UK | Research & Forecast Report

REIF IN BRIEF
Q2 2018

Economic Outlook

UK economic growth almost stalled in Q1 2018 as GDP rose by just 0.1% q/q, down from 0.4% in Q4 2017 and highlighting a loss of momentum at the start of the year. Bad weather, undoubtedly, had a negative impact on economic activity, especially in the construction sector where output declined by 2.7% q/q. Encouragingly, household spending continued to rise despite a drop in retail sales, meaning that non-retail spending on services increased. Data available for Q2 2018, so far, points to an improvement in the UK economy. Retail sales rebounded in April and positive real wage growth returned, suggesting that consumer spending may begin to support the economy to a greater degree. Business survey data added further evidence that the economy rebounded in Q2, with the UK composite PMI consistent with GDP quarterly growth of around 0.3 to 0.4%, according to IHS Markit.

CPI inflation slowed further to 2.4% y/y in April, from 3.0% at the beginning of the year and in line with the Bank of England's (BoE) Monetary Policy Committee's expectations. Inflation is now at its lowest level in over a year. RPI rose 3.4% in April, little-changed from 3.3% in March, but also down considerably from the start of the year. Economic commentators and forecasters are divided as to whether the BoE will continue to normalize monetary policy this year. Disappointing economic growth in the first quarter and slowing inflation are arguments against a rate hike. However, a weakening pound and rising oil prices could, in fact, result in a slight uptick in inflation in the second half of the year and GDP growth is likely to accelerate in Q2 after a weather-related near standstill in Q1, thereby supporting a rate hike.

All Property Forecasts

All-property total returns for 2018 are expected to slow to 5.7%, markedly weaker than the 10.2% achieved in 2017 and well below the post financial crisis average of 9.4% per annum. Total returns are forecast to consist of 0.8% capital growth and 4.8% income return (0.1% residual). Performance is expected to slow further in 2019 to 3.8%, comprised of -1.0% capital growth and 4.9% income return (0.1% residual).

Equivalent yields have proved fairly stable this year, so far, and should end 2018 down by a modest 3bps before softening in the years thereafter. All-industrial yields are predicted to harden by 32bps this year. In contrast, offices will fall by 3bps and retail yields will soften by 14bps this year.

Rental growth will slow to 0.5% y/y by the end of the year, down from 2.3% y/y last year - the weakest performance since 2012. In contrast to a 3.8% predicted increase in all-industrial rents, declines are expected in the office and retail markets. All-property rental growth is set to turn negative in 2019.

Direct investment trading volumes in 2018, so far, are down around 14% compared to the same period last year after disappointing April figures. However, provisional figures from Property Data suggest that transaction volumes may have surpassed the £4bn mark in May. Far Eastern appetite for UK commercial property slowed this year, accounting for just 8% of all property transactions, down from 20% in 2017. However, recent reports suggest that an easing on capital controls for Chinese overseas investment could spur fresh investment into UK commercial property in the coming months and pricing is therefore likely to remain under pressure. Limited supply of investible assets will maintain upward pressure on pricing and hold all property yields steady across most asset classes.

All Property Forecast Summary

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% p.a.)	2.3	0.5	-0.3	0.8
Equivalent Yield (% eop)	5.7	5.6	5.7	5.8 (2022)
Capital Growth (% p.a.)	5.2	0.8	-1.0	0.1
Total Return (% p.a.)	10.2	5.7	3.8	5.1

Retail Forecast Summary

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% p.a.)	1.4	-0.9	-1.6	-0.7
Equivalent Yield (% eop)	5.5	5.7	5.8	6.0 (2022)
Capital Growth (% p.a.)	1.7	-3.5	-2.7	-1.8
Total Return (% p.a.)	6.9	1.6	2.7	3.7

