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ADVISORY

UK Real Estate Update

Autumn 2014

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Richard White,
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No let up in demand for UK real estate

In our previous issues we have raised concerns as to whether the UK can continue to attract the same levels of in-bound capital in the face of rising markets in continental Europe. The results for H1 2014 indicate that our markets continue to strengthen and, in the face of ever increasing competition for stock, investors are expanding their UK horizons, looking to UK regional opportunities and not just exiting our shores in a bid to find value. While rising competition from the key cities across Europe is a factor, Investors are also reassured by the economic stability, transparency and maturity of our markets.

Capital value growth is again achievable, driven by competition, yet the focus on identifying and realising latent value through active management and development remains. While there is concern about the 'temperature' of the market and the potential for a disconnect from the economic fundamentals, in our day-to-day dealings with our clients it is clear that much has been learnt from the crisis. The significant focus on long term income generation has also had its part to play in placing more value on management skills.

While the UK Regional markets are showing growth in transactions, London still dominates and overseas investors hold the key to a significant proportion of London's commercial real estate (CRE). As a result, their investment preferences have the potential to drive, or inhibit activity within our market. The nature and investment intentions of this capital - whether to buy, hold, or sell – could drive a fundamental shift in the liquidity of our market.

The market is used to the closed end fund model of seven to ten years which has produced a churn of property reaching the market. In contrast, the institutional and ultra high net worth investors' (UHNWI) overarching strategies usually see them hold properties for longer periods than the opportunistic players or traditional funds, which is likely to further compound the lack of stock reaching the market. Another notable factor, the appetite for development, would naturally imply future supply hitting the market, however, this assumes that these investors intend to release these investments to the market. Given the rising interest of Sovereign Wealth Funds and UHNWIs in large scale development projects we cannot necessarily assume that will be the case.

These factors, combined with strengthening real estate markets on the continent on top of already limited supply in London, suggest there is still a significant potential threat to London's dominance of the pole position for transaction volume in Europe.

Richard

Macroeconomic overview

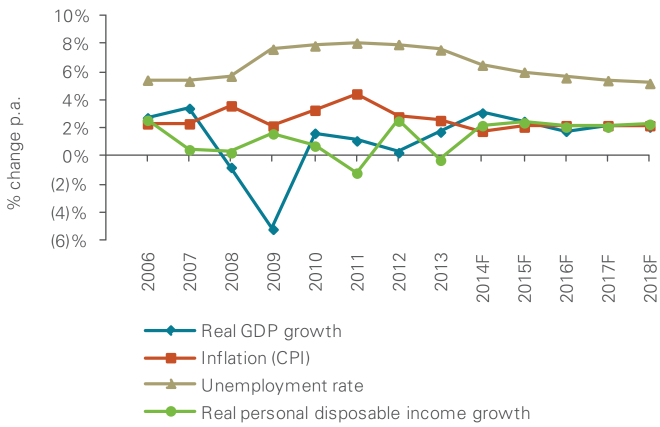
The economic outlook for the UK remains positive. According to the Office for National Statistics (ONS)[1] GDP grew by 0.8% in Q2 2014, contributing to a year-on-year increase of 3.2% - 0.2% above the pre-downturn peak in Q1 2008. This is the sixth successive quarter of growth and moves the UK from having one of the slowest growth rates in the G7 since the downturn to one of the fastest, ahead of Germany (1.3%) and the US (2.5%). The Bank of England's August Inflation Report declared that robust, broadly based, growth over the past year has taken output to above its pre-crisis peak and unemployment has fallen sharply.

The services sector continues to dominate output growth; however this has also spread across a broad range of sectors, with growth accelerating over the last year. There has also been a normalisation of the labour market, with a decrease in unemployment driven by a sharp reduction in the job separation rate in recent quarters. This return to pre-downturn levels, both for recent recruits and more experienced workers, has increased job security and provided a boost to the office property market. Reduced uncertainty, along with improved credit conditions, has also helped to maintain strong household consumption and high consumer confidence, despite a continued weakness in real wages. This consumption is set to continue and the so-called "cost of living crisis", with inflation rises outpacing wage rises, is expected to turn around in 2014 according to a forecast from the Institute for Fiscal Studies[2]. A possibility that is looking increasingly likely given that inflation for July fell more than expected (1.6%, down from 1.9% in June per the ONS) and remains below the Monetary Policy Committee's 2% target.

