BTG Global Advisory

UK INSIGHT

Real Estate Issue 3: January 2015

Hot property

In the third of a series of real estate updates for BTG Global Advisory we provide comment on the UK property market, which is experiencing strong growth in London and across the regions. However, there are concerns whether the market can maintain its upward momentum.

Nowhere across UK PLC has the London and South East bubble been more pronounced and apparent than in real estate. From Chinese residential investors snapping up executive apartments in landmark London schemes to institutions trading office, retail and industrial space, the story of 2014 has been all about the bottom right-hand quarter of Britain.

So super-heated is the market that London's West End retained its title of the highest priced office market in the world last year. The West End's overall prime occupancy cost of £174.40 per sq ft means the area ranks number one in CBRE Research's semi-annual Global Prime Office Occupancy Costs survey, beating off all comers. The City of London was in eighth place, with costs of £97.79 per sq ft, while the next highest UK city was Edinburgh, trailing at 33rd.

Last year was an outstanding year for UK commercial real estate generally and unleveraged total returns came in close to 20%. Most of last year's performance has been driven by a favourable fall in property yields (income as a ratio of capital value), as investors focused on income returns. This year total returns are likely to remain in double figures, but rental growth will make a larger contribution to gains compared with capital appreciation.

There are two reasons for this. First, the recovery in the economy continues to create demand across all major commercial categories, and secondly, low levels of development and very little speculative development means that the balance between demand and supply is continuing to swing in favour of landlords and this should pave the way for further rental growth.

For the moment, all things are led by London. The UK capital experienced the strongest rental growth in 2014 and it is likely to stay in the lead over the next 12 months. While an election year does throw in some unpredictability, the broad similarities between the main parties mean that most in the sector are not expecting dramatic changes in policy, regardless of the ultimate outcome. Far more important was that the Scottish independence issue was resolved in 2014. Even outside factors, such as the ongoing Russian crisis, should not shake London, which attracts much of its incoming overseas capital because of its safe-haven reputation.

In the office sector, the emergence of Central London as a powerhouse for international accountancy, law, media and technology companies has pushed vacancy rates back down to pre-crisis levels, not just in the prime locations of the City and West End, but also in less established but upcoming areas such as Farringdon, Kings Cross and the South Bank.

In previous cycles, this squeeze on space and upswing in rents would have triggered a big increase in development activity and encouraged companies to move to cheaper offices in outer London or other cities. However, there has been relatively little new office building in Central London, partly because of stricter capital adequacy rules, which mean that banks are now less willing to fund projects, and partly because competing residential schemes are often more profitable.

While rental growth outside London is patchier, some regional markets are definitely emerging from hibernation. In the office sector, Manchester stands out as the strongest of the big regional cities, largely thanks to the success of its professional services. In addition, there is good demand for office space in Bristol and Edinburgh and certain smaller markets such as Aberdeen, Brighton, Cambridge and Reading, with strong local economies.

In the industrial market, rents are rising by 2% across the South East and Midlands. Part of this is driven by a cyclical upturn in demand from traditional occupiers such as builders' merchants, but in part this is also due to the rapid growth in parcel deliveries, driven by soaring online retail sales.

According to property agent Savills, after a period of very strong recovery, affordability constraints and mortgage regulation are beginning to slow the annual rate of mainstream UK house price growth and these factors, combined with interest rate rises, will cap the potential for further growth. The firm forecasts that before any adjustment for inflation, average UK house prices will rise by 19.3% in the five years to the end of 2019. However, price growth will be limited at just 2.0% in 2015 after a 9.0% rise in the year to the end of October 2014 that leaves the market with limited scope for further growth in the short term.

Forecast Rise in UK Residential Prices

	2015	2016	2017	2018	2019	Five Years To End 2019
Central London	-1%	8%	6.5%	5%	5%	25.5%
Other London	0%	6%	5%	4%	4%	20.4%
Suburbs	1%	7%	6%	5%	4.5%	25.7%
Inner commute	1%	7%	5.5%	5%	4.5%	25.1%
Outer commute	1%	6%	5.5%	5%	5%	24.5%
Wider South of England	1%	4.5%	5%	5%	5%	22.2%
Midlands / North	1%	4%	4%	5%	5%	20.4%
Scotland	0%	4.0%	4.5%	4%	4%	17.5%

These forecasts apply to average prices in the second-hand market.
New build values may not move at the same rate.

