

A large, modern skyscraper with a glass and steel facade, viewed from a low angle against a clear blue sky. The building's design features a grid of windows and a prominent corner section. A yellow diagonal band runs across the middle of the image, partially obscuring the building. The bottom portion of the image is covered by a solid yellow rectangular area containing the text.

January 2018

# UK Real Estate Market Outlook

For Investment Professionals only

## Executive summary

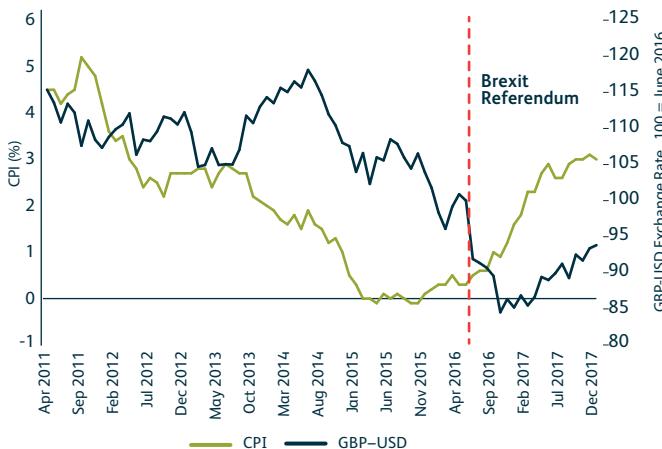
- Positive UK economic tailwinds drive confidence in the market
- Progress made on first phase of Brexit negotiations, opening up future UK-EU trade talks
- Central London opportunity in 18-24 months as gradual recovery takes place
- PRS in the most attractive regional markets to outperform Central London
- Big ticket deals a key driver of investment, but UK real estate offers a wealth of advantages



## Tailwinds drive the UK economy

**The UK economy continued to defy gloomy market expectations during the third quarter of 2017, with GDP expanding by 0.4%. The latest set of positive data saw the Bank of England lift interest rates to 0.5% in November, a sign of their overall confidence in the market. We expect further moderate rises to continue in the medium term, as a gradual recovery of the economy takes hold from 2019 onwards.**

### UK CPI and currency exchange rate



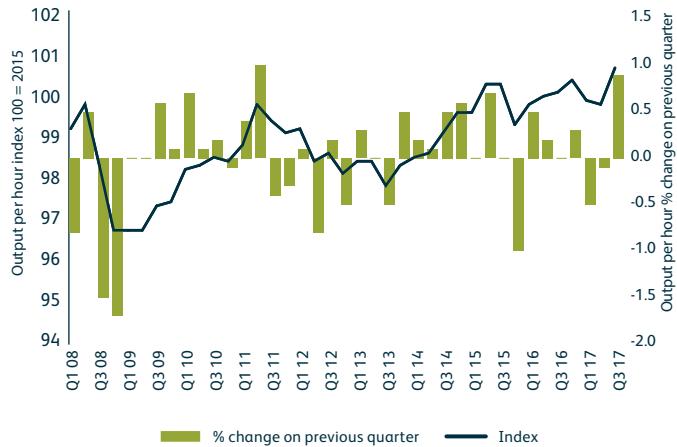
Source: Bloomberg, ONS.

The effects of Sterling weakness have been filtering through to the wider economy. Inflation reached 3.1% in November, with wage growth lagging at 2.2%. Clearly if disposable incomes are increasingly squeezed, this could slow down a consumer-driven economy in the short term. That said, inflation is now likely to have peaked, as the Pound continues to recover. Whilst still down 7% versus the US Dollar in December compared to pre-referendum levels, this compares to -19% at the start of 2017.

Several positive economic tailwinds are helping to drive confidence in the market. In the short term, leading indicators point to sustained GDP growth. The Services PMI indicator was 54.2 in December, having been above the 50 growth benchmark for 17 consecutive months. Businesses have continued to invest and hire since the Brexit referendum and overall remain optimistic regarding the year ahead. At the same time, the Manufacturing PMI reached 56.3 as output, new orders and employment all rose at faster rates, reflecting both domestic and export demand.

