UK | Research & Forecast Report

REAL ESTATE INVESTMENT FORECASTS

Q1 2017
All Property Forecasts

By all accounts, year-end property metrics came ahead of most expectations, including ours, with yields resilient in the face post-EU referendum uncertainty. Economic performance appears to have been back loaded, with activity rallying in the latter months as consumers continued to spend, despite downcast predictions. However, according to most forecasts the impact of ‘Brexit’ may have simply been delayed, with Article 50 and any EU divorce proceedings not yet triggered, events which are likely to drag out and incite uncertainty across markets, despite the clear will of the UK government to fully exit the single market. This clarity has also resulted in some obvious repercussions for the property market, particularly focused on the central London office market. Nevertheless, despite all this uncertainty, total returns are forecast to decline only marginally in the year ahead, falling from 3.5% in 2016 to 3.3% by the end of December, consisting of 5.1% income return and -1.8% capital growth. All-property equivalent yields are expected to move out by around 12bps in 2017 and another 9bps next year.

The industrial sector will continue to drive all-property total returns and lead performance, with strong total returns of 7.6% this year, comprising 5.4% income return and 2.1% capital growth (0.1% residual). In a reversal of fortunes, offices are now expected to be the worst performing sector of the commercial property market, with total returns of 0.3% this year and 3.7% in 2018, as the decision to exit the single market, with the prospect of losing ‘passporting’ rights and euro clearing functions, coupled with record low interest rates and punishing business rates, impacts on occupier and investor demand. The retail sector is anticipated to see a slight improvement on 2016 in terms of total returns (3.5%) this year, but this is mostly attributable to a smaller outward yield correction than in the previous year, rather than any organic growth. Indeed, the sector will remain besieged by online retailing, structural issues and changes in shopper behaviour, but with the added impact of inflationary pressure and a squeeze to disposable incomes exacerbating the situation.

In addition to these factors, the business rates revaluation is likely to temper rental growth across the UK property market, but particularly in South Eastern and London locations. The all-property rental index is expected to fall marginally (~0.2%) in 2017, before recovering slightly to 0.6%. Central London will continue to provide the main impetus to rental performance, benefiting from the weak pound and strong tourist numbers, but rental uplifts are set to be limited by rises to occupational costs. Indeed, these marked increases to overheads, together with other ‘Brexit’ related factors, should push Central London offices to the opposite end of the spectrum, with the City of London, Mid-town and West End set to see negative growth this year. Generally, MSCI rental growth in 2017 is forecast to be strongest for industrial space, where rents are expected to see an uplift of 2.5%, and weakest for offices, which are anticipated to record a contraction (~2.4%). Performance is, nonetheless, expected to stabilise in the following years, with annual average rental growth of 0.7% for retail, 1.1% for offices and 2.5% for industrial.

All Property Summary Forecasts

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Source: Colliers International, MSCI
Economic

GDP growth was pegged back to 1.8% for the whole of 2016; however, economic activity appears to have been back loaded as Q4 1% growth was revised up to 0.7% q/q: Consumer spending, which accounts for over 60% of GDP, continued to provide the main impetus as it grew by 0.7% q/q in Q4. However, investment growth flat lined in the same quarter, fuelled by restrained investment in ICT and other machinery and equipment.

Following a 17-month high in December and a positive start to the year, business surveys suggest that the Q4 acceleration is losing some steam. The latest PMI readings of the three main sectors of the economy either edged up or slowed in February, with the sterling induced cost pressures beginning to take a toll. Services PMI, surveying the dominant sector of the UK economy, fell from 54.5 in January to 53.3 in February, with a slower employment uplift, weaker new work growth and higher business costs acting as a drag on sentiment. A similar correction was also evident for manufacturing PMI, which eased back to 54.6 in February, while construction rose marginally to 52.5. Nevertheless, despite the general cooling in sentiment in February, all surveys still point to an expansionary period consistent with GDP growth of 0.4%-0.5% in Q1.

The latest PMI readings did, however, have an immediate impact on currency markets as sterling’s recent relative stability was interrupted, pushing the pound down to £1/US$1.22 and £1/€1.14 at the time of writing. Any further sterling devaluation is only likely to swell the inflationary tide poised to crash into the shores of the UK economy, exerting downward pressure on those consumers and businesses currently afoot. This price pressure is already manifest in the official statistical figures, with inflation having rapidly gathered pace since the referendum, reaching 1.8% in January and set for a further acceleration in the months ahead. Despite a higher inflation outturn, the MPC is not expected to raise the base rate in the short to medium term, with the prospect of price pressures, subdued business sentiment, weaker retail sales growth and a softer housing market likely to prolong the ultra-low interest rate environment well into 2018.

