was high by historical standards and made 2017 the fourth strongest year on record. Overseas investors accounted for 52% of investment volumes in 2017, a slight increase on their 50% share in 2016. Overseas purchases were heavily weighted towards Central London offices. Overseas interest in UK real estate is expected to endure into 2018.

## Regions offer promise

London yields reached new lows in 2017, reflecting the overseas investor demand. In December 2017 net initial yields were 3.5% in the West End and 3.8% in the City. The investment market was somewhat decoupled from occupational conditions. Occupiers were active but take-up was flattened by flexible workspace expansion whose occupancy rates are unclear. Flexible providers now account for around 4% of office space, which – according to JLL – is the highest proportion globally. A high quantum of supply is being built out,

meaning that current conditions favour occupiers. Rents in some submarkets have fallen and more incentives are on offer. Pricing in the UK's regions offer value. Take-up in the "big 6" regional markets equated to 5.6m sq ft, a 19% increase on 2016. The regional office supply pipeline has been suppressed for some time, leading to acutely low prime vacancy rates. Portfolio optimisation has led many large corporates to relocate some functions away from London to the regions. The desire for urban living and ongoing infrastructure development is expected to strengthen regional demand further. We expect continuing tenant demand for quality stock to place downwards pressure on availability and upwards pressure on prime rents.

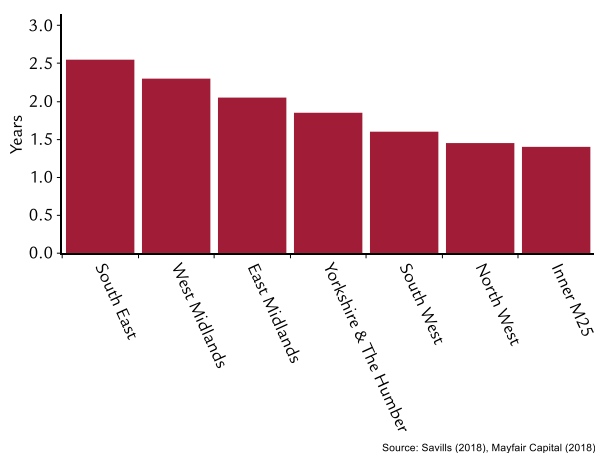
## Further to run

Industrials were the strongest asset class in 2017 with 21.1% returns in light of the UK's ongoing pivot towards online retail. This was their strongest annual return since December 2014. The move to e-commerce is focusing occupier attention on supply chains and urban logistics at the expense of high street retail. The UK's online penetration rate is already high at 17% in 2017. And yet this rate is expected to reach 22% by 2023, driving take-up. According to Savills, supply is constrained, with under 2.5 years of supply in almost all regions. We expect industrial yields to remain firm in 2018. Occupiers will focus their attention on quality real estate in locations with access to reliable power, large metropolitan centres and labour markets. Quality real estate with these characteristics can expect to achieve rental value growth and enjoy high demand.

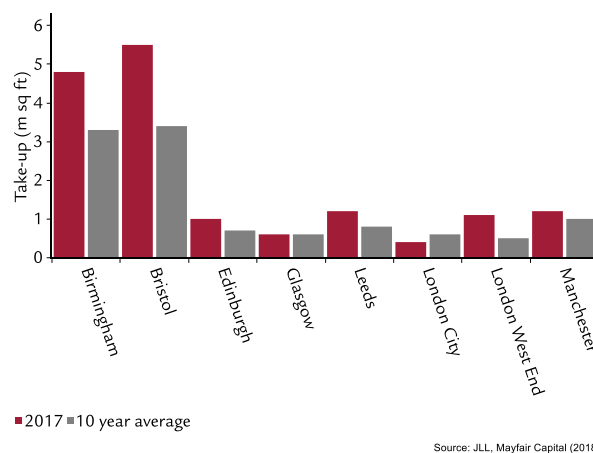
## Opportunities and threats

The retail sector had divergent fortunes in 2017, reflecting the shift online and the focus on experiential retail. Well located, high footfall prime locations and conveniently based shopping centres performed relatively well. Secondary shopping centres and high streets struggled. Analysis of capital growth returns in 2017 demonstrates this, given the spread between Central London retail (3.6% capital growth) and shopping centres elsewhere (-3.6%). The retail sector is likely to carry on polarising in 2018. Inflation, slow wage growth and economic uncertainty are likely to benefit discount value retailers, who have consistently gained market share over the last few years.

**Chart 1: Industrial Grade A years of supply**



**Chart 2: Office take-up in major cities**



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