Over the longer term, an uptick in UK productivity could well start to materialise given current labour market strengths. In fact productivity picked up over Q3 2017, growing at its highest rate since Q2 2011. With unemployment (4.3%) at a four-decade low, a ready supply of available labour is increasingly restricted. Furthermore, labour costs are rising, driven by the introduction of policies such as pensions auto-enrolment and the National Living Wage, which will increase to £7.83 per hour in April 2018. This is likely to incentivise businesses to make productivity-enhancing investments to offset these costs. Further rate increases will force through efficiencies in the least productive businesses, while foreign investment, which has continued since the referendum, has also been shown to boost productivity.

### UK Productivity: output per hour



Source: ONS.

### Brexit negotiations make progress

**Against this backdrop, the UK government has made progress on Brexit negotiations, with talks on the future EU-UK trade relationship now set to begin in March 2018. Negotiations have also begun over the conditions of the two-year transitional period, which ultimately allows the UK to exit the EU on March 2019, but with existing trade and customs agreements still in place.**

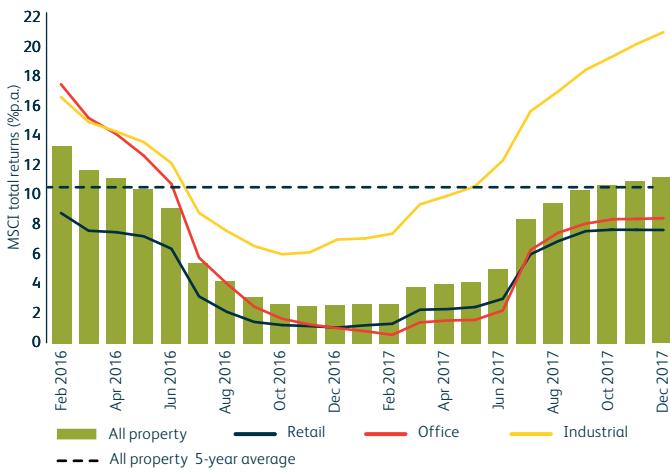
This outcome would provide both economies the much-needed time to renegotiate the 53 trade agreements and avoid a cliff edge scenario whereby WTO tariffs of 10% are applied to UK exports.

Arguably, the next 12 months are likely to bring increasing clarity as the next Brexit phases are negotiated and agreed upon. As such, whilst there is clearly some downside risk to the economy, investors should equally not underestimate the upside potential as well.

## Property market performance exceeds expectations

**Whilst the last 12 months have been characterised by lingering political and economic uncertainties, the UK real estate market has ploughed on, with the MSCI All Property index returning 10% over 2017.**

### MSCI rolling 12 month returns



Source: MSCI, data to 31 December 2017.

Average rents for each of the main sectors have continued to grow, supported by positive supply and demand dynamics in many parts of the occupier market. Demand for space has generally held up and remains above its five and ten-year averages. At the same time, construction levels, which were yet to fully recover following the Global Financial Crisis, have fallen even further due to macro uncertainties. Vacancy rates across the UK industrial and office sectors therefore remain at record lows, with prime vacancy in many markets now less than 2% of stock.

## Central London represents long-term opportunity

**In Central London, the risk from potential financial sector relocations related to passporting rights post-Brexit is starting to impact the market. With additional concerns of rising levels of speculative supply, landlords have been offering higher incentives, with net effective rents falling c.10% in the City and c.20% in the West End.<sup>1</sup> Given Brexit-related uncertainty in the services sector, which forms a major component of output growth in the capital, we expect the London economy to expand at a below trend rate of growth in the short term.**

<sup>1</sup> Source: CBRE.

<sup>2</sup> Source: Deloitte Crane Survey Winter 2017.

<sup>3</sup> Source: CBRE, December 2017.

