Look back, face forward

A review of 2017 and our predictions for 2018

January 2018

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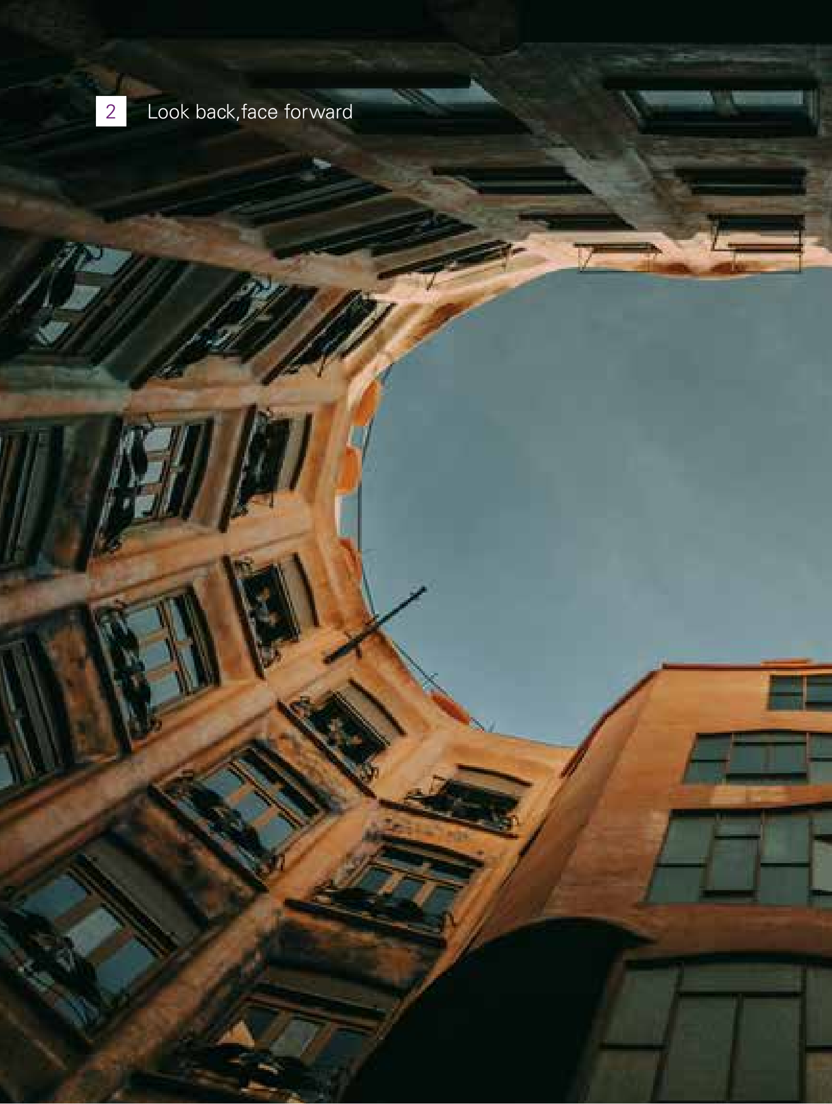

Introduction

After a slow start to the year, UK commercial real estate transaction volumes were relatively healthy in 2017. Prospects for 2018 are mixed but overall the UK remains an attractive destination for investors.

Keeping overseas investors keen

Although transaction volumes have been robust, this masks a drop in the actual number of deals. Large trophy acquisitions by non-domestic and prominently East Asian investors, such as the Walkie Talkie and Cheesegrater buildings, bolstered volumes in 2017. Whilst this apparent reliance on overseas capital may concern some commentators, the pound is expected to remain weak through 2018 and UK commercial property yields are comparatively high against the European and Asian markets. We expect that Chinese capital will continue to target the UK market, despite the clampdown on overseas investments by the Chinese government.

Perhaps of greater concern is the announcement in November's Autumn Budget that non-residents will be charged capital gains tax on the increase in value of UK investment property from April 2019. Although there are expected to

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be some exemptions, we have already seen some deals stalling as a result of this announcement. The Government needs to be careful to avoid reducing the attractiveness of the UK property market to overseas investors as they iron out the finer details of this change.

Looking beyond core

With a flight to prime as a result of ongoing political and economic uncertainty, and global investors dominating the market, competition for assets is high. Investors are often finding ten other buyers willing to pay the same price or more for assets they are bidding for, which makes sticking to risk and pricing criteria difficult. With some investors adopting a wait-and-see approach, there are also fewer assets on the market in many sectors. As this trend continues into 2018, investors are likely to increasingly look at value-add opportunities in non-prime markets, where competition is less fierce and prices are more appealing. Income-producing assets, such as logistics, PRS and serviced offices, should remain highly attractive in the year ahead, with more players seeking to enter these markets. Consumer demand for flexibility will also be reflected in the steady rise of sectors such as co-working.

