UK commercial real estate market

UBS Global Asset Management, Global Real Estate Research & Strategy

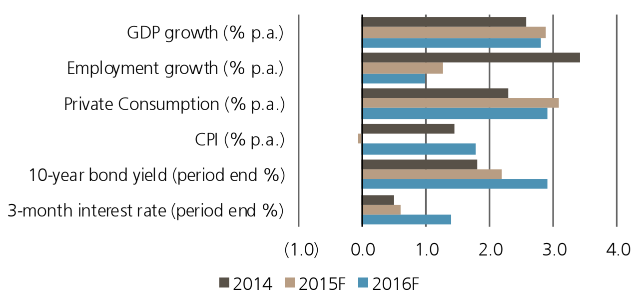
Outlook 1H15

Will 2015 be a year of *two halves?*

The economy

Economic data from the end of 2014 continued the pattern of softer growth recorded since the summer, with 4Q14 GDP growth of 0.5% the slowest for a year. Nonetheless, this left growth for 2014 as a whole at a robust 2.6% and the fastest of the G7 nations, and given some reasonably strong high frequency data in 4Q, it is likely the final figures may be revised up in the future.

UK key economic indicators



Source: Oxford Economics Forecasts, Forecast Database; 12 February 2015
Note: Past performance is not necessarily an indicator for future results

Despite the slight slowdown, the outlook moving into 2015 is generally positive, as falling energy prices, wage growth momentum and cheap credit fuel further growth in consumer spending. As a result, the growth outlook for 2015 has actually been upgraded slightly since summer 2014, from 2.8% to 2.9%. The strengthening of the pound against the euro following January's QE announcement could impact UK exports in the short term; however, if the move achieves its goal of stimulating growth and staving off deflationary risks UK exports will be comfortably compensated for any short-term FX driven decline over the longer term. During most of 2014 commentators expected pressure for a rise in interest rates to develop from early 2015; however, with CPI expected to be marginally negative for 2015, the whole of the MPC voted for the first time in five months to leave the interest rate unchanged in January. With a rate rise now unlikely to happen in 2015, the flow of capital into higher yielding UK real estate looks set to continue, which could be further fuelled by the availability of cheap finance for the sector.

While the outlook for CRE investment in the UK looks bright for 2015, there is an inevitable degree of uncertainty surrounding the upcoming general election. Although UK elections have historically been fairly clear-cut, this looks unlikely to be the case this year. Polls are generally showing support for Conservative and Labour to be neck and neck, with both parties over 30 seats short of forming a majority government. A coalition therefore seems likely, which adds a further element of uncertainty to the future of policy.

But perhaps the biggest cause for uncertainty which is explicitly linked to the result of the election is a decision on whether the UK will hold a referendum on EU membership. David Cameron has pledged that, should the Conservatives return to government, he will call an in-out referendum on membership in 2017, which could lead to two years of business uncertainty in the lead up. If it appears that the UK, and in particular London, is at risk of losing its position within Europe, there could be serious ramifications for both the occupier and investment markets in the coming years.

Office sector outlook

The strong rebound in economic growth coupled with the widespread return of business confidence translated into a strong year of take-up in regional office markets across the country. All of the major regional office markets recorded annual take-up well ahead of five-year average levels, and an improvement was seen in take-up across all size bands during the year. Professional services firms were particularly active during the year, a marked change from recent history. For most regional cities, the proportion of take-up attributable to professional services occupiers was back up to the levels recorded before the financial crisis. In Bristol, for example, there were two significant pre-lets to professional services firms KPMG and PwC during the second half of the year, while there were numerous significant deals with law firms, including those with Slater Gordon and DLA Piper for 100,000 sq ft and 44,800 sq ft at the speculative One St. Peter's Square in Manchester, respectively.

Due to the strength of occupational activity and the depleted supply of Grade A property due to the lack of development activity in recent years, speculative development activity resumed in the main regional office markets during 2014. Of course, a number of pioneer speculative office schemes had already started during 1H14 in Manchester, Glasgow and Bristol but in the main there was little activity outside London and the south east until 2H14. Further development starts followed in the second half of the year with the largest, most notable scheme being phase one of Paradise, a major city centre redevelopment in central Birmingham. Therefore, for the first time since the downturn there is now speculative development underway in all major regional office markets.

