



Look back, face forward

January 2017

A review of 2016 Real Estate transactions
and predictions for 2017

kpmg.com/uk



"Chance favours the
prepared mind"

Louis Pasteur

Introduction

Pollsters, financial markets and bookies failed to predict the key unexpected changes in 2016: Brexit, Trump and Leicester City.

In the run-up to the EU referendum, the Remain campaign predicted plunging markets and a mass exodus of talent from the City to Frankfurt, Dublin and Paris. In the immediate aftermath of the vote share prices of REITS and housebuilders plummeted, almost all open-ended property funds suspended trading, and deals were delayed as everyone tried to work out what it all meant.

In reality, the impact hasn't been anywhere near as bad as predicted. Transaction values and volumes have fallen, but by nothing like the levels predicted ahead of the vote. There was an increase in foreign investment activity as the weak pound encouraged investors from around the world to look for bargains. Many of those worst hit bounced back, and most of the open-ended property funds have re-opened. UK investment volume for 2016 is still expected to be a little under £50bn – significantly above the drop seen post the global financial crisis.

It is always difficult to make predictions, and arguably harder than ever to think about what might happen in 2017. What is certain is that we will all have to live with uncertainty on an ongoing basis, particularly around what Brexit is likely to mean in practice for the UK and the EU. The UK government's position is gradually emerging, and the elections in Germany and France could have a significant impact. We will have to see whether the EU wants to 'punish' the UK, potentially to deter other wavering countries, or negotiate a deal that works for both sides.

Regardless of the outcome on Brexit, many investors continue to see the UK's underlying fundamentals as strong and the fall in sterling has made UK assets cheaper to overseas investors. I think it is very easy to generalise around the potential impact of Brexit on property asset classes, but in reality the impact on individual assets will be very different, based on their particular attributes. Many investors, particularly the REITs, are positioned defensively, but with significant available capital to deploy on the right opportunities. Those investors who can be nimble and who are strong on stock selection and asset management will prosper – as they always have in the past.

Andy Pyle

Head of Real Estate, KPMG UK

2016 deal review

KPMG in the UK has advised on a number of landmark UK and European deals across commercial real estate asset classes in 2016.

5,500 bed student accommodation acquisition



Advised on one of the biggest UK student accommodation deals to date, comprising over 5,500 beds across major UK cities.

Also advised Select Property Group on the raising of £169m of senior debt and junior capital facilities to fund the development of three new student accommodation sites totalling 1,500 beds.

c.700,000 sq. ft. storage space acquisition



Advised on a US operator's entry into the European market with the largest ever investment transaction in the UK self-storage sector. The portfolio totalled nearly 700,000 sq. ft. of storage space across 15 locations with a total of almost 10,000 units.

Disposal of c. 7,000 bed premium hostel portfolio

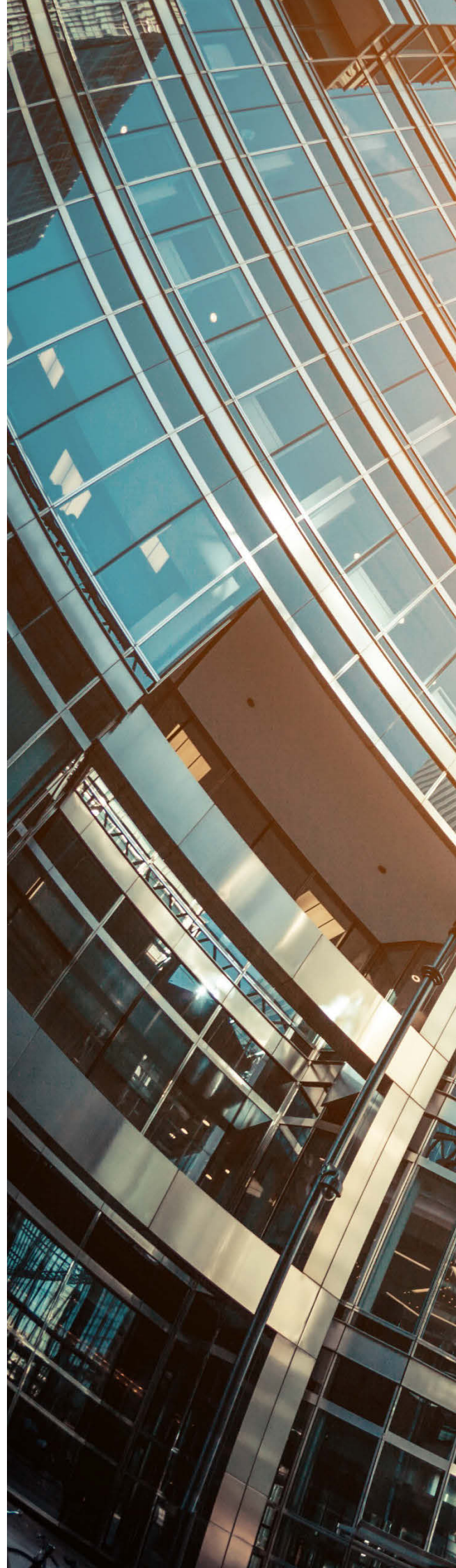


Advising on the sale of one of Europe's largest providers of premium hostel accommodation.