> "Investors are often finding ten other buyers willing to pay the same price or more for assets they are bidding for, which makes sticking to risk and pricing criteria difficult"

London holds its own

In terms of Brexit, the occupier response has so far been pragmatic. Banks and other financial services occupiers are paying close attention to the negotiations and there has been talk of relocations to the likes of Frankfurt, Paris and Dublin. Yet it looks unlikely that London's role at the centre of FS is about to end any time soon.

The factors that make London attractive to occupiers – language, timezone, transparency, rule of law, an established ecosystem of expertise and a history of adapting to global change – remain in place and are not going to change overnight. Furthermore, the sheer size of London's financial services sector makes it difficult to conceive of another city having the capacity to take up the baton. The UK property market also continues to offer comparatively less risky investment opportunities, particularly for institutional investors looking to deploy long-term capital.

Technology and long-term trends

Though Brexit remains a hot topic, I would argue that there are longer-term trends that will have a far more profound impact on the industry. The automation of white collar jobs, as technologies such as robotics and artificial intelligence progress, will have a major effect on demand for office space. Urban environments will also be transformed by autonomous vehicles and the advent of mobility as a service: vast swathes of parking space and redundant wide multi-lane roads will offer interesting repurposing opportunities. These changes may seem some way off but technological change is rapid, and the long-term nature of buildings mean that investors and developers should be taking them into account now to avoid expensive retrofitting or building obsolescence.

Technology is also reshaping how the real estate sector itself operates. Our recent Global PropTech Survey, Bridging the Gap, illustrates that the industry now recognises the value that PropTech can bring, with 86% saying that they view digital and technology innovation as an opportunity. Having gone through a period of acceptance over the last 12 to 18 months, it will be interesting to see if 2018 can be the year of adoption.

We expect to see more firms making better use of their data to improve areas such as decision making, customer service and building optimisation. Innovation and digital strategy will also continue to rise up executives' agendas as the sector adapts to the digital age. Expect to see more firms looking to appoint roles such as chief technology, innovation and data officers, and the establishment of multi-discipline innovation boards.

Finally, December saw two major public markets transactions announced, with Unibail-Rodamco acquiring Westfield and Hammerson merging with Intu. A number of REITs continue to trade at a discount to NAV, meaning there could well be further public markets M&A activity in 2018.

Andy Pyle
UK Head of Real Estate

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Market trends for 2018

Tax

UK tax authorities have put property under the spotlight for a number of years now and 2017 was no exception. In the 2017 Autumn Budget the UK Chancellor announced that from April 2019, non-UK residents will be charged capital gains tax on the increase in value of all UK investment property.

This pivotal move will directly impact a significant proportion of the overseas players that invest in the UK property market, and whilst there will be some exemptions, for example sovereign immune investors and pension schemes, they could also still be indirectly affected by the change depending on the nature of their holding structure.

This has the potential to produce a shift in deals activity in 2018, particularly given the proportion of overseas investors active in the UK market. According to Real Capital Analytics data, cross-border investors have consistently accounted for 50% or more of total UK commercial property transactions for the past five years. Whether this will be a short-term impact as investors adjust to the change, or a more long-term deterrent, remains to be seen.

International investors are also the focus of a proposed change that will see non-UK resident companies that run a UK property business, or have other UK property income, charged to corporation tax (rather than to income tax as at present). The Government plans to publish draft legislation for consultation in summer 2018, with the change taking effect from 6 April 2020. This would also mean that gains arising to non-resident companies on the disposal of UK property will move from capital gains tax to corporation tax from April 2020.

2017 also saw the Corporate Interest Restriction (CIR) rules (or BEPS Action 4) come into play following a series of amendments, the last of which were announced in December. Broadly speaking, these rules limit a group's UK tax deductions for its net interest expense to the lower of a percentage of the UK tax EBITDA, taken from the tax computations, and a measure of the net group interest expense, taken from the group accounts. The application of the CIR rules can be very complicated in practice, and the devil is very much in the detail. With this in mind, KPMG has put together a series of articles which can be found in our BEPS Action 4 Diary, where we look at the detail of the rules in 'bite sized chunks'.

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KPMG's capital allowances team identified expenditure qualifying for tax relief of c.£80m across 15,000 beds in the student accommodation sector. The team of tax experts and chartered surveyors have worked across single asset acquisitions, portfolio acquisitions and new build construction projects to secure the capital allowances.

Debt

The trend of increased participant numbers in the UK debt market continued in 2017 and there is a more diverse pool of lenders than ever before. Insurance companies, pension funds, asset managers, debt funds and alternative lenders are all competing for different types of business.

We saw record low syndicated deal activity in 2017, which signals three key trends. Firstly, that overseas buyers are bringing their own debt or wholly equity funding; secondly, more club deals with financing are being directly placed with institutions in the primary market; and finally, there is less transparency on deal terms in the market.