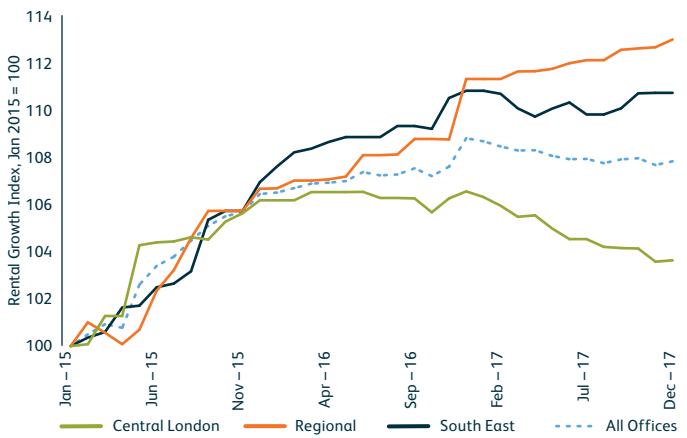
<sup>4</sup> Source: M&G Real Estate PRISM, BoE, ONS.

A gradual recovery is expected in 18 to 24 months, however, presenting opportunities for experienced investors. Office construction across Central London already appears to have peaked, having fallen 9% over the last six months to 12.6 million sq ft.<sup>2</sup> As available space is steadily absorbed and the balance swings back in favour of landlords, this should drive a return to rental growth. Fringe submarkets, such as South Bank, Old Street and Farringdon, already benefitting from undersupply and lower vacancy rates, have seen headline rents hold up. Take-up across London is also increasingly supported by a burgeoning technology sector. Global technology firms, including Apple, Facebook and Google, have all recently committed to new office space, with London's economy continuing to diversify away from finance. The TMT sector now employs 10% more people than finance and insurance, according to the ONS.

## Regional office markets position themselves as desirable alternatives to London

**Outside of London, regional office markets have held up well, demonstrating their resilience amidst Brexit uncertainty. Office demand in the Big 6 is above historic averages, supported by HMRC and Government Property Unit public sector consolidations, while business services firms continue to be active. The lack of good quality supply has seen regional offices outperform both the South East and Central London markets, with prime rents growing 4.5% since the June 2016 referendum.<sup>3</sup>**

### Prime Office rental growth (Y-O-Y)



Source: CBRE, data to 31 December 2017.

Alongside better value found in the regions, macroeconomic drivers are proving attractive for investors. Urbanisation and strong demographics are driving healthier office demand, while affordability and cost of living factors also help to attract and retain staff. House Price to Earnings ratios are now 5.7 in the Big 6 cities versus 13.9 in Greater London.<sup>4</sup> Coupled with regeneration schemes and transport infrastructure development, regional cities continue to position themselves as desirable alternatives to the capital to live and work.

## Automation in the industrial sector to drive innovative design solutions

**The industrial sector continues to strengthen, driven by unprecedented competition for stock, either for industrial or alternative use. Healthy rental growth of 5% y-o-y to December 2017 has been supported by the need for inner city space, close to major arterial routes and large populations. Importantly, the need to service accelerating online and last mile needs from consumers and businesses alike has seen a structural, rather than cyclical, shift in demand.**

Whilst we expect some moderation in rental growth in the medium term, there is still a chronic shortage of well-located supply in the multi-let estate sector. As such, investors should feel confident in taking on development or refurbishment risk to alleviate this issue, particularly in the South East as well as core regional cities such as Manchester, Birmingham and Bristol.

As occupiers continue to streamline and modernise their space requirements, technology and design innovation in the sector is likely to accelerate. Given the increasing levels of automation and data

### Industrial IPD performance (%)



Source: MSCI, data to December 2017.

used in distribution warehouses, one key issue will be access to a sufficient power supply. Design solutions that utilise solar or kinetic energy or those which can optimise or reduce the use of energy from existing sources, will be key to attracting and retaining tenants by cutting operating costs.

## Retail sectors with online immunity to offer best investment opportunities

**The performance of the retail sector continues to be increasingly polarised between secondary and prime pitch locations.**

The latest consumer spending and retail sales figures indicate more challenges for retailers, as higher inflation starts to bite and consumers become increasingly selective with their shopping habits. This has seen even the most profitable of retailers reassess their store footprints. Optimisation and right-sizing continue to bolster first tier locations, but at the expense of secondary and tertiary retail markets. Additional interest rate rises could well tighten disposable incomes further, with poorer retail assets expected to be impacted the most.