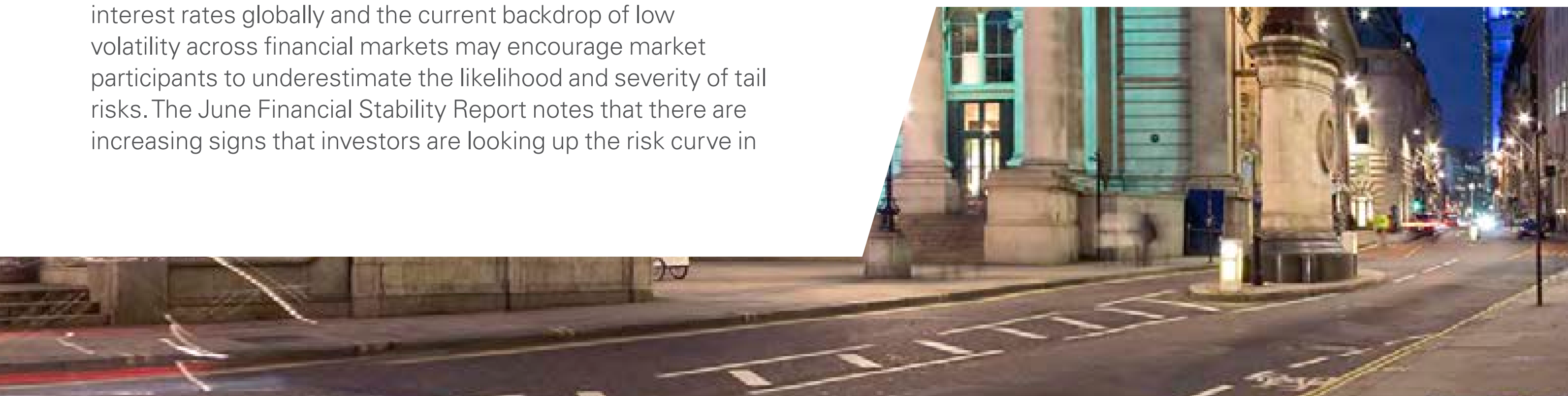
According to the Bank of England's 2014 H1 Systemic Risk Survey, the perceived probability of a high-impact event in the UK financial systems has fallen to its lowest levels since the financial crisis. However this period of low uncertainty is not without its risks. The BoE warns that historically low interest rates globally and the current backdrop of low volatility across financial markets may encourage market participants to underestimate the likelihood and severity of tail risks. The June Financial Stability Report notes that there are increasing signs that investors are looking up the risk curve in search of yields and may be exposing the financial system to shocks, particularly if potential structural changes reduce the availability of market liquidity at times of stress. Furthermore, there remains uncertainty over the degree of spare capacity in the labour market, with slack being used up at a faster pace than expected over the three months to August.

The deficit of trade in goods and services continues to pose a threat to the UK's long-term recovery. According to the ONS[3], between June and July 2014 the deficit increased to £3.3 billion, driven by rising imports (up £1.3 billion). Overall in Q2 2014 the deficit grew by £2.9 billion to £28.7 billion.

Economic indicators



Source: Economist Intelligence Unit

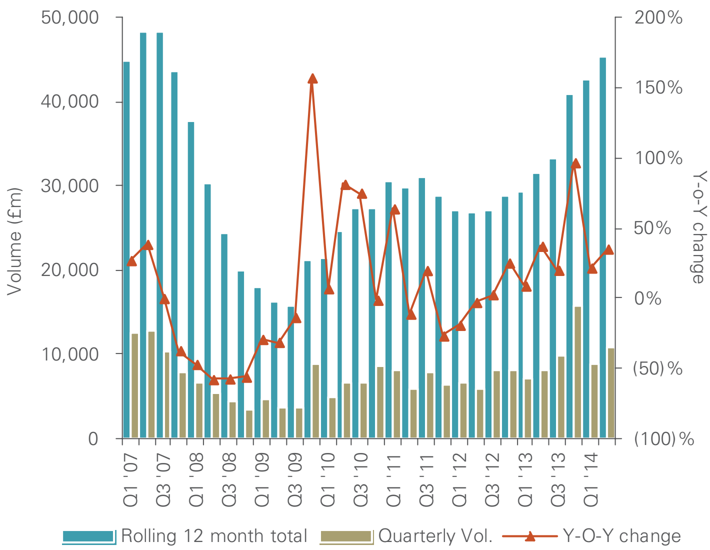


And back to the Real Estate!

The UK real estate market continues to perform strongly through H1 2014, building further on the strong end to 2013. Continued high demand from overseas investors is combining with further improvements in economic sentiment to drive a resurgent real estate finance market and increasing investment beyond London and into the UK's regional markets.

Transaction volumes remained robust throughout H1 of 2014 with total CRE volume (according to RCA[4]) up by 29%, year-on-year ("y-o-y"). While Q1 2014 volumes (£8.9 billion) fell versus the staggering £15.8 billion seen in Q4 2013, Q1 2014 still registered y-o-y growth of 22%. With £10.9 billion of CRE volume transacted in Q2 2014, the UK market experienced its highest quarterly volume since Q3 2007, save for that seen in Q4 2013.