Disposal of c. 750,000 sq. ft. iconic office portfolio



Advising on the sale of a portfolio of iconic five and four-star serviced offices in Central London.



100 acre regeneration site



Advising on the redevelopment of the 100 acre former railway yard site adjoining York Central– a key development within the “Northern Powerhouse” and the biggest urban regeneration project in the UK outside of London.

Also providing public sector strategic and land regeneration advice to several London boroughs and UK councils.

Disposal of €2.4bn 35.5m sq. ft. logistics portfolio



Advised on the sale of P3 Logistics Parks by TPG and Ivanhoe Cambridge to Singapore's sovereign wealth fund GIC for €2.4bn – labelled Europe's largest real estate deal of 2016, the portfolio is made of 35.5m sq. ft. with a development pipeline totalling 15m sq. ft.

European capital trophy mixed-use acquisition



Advised Brookfield Property Partners on the acquisition of Potsdamer Platz, the c.3m sq. ft. central Berlin site comprising 17 buildings home to more than 480 national and international companies.

External audit appointments



In 2016 KPMG UK was appointed external auditors to St Modwen Plc, **TR Property Investment Trust**, Big Yellow Group Plc, **Standard Life Plc**, BT Pension Scheme and Hermes Fund Managers, **Legal & General Plc**, Argent's Brent Cross South development, **Catalyst Capital's European Fund II (fronted by the Luxembourg team)**, and Meyer Homes.

Market trends for 2017

PRS/ Build to Rent



Demand for rental accommodation continues as the lack of new housing means home ownership becomes unaffordable, and lifestyle choices change. This is compounded by demand and supply dynamics continuing to favour this sector as does the general population growth.

To meet this demand the evolving PRS/ BtR market is growing in the UK and gaining momentum, despite some recent adverse government policies. There is real interest in replicating the successful multifamily models of accommodation in existence in the US and Europe.

We are seeing a number of UK and international clients launch funds as well as serve segregated mandates and we anticipate that interest in this sector will continue to grow. This is supported by investors looking for stabilised rental income returns as well as development returns. In 2017 we expect existing entrants to increase their transactional activity, to continue to see new organisations appear in the sector and in the future for this asset class to begin to see a period of consolidation.

Transactions



There is widespread consensus that volatility will continue as the UK Government navigates us towards Brexit. The key question is "how long this is likely to take" and, while we all scratch our heads over that one, we are adjusting to life with heightened uncertainty, which makes life working on transactions somewhat 'interesting'!

2017 will undoubtedly present challenges to those looking to transact or seek capital. Preparedness will be vital to ensure speed to market when opportunities arise. We saw some of this in Q4, with many having used the downtime that the referendum provided to do some 'housekeeping' and execute deals swiftly once the initial turmoil had subsided. As the theme of 'Lower for longer' returns continues in the face of potential stagflation we are seeing increasing focus on risk mitigation, with areas such as the strength of the tenants' covenants being the subject of additional diligence.

Additional diligence can naturally lead to longer timelines, which in turn lead to higher transaction costs; to mitigate this sellers are going to have to ensure that they have readied the corporate vehicle and not just the asset itself. As some industry players appear to hunker down ahead of Article 50 there is concern that by taking an overly cautious approach opportunities may be missed, participants may stagnate and ultimately underperform. However, with some sizeable transactions on the horizon, a number of deals underway and clients still showing desire for investment opportunities, we remain optimistic that this can be avoided.

Restructuring



We have seen a general slowdown in new restructuring engagements in the real estate space, but we are still busy finalising the work out of a number of assets from legacy appointments.

The feel in the market is that the main clearing banks and the second tier, smaller lenders, have dealt with the majority of their problem loan positions. Even if we see a small increase in interest rates we don't see any change in this position during 2017.

Where opportunities may present themselves could be in the top end of the London residential development market. We have already seen a couple of projects where we are being asked to provide reassurance to a nervous market about the covenant strength of main or second tier contractors before they are awarded contracts. This sits alongside our views that the construction sector is in for a rough ride during 2017 as costs rise during Q1 and Q2 of 2017 (both labour and materials). Those that have hedged or contracted on cost plus will be protected, those on fixed price contracts could find themselves taking losses on projects.

Whether this will knock onto the owners of the underlying assets being developed and therefore create pressure on debt positions is yet to be seen.

Business rates will be a factor for trading businesses that have a property footprint – we are predicting a tough time for a number of firms in the casual dining, pub and club and restaurant space. A perfect storm of labour costs, material costs and property costs coming down the line.