Source: Savills

Lucian Cook, UK head of residential research at Savills, says that stress testing of borrowers' ability to service a mortgage and loan to value lending caps will increasingly limit the amount buyers can borrow, making it more difficult to access or trade up within the market. Not only will this suppress price rises, particularly in London, it will also reduce the potential for transaction volumes to return to anything close to a pre-crunch norm.

London prices will be most constrained after a long bull run that is expected to culminate in full year price growth of 15% in 2014. The market now looks relatively fully valued and this has already prompted a change of sentiment among buyers. Savills is, therefore, forecasting that mainstream London house prices will flatline next year, with five-year price growth totalling just 10.4%, the lowest of any region. By contrast, the South East and East of England are expected to show the strongest growth, at 26.4% and 25.2% respectively, as buyers priced out of London seek relative value beyond the capital.

Transaction volumes, which at just over 1.2 million in 2014 remain well below their long run pre-crunch average of almost 1.7 million a year, will struggle to recover significantly in this environment. The inevitable consequence will be that fewer people will be able to attain home ownership, with first-time buyer numbers expected to show no net growth over the next five years, adding further to the number of households living longer term in the private rented sector.

Offices: Regionals an Alternative to London

Investment demand is robust across all markets and activity is increasing thanks to a greater supply of product. The London City market is still a firm favourite for domestic and international investors which are unable to compete in the West End, driving both prime and secondary yields down. Solid demand in London's West End alongside low prime supply has sustained upward pressure on pricing, with prime yields contracting to 3.5% and secondary yields to 5.0%, according to agent Cushman & Wakefield.

Regional markets have become a good alternative for investors. Some, such as the Thames Valley, are still suffering from a lack of prime product while Scotland saw a notable bounce after the referendum uncertainty passed. Yields have fallen markedly due to the weight of money chasing prime product.

The regional office market performed well in Q3 2014, with Manchester remaining the top performer in terms of take-up and Birmingham and Leeds also showing healthy rises of 15% and 29% respectively. Grade A supply is still falling and there were minimal development completions last year, although an increase in speculative schemes should alleviate this in the medium term. London's West End has also seen an increase in demand, but diminishing supply has resulted in a record low vacancy rate of 3.1% against the ten-year average of around 5.2%. This has inevitably led to a rise in rents across the West End. Locations such as Kings Cross have seen a 22.5% year-on-year increase in rents, with demand driven from the media and tech sector. Take-up in the City and Docklands has been extremely strong, with 86% of activity concentrated on new or refurbished grade-A stock. Rents and incentives remain static, as supply continues to match positive take-up figures, but more upward pressure is evident.

With a lack of prime office stock currently available across the UK, Savills highlights the growing rationale for investing in secondary assets that offer refurbishment opportunities and the potential for rental growth. The current yield gap between prime and secondary is wider than usual at 398bps, with the secondary office market representing some good investment opportunities. Savills expects that this gap will continue to close in 2015, reverting to a more normal spread of 300bps.

It is, however, a dearth of available development finance for speculative projects that is a growing concern. While few would advocate a return to the gung-ho days of 2007, in many large cities the lack of available grade-A space is becoming a threat to economic growth and there is a growing gap between what is required and the development pipeline to feed it.

IPD UK Quarterly Property Index and Comparative Data

	Total Return June 2014 (Dec 2000 = 100)	Total Return Sept 2014 (Dec 2000 = 100)	Total Return (%) 3 month	Income Return (%) 3 month	Capital Growth (%) 3 month	Annualised Total Returns (%) 1 year	3 Year	5 Year
All Property	253.8	264.9	4.4	1.3	3.0	18.3	9.2	11.9
Retail	254.4	263.7	3.7	1.3	2.3	14.6	7.2	11.1
Office	244.9	257.3	5.1	1.2	3.9	22.8	11.7	13.4
Industrial	261.4	275.6	5.4	1.5	3.9	23.0	11.2	11.9
Equities	175.9	174.3	-0.9	–	–	6.0	13.0	9.0
Property Equities	192.9	196.3	1.8	–	–	20.3	19.4	11.5
Bonds	211.2	217.4	2.9	–	–	4.4	3.1	5.6
Inflation	148.8	149.6	0.5	–	–	2.3	2.7	3.7