In contrast to the relative strength of the main regional office markets, the South East Office market disappointed in 2014 in terms of market activity and take-up, with a much softer end to the year compared with the same period last year and with regional office markets. There was a marked slowdown in activity during the year and a reduction in the number of larger size deals. This meant that the overall total of deals done was substantially lower in 2014 and 12% below the five-year average. A reduction in deals done was partly a reflection of the lack of large floorspace available and pre-letting activity. However, despite the slight weakening in market conditions available supply for the region was just 12.1 million sq ft, the lowest level recorded since 2011. The reduction in stock can be attributed to take-up, a lack of development activity and the conversion of existing offices to other uses including residential.

Leasing contracts in the south east were generally taking longer to negotiate in 2H14, which was partly due to the mismatch between occupier and landlord expectations. During the year capital values appreciated substantially; however, the occupational market did not move at the same speed with some landlords' expectations becoming higher than those of occupiers. After all, in most markets take-up was down and a reasonable amount of supply with the exception of several stronger markets in the Thames Valley office region (Reading and Maidenhead).

Central London offices had a strong end to an exceptional year. During the course of 2014, the annual take-up rate in Central London Offices comfortably exceeded the 10-year average, posting the highest level since 2006 with 15 million sq ft. All sub-markets experienced a good year relative to long-term trends, although the strongest market was Southbank where take-up was 54% above the long-term average. Due to the solid economic upturn seen in 2014 demand was broader based in central London office markets with weaker segments starting to contribute to a larger contribution of overall take-up. There was a notable upturn in demand from financial organisations following a weak period since the downturn.

Consistent with improving sentiment and take-up, available supply dropped to its lowest level in central London in 4Q to 11 million sq ft. This was a substantial 29% lower than the 10-year average level of 15.4 million sq ft, indicating the strength of the market in 2014 and start of 2015. The overall vacancy rate for central London is now just 3.7%, which is the lowest rate since 2008. However, the vacancy rate is not evenly distributed across the sub-markets with the lowest rate evident in the Southbank (2.5%) and the highest in Docklands (4.7%). The rates for the West End and Midtown sit firmly in the middle of this range at 2.7% and 3.1%, respectively, with all markets at their lowest level for over 10 years.

Development activity in the City was high in 2014 with 3.4 million sq ft completing during the year but more constrained in the West End with just 0.8 million sq ft completing, 20% less than the 20-year average. In 2015, development activity is expected to be relatively subdued in the City with completions significantly less than the 1.6 million sq ft per annum (p.a.) 20-year average. Looking ahead, both the City and West End have relatively full development pipelines as developers continue to react to the ongoing strength in the UK economy and the strengthening in business conditions, particularly in the capital. Development starts are expected to increase in the West End with 6.4 million sq ft scheduled to complete during 2015-19 and 14.3 million sq ft is expected to be delivered in the City during the same five-year period. Currently, 11.2 million sq ft (78%) of the space is in the City and 5.6 million sq ft (88%) in the West End is speculative, although it is anticipated that most schemes will wait to secure a pre-let before commencing construction. 2016 is expected to be the peak development year in the West End with 2.2 million sq ft expected to complete, with the majority being speculative space in Victoria. Similarly, development activity is expected spike in 2016 and 2017 in the City with 4 million sq ft p.a. expected to complete.

The London office investment market had another strong year in 2014 following an exceptional year in 2013. The final quarter of 2014 was very strong with GBP 6.7 billion transacted for a total of GBP 18.4 billion for the year as a whole. Demand was supported by strong overseas demand from international investors and a robust leasing market. Overseas investors accounted for 69% of investment sales, with Asian and US and Canadian investors the most prominent accounting for 22% and 19% of investment volumes, respectively. Domestic investors represented 28% of investment volumes.

In terms of the geographic distribution of investment sales, the City and West End sub-markets accounted for two thirds of total volumes with a relatively even split of activity. However, Docklands and Midtown had a good year and contributed to the overall total with GBP 2.7 billion and GBP 2.4 billion, respectively. Midtown had its strongest year on record in 2014, reflecting the ongoing strengthening and improving perception of this sometimes overlooked office sub-market.

Investment demand for Central London Offices remains robust from a range of investors, both overseas and domestic although their area of focus is quite different. International investors, in particular those from Asia and the Middle East, tend to focus on core locations and better quality property whereas domestic investors have been more focused on higher yielding assets with asset management potential.