The unemployment rate fell to 4.7% in the three months to January, the lowest point since September 2005. What is more, the claimant count declined by another 11,300 in February compared with January. However, total earnings growth (including bonuses) cooled for the second consecutive month, from 2.6% in December to 2.3% in the three months to January. Irrespective of the tight labour market, pay rises are now struggling to keep pace with inflation surpluses, which is constraining real wage growth and squeezing disposable incomes, a trend likely to intensify in the months ahead.

Investment Market

Total trading volumes in 2016 exceeded £51bn according to Property Data, marked down by 27% on the previous year’s total of £71bn, with both cyclical and political concerns impacting on investor confidence and, consequently, activity. The investment pattern was also uneven, with the bulk of transactions concentrated in July and August, with activity widespread across all sub-sectors. In 2017, expectations are for a return to more normal trading volumes, with the overall rate of investment activity likely to be more evenly spread throughout the year.

Investment market volumes are expected to be £9bn lower this year, down to £42bn, with expectations of improvement across all sub-sectors, with the exception of high street retail and industrial. Significant sales in the first half of 2016, such as the sale of the iconic Reuters Plaza in Canary Wharf for £915m, represents a challenging bar against which to judge performance in 2017.

Overseas investors were by far the largest investors (£22bn) in the UK market in 2016, representing 43% of all acquisitions. Together with UK private investors (£2.6bn), they were the only net buyers last year, but also the largest (£8.8bn) by some distance, and their presence shows no signs of diminishing based on recent evidence. Indeed, preliminary figures for the first two months of 2017 suggest their £3.2bn worth of acquisitions amounted to a share of 57% of all purchases, while they were again the largest net buyers (£1.4bn) in the market, with sterling’s devaluation and ongoing weakness potentially widening the gap between domestic and overseas players further in the coming months.

Trading volumes in January-February totalled £5.9bn, a fall of 39% compared with the £9.9bn transacted in the same period last year. Although the 2017 figures will be revised up in the coming week, activity has undoubtedly been sluggish. However, pricing has been resilient according to prime transactional evidence and the more average MSCI sample, suggesting that this lurching environment has more to do with a shortage of product on the market rather than subdued demand. Average MSCI yields hardened again in January, bringing the post-September yield compression to 9bps. A handful of sub-4% deals were transacted in January to early March, mostly in London and primarily by foreign investors, the highlight of which was the £1.15bn (IY 3.5%) sale of 122 Leadenhall, unofficially known as the ‘Cheesegrater’, for £1.15bn (IY 3.5%). The sale of the iconic building by British Land and Oxford Properties to the new Chinese owners was a landmark deal which highlighted the enduring appeal of super prime UK assets to overseas investors, the highlight of which was CC Land’s acquisition of 60 Cheapside (IY 3.9%).

However, most importantly, the Cheesegrater’s acquisition also highlighted the enduring appeal of super prime UK assets to overseas investors against a backdrop of EU referendum uncertainty, with its keen pricing representing a premium of £235m on the asset’s valuation of £1.15bn just six months prior to the exchange. While this year will likely see more currency plays by foreign investors, on balance, demand is anticipated to be more subdued for Central London office assets as the reality of a softer occupier market begins to filter through. Trading volumes are expected to fall slightly from the £51bn recorded last year, but they should still end the year above the long-term average. Colliers expects all-property equivalent yields to soften by 12bps this year and another 9bps in 2018, with the largest outward movement (around 30bps) in the City of London.
Retail

Standard Shops

Retail sales disappointed for a second consecutive month in January, with negative growth (-0.3%) on a monthly basis and the lowest y/y rate (1.5%) since late-2013. The latest figures were weighed down by declines in non-store retailing and household goods sales growth, both of which contracted by around 10% y/y over a two-month period. One of the main reasons behind this disappointing trend may be the end of the ‘discourting years’, with the deflationary trend seen in recent years fizzling out as sterling’s weakness increases retailers’ costs. Indeed, the retail-prize deflator (incl. fuel) touched 19% in January, the fastest pace since mid-2013.