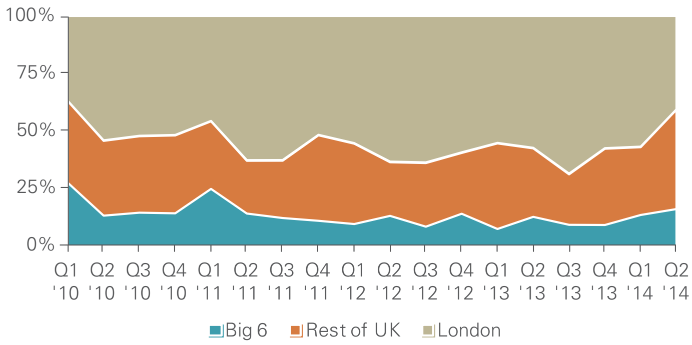
Commercial real estate sales



Source: Real Capital Analytics, rcanalytics.com

While London continues to enjoy its top ranking, based on volume, amongst the European markets, and still received the lion's share (48%) of the UK's total transactional volume in H1 2014 (down from 57% y-o-y), competition for assets remains aggressive. With overseas investors, UK institutions, Listed REITs and Property Companies all in the market, there is greater interest in both secondary geographies and secondary asset classes as investors are forced (competition) and encouraged (economic stability) towards more value-add and opportunistic ends of the investment spectrum. We expect this trend to continue, and with it further yield stabilisation and, in cases, compression, outside London.

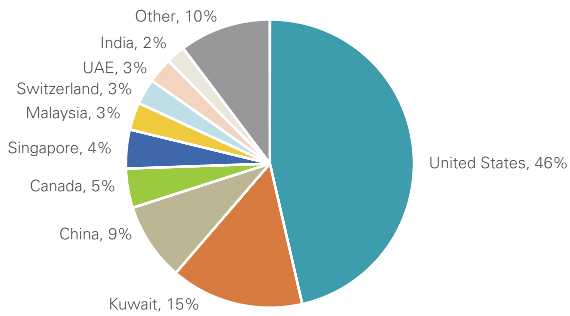
Commercial real estate – transaction volume composition



Source: Real Capital Analytics, rcanalytics.com

Through our day-to-day dealings with our clients, it is clear that the UK market remains attractive to a wide range of overseas investors. While Asian and Middle Eastern investors remain a key source of capital for the UK, North American investors have dominated H1 2014, contributing over half of the inbound global capital in the first six months of the year.

Cross-border capital sources (H1 2014)



Source: Real Capital Analytics, rcanalytics.com

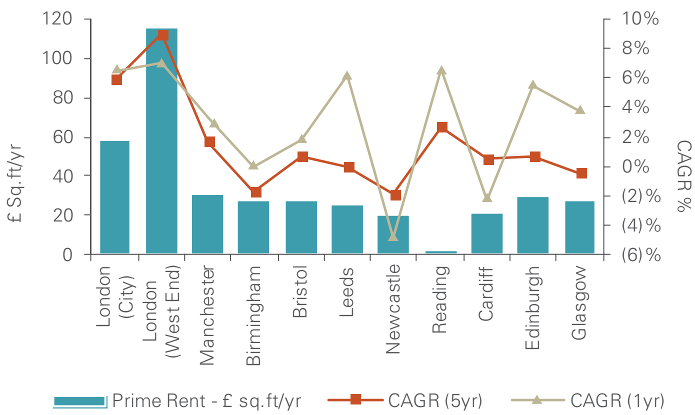
As many of the Sovereign and Super Funds focus on large complex acquisitions, it is reasonable to expect some fluctuation in the capital sources over short time frames. For example, whereas Kuwait contributed 15% of the global inbound capital in H1 this relates to only two deals: the first being the circa £1.7 billion acquisition of the More London portfolio in January 2014; and the second being an approximately £40 million office block, physically linked to the Welsh Houses of Parliament (the Senedd), and acquired in March 2014.

We also expect further fluctuations in capital sources as some investors, particularly those with significant exposure to the UK and/or those with more property management skills, shift their focus to the peripheral European markets, in a bid to secure hidden value. However, in the short to medium term we expect such capital to be replaced by other global investors.

1 Office market

Rising economic sentiment and improving business confidence is leading to increases in leasing activity and rental growth. This is not restricted to London but can be seen across the UK's largest cities and, even in markets where demand has lagged; there is consensus amongst industry commentators that most markets should see a strong FY14 based on space under offer and economic drivers.

Prime office rents – June 2014

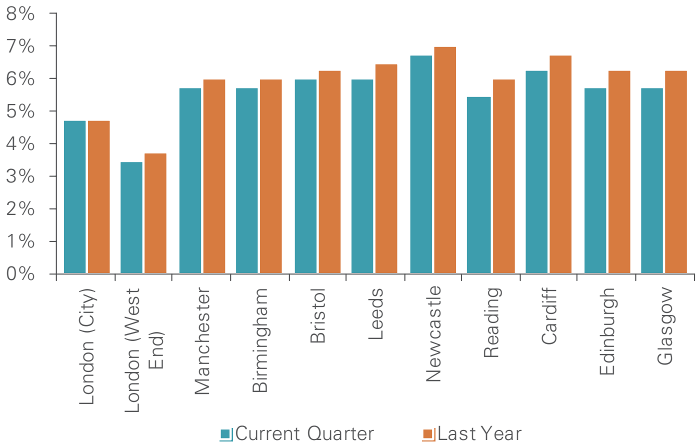


Source: Cushman and Wakefield

Supply remains limited, especially for Grade A space, which is leading to some signs of occupier relocation. While development activity is currently limited we expect to see increases in speculative development across the larger cities as access to finance continues to improve and economic growth drives demand.