Investment activity in the main regional office markets strengthened further during 2H14 including Scotland where there was a pause in activity during 1H14 due to the uncertainty surrounding the outcome of Scottish referendum vote. Increased activity reflects increased investor interest in markets outside London and to a lesser extent the South East Office market. The resurgence in investment activity in Scotland in the second half of the year post-Scottish referendum vote helped to support annual investment volumes in both Edinburgh and Glasgow with GBP 275 million and GBP 164 million transacted. Unfortunately the same was not the case for Aberdeen as the city was impacted by the rapid reduction in oil prices; this in turn affected investor sentiment, especially in relation to more secondary product. However, investment activity was particularly strong in Manchester during the year with an annual investment total of GBP 900 million, although investment was similarly robust in Birmingham at GBP 630 million.

Despite the more subdued leasing environment total investment turnover for the south east was GBP 2.57 billion in 2014, which was slightly higher than the investment volume recorded in 2013 of GBP 2.48 billion. Demand was high for investment product although there was a limited amount of stock available in which to invest, which curtailed activity a little. There was also a notable absence of portfolio transactions offered to the market. However, the strong demand for the properties, especially higher risk assets requiring greater levels of asset management, led to a further reduction in the yield gap between prime and good secondary assets in the region.

During 1H15, we expect that investors will continue to move up the risk curve as occupational markets strengthen further and competition for assets remains strong. Investors are likely to become even more focused on asset management/value add opportunities in the main regional city centre markets of Manchester, Birmingham, Bristol, Edinburgh and Glasgow.

Prime yields in Central London remained stable in the West End during 2H14 at 3.75% and moved in 25 basis points (bps) in the City to 4.25%. Prime regional office market yields remained stable at 5.5% and moved in 25 bps in the South East to 5.5%. Further yield compression is possible in these markets during the course of 2015 due to the weight of capital in the UK market.

Prime rents increased in all Central London sub-markets during 2H14. Rents in the South Bank saw the greatest rental growth during 2014, with growth of 15.7% to GBP 55 per sq ft. Similarly, growth in prime rents was recorded in Edinburgh, Glasgow, Manchester, Leeds, Birmingham and Bristol city centres during 2014.

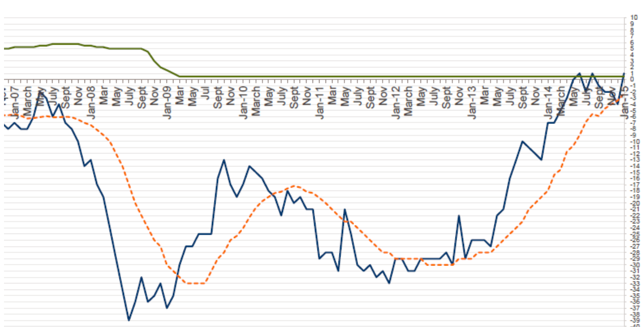
Severe quality supply shortages are likely to create further uplifts in prime rents during 2015 in the main regional city centre markets. Despite high investor demand, we continue to believe that there is limited scope for inward yield shift in the Central London prime office sector in 2015. We expect rents to grow further this year as demand strengthens and new stock is delivered to the market.

Retail sector outlook

Retail sales continued to perform well in the second half of 2014 and consumer confidence mirrored this. Retail sales volumes grew 2.3% in the three months to January 2015 compared with the previous three months, indicating strong growth. This represented the 23rd consecutive month of growth, the longest period since November 2007. Non-food sales were strongest with 2.4% growth compared with food store sales growth of just 1.3%, highlighting the weakness and price competitive nature of the supermarket sector at present.

Consumer confidence was strong, GfK's UK Consumer Confidence Index increased by five points in January to 1. All five measures used to calculate the index saw increases in January while the Major Purchase Index increased by a significant six points to a score of 5, 15 points higher than this time last year.

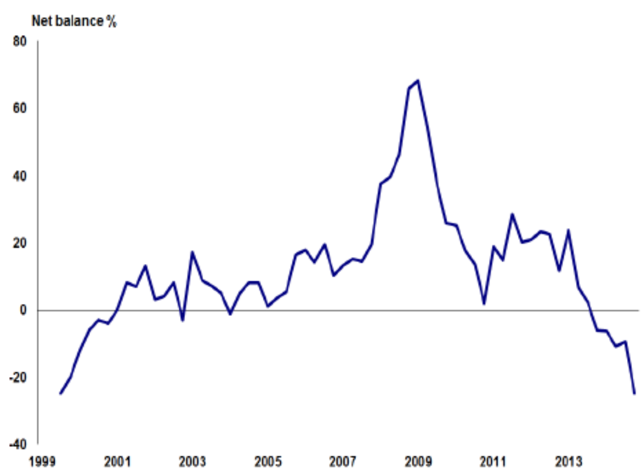
Consumer confidence barometer – January 2015



