UK | Research & Forecast Report

REIF IN BRIEF

Q4 2017

Economic Outlook

Economic activity remained sluggish in Q3 as GDP expanded by 0.4%, albeit this was an improvement on the 0.3% recorded in Q2. Business surveys for Q4 were in positive territory, with October PMI headline figures for all three main UK sectors improving on the previous month and in expansionary mode. However, fortunes were slightly more mixed in November. Manufacturing PMI powered ahead as it reached a new four-year high (58.2) aided by a broad-based uplift in production and new orders for consumer, intermediate and investment goods. Construction PMI also accelerated to 53.1, driven by an upturn in house building. However, the dominant services sector slowed from 55.6 in October to 53.8 in November, with the growth rate of new business slowing. Nevertheless, all three sectors remained significantly above the expansionary threshold of 50 and a GDP upside surprise in Q4 may materialise.

Inflation (CPI) was static at 3.0% in October, while RPI rose slightly to 4.0%. Despite the current elevated levels, 'base effects' from sterling's post Brexit devaluation are set to slowly lift some of the upward pressure and should signal the start of a more moderate inflation profile. Higher oil prices, should they persist, and another increase of 4.4% to the living wage in April will, however, work in the opposite direction. The MPC's November rate hike, from 0.25% to 0.5%, did not come as a significant surprise and was generally perceived as reclaiming some monetary 'ammunition' lost in 'Brexit's' aftermath, with BoE comments suggesting a slower and more gradual tightening cycle. Real wage growth remained negative against an inflationary backdrop. Total pay growth was unchanged in the three months to September at 2.2% y/y, well below the inflation rate, and continued to squeeze disposable incomes and household spending.

All Property Forecasts

All-property total returns are expected to settle at 8.8% by the end of this year, a marked improvement on 2016 and previous forecasts, consisting of 3.8% capital growth and 4.9% income return (0.1% residual). Performance is expected to slow in 2018 to 5.3%, comprised of 0.3% capital growth and 5.0% income return.

Equivalent yields have proved increasingly resilient this year and should end 2017 down by 19bps, before softening marginally next year. All-industrial yields are expected to harden by 50bps this year, in contrast to the more measured falls for retail (8bps) and offices (14bps). A number of downside risks remain in play for 2018, which may adversely impact pricing, including ongoing 'Brexit' negotiations, capital-gains reform plans for foreign entities from 2019, and 'frothy valuations' and cyclical concerns. Nevertheless, assuming a relatively smooth Brexit, retail and offices are forecast to move out by 5-8bps, while industrial pricing should remain under pressure and harden by 8bps.

Rental growth will remain largely tepid, particularly in the retail sector, where squeezed purchasing power, depressed consumer spending and ongoing structural shifts will continue to weigh on occupier demand. All-property rental growth is forecast to reach 1.6% by the end of this year, before slowing to 0.6% in 2018.

Trading volumes in 2017 have been robust, despite political developments and 'overvaluation' fears, and are expected to easily surpass the £51.7bn transacted in 2016. Investment activity has been supported by favourable exchange rate movements for foreign investors, who have snapped up 'trophy' assets in Central London. Capital value growth is anticipated to end the year at 3.8% and average 1.7% over the 2017-2021 period.

All Property Forecast Summary

	DEC-16	DEC-17	DEC-18	2017 - 2021
ERV Growth (% p.a.)	2.1	1.6	0.6	1.6
Equivalent Yield (% eop)	5.9	5.7	5.7	5.7 (2021)
Capital Growth (% p.a.)	-1.3	3.8	0.3	1.7
Total Return (% p.a.)	3.5	8.8	5.3	6.7

Retail Forecast Summary

	DEC-16	DEC-17	DEC-18	2017 - 2021
ERV Growth (% p.a.)	1.0	1.0	0.4	1.0
Equivalent Yield (% eop)	5.7	5.6	5.7	5.6 (2021)
Capital Growth (% p.a.)	-3.3	0.8	-0.6	0.7
Total Return (% p.a.)	1.7	6.0	4.8	6.0