Despite a slight tempering of lending levels by the Brexit vote, the UK real estate debt market remains relatively liquid. However, there are a few key themes for the coming year and beyond:

- Despite a strong development debt market in 2016, capacity does remain focused on the best opportunities. A number of the (limited) participants are now slightly overweight on development, and residential development in particular is an area that is underserved.
- UK clearers are finding pricing on the best investment grade credits too tight for their regulatory model without significant ancillary business. This poses some risk to UK borrowers without diversified access to different markets.
- Banks are under increased regulatory capital pressures, and ring-fencing and new IFRS standards are also potentially making themselves felt.
- Apartments, and built-to-rent, are becoming increasingly popular as investors look to income-producing assets. This poses a number of unknowns to financers – a lack of comparables and benchmarking, additional intangible value, and less security of tenure and tenant credit quality, to name a few. A degree of flexibility in the traditional valuation criteria of real estate is required to succeed in financing this sector – and with the rising popularity of these models, lenders would be wise to adapt.

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Equity capital markets

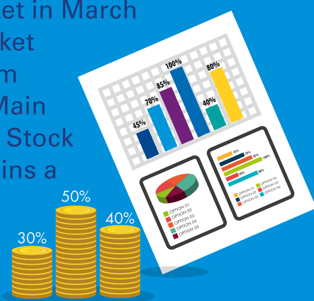
Despite global equity capital markets (ECM) volumes recording a modest year-on-year decline in the second half of the year, 2017 is on track to set a new record for full year global ECM issuance. With headline equity indices registering gains and market volatility remaining low, IPO activity in particular was robust in the second half.

Regionally, while reduced issuance in China and the US led global issuance was lower, Europe saw a strong recovery in IPO activity in the second half. In the UK, there was a notable shift in the mix of ECM activity with healthy IPO volumes offsetting more limited follow-on issuance.

Real Estate proved particularly resilient throughout 2017 in the UK, raising £5,477m via 42 deals, of which 10 were IPOs raising £1,715m.

We believe that 2018 is likely to start off strongly and continue 2017's momentum. However, as the year goes on, it is possible that volatility will increase as macro and political factors make themselves felt, especially in the UK. We would advise clients to prepare early to take advantage of, what are likely to be, short windows of opportunity.

KPMG advised Sirius Real Estate Limited on their transition from AIM to the Main Market in March 2017. SREL had a market capitalisation of £415m on admission to the Main Market of the London Stock Exchange and maintains a secondary listing on the Johannesburg Stock Exchange.



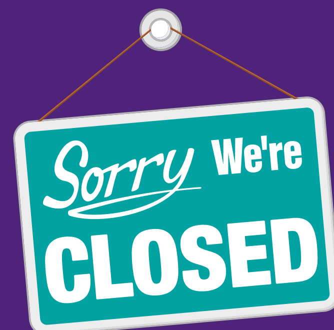
Restructuring

We are predicting that 2018 will see the return of the CVA.

The perfect storm that is surrounding the casual dining and retail sector at the moment will bring a raft of restructurings in the marketplace, with the main real estate impact coming from CVA proposals to compromise rents and payment terms together with a rise in store closures. This is driven by pressure on consumer spending, cost inflation, labour price increases/ shortages and the new business rates regime.

The impact is being felt across the market from small niche players all the way through to the larger national players. This will result in landlords having to deal with yield pressure and empty premises – creating a knock-on impact for their own capital structures and ability to service debt commitments where highly geared.

In turn this will create opportunities. We predict that flexible and liquid funds will be increasing active in looking for opportunities to acquire distressed real estate, either single asset or portfolio.



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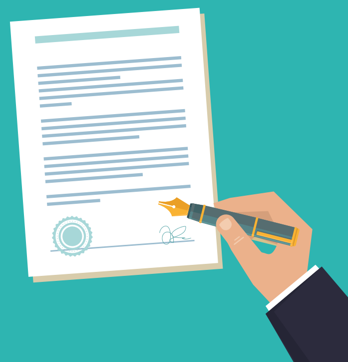
Accounting

Following a 2016 transitioning from 'old UK GAAP', 2017 was a relatively quiet year for many real estate accountants. The accounting world is now preparing itself for a triumvirate of new standards: IFRS 9 Financial Instruments, IFRS 15 Revenue from Contracts with Customers (both applicable from 1 January 2018) and IFRS 16 Leases (applicable from 1 January 2019).

The implementation of these standards is a major undertaking for many industries, however real estate investors benefit from lease income being out of scope of the new revenue standard and there being no substantial changes to accounting for lessors of investment property.

There is talk in the industry on whether tenants' commercial evaluation of rent clauses will change as they bring their lease liabilities 'on balance sheet'. Shorter lease terms, leases with market rather than fixed uplifts and a higher proportion of rent linked to turnover would reduce accounting liabilities for tenants. Whether landlords will be amenable to such requests and what they will require in return remains to be seen. And if such a change does occur, how will valuations be affected?