Source: © GfK 2014 I Consumer Confidence Barometer I January 2015

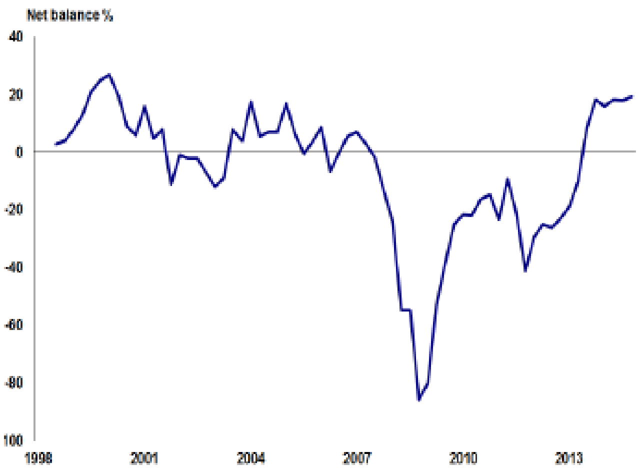
UK retailing is enjoying a period of relative buoyancy which has been absent from the market since the onset of the financial crisis and subsequent recession in 2008. In recent months there has been a notable improvement in household finances in an environment with low inflation, rising wages and fairly strong employment growth. As such, these factors have helped support consumer confidence and real income growth which should translate into further strength in retail spending in 2015. The 4Q14 RICS Commercial Market Survey corroborates the strengthening retail outlook illustrated. The occupier and investment market is showing continual improvement from the upward trend that became apparent in the first half of last year. From an occupier perspective, tenant demand was maintained in 4Q14 and availability continued to decrease, albeit for better quality stock in more dominant retail centres. The RICS UK Commercial Market Survey continued to show a positive net balance in surveyor perceptions of retail demand for the next three months; i.e. the number of surveyors expecting improved conditions over the next quarter. Furthermore, surveyors also anticipated a reduction in available retail space (vacancy) in 4Q14. Rent expectations were also positive although it is recognised that vacancy rates are elevated in many areas of the country, including secondary towns, and it may take a while for growth to return to some markets. On a similar positive note, the survey also showed an improvement (reduction) in leasing incentives (rent inducements), signaling an overall improvement in occupational retail conditions.

Retail: available space balance



Source: RICS UK Commercial Market Survey; 4Q14

Retail: rent expectations



Source: RICS UK Commercial Market Survey; 4Q14

In terms of the retail segment, the outlook remains incredibly mixed. Retail warehouses are expected to outperform both standard retail and shopping centres in 2015; however, prime shops are likely to remain strong in major cities and in London's West End with robust demand from both domestic and international retailers. Outside of these areas, demand is considerably weaker but improving, with the larger more dominant centres seeing a greater share of retailer requirements. Shopping centres are expected to lag retail warehouses and unit shops, especially those in more secondary locations.

The prospects for the retail warehouse sector have strengthened somewhat over the past 12 months, in line with improving retail sales and confidence. Open A1 retail parks have generally been more resilient than bulky goods parks in recent years although it seems the short-to-medium term outlook is now brighter in the latter than the former. The bulky goods sector is now benefiting from the improving economic outlook and the UK-wide recovery in house prices (up 8.3% on 2013). These were greatest in London (17.8%) and the Outer South East (10.6%) regions; however, growth returned to all UK regions in 2014. This increased confidence is now translating into new retail warehouse park requirements in the bulky goods sector.

In addition, a number of key occupiers in the sector are now also benefiting from the demise of competitors in recent years. The big three furniture retailers of Harveys, IKEA and DFS are all performing well and are in expansion mode, benefiting from the closure of MFI in recent years. DFS has adapted its retail offer following the purchase by Advent International and has launched a 10,000 sq ft format store for smaller catchments and city centres. Furthermore, new entrants to the physical store market include previously internet only retailers Wren Living and Oak Furniture Land. The prospects for open A1 retail parks are slightly less rosy, partly due to the fact that there was more stability in the sector during the downturn.