Hotels and leisure



UK hotels, restaurants and retailers delivered strong performance in the second half of 2016, buoyed by tourists attracted by the weakness of the pound following the Brexit vote. That is not to say that there are no concerns for 2017, with worries on how Brexit may impact the performance of the regional hotel market, and asset managers will be paying close attention to performance numbers.

Investor appetite continues to be very strong, with high levels of interest from international investors expecting to benefit from the weakness of the pound. We are particularly seeing interest from Asian countries such as Singapore and China, and Middle Eastern clients remain keen to invest having taken time to digest the impact of the vote. Overall, London remains one of the top three cities for any international real estate and hospitality investor and the UK continues to benefit from its reputation as an economically and politically stable location for investing capital.

In 2017 the UK is expected to continue to attract tourists and indeed capital from Asia and there is an expectation that this will encourage the market to do well.

Student accommodation



Student Accommodation investment remains strong. Transaction levels continued at near peak levels in 2016 at an expected £3.25bn, with a number of high profile transactions and international investors maintaining their interest in the asset.

Yields have compressed and values increased, however investors continue to see this sector as providing good diversified income, driven by favourable demographics and the attractiveness of the UK accommodation sector.

Brexit has created some concerns over international student numbers but we believe the underlying fundamentals of the sector remain strong. We are predicting continued strong transactional activity and returns in the sector for 2017.

Equity Capital Markets



The European Equity Capital Markets (ECM) overall had a difficult 2016, with the number of deals approximately 40% lower versus 2015 and less than half the number of IPOs printed versus 2015. In the UK IPO volumes fell by almost 60%. This poor performance was principally driven by macro events increasing market volatility and damaging investor sentiment.

The outlook for 2017 is marginally better, with a growing pipeline and both economic and corporate news expected to be broadly more positive. However, there are potentially significant headwinds, including political uncertainty in Europe and the US. We expect unpredictable and short windows of opportunity for ECM activity, opening or closing quickly around positive or negative events.

UK Real Estate issuance was also affected by uncertain markets as volumes for all ECM activity fell from nearly £4bn in 2015 to £3.2bn in 2016 (2014 was over £5bn). As is usual for the sector, issuance has predominantly been follow-ons or cash placings to finance acquisitions or investments. There were 4 IPOs during the year compared to 6 in 2015 and 7 in 2014.

In 2017 we expect this trend to continue, and indeed be accentuated. Follow-ons or cash placings have a much shorter lead time and, if structured around a particular acquisition or investment, they can take advantage of short-term windows of opportunity and a shareholder base with existing strategic buy-in. If, however, markets do suffer significantly and bond yields rise as expected, lower share prices of Real Estate sector stocks, when viewed as acquisition currency, may reduce the appetite or ability of the sector to raise money for assets.

Tax



Tax authorities everywhere love property: they know who owns it, and of course it can't be moved offshore. As a result, a broad swathe of taxes are levied on its ownership, its occupation, its income and on transactions. But is the UK going too far? £1 in every £8 of UK tax revenue comes from property taxation, the highest proportion in the OECD (the average is 5%). The last few years have seen a raft of changes to shore this up, principally aimed at the privately-owned residential sector.

More recent changes – notably the introduction of Diverted Profits Tax and the revised transactions in land rules – are extending this approach to property developers. Institutional investors are next in line – the Government announced it will consult on moving non-resident investors to a corporation tax basis that would, in practice, eliminate tax relief on shareholder debt and impose limits on the relief available for losses incurred during the development phase against future rental income. The UK market is dependent on foreign capital for transactions and development – according to Real Capital Analytics [rcanalytics.com] cross-border capital has consistently accounted for over 50% of investment volumes since 2014 – and while the property itself can't be relocated, the capital funding for it can be. Stamp duty changes are already impacting turnover in the London residential market: let's hope love doesn't become a Fatal Attraction.

Debt



Participant numbers in the debt market will continue to increase as a greater range of lenders seek niche opportunities. We expect to see an increase in non-UK and continental banks lending in London (following their local clients who will be looking for opportunities). As lenders have a greater understanding of the PRS model we think that the BtR market should have fuel to grow more significantly.

Debt funds are likely to become more prevalent across development financing, particularly in the regions, as traditional bank lenders remain cautious and the universe of banks willing to deploy capital in this space remains limited. Expect their cash to become more flexible, moving up and down the capital structure.

Expect pricing, leverage and covenant levels to remain more prudent than 2015, reflecting the ongoing geopolitical volatility. Lender appetites on different asset classes are likely to diverge as foreign exchange rates, imported inflation and GDP growth cause performance profiles to alter.

Finally we expect more coverage of the market from fintech platforms, particularly at the smaller end of the market. In the light of fears about the global economy and Brexit, UK real estate investment fell in 2016 compared with a very strong 2015. Total investment in 2016 is unlikely to top £50bn. Currency effects, which have supported investor interest, will be a double-edged sword. Appetite for UK property remains strong, however, with Asian investors coming to the fore. At just 1.1% in 2017, total returns will rely much more heavily on income.



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