In November 2017 the FRC released its thematic review into alternative performance measures. Consistent with our observations of the real estate sector, all companies reviewed used an 'alternative' measure of profit. Whilst commonly quoted, EPRA earnings tends not to be the primary alternative profit measure used by the listed real estate sector, with other profit items often being excluded beyond those required by EPRA. Ensuring transparency of adopted measures, and balancing their prominence against GAAP measures, remains a stated focus area for the regulator and should continue to be an agenda item for Audit Committees and their auditor.



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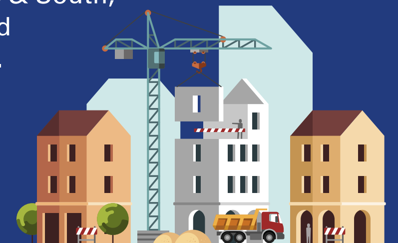
KPMG advised Bridgepoint on their acquisition of UK housebuilder Miller Homes for £655m. Established in 1934, Edinburgh-based Miller Homes is the largest privately-owned housebuilder in the UK, with a large regional footprint through three divisions (Midlands & South, North, and Scotland).



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Private Rented Sector (PRS) & Build to Rent (BtR)

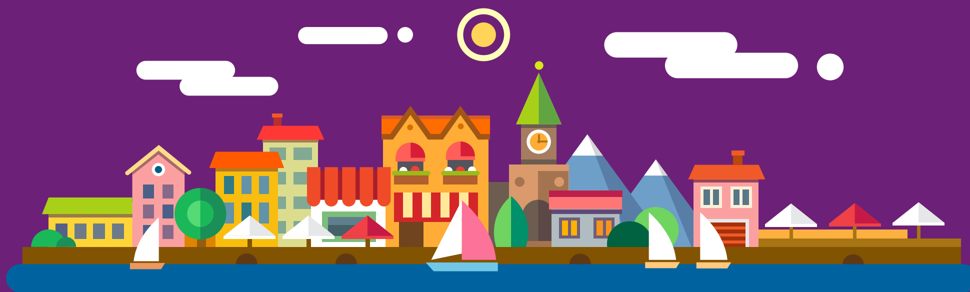
There was increased momentum in the sector in 2017, with over 95,000 build to rent units either completed or planned across the UK and circa 17,000 completed, according to the British Property Federation's build to rent map. The housing crisis continues, with demand outweighing supply.

There still remains limited transactional evidence in the market. However this has improved, especially in London where net yields of sub-4% are being achieved.

For 2018, public / private partnerships in the sector are likely to increase, given the strong long-run investment fundamentals for PRS and the need to provide local housing solutions. There will also be a higher volume of investment and forward-funding deals in the market with institutional, public bodies and overseas interest.

As the market matures, there will be more evidence on operating costs, rental levels and let up periods which will assist with valuations and investor confidence in the market.

KPMG is advising EcoWorld International Berhad on their acquisition of a 70% stake in Be Living, Willmott Dixon's residential development business. The joint venture will also develop 12 sites in Greater London and the South East of England, with sites being acquired in two stages over 2018.



KPMG advised global real estate company Greystar on their acquisition of two plots from Royal Mail plc on its Nine Elms site in London. Greystar plans to develop purpose-built, high-end apartments and a range of amenities with partner Telford Homes.

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Hotels and leisure

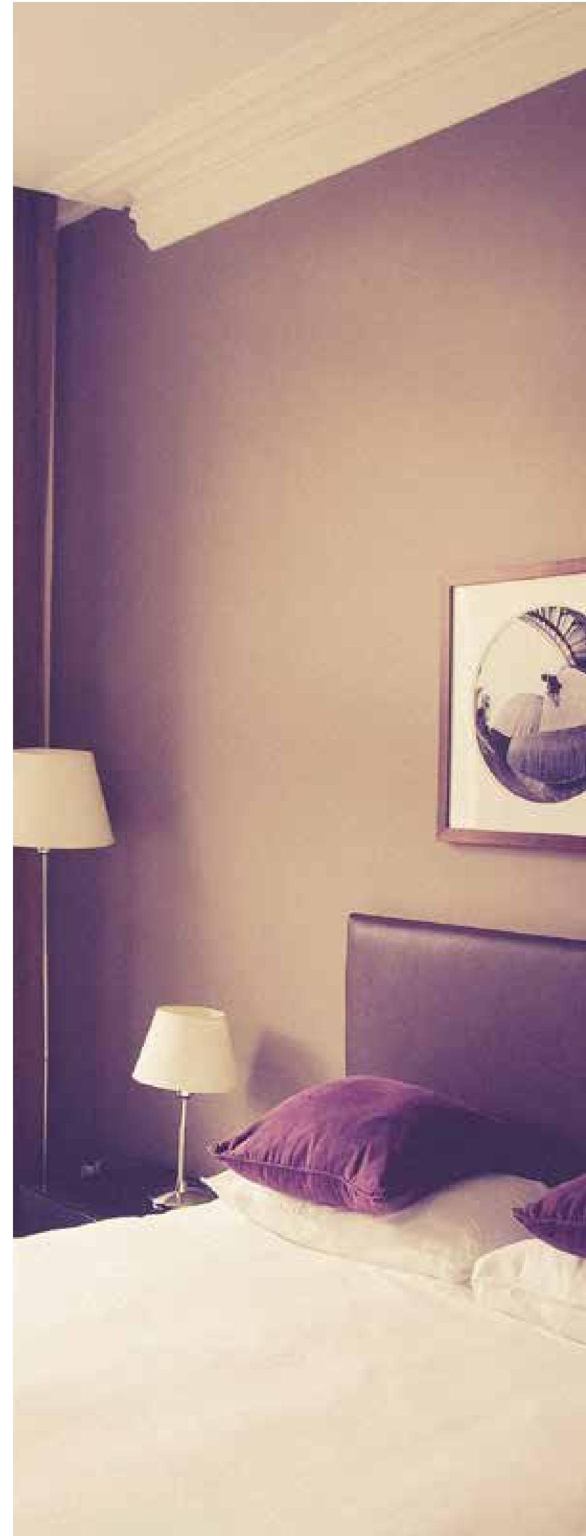
Despite significant challenges facing the sector, UK hotels continued to perform strongly in 2017. This was helped by the sustained influx of overseas visitors attracted by the pound being at its lowest level for many years. Transaction volumes have also been maintained with a number of significant portfolios trading, in the market or rumoured to be about to be launched: that includes Q hotels, Jury's Inn, and the Principal & DeVere brands. Asian investors in particular continue to look for UK opportunities in the sector.