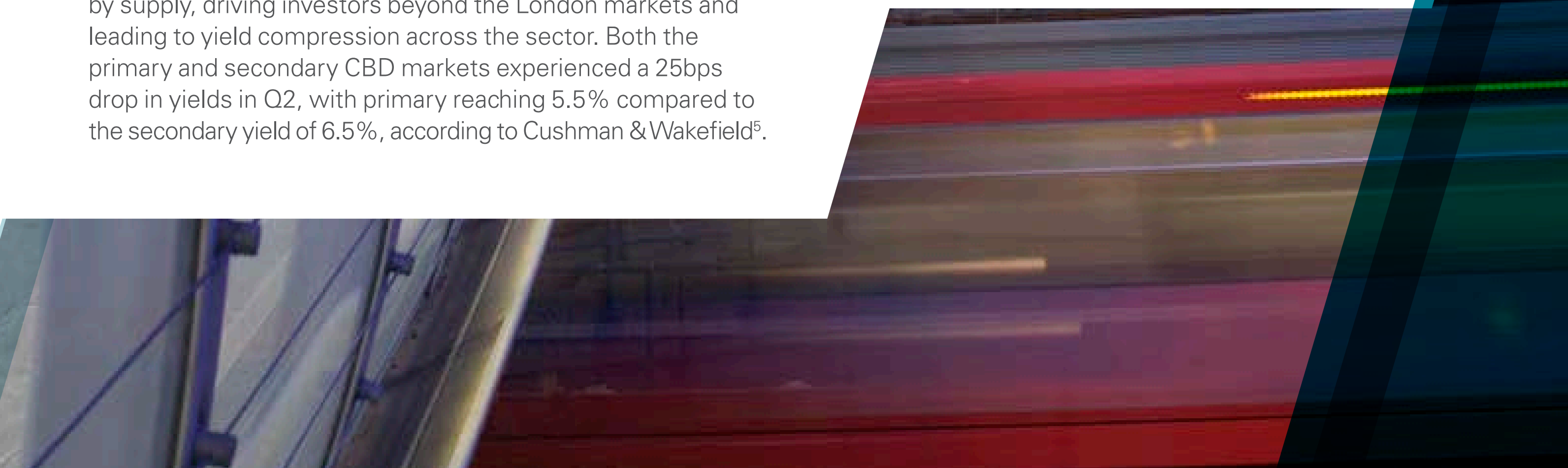
Offices continue to attract significant investor appetite and, according to RCA[4], secured 55% of UK CRE transactions in H1 2014. Access to investment opportunities are also limited by supply, driving investors beyond the London markets and leading to yield compression across the sector. Both the primary and secondary CBD markets experienced a 25bps drop in yields in Q2, with primary reaching 5.5% compared to the secondary yield of 6.5%, according to Cushman & Wakefield[5].

Prime office yields (net) – June 2014



Source: Cushman and Wakefield

Overseas investors continued their substantial activity, especially in London, accounting for almost 65% of volumes in H1 2014. Notable transactions include the acquisition of the More London Portfolio for circa £1.7 billion mentioned above.

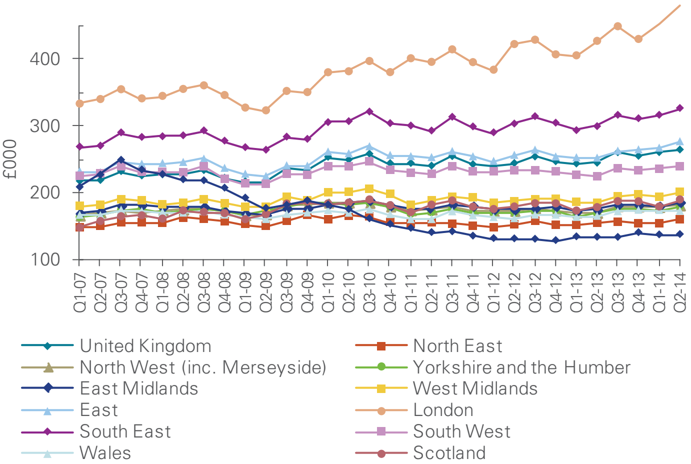


2 Residential market

UK house prices continued to rise in H1, amidst mounting concerns the market was entering bubble territory. However, July recorded the slowest growth since April 2013 at just 0.1%, bringing the annual house price growth to 10.6% (down from 11.8% in June[6]). This slowdown in activity was not unexpected and was largely due to an increased moderation of the market as well as a shortage of properties coming on to the market. The introduction of the Mortgage Market Review by the FCA in April this year appears to have impacted on the number of mortgage approvals as banks introduced new processes and trained staff – almost a 20% reduction between January and May according to Nationwide[6]. The modest rebound in mortgage approvals in June suggests this adjustment is temporary and will pick up once processes are established. Indeed, prices increased by 0.8% in August taking annual growth to 11%.