### Future-proofing retail



Source: M&G Real Estate.

The need to complement in-store with online will continue to drive demand for prime pitch locations, where optimal footfall and high employment enable sustainably higher rents. Destination locations in major cities and diverse retail offerings, which combine leisure, food and beverage, should offer the most attractive investment prospects.

Whilst higher occupational and business rate costs have hindered Central London retailers, this has largely been offset through higher tourism spend. Visitor spending is expected to see a 14% y-o-y increase in 2017, amounting to £26 billion. As such, we expect Central London rents to continue outperforming other retail sectors, albeit growth will moderate from historic levels.

We believe those retail sectors which benefit from either immunity or a symbiotic relationship with online sales can provide defensive investment opportunities. Retail warehouses have become a good income play, with favourable pricing and the potential for healthy rental growth. Their flexibility to be positioned as both experiential shopping destinations and click-and-collect outlets should attract occupiers and visitors alike.

The supermarket sector is also entering a clearer, more stable period of growth. Online retailers have struggled to make substantial inroads within the food sector (only 7.2% of food and grocery sales are online – Global Data 2017), and instead consumers prefer convenience food shopping, favouring small to medium supermarkets close to transport nodes. Whilst open market rents are not expected to grow significantly in the near term, inflation-linked leases should see a pick-up as a result of higher inflation.

## PRS in the most attractive regional markets to outperform Central London

**The RICS UK Residential Market Survey suggests that tenant demand for private residential homes in Central London is starting to slow. A surge in new supply and affordability constraints have continued to weigh on rents in the capital, which are experiencing an ongoing deceleration. With limited change to market fundamentals in the short term, we expect Central London PRS rents to see some decline over the next 12 months.**

Polarisation between Central London and outer London and the wider South East is likely to continue throughout 2018. We expect rents in the latter two markets to see some acceleration over the next three years, outperforming inflation, as tenant demand remains buoyant against a backdrop of supply constraints.

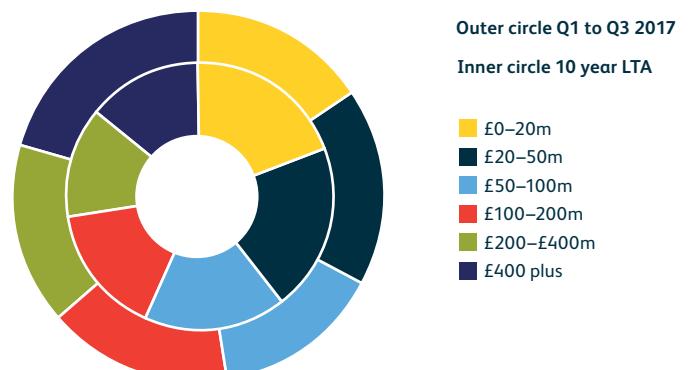
Core regional cities are likely to strengthen further, as demand picks up for affordable city centre space. Thus, with limited future development pipelines, rents in the most attractive regional markets should outperform both London and the South East over the next 12 months.

In the Autumn Budget, housing supply continued to be a high priority for the government. Several measures were announced aimed at boosting supply to the ambitious target of 300,000 homes per annum. Alongside extra funds for small and medium housebuilders, the government sought to proactively support Build-To-Rent, pledging £8 billion of new financial guarantees to drive private housebuilding in the sector. Whilst this could lead to a pick-up in development, we expect the focus to remain on London and the South East.