2018 may be more challenging as economic growth is expected to slow in the UK, whilst labour and other costs increase and more supply comes on stream. This is likely to be compounded by continuing Brexit and international uncertainty. A number of groups operating hotels in the UK are already trying to identify alternative labour pools.

Finally, we are likely to see further expansion into adjacent sectors such as serviced accommodation, with owners and investors expecting consolidation as demand grows.

KPMG advised UK-based real estate investment company Aprirose on their acquisition of the Qhotels portfolio from Bain Capital Credit and Canyon Partners. The portfolio of 26 UK hotels totalling 3,680 beds was acquired for a sum of £525m.

KPMG advised Swedish hotel group Pandox on their acquisition of 37 hotels including the Jurys Inn chain from Lone Star for £800m. The transaction was made with Fattal Hotels Group ("Leonardo") as operating partner. Following a reorganisation of the portfolio, Paradox will retain 20 investment properties and one operating property in the UK and Ireland, and Leonardo will acquire the operational platform with 36 hotel operations under the Jurys Inn brand.



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Student Acommodation

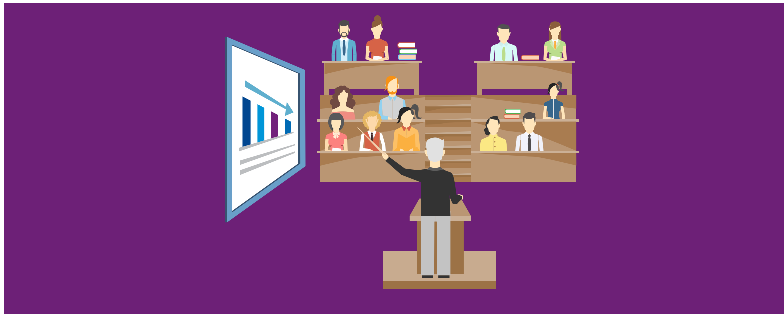
There continues to be strong investor appetite in the sector, despite Brexit looming and a drop in the number of university applicants. There has been a flight to quality – schemes located in the right place within the right university locations.

Investors have been both UK-based and from overseas and there are some substantial student accommodation portfolios in the market, which are expected to close towards the end of 2017 or early 2018.

For 2018, UK developers and investors will continue to expand outside of the UK and into Europe, in the search of yield.

Developers will look to produce a cost-effective product due to the increased costs of labour and materials, so there could be more modular and space efficient schemes. With the increases in fees, affordability and 'value for money' will also be vital for students.

KPMG advised iQ Student Accommodation on their acquisition of Pure Student Living and its portfolio of 11 sites in Bath, Bristol, Edinburgh, London and York.



KPMG advised Greystar and joint venture partners AXA Investment Managers – Real Assets and CBRE Global Investment Partners (both acting on behalf of clients) on their acquisition of the Spanish student accommodation portfolio Resa. AXA IM - Real Assets and CBRE GIP acquired equal sized shares representing the substantial majority holding in the portfolio, while Greystar, who will act as property, development and asset manager for the portfolio, purchased the remaining balance. The deal represents the largest investment transaction in student housing on the Iberian Peninsula.