The RICS UK Residential Market Survey, June 2014, suggests that new instructions across the UK increased very modestly for June and July, while Knight Frank[7] note that the uncertainty caused by the upcoming 2015 election and imminent interest rate rises is causing demand for property to ease, particularly prime residential property in London. The impact of uncertainty is also evidenced in Scotland, the weakest performing region of the UK for Q2, as buyers and sellers appear to have adopted a wait-and-see policy in anticipation of the 18 September Referendum. Regardless of the outcome, activity should pick up once the political environment settles.

Average UK house prices by region



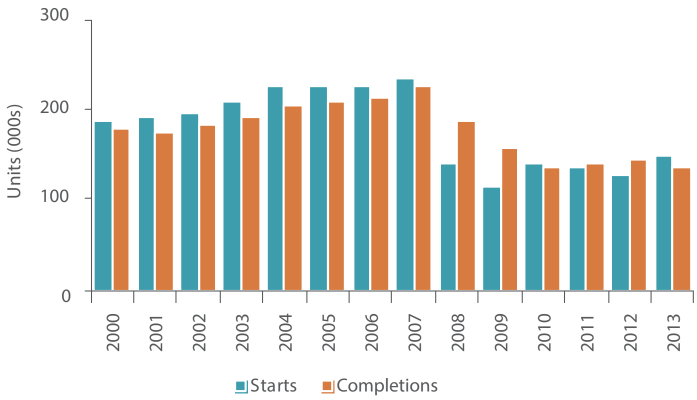
Source: Department for Communities and Local Government

Although all UK regions saw annual price rises in Q2 2014, London continues to outpace the rest of the UK, with annual growth accelerating to 26% according to Nationwide. Prices in the capital are now 30% above their 2007 peak, and the gap in average prices with the rest of the UK is the widest it has ever been, both in cash and percentage terms. However, it is anticipated that this will narrow as the ripple effect from the capital increases confidence across the county and London homeowners seek to take advantage of the value gap in the surrounding regions.

The growth in house prices has been driven by improved economic conditions and pent up demand following a sustained period of low activity, but central to allowing this has been historically low interests rates. The Help to Buy mortgage guarantee scheme, though relatively limited in its direct impact, has supported the reopening of the market for mortgages at higher LTV ratios – the number of mortgage products available to borrowers with LTV ratios greater than 95% trebled over the year to May 2014 according to the Bank of England[8]. As a result, borrowers with high LTVs now form a significant proportion of outstanding mortgage debt and are vulnerable to any rises in interest rates. It is also noteworthy that the UK house price to average earnings ratio has risen to more than six times annual earnings in the past few months. Though lower than the 2007 peak of more than seven times earnings, this is significant for predicting the future of the housing market and will have a stalling impact on house price growth unless wages start to increase. Recent research by the TUC[9] shows there is now only one local authority in England with average house prices less than three times the average annual salary, compared to 72 in 1997. The slow growth of average wages is one of the key reasons that the Bank of England has refrained from increasing interest rates despite the blossoming economy.

UK housebuilding is currently thriving, growing at its fastest rate since 2003 in July[10], and providing a boost to the construction sector. This is driven in large part by a rise in confidence in the market and huge demand for new projects resulting from a backlog in supply. Despite this, there remains a critical imbalance between supply and demand – the net new supply of private housing was 110,000 in 2013, well below the 2000-07 average of 180,000 according to the Bank of England[8]. The Government's Help to Buy Equity Loan has been extended to 2020, directly increasing demand for new builds and having an indirectly positive impact on the market by improving developers' confidence in the market. Whilst there is a general consensus among the leading parties on the need for more homes, local issues are hindering progress. Changes in planning laws by the National Planning Policy Framework in 2012 were intended to encourage growth; however Savills analysis shows Local Planning Authorities have been slow and reluctant to embrace a growth agenda. Where to build new homes is high up on the political agenda and likely to remain so, particularly as the government seeks to demonstrate its role in the housing-led recovery in the run up to the 2015 election.

UK housebuilding starts and completions



Source: Department for Communities and Local Government

3 Retail market

Improving consumer confidence is driving further improvements in the retail sector. With confidence reaching the highest level for nine years in June, certain retailers are increasing their demand for space, especially in prime locations. And while rationalisation remains a theme, distress has been less pronounced with stores, being released to the market, receiving interest.