Source: IPD

Retail: Economic Strength Fuels into UK

No sector of the market is as closely associated with economic – and, therefore, consumer – sentiment as retail, and compared with Europe's other big five retail nationalities, the strongest economic growth has been in the UK. In October 2014, sales increased by 4.3% compared with October 2013 – the 19th period of consecutive year-on-year growth.

While the surge in e-commerce spending means that not all that money is walking through the doors of stores up and down the country, nor that the spend is evenly split across categories or geographies, increased spending is bolstering retail locations.

With little new development in 2014, the biggest news of last year focused on major purchases, most notably that Land Securities completed its purchase of a 30% stake in the Bluewater shopping centre for £656m from Lend Lease for an overall net initial yield after expiry of rent-free periods of 4.1%. The official opening of Grand Central and Birmingham New Street Station has been confirmed as September 2015, bringing a full-line John Lewis and over 60 premium retailers and restaurants and cafes to the city with nearly 500,000 sq ft of shopping and dining. Yet little else will open this year, although the prime pipeline is gradually unwinding. Land Securities is also developing Buchanan Galleries in Glasgow – having bought the remaining 50% holding from TH Real Estate in October – and Westgate in Oxford, the latter developed with The Crown Estate. TH Real Estate is developing the St James Centre in Edinburgh, Hammerson is on site with Victoria Gate in Leeds, while Intu has a series of refurbishments underway and is likely to submit plans for Nottingham during 2015.

Industrial: An Online Agnostic Channel

The UK's industrial sector has been boosted by marginal increases in UK manufacturing and particularly by the explosion in online buying and fulfilment, not only from pure players such as Amazon but from omni-channel retailing through the major store chains. This surge in buying has created demand for everything from mega-sheds of 500,000 sq ft and up through to parcel hubs near urban conurbations and to specialist newcomers such as Network Rail-backed newcomer, click-and-collect store chain Doddle.

Overall transaction volumes for the first three quarters of 2014 reached £2bn, 50% up on the same period last year which totalled £1.1bn, according to Savills. The main level of demand is still for prime assets; however, investor requirements are currently outweighing the supply of stock as the flood of properties predicted to come to the market over the last three months has not materialised. This increased level of demand for retail warehouse assets has inevitably resulted in continued downward pressure on prime yields, with schemes such as Leamington Spa and Blackwater demonstrating that 4.25% is now achievable. The market has moved 75 basis points since December 2013.

There has also been a rise in interest from overseas investors, particularly the US, Canada and Asia, which are in the market for top-quality assets. As a result, prime locations in the South East have seen some recent upward pressure on rents due to tight supply of available space and high demand from occupiers. An example of this is Springvale Retail Park in Orpington, where recent lettings have achieved £409 per sq m, approaching the levels set during the mid-2000s which reached £430 per sq m.

Such demand has finally led to some speculative development – almost all new space has been build-to-suit in recent years – as the excess stock created by the 2008 crash has finally been absorbed and investor confidence has returned to this niche property sector.

Outlook

Having enjoyed a robust year across property classes, the UK's real estate market is primed for another strong performance in 2015. However, debt constraint, potential macro-economic shocks and the fragility of the recovery mean that this is not a risk-free year. On top of that, polarisation may have been tempered slightly by a return to secondary investment where prime pricing has taken premium real estate away from good value, but there is plenty of tertiary stock which is all but worthless. Whether some of the office stock in marginal locations or tertiary shopping centre space will ever recover is a moot point – repurposing as residential is probably the best that some locations can hope for.

That said, the storm clouds of 2008 have well and truly passed and occupier demand, led from London and the South East, should mean that the real estate sector can look forward to a positive year. What has distinguished the recovery period this time round is that construction has not taken off in the way it did in previous upturns. While this may stifle some growth, it should also mean a controlled supply of new space, maintaining stability and supporting sustainable rental growth.

Ref: BTG 1381/01.15