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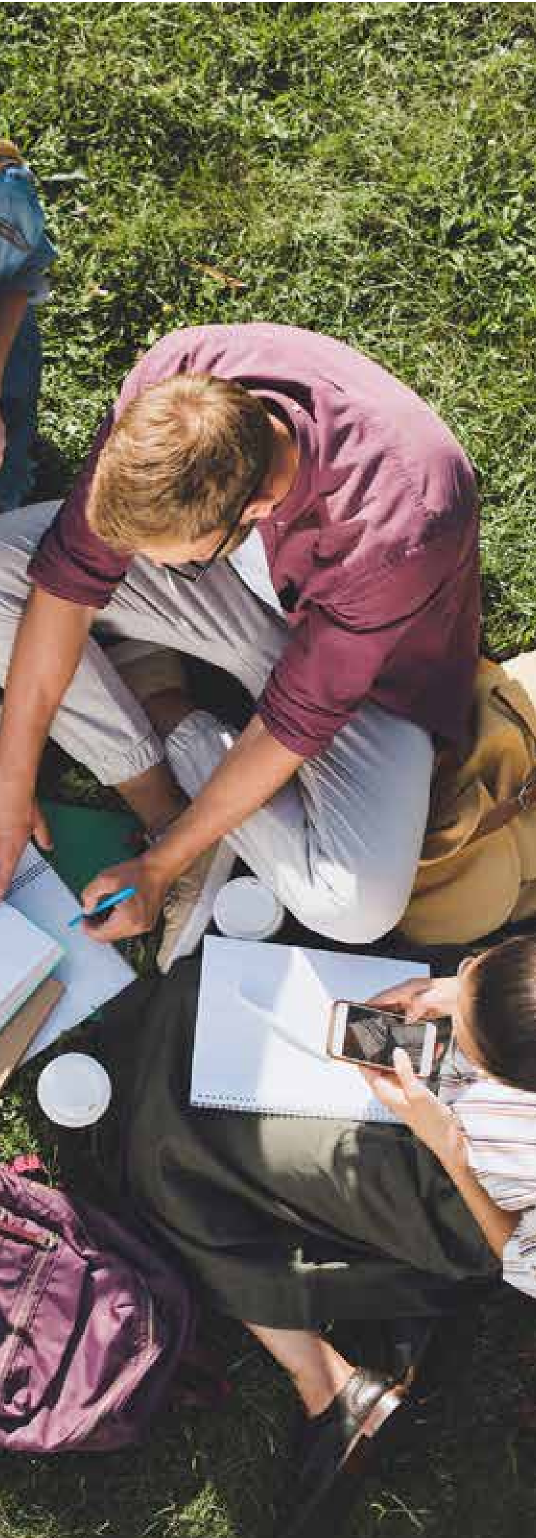


Office

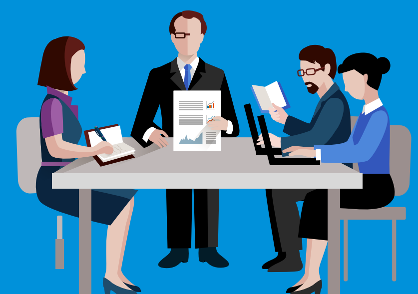
The office market has been relatively resilient to the Brexit uncertainty that many anticipated. The sector remains particularly attractive to overseas investors, largely due to the weak pound and comparatively higher yields and lower risks than elsewhere in Europe and Asia. Furthermore, some domestic players have become more cautious about investments on home soil, although this is also due to overseas capital preventing a market correction that many expected the Brexit vote would bring.

Although Brexit could see some organisations relocating staff to elsewhere in Europe, at this stage it looks unlikely that we will see a mass exodus from London. In many respects longer-term structural changes pose a far greater threat to occupier demand. Developments in technologies such as artificial intelligence will see a huge proportion of corporate jobs automated over the next decade, possibly even sooner. This could result in a significant shift in demand for office space and requires flexible assets that can adapt. Real estate players would be wise to pay as much attention to these developments as the evolving negotiations in Brussels.

One area of the sector that is booming is in flexible offerings such as co-working spaces. We expect this to continue in 2018 and anticipate more players entering this market, whether wholly or through sub-brands, partnerships or simply allocating a floor to short-term lets. Demand for such flexibility isn't just driven by fast-growing emerging businesses which need to be able to scale up or down as they evolve. Larger corporates are also attracted by the ability to reduce their committed overheads whilst having access to space when required, as well as recognising the value that working in environments alongside innovative new businesses brings.

Across the sector we are seeing a continued shift from tenant to customer as landlords place more focus on the needs of the end users of their buildings. In the war for talent, demand is particularly high for imaginative spaces that will appeal to the cross-generational workforce of today and tomorrow. This is also being reflected in location choices, with emerging destinations, such as King's Cross and Battersea in London, attracting tenants looking for well-located space with provisions such as gyms and entertainment as the line between work and leisure blurs.

KPMG advised NorthStar Realty Europe Corporation and China Resources Land on their acquisition of 20 Gresham Street from AXA. The acquisition of this trophy London office building represented CR Land's first real estate investment in Europe.