"Click-and-collect" and "multi-channel" continue to be well used buzz-words, however, the attitudes to these fundamental shifts are changing and many in the sector are now embracing the challenge, seeing the speed to react as being a critical success factor.

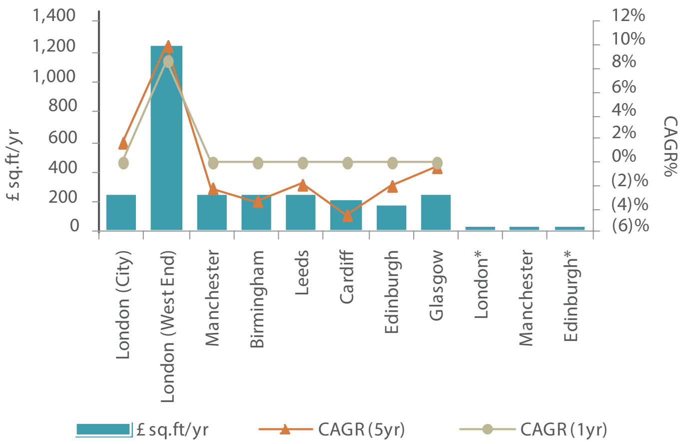
New entrants from overseas have also been a dominant driver, especially in London, where demand has forced many to take space in less traditional areas of the City. According to CBRE[11], London is home to more international retail brands than any other city in the world with 31 international retailers opening stores in 2013.

Investment volumes remained strong in H1 2014, reaching circa £6 billion and reflecting 23% growth y-o-y according to RCA[4]. However, as seen in other sectors, Q1 was unable to keep pace with the volume seen in Q4 of 2013. Given that deals can range from major shopping centres to high street stores, the sector can experience fluctuations depending on whether significant deals complete, so it is notable that the volume of investment for the 12 months to 30 June 2014 showed a 40% increase on the prior year returning to levels not seen since 2007[4].

Demand from overseas investors, institutional, private equity, REITs and UK property companies is apparent and continues to focus on prime opportunities but also secondary stock as supply of prime stock, as with other sectors, is extremely limited. This trend is not only limited to the large shopping centres as, while the small lot sizes may deter certain investors, those institutions holding high street stock are showing some reluctance to release. The competition for Lend Lease's 30% share in Bluewater (acquired by Land Securities for circa £656 million) was fiercely fought with a host of REITs, Sovereign Wealth and Super Funds, UK and Overseas institutional investors all reported to have circled the asset.

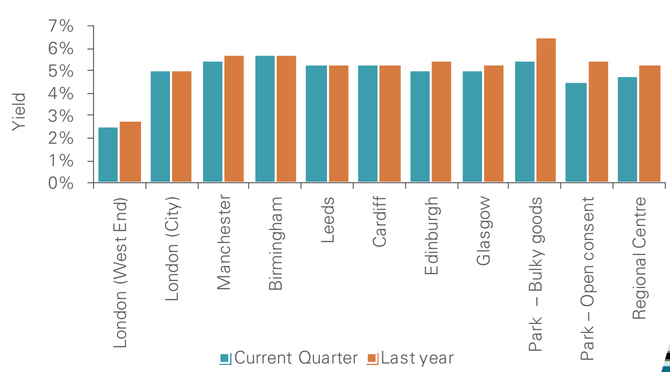
With a reasonably stable economic environment coupled with significant investor interest it is unsurprising that prime rents continue to rise in the best locations while yields are compressing. As UK occupiers look to expansion rather than rationalisation this trend is filtering through to secondary with high streets showing modest improvement. Polarisation around the UK remains with in-town vacancy rates running in the region of 25-30% in some of the weaker locations.

Prime retail rents –June 2014



Note: * Bulky goods
Source: Cushman and Wakefield

Prime retail yields – June 2014



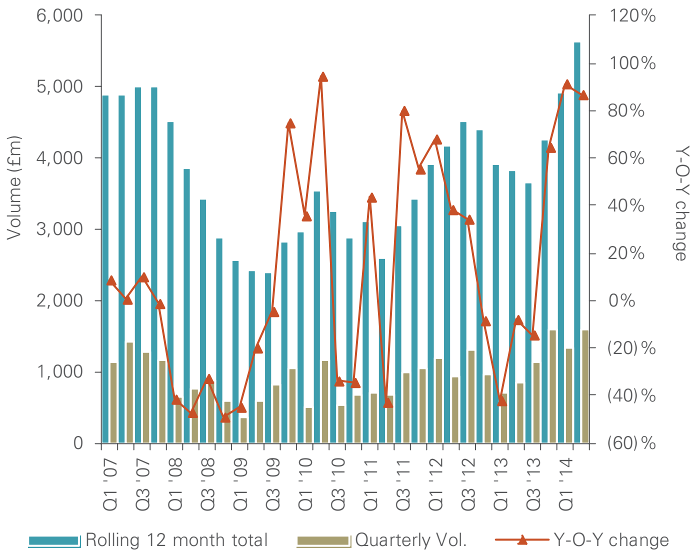
Source: Cushman and Wakefield

4 Industrial market

The industrial sector has continued to benefit from the country's economic growth and improved market confidence. Headline prime rental values have remained largely stable, with a relatively modest increase expected over the next four years. Investment volumes have been on the up, with H1 volumes matching the high rate seen in the last quarter of 2013. Demand remains high for good quality large and modern stock, driven by the continued expansion of the e-commerce sector as well as a revival of manufacturing in some of the regions.