Office Forecast Summary

	DEC-16	DEC-17	DEC-18	2017 - 2021
ERV Growth (% p.a.)	2.9	0.8	-0.4	1.4
Equivalent Yield (% eop)	6.0	5.8	5.9	5.9 (2021)
Capital Growth (% p.a.)	-1.7	2.6	-0.9	1.2
Total Return (% p.a.)	2.3	6.8	3.4	5.7

Industrial & Logistics Forecast Summary

	DEC-16	DEC-17	DEC-18	2017 - 2021
ERV Growth (% p.a.)	3.5	4.2	2.3	3.0
Equivalent Yield (% eop)	6.3	5.8	5.7	5.7 (2021)
Capital Growth (% p.a.)	2.0	10.8	3.1	4.0
Total Return (% p.a.)	7.3	16.5	8.2	9.3

Source: Colliers International, MSCI (IPD)

Retail

Annual retail sales growth continued to disappoint in the first month of Q4, falling for the first time in four years. October retail sales volumes declined by 0.3% y/y, driven by broad-based falls in both food and non-food stores. Higher prices and negative real wage growth remain persistent thorns in the retail market's side, although some respite may gradually materialise next year as inflation eases. Nevertheless, at the moment, the MSCI Monthly all-retail rental index suggests a deterioration to the growth rate (0.4% y/y in October), with all regions witnessing some softening.

Central London was not immune to this trend and rental growth slowed significantly over the last three months, culminating in a modest 1.1% y/y uplift in October. The sub-sector has been weighed down by higher business rates and general concerns related to the UK economy. What is more, the 'base effects' from sterling's devaluation last year, have had a comparatively negative impact on duty-free sales growth this year, with the New West End Company data estimating a fall of 11% y/y in September. 2018 is expected to be more challenging; however, the arrival of the Elizabeth Line, various development projects and continued increase in visitor numbers, is expected to re-energise the Central London market.

Trading conditions will be more challenging elsewhere in the country and rental performance is expected to be subdued, with shop rental growth (excluding Central London) forecast to be in negative territory (-0.3%) in 2018, with flat growth for Rest of London and the South East, and a decline of 0.5% forecast for Rest of UK shops.

A similar trend is anticipated for other sub-sectors, with shopping centre and supermarket rental growth flat-lining in 2018, while retail warehouses are forecast to outperform slightly (0.5%). The headline MSCI shopping centre index will continue to flatter the sub-sector, with some of the 'super prime' dominant schemes pushing the average up, while secondary and tertiary schemes will see further rental erosion. RPI-linked leased supermarkets should continue to provide good opportunities for investors seeking long, secure income, hedged against inflation, although structural concerns will continue to act as a drag. All-retail total returns are set to slow next year to 4.8%, consisting of -0.6% capital growth and 5.3% income return (0.1% residual), and should average 6.0% over the 2017-2021 period.

Offices

Office assets have weathered the EU referendum 'storm' better than expected, with the banks' exodus from London, anticipated by some, not transpiring and the development pipeline adjusting relatively quickly to 'Brexit' concerns and softer demand. Indeed, it is likely that supply of new product will remain constrained. Developers and investors are delaying major schemes, many seeking substantial pre-lets before undertaking construction, particularly in the City of London. High profile searches and deals in advanced talks (e.g. BoA, CITI, EBRD, SNBC, TP ICAP) are set to further denude the limited speculative reservoir. Nevertheless, Central London office rental growth is still expected to turn negative next year (-1.4%), albeit this is more positive the initial forecasts following the EU referendum.

Rental growth in other parts of the country is anticipated to be more upbeat, although the pace of expansion is expected to slow. Rest of London and the South East are forecast to lead the pack, growing by 1.1% and 0.8% respectively in 2018. Rest of UK is set to see an uplift of 0.3%, as financial and business service employment growth stagnates, but with some cities better positioned than others.

All-office MSCI rental growth is forecast to reach 0.8% by the end of this year, before turning negative (-0.4%) in 2018. Most of the impetus will be provided by the South East and Rest of London, before London takes on the mantle from 2020 onwards. The office rental index is forecast to average 1.4% annually in the 2017-2021 period.