The rise of fixed occupational costs in the West End has impacted store profitability and, together with the aforementioned rise in inflation and the uncertainty of the long-term economic consequences of Brexit, it has resulted in an increase in the number of properties becoming available as retailers re-evaluate their store portfolio across the district. After unprecedented rises over the past five years across Central London, a rental growth cooling is anticipated over the next 12 months and selected streets, where occupancy costs have reached unsustainable levels, may even see rents ease back once the imminent increase to business rates filters through. Nevertheless, both international and domestic demand for the prime West End locations remains strong, based on recent letting activity. Furthermore, the West End is entering a new and exciting development phase with the opening of the Elizabeth Line in December 2018. Additionally, plans to significantly improve the retail environment, particularly along Bond Street, Tottenham Court Road and Oxford Street, with a significant reduction to traffic and a potential removal of buses in the latter, should create a better shopping experience for consumers.

In the South East retail market, deals are being completed, but they tend be slow and cautious. On the larger space transactions, there is a virtual standstill in shopping centre investment activity. The growth this year is forecast to reach 3.5% in Central London, 1.5% in Rest of London, 2.8% for Rest of the South East & Eastern and -0.5% for Rest of UK.

Shopping Centres

According to MSCI Quarterly figures, shopping centre rental growth has held up surprisingly well in recent quarters, a disconnect from the virtual standstill in shopping centre investment activity. The rental growth index rose by 1.6% in Q4 16 on an annual basis, slower than the 2.1% recorded in Q3 16, but still above the wider perceived weakness in the market. Against a backdrop of subdued occupier activity, the surprisingly positive MSCI rental performance may be attributed to a sample which is disproportionately influenced by lettings in the larger, more dominant schemes. Indeed, rental growth across shopping centres above 50,000 sq ft has risen for four consecutive quarters, reaching 2.0% in Q4 16. Void rates across the MSCI shopping centre quarterly universe have also drifted down, falling from 14.7% in Q3 16 to 13.6% in Q4 16. Despite this benign environment painted by MSCI, there are a multitude of issues which are heavily impacting retailers’ profitability. The aforementioned rise to the minimum wage, the South East biased rising business rates, general increases to input costs, combined with the ongoing erosion of growth from internet spend and excess supply of secondary/tertiary schemes, it should keep prime shopping centre growth static whilst witnessing broad-based negative rental growth in weaker locations. On balance, Colliers expects no growth this year and an annual average of 0.4% in 2017-2021.

Retail Warehouses

The occupier market appears slightly cautious at the moment, with retailers not in a hurry to complete deals, particularly in the fashion segments. Indeed, lettings here are becoming increasingly challenging, not just due to the length of time to complete, but also the financial contributions needed in terms of incentives. The bulky goods sector is seeing some limited growth in the furniture and carpet segments, whereas DIY is receiving a boost from Bunnings, albeit this is modest. Although electrical sales have been improving, they have cooled slightly in the latter part of the year, as the terms occupiers are seeking. Indeed, household goods sales have generally been weaker across the board in recent months, underpinned by the 2% y/y decline in January, only the second time households stores sales contracts have fallen by 3 months. Akin to the wider retail story, this may be due to inflationary pressures filtering through to the retail market, with the household goods deflator creeping up to 3.8% y/y in January, the second consecutive positive reading since mid-2014, but it could also be attributed to a cooling in the housing market. Meanwhile, MSCI retail warehouse rental growth has remained largely stable since September 2015, oscillating between 0.8% and 0.9% on an annual basis. However, Colliers expects retail warehouse growth to fall towards the lower end of 0.6% this year, reflecting the possible rise in incentives, before rents resume a gradual upward trend in 2018-2021.