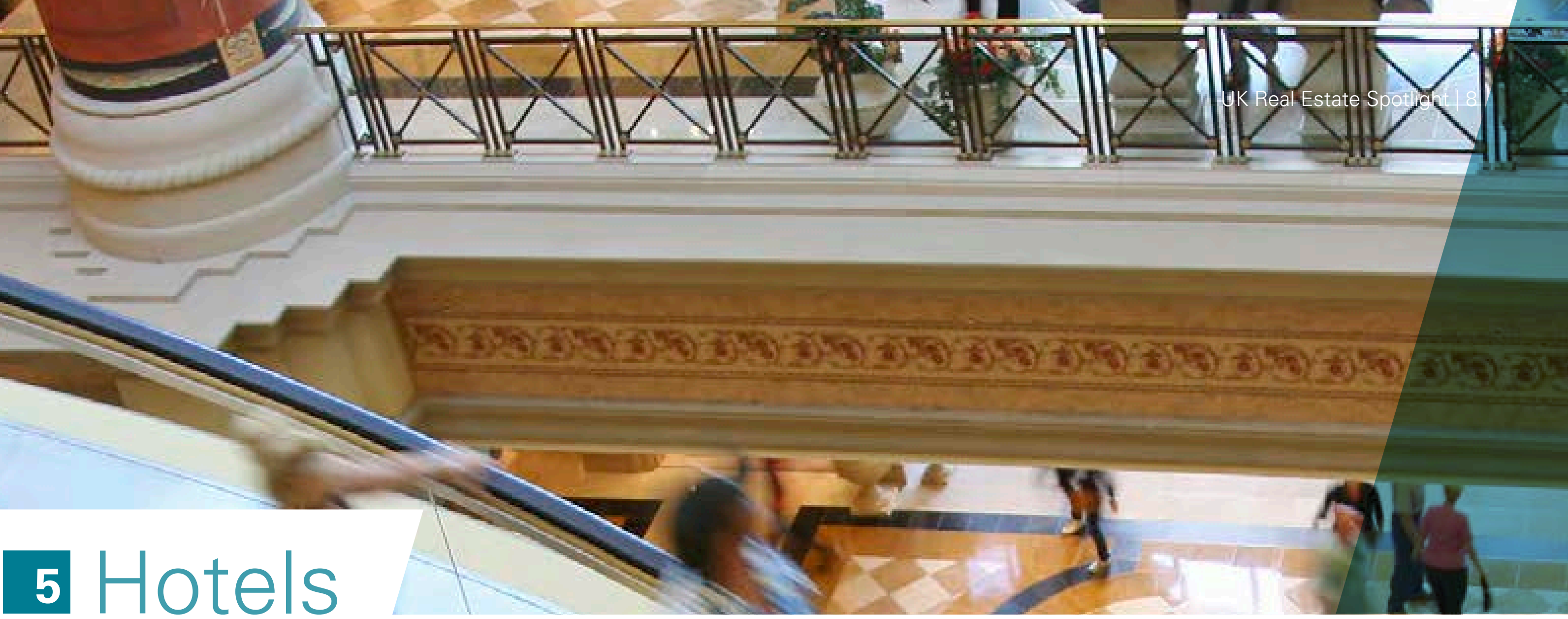
However a continuing theme for the industrial market is the supply/demand imbalance and, though speculative developments have begun to pick up in regions such as the South East and West Midlands, supply constraints remain a hindrance across the whole of the UK market. Investors are expected to consider secondary stock as well as well-linked regional locations for opportunities, while occupiers may also look to design-and-build developments. The West Midlands, for example, has continued to experience a thriving market, particularly along the key M42/M6 links. Yields are seeing a resultant compression across the property grades.

Real estate sales



Source: Real Capital Analytics, rcanalytics.com

The lack of supply of grade A stock is likely to continue as speculative development, whilst picking up with improved market confidence, is expected to remain modest for the year. With the improved outlook for the industry it is hoped this will gain momentum as we move into 2015.