## Big ticket deals – a key driver of investment, but UK real estate offers a wealth of advantages

**Despite economic data holding up better than expected over the last year, investors in UK real estate have tended to be much more cautious, focusing largely on downside risks. Whilst falling 35% from peak (Q2 2015) to trough (Q1 2017), the last two quarters have seen a 10% rise with y-o-y volumes reaching £55.6 billion in Q3 2017.**

### Investment volumes by lot size

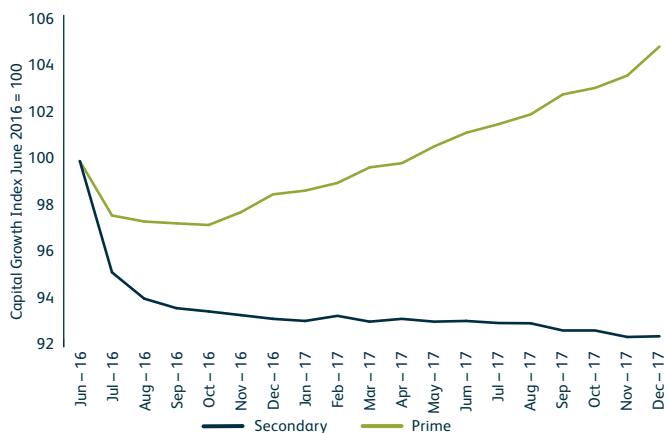


Source: LSH, Q3 2017.

Higher levels of market liquidity have partly been driven by overseas investors, who accounted for some £28 billion of investment into the UK over the last four quarters to Q3 2017. Big ticket deals, particularly in Central London, have increased, with over £200 million transacted, accounting for 37% of 2017 volumes and up 10% on the 10-year average. The limited availability of “trophy” office buildings, stricter controls on capital outflows from China and lower global liquidity could see a slowdown in such transactions. Whilst this could hamper future volumes, greater clarity over the UK's position outside of the EU may well support increased liquidity across all lot sizes.

In addition, although the impact of Sterling weakness has certainly been accretive to international capital inflows, the UK still offers a wealth of advantages which lend support to continued investment. It ranks first globally for transparency,<sup>5</sup> while the size of its real estate market - the third largest in the G7 – alongside the high quality of stock make it attractive to a broad range of investors. The combination of longer leases and upward only rent reviews are also attractive market features.

### Capital value change %



Source: CBRE, data to 31 December 2017.

### Pricing divergence creating opportunities for value-add strategies

**Whilst risk aversion has led to strong competition for prime assets with secure income streams, ultimately pushing the pricing back up to pre-referendum levels, demand for secondary assets with risk attached have fallen out of favour. Weaker sentiment towards these assets is clearly reflected in current pricing, with secondary real estate in the UK at a 8% discount to pre-referendum values.<sup>6</sup>**

Caution in the UK's capital markets is likely to drive further divergence between prime and secondary pricing over the next 12 months. As such, we believe experienced investors with value-add strategies willing to take on more risk could be well-placed to take advantage of pricing discounts.

Despite concerns over the impact of rising interest rates on property yields, a healthy risk premium of 470bps<sup>7</sup> is still being priced in. Further monetary tightening from the Bank of England is likely to be gradual and predictable. Whilst we expect the spread between property and government bond yields to narrow, bond yields will need to rise significantly before UK real estate becomes unattractive.

### UK to remain attractive for long-term investors

**We believe the UK's long-term prospects are still highly attractive, although undoubtedly the next two years of Brexit negotiations will test the UK economy and its real estate markets. Despite the uncertainty, consensus estimates for long-term economic growth suggest the UK will see 2% p.a. GDP, the second highest G7 country behind the US.**

Whilst some moderation is expected in the short term, strong supply and demand fundamentals are likely to support continued rental growth in key markets. As we go through 2018, we believe further clarity on Brexit negotiations will provide plenty of reasons for optimism on UK real estate.

#### Weather existing uncertainties

- Focus on geographies or sectors not directly influenced by Brexit in short term
- Target good quality, long lease or defensive assets with secure income streams
- Maintain a balanced, diversified portfolio

#### Take on measured risk

- Selectively seek out pricing discounts on riskier assets in core markets
- Actively asset manage property to future proof and drive higher returns
- Access supply restricted markets where demand imbalance is greatest

#### Think long-term

- Consider current macro and micro real estate strengths and risks
- Embrace technological innovations which will drive outperformance
- Take advantage of Central London recovery in 18 to 24 months

<sup>5</sup>Source: JLL Global Transparency Index 2016.

<sup>6</sup>Source: CBRE, December 2017.

<sup>7</sup>IPD All property equivalent yield over 10-year gilt yields.

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