Office Forecast Summary

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% p.a.)	1.5	-0.1	-0.4	0.8
Equivalent Yield (% eop)	5.8	5.8	5.9	5.9 (2022)
Capital Growth (% p.a.)	3.6	0.1	-1.0	0.6
Total Return (% p.a.)	7.9	4.3	3.2	4.9

Industrial & Logistics Forecast Summary

	DEC-17	DEC-18	DEC-19	2018 - 2022
ERV Growth (% p.a.)	5.3	3.8	2.1	3.0
Equivalent Yield (% eop)	5.7	5.3	5.3	5.6 (2022)
Capital Growth (% p.a.)	13.9	9.6	1.8	2.8
Total Return (% p.a.)	19.6	14.7	6.4	7.5

Source: Colliers International, MSCI/IPD

Retail

April's retail sales figures brought relief, with sales volumes rising 1.6% m/m, according to the ONS, thereby more than reversing the weather-related downturn (1.1% m/m in March). The upturn was broad-based, with both food and non-food stores reporting higher sales. The latest Gfk Consumer Confidence Index pointed to a slight improvement in sentiment and rising real wages should offer further much needed support for the sector in the coming months. Rental growth slowed in April to a 0.3% y/y rate, according to the MSCI Monthly all-retail rental index.

Rents for standard shops in Central London (+3.3% y/y) continued to outperform all other regions in April, but the rate of rental growth has slowed significantly from double-digit rates only two-and-a-half years ago. There is no doubt that ongoing Brexit uncertainty, higher business rates, rising e-commerce and the National Living Wage provide further challenges to high street shops, but the arrival of the Elizabeth Line, robust tourism numbers and a relatively weak pound should counter some of those negative impacts. London standard shops are forecast to record rental growth of 2.0% y/y in 2018 before slowing further in 2019.

Outside of London, trading conditions will remain challenging. Shop rental growth (excluding Central London) is forecast to fall by 1.8% y/y in 2018 with Rest of London and the South East declinging by 0.4% y/y. Rest of UK shops will fall by 3.0% y/y over the next three years. Other sub-sectors are anticipated to follow a similar trend. Retail warehouses and supermarkets are predicted to record rental growth of -1.0% y/y, while shopping centre rents are expected to fall at an even sharper rate (-2.0% y/y) in 2018.

While retail casualties since the start of the year will contribute to increased caution, in general, investors seeking long let, secure income will continue to support demand for supermarkets and retail warehouses. Interpreting shopping centre investor sentiment remains difficult given the lack of transactions and pricing evidence, although prime regional centres will remain liquid and pricing firm. In 2018, all-retail total returns are set to slow to 1.6% y/y compared to 6.9% y/y in 2017. This reflects negative capital growth of -3.5% y/y offset by a positive 5.2% income return (0.1% residual). Returns should average 3.7% over the 2018-2022 forecast horizon.

Offices

Despite the unexpected outcome of the Brexit referendum almost two years ago, demand for space in the City remains high, while supply remains constrained. This is demonstrated by the vacancy rate ticking down for the first time in two years, despite below average take-up in Q1 2018. Supply shortages are set to continue, with City and West End speculative completions more than 50% below their respective ten-year averages. Outside of London, prime rents in the major CBDs have all topped £30 psf with Manchester rents reported to be on their way to £40 psf marker by 2020. The ex-London markets are also supported by limited availability of space, especially Grade A space.

All-office MSCI rental growth is forecast to turn negative this year (-0.1%) and to remain negative in 2019 (-0.4%). Sustained rental growth in Rest of London (0.5%), Rest of UK (1.2%) and South East (1.5%) contrasts with declines across the Central London market (-1.1%). All-office rental growth is predicted to average a modest 0.8% per annum over the 2018-2022 period.

Although overseas capital still dominates the London office market, accounting for roughly half of all transaction volumes this year, so far, this is down from 78% in 2017. As mentioned above, an easing on Chinese capital controls may result in a pick-up in overseas investment into UK commercial property and, particularly, the London office market.