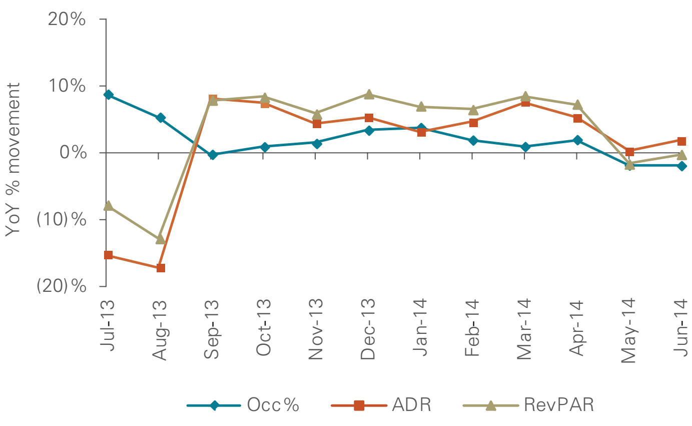
5 Hotels

The UK hotel market has experienced high levels of activity for H1 2014 compared to the same period last year. This is largely driven by growing investor confidence and a rebalance of pricing expectations between buyers and sellers. Indeed, more realistic pricing has reduced the time that transactions are taking to complete.

According to Savills[12], UK hotel transaction volumes for H1 2014 totalled £2 billion, and are forecast to reach £3.1 billion by year end. Regional transactions have risen significantly this year with volumes up 135% for August year to date on the same period last year, increasing the share of the UK market to 59% from 43% in 2013. However, this is still below pre-downturn levels when regional activity typically accounted for 82% of volumes. As with many of the commercial real estate sectors, hotel investors are looking to the regions as stock issues increasingly hinder the London market and so we would expect this upward trend in activity levels to continue.

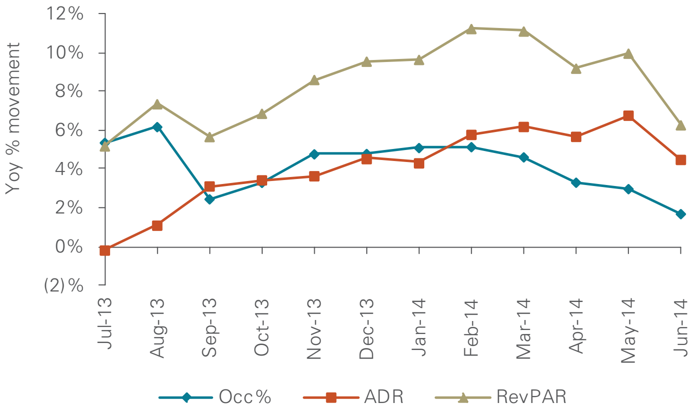
Operational performance has also continued to improve in the regions, further increasing its appeal to investors. The strength of regional performance has caught most market participants by surprise. However improvements have not been uniform across the UK. Whilst cities such as Bristol have experienced strong growth, other areas such as the West Midlands have continued to face challenges. At the weaker end of the regional market, tired assets remained under-invested as hoteliers struggled against rising costs to implement capital expenditure projects and remain competitive in a market now dictated by instantly available customer feedback.

London hotel RevPAR, occupancy and ADR growth – June 2014



Source: STR Global

Provincial hotel RevPAR, occupancy and ADR growth – June 2014



Source: STR Global

5 Hotels (cont.)

The London investment market witnessed a 155% increase in Q1 2014 compared to the same period last year, 8% up on Q4 2013 according to JLL[13]. The largest source of investment has come from domestic buyers, although this fell by 39% in Q1 and a significant increase in appetite has been shown by international investors. Investment money from Asian buyers increased from 0% to 33% over Q4 and Q1 whilst there was a 5% increase from Middle Eastern markets. A rise in Chinese tourists visiting the UK, boosted by government initiatives to make it easier for Chinese visitors to obtain visas, is leading to an increase in UK brand acquisition by Chinese investors. US investors are also creating and enlarging their UK operating platforms through the acquisition of portfolios. Increasingly these buyers are being frustrated by a lack of stock and may look further afield, both outside the traditional West End core and beyond London itself.

There could also be opportunities for Chinese hotel brands to enter the UK market, particularly for budget and mid market brands given the current traveller's focus on price. At the five star end of the market, South London's Nine Elms regeneration site is set to see the first luxury hotel opened by a Chinese brand outside of China in an area undergoing intense programme of redevelopment over the next few years.

Bank and administrative led sales continue to dominate, although there has also been a rise in the 'distressed buyer' looking to spend their allocated funds. While private equity and investment funds have remained dominant, high net worth individuals and sovereign wealth funds have increased their share of transactions particularly targeting acquisition of trophy assets in London. As well as these trophy assets, London is appealing for its low cap rates, maturity of market and the strength it has demonstrated in maintaining high performance levels in the aftermath of the Olympics.

Sources:

1. Second Estimate of GDP, Q2 2014, Office for National Statistics
2. The IFS Green Budget, February 2014, Institute for Fiscal Studies
3. UK Trade, July 2014, Office for National Statistics
4. Real Capital Analytics, rcanalytics.com
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13. http://www.joneslanglasalle.com/hotels/EN-GB/Pages/NewsDetail.aspx?ItemID=30700

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