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Retail

The retail sector had another challenging year in 2017, with weaker sales, volatile consumer spending and the ongoing popularity of e-Commerce. Political and economic uncertainty continue to loom over the sector and there are further structural headwinds ahead.

We expect to see further store rationalisation as retailers try to reduce their overheads, and many will be assessing their property portfolios in preparation for IFRS 16 coming into effect on 1 January 2019. More retailers are expected to face a challenging year in 2018, with the possibly of Brexit-driven price hikes and inflation, coupled with consumers being hit by stagnant wage growth. Furthermore, they will need to take into account how Brexit might impact their existing supply chains.

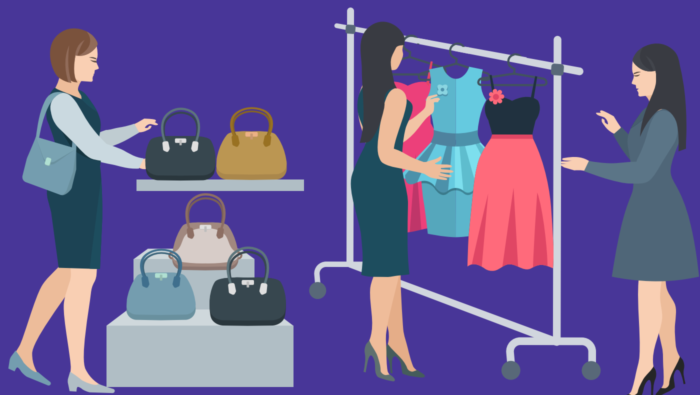
Unsurprisingly, investor appetite for retail property has reflected these uncertainties, with players approaching the sector with caution. We have also seen some consolidation in the market, with announcements in December 2017 that Intu is merging with Hammerson and Unibail-Rodamco have purchased Westfield.

However it's not all doom and gloom for bricks and mortar. Shoppers continue to enjoy the experience of visiting physical stores, and we anticipate a multichannel future rather than a complete shift to online. This is clearly demonstrated in the results of KPMG's 2017 Retail Survey, where 40% of respondents said that they used the store at some point in their path to purchase. This might be when deciding what to buy, through the use of click and collect facilities, or to return unwanted purchases.

Sites that offer the experience, value and convenience that retailers crave should continue to perform well, but secondary assets are likely to struggle. Investors will continue to be careful with their asset selection, paying close attention to the quality of tenants and strength of covenants.

It will be interesting to see how deals such as the sale of Bluewater and the Intu/Hammerson merger play out as we progress into 2018. Indeed Hammerson's proposal to dispose of £2bn of non-core, predominately UK, assets following the merger will be a good litmus test of investor attitudes to UK retail property. It could be that we see some opportunistic investors seeking to capitalise on the hesitancy of others through snapping up assets cheaply.

KPMG advised Europa capital on their acquisition of Spanish shopping centre Gran Via de Alicante. Gran Via is one of the largest shopping centres in the area, with over 40,000 sq. ft. of gross leasable area.



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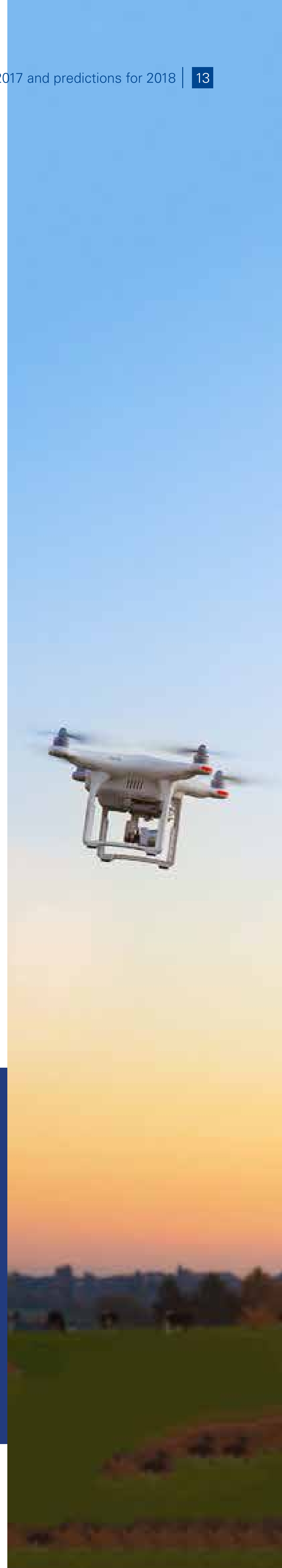


Logistics

Structural changes and strong fundamentals are expected to continue to drive demand in the logistics sector, with e-Commerce maturing and penetrating new markets. Overseas investors and new entrants have been attracted to the UK market in recent quarters, and we expect to see that continue into 2018.