Supermarkets

The main occupational theme last year centred on retailers shrinking the larger units of between 120,000 to 150,000 sq ft, which were the optimal size several years ago, in favour of the 50,000-70,000 sq ft units, now typically viewed as the ideal size to dominate a particular catchment. However, instead of cutting back, operators are now also looking to work smarter and the focus is on accurately targeting the individual store offer. Expansions have been primarily driven by convenience retailing and discounters, led by the likes of Co-op, which opened 100 stores in 2016. Also Aldi and Lidl have plans to open another 60-70 stores a year over the coming years. However, excess supply of larger units, the rise in convenience retailing and a change in consumer habits, remain thorny issues which continue to pressurise rents. Indeed, supermarkets were the worst performers in January, with a 2% y/y decline in sales. The occupier market appears slightly cautious at the moment, with retailers not in a hurry to complete deals, particularly in the fashion segments. Indeed, lettings here are becoming increasingly challenging, not just due to the length of time to complete, but also the financial contributions needed in terms of incentives. The bulky goods sector is seeing some limited growth in the furniture and carpet segments, whereas DIY is receiving a boost from Bunnings, although this is modest. Although electrical sales have been improving, they have cooled slightly in the latter part of the year, as the terms occupiers are seeking. Indeed, household goods sales have generally been weaker across the board in recent months, underpinned by the 2% y/y decline in January, only the second time households stores sales contracts have fallen by 3 months. Akin to the wider retail story, this may be due to inflationary pressures filtering through to the retail market, with the household goods deflator creeping up to 3.8% y/y in January, the second consecutive positive reading since mid-2014, but it could also be attributed to a cooling in the housing market. Meanwhile, MSCI retail warehouse rental growth has remained largely stable since September 2015, oscillating between 0.8% and 0.9% on an annual basis. However, Colliers expects retail warehouse growth to fall towards the lower end of 0.6% this year, reflecting the possible rise in incentives, before rents resume a gradual upward trend in 2018-2021.

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Offices

Central London

Despite a positive uplift in transactional levels in Q4, London offices data for the whole of the year highlighted the challenging nature of 2016. Take-up in the last quarter rose by 10% q/q and 16% y/y, but the figure for all of 2016 was down by around 1m sq ft - 8% lower than the 10-year average. Much of the Q4 uplift could be attributed to the letting of 542,000 sq ft at 10 South Colonnade, E14, to the Government Property Unit, although pre-letting activity continued with the highlight deal to Barings, who signed for 113,000 sq ft at Land Securities’ 20 Old Bailey, ECA.

Inevitably, vacancy rates have begun to rise within the City and West End markets. Absorption has slowed markedly, but remains far removed from the depressed levels witnessed during the financial crisis. Grey space is beginning to filter onto the market, particularly in the City, with close to a million square feet currently being marketed. Nevertheless, rates still remain below trend and, coupled with supply levels that are still consistently below average, there is no prospect of oversupply in the short term.

The possibility of increased lease re-gearings and landlords seeking to retain tenants during this continuing period of uncertainty, are impacting on stock churn and occupational levels. Nevertheless, Grade A vacancy remains significantly below trend. The release of grey space is increasing, although current levels are within normal parameters. Approximately 1.5m sq ft is expected to be released to occupiers over the next two years. Encouragingly, Canary Wharf, which has been a significant source of ‘grey space’ in previous cycles, saw close to a million sq ft of surplus space absorbed in 2016.

After rising, ahead of the EU referendum, to record levels of £125 psf in the West and £75 psf in the City of London, prime headline rents have softened since the vote, with West End rents declining to £118.5 psf and the City falling back to its pre-Brexit figure of £70 psf in the West and £75 psf in the City of London, prime headline rents in the North West edged up by an average of 3.8%, driven by moderate rises in Manchester City (£35 psf, 2.9%) and Liverpool (£29 psf, 2.4%), but otherwise a double-digit growth in Salisbury Quays (£24.50 psf, 11.4%) and a good uplift in Manchester South (£24 psf, 9%). However, it was the South West which took over the mantle of prime pricing, with the region as headline rents fell by an average of 6.5%, fuelled by double-digit increases in Bristol out-of-town (25.6%), Swindon (15.6%) and Exeter (10%). West Midland’s average prime rents rose by 2.4%, but were up less than 1% on the region as headline rents were flatter than in 2015 across most markets, but double-digit growth seen in key towns such as St. Albans (44%), Croydon (38%) and Watford (19%) pushed rents to new heights. There were 10 transactions above the £50,000 sq ft mark last year, which represented 30% of the total take-up. However, the bulk of lettings consisted of smaller sub 20,000 sq ft lots, with the average letting floor area of around 16,000 sq ft.