Total returns are expected to reach 6.8% by the end of this year, but performance will slow in 2018, with all-office total returns of 3.4%, comprised of -0.9% capital value growth and 4.3% income return. South Eastern standard offices are set to finish the year on a high as total returns are forecast to approach 8.0% and should outperform the rest of the country (5.1%) again next year. Mid-town, the West End and the City of London are expected to be the laggards in 2018 at 1.8%, 2.3% and 2.5% respectively.

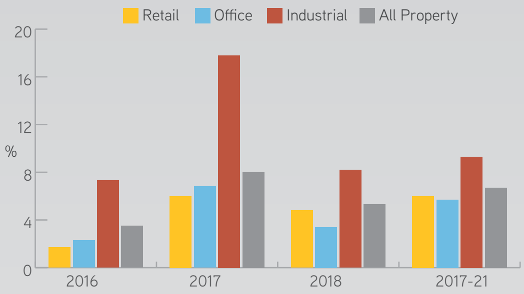
Industrial & Logistics

The occupier sector in the South East remains somewhat patchy, with sluggish demand for occupiers seeking units above 100,000 sq ft, but strong activity in the small to mid-range market (below 100,000 sq ft). New enquires have slowed slightly over the last two months as occupiers have focused more on issues outside of property. However, there is still a distinct supply shortage, particularly for quality industrial sites. This demand/supply imbalance continued to galvanise rental growth, with the latest MSCI Quarterly index suggesting industrial rents rose (5.0% y/y) for the fourth consecutive quarter in Q3, driven by standard. industrial growth rates of 7.2% y/y in London, 6.9% in the South East, and 2.8% in Rest of UK. Distribution warehouses were also on an upward trajectory, with an annual uplift of 3.8%.

The current economic environment is particularly benign for manufacturing activity, with sterling's depreciation and rising global GDP growth supporting export-driven manufacturers, as confirmed by the aforementioned strong November manufacturing PMI figures. However, the more subdued consumer spending backdrop should, in theory, apply some brakes in 2018 to the remarkable e-commerce growth witnessed over the past few years, potentially constraining domestic-driven manufacturing and logistics output.

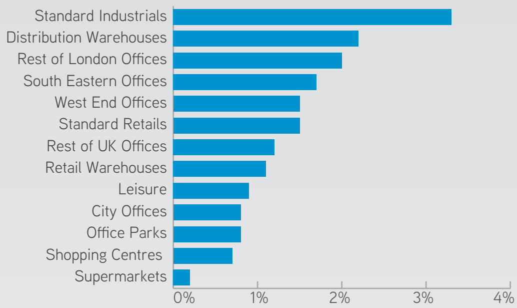
Notwithstanding some headwinds, the industrial sector is forecast to remain the best performing commercial property sector over the coming years. The all-industrial MSCI rental index is expected to increase by 4.2% this year, before slowing to 2.3% in 2018, and should average 3.0% over the 2017-2021 period. Total returns will comfortably outstrip other sectors, reaching double digits (16.5%) this year, consisting of 10.8% capital value growth and 5.1% income return (0.6% residual). While returns are set to slow next year, industrials will continue to outperform the rest of the commercial sector, with total returns of 8.2%, comprised of 3.1% capital growth and 5.0% income return (0.1% residual).

Figure 1: Total Return by Sector



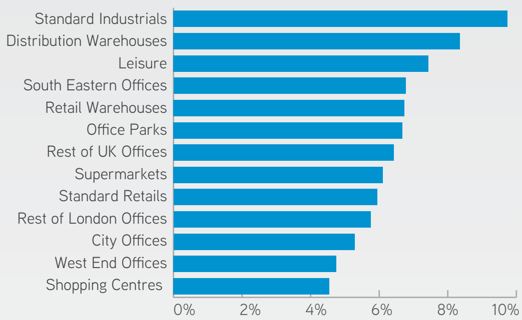
Source: Colliers International, MSCI

Figure 2: ERV Growth 2017-2021 (% p.a.)



Source: Colliers International

Figure 3: Total Return 2017-2021 (% p.a.)



Source: Colliers International

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