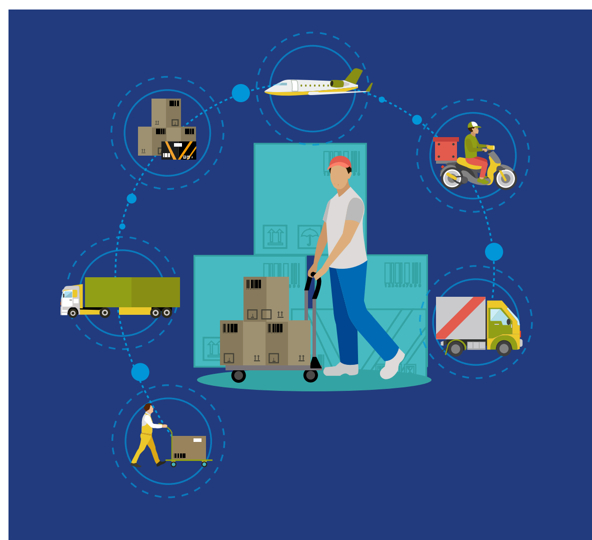
Consumer demand for instant gratification has driven an increasing focus on last mile logistics and a rise in urban hubs, particularly in London. This will see the industrial sector competing with residential for land and assets, and provides opportunities for mixed use spaces that accommodate both.

There remains a risk premium relative to other commercial real estate sectors, but it is key for investors to assess logistics assets on a granular level to ensure returns. Investors should consider distribution efficiency; proximity to dense populations, labour pools, and transport networks; and availability of land for extension. Occupiers appear willing to pay for quality and well-located assets.

It is also critical to consider the longer-term trends impacting the sector to avoid expensive retrofitting and building obsolesce. Rising automation of warehouses places increased importance on power supply, wireless connectivity and robot-friendly layouts. Autonomous Vehicles (AVs) and new technologies such as 3D printing will also impact location requirements and demand for space.

Finally, there is ongoing uncertainty around Brexit and how the UK's exit from the European Union will impact the sector. E-Commerce is generally more established in the UK than continental Europe, and this is expected to maintain demand regardless of how Brexit plays out. It is however possible that a departure from the Customs Union would lead to an acute shortage of warehouse space, as those operating just-in-time supply chains would potentially need to be able to store three days' worth of inventory in the UK. With the details of Brexit still largely unknown, it would be unsurprising if players in the market adopt a wait and see approach before responding to this potential change in demand.

KPMG advised the acquirers of Logicor on their purchase of the pan-European logistics company from Blackstone. Logicor's portfolio of assets is located in 17 countries and totals 147m sq. ft., with over 70% concentrated in the UK, Germany, France and Southern Europe.



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PropTech

More organisations across different industries are coming to terms with how emerging technologies and digitisation are redefining the way they go about their business and what this means for the buildings they use.

The changes that the occupiers of property are undergoing have in turn helped to drive a shift in the real estate industry, towards a wider recognition of PropTech and its potential. We have seen an increase in published reports and insight into 'PropTech' and the emergence of new roles such as Chief Technology Officer (CTO), Chief Data Officer (CDO), technology champions and directors of innovation, as technological change rises up executives' agendas.

> This industry move towards acceptance is supported by the recent KPMG Global Proptech Survey, where 86% of respondents stated they saw digital technology as an opportunity, as opposed to just 4% who saw it as a threat.

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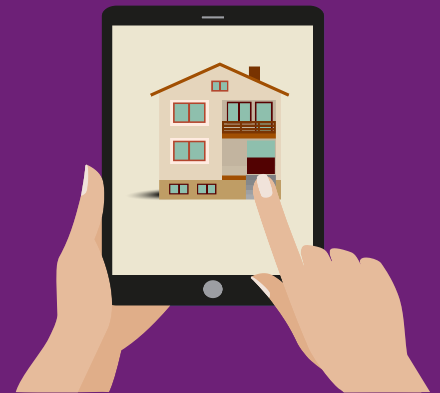
These shifts are forcing businesses to step outside of their existing models and investigate what digitisation and innovation mean for their organisations.

They are recognising that having a clear strategy will keep them ahead of the game in today's rapidly changing environment. However, this is proving more complicated than just appointing a champion and procuring some new technology. There are wider organisational implications which are forcing a shift in mindset and a move to greater collaboration across their own organisation and with emerging technologies.

Expect to see more collaboration in 2018 not only from corporate real estate companies but also across the technology providers as the consolidation of technologies, ideas and skills proves the best way to win new customers. All organisations need to engage with these developments in order to capitalise on the growing number of opportunities emerging across the sector.'

KPMG advised Zoopla Property Group on their acquisition of research analysis company Hometrack. Hometrack provides residential property market insights, analytics, valuations and data services to businesses across the property ecosystem, and is the UK's leading automated valuation model (AVM) provider.



Andy Pyle, UK Head of Real Estate, was voted sixth in LendInvest's PropTech Powerlist, recognising the most influential people advancing the use of technology to reinvent the property industry.

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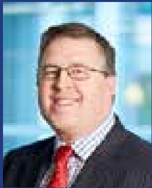

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