All-office total returns are expected to slow to 4.3% in 2018, comprised of 0.1% capital growth and 4.1% income return (0.1% residual), down from 7.9% in 2017. Rest of UK offices are set to outperform with total returns of 7.8%, followed by South East at 6.6%. The West End, Midtown and the City of London will see a weaker performance with total returns of 1.6%, 2.2% and 2.7%, respectively.

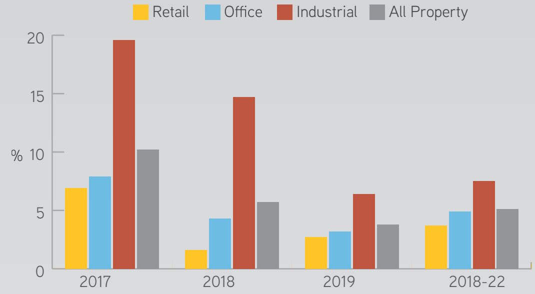
Logistics & Industrial

Latest take-up figures suggest that occupier demand for UK industrial and logistics assets remains strong amid supply constraints. A recent example highlighting strong demand is Amazon's search for multi-level fulfillment centre sites in the West Midlands and North East, amounting to 2.2m sq ft alone.

Rental growth across the industrial sector remained robust in Q1 18, according to the MSCI Quarterly index. Standard industrial rents rose by 8.4% y/y in London, 6.9% y/y in the South East and 2.9% y/y in Rest of UK. Distribution warehouses also recorded an uplift on rents, rising at a 3.7% y/y rate. The latest PMI data suggests that, although production growth accelerated in May, the second half of the year may prove tricky for manufacturers. In particular, the increase in output was accompanied by the steepest build-up of finished goods inventories in 26 years, while the amount of backlogged work declined. Moreover, manufacturers are facing renewed headwinds from a rising oil price and a weakening pound which, if sustained, will ultimately result in higher input costs. Firms may then find themselves in the difficult position of either accepting lower profits in order to secure business or raise their output prices in order to protect margins.

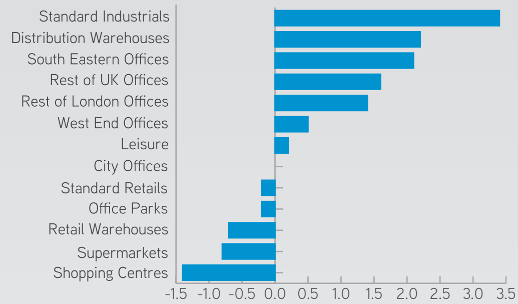
Despite these concerns, the industrial sector is expected to remain the star performer across the commercial property universe in 2018. The all-industrial MSCI rental index is expected to increase by 3.8% this year, before slowing to 2.1% in 2019. Rental growth should average 3.0% over the 2018-2022 period. Total returns will easily outperform all other sectors, reaching 14.7% this year, consisting of 9.6% capital growth and 4.7% income return (0.4% residual). Returns will slow considerably in 2019 to 6.4%, comprised of 1.8% capital growth and 4.6% income return, but will nonetheless remain higher than the rest of the commercial property sector.

Figure 1: Total Return by Sector



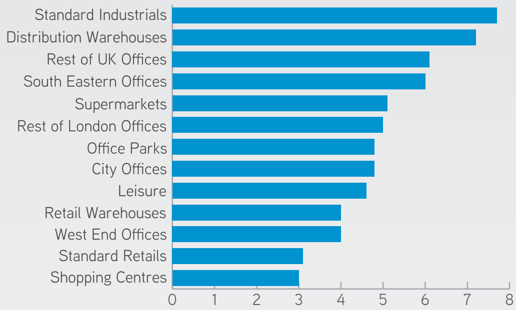
Source: Colliers International, MSCI/IPD

Figure 2: ERV Growth 2018-2022 (% p.a.)



Source: Colliers International

Figure 3: Total Return 2018-2022 (% p.a.)



Source: Colliers International

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