Current market sentiment in Q1 17 is better than most anticipated, with a number of viewings taking place, albeit mostly for space below 30,000 sq ft. Although this has yet to turn into take-up, it is a positive early sign for the year. permitted development rights (PDR) for office to residential conversions continue to remove secondary and tertiary stock out of the market, which has supported headline figures. Rental growth should linger in selected markets, such as Slough, Reading, Uxbridge and Stockcross Park, where new office developments and refurbishments have recently completed, albeit not at the levels that were anticipated alongside a cooling in financial and business employment growth in the year ahead, Colliers forecasts the MSCI South East rental index will decline by 0.2%, before rebounding slightly in 2018. The five-year annualised growth rate is anticipated to reach 1.3% in 2017-2021.

Rest of UK Offices

Almost nine months on from the EU referendum result, occupational markets in the regions have seen no discernible adverse impact from the vote, yet. Indeed, prime rents across major regional cities continued to edge up on an annual basis in 2016, albeit most of the rises did take place prior to the referendum. Prime headline rents in the North West edged up by an average of 3.8%, driven by moderate rises in Manchester City (£35 psf, 2.9%) and Liverpool (£29 psf, 2.4%), but otherwise a double-digit growth in Salisbury Quays (£24.50 psf, 11.4%) and a good uplift in Manchester South (£24 psf, 9%). However, it was the South West which took over the mantle of prime pricing, with the region as headline rents fell by an average of 6.5%, fuelled by double-digit increases in Bristol out-of-town (25.6%), Swindon (15.6%) and Exeter (10%). West Midland’s average prime rents rose by 2.4%, but were up less than 1% on the region as headline rents were flatter than in 2015 across most markets, but double-digit growth seen in key towns such as St. Albans (44%), Croydon (38%) and Watford (19%) pushed rents to new heights. There were 10 transactions above the £50,000 sq ft mark last year, which represented 30% of the total take-up. However, the bulk of lettings consisted of smaller sub 20,000 sq ft lots, with the average letting floor area of around 16,000 sq ft.

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South Eastern Offices

Last year proved a fruitful one for landlords as tighter availability and lower vacancy rates in Thames Valley (11.8%), North M25 (6.7%) and South M25 (10.8%) pushed average prime rents to their highest levels on record. Headline rents were flatter than in 2015 across most markets, but double-digit growth seen in key towns such as St. Albans (44%), Croydon (38%) and Watford (19%) pushed rents to new heights. There were 10 transactions above the £50,000 sq ft mark last year, which represented 30% of the total take-up. However, the bulk of lettings consisted of smaller sub 20,000 sq ft lots, with the average letting floor area of around 16,000 sq ft.

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Industrial

Standard Industrial and Distribution Warehouses

Activity in the industrial sector has been robust, particularly for the smaller and mid-range units in London and the South East, but occupier demand has undeniably cooled for space over 100,000 sq ft. Indeed, not many deals of note were completed over the period. Anecdotal evidence also suggests capex retention in some cases, whilst retailers adopt a ‘wait and see’ with regard to the triggering of Article 50 and the ‘Brexit’ process. There has, therefore, been no real commitment for larger deals and some examples of contractions, with Tesco closing two depots in Welham Green and Chesterfield, and John Lewis cutting retail staff in favour of more online business.

Supply remains extremely tight as evidenced by the lowest vacancy rates on record, with a particularly noticeable shortage of product in the South East and London. Despite this, there is currently not enough speculative development in the pipeline.

Although the manufacturing PMI eased back from 55.7 in January to 54.6 in February, the index remained in buoyant territory as it suggested growth for the seventh consecutive month. Indeed, the survey’s latest headline figure was well above the expansionary level of 50 and its long-term average of 51.6. New business orders continue to grow, fuelled by both domestic and international demand, with sterling’s depreciation continuing to support the latter. Nevertheless, the pound’s weakness is continuing to exert upward pressure on input costs, albeit inflation did ease back slightly in February. The trade-off between the sterling devaluation-induced export growth and rising input costs should determine whether the EU referendum result has been a boon or hindrance to UK manufacturers in the year ahead, although at current levels it has undeniably aided the sector.

Colliers still expects industrial properties to outperform all other sectors over the five-year horizon. All-industrial MSCI rental growth is forecast to reach 2.5% this year, 1.6% in 2018 and should average 2.5% annually in 2017-2021. London is anticipated to, yet again, lead the way, with average rents rising by 4.0% in 2017, followed by Rest of South East (3.5%) and Rest of UK (1.5%). Meanwhile, distribution warehouses are expected to record another positive year, with growth of 2.0% this year, before cooling slightly to 1.3% in 2018.
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