In contrast to the relative strength of the retail warehouse sector, the outlook for unit shops and shopping centres remains more challenging and patchy. Secondary unit shops and shopping centres continue to struggle and it is here where vacancy rates and leasing incentives are highest and rents most challenged. Unit shops in London and the south east have generally been more insulated from the wider troubles in the high street retail sector, partly due to the stronger economic outlook and higher levels of affluence. Prime pitch regional city centre retail unit shops have also been reasonably robust due the breadth and depth of the retail and leisure on offer in these centres. Similarly, dominant regional shopping centres have and continue to perform more strongly than smaller secondary centres where vacancy rates remain elevated and rents and lease lengths are under pressure. The number of retailer administrations seems to be abating although the pressure from online remains a constant threat. The pressure from an increased desire for multi-channel retailer is translating into a real need for portfolio optimisation by retailers to increase efficiency and profit margins. Secondary retail (unit shops and shopping centres) will continue to face increasing challenges.

The retail development pipeline continues to fall in both the shopping centre and retail warehouse sectors. There are currently 42 million sq ft in the shopping centre pipeline, down from 49 million in the 1H14. Similarly, the retail warehouse pipeline with planning consent has also contracted and now stands at 11 million sq ft. The reducing development pipelines illustrate the over-supply of retail space in the UK. A considerable amount of current UK stock is not suitable for modern retail, and some secondary and tertiary retail centres will probably need to be repositioned, perhaps to more mixed use convenience-led community hubs with residential.

In terms of investment, volumes have increased substantially in the second half of 2015 although interest remains concentrated on particular market segments. Annual retail investment volumes increased in line with total UK CRE (Commercial Real Estate) in 2014, accounting for 6% of overall investment. However, within the retail segment, shopping centre volumes recovered more strongly than the sector as a whole, accounting for 9.0% of total annual investment sales in 2014 compared with a 2013 contribution of 7.7%. During the same period, unit shop investment market volumes fell from 7.7% in 2013 to 6.3% in 2014 and retail warehouse investment share remained stable at 4.5% and 4.6% in 2013 and 2014, respectively. In absolute terms, retail warehouse investment activity has improved with increasing appetite for bulky goods parks as a result of improving retailer performance and housing market activity.

Going forward into 2015 we expect a gradual improvement in the leasing environment for the retail sector in line with improving economics, although the strength of the improvement will be highly dependent upon retail and location type following the trends outlined above. Looking to 1H15, we believe more secondary bulky goods retail parks with asset management angles now look interesting as do quality secondary shopping centers as the prospects for improved retail spending, house price and economic growth in 2015 continue to boost investor confidence.

Expected five-year retail segment total returns

(% p.a.)

Source: UBS Global Asset Management, Global Real Estate Research; February 2015

Logistics sector outlook

The strong demand momentum of 1H14 was maintained in the second half of the year, translating into robust take-up. Demand for big box logistics units over 100,000 sq ft was strong in 2014 with over 20.2 million sq ft acquired, of which 12.1 million was signed in 2H14. Pre-let and early marketed properties represented almost half of all take-up during the year.

In terms of the demand profile for logistics assets, third-party logistics operators and retailers dominated take-up during the year, accounting for half of overall take-up with 27% and 25%, respectively. However, the available supply of quality, large modern warehouse units are reasonably scarce in sought after logistics hubs. Thus, the trend towards built to suit development activity is increasing as it means tenants can access the best logistics hubs and acquire space that is most appropriate for their evolving needs. Recent large examples of built-to-suit development activity in the Midlands are the 1,000,000 sq ft letting to Primark at A14 Central, Thrapston and the 780,000 sq ft pre-let to Euro Car Parts at Birch Coppice, Tamworth.

In response to improving market conditions and the corresponding increase in built-to-suit development activity, speculative development also returned to the UK logistics market in 2014, although the volumes remained modest in an historical context. Demand for modern logistics space is robust and the limited availability of product in key logistics hubs has meant well located speculative development have been quickly acquired thus far by space hungry logistics operators, retailers and automotive suppliers.

Investment momentum in the UK logistics market was particularly strong in 2014 with GBP 2.85 billion of property transacted, equating to a year-on-year increase of 64%. The sector benefitted from a range of investors seeking solid long-term income streams. Investors particularly active in the sector include UK institutional investors for single assets as well as overseas and REIT investors for larger portfolio transactions. Overseas investors have been seeking "safe haven" investments while taking advantage of favourable exchange rates. As such, these investors are usually more focused on the strength of the income stream rather than being purely total return driven. Consequently, due to the strong and diverse level of demand targeting UK logistics assets, prime distribution yields moved in by 50bps to 5.0% during 2H14. Similarly prime inner M25 and regional multi-let industrial yields also moved in by 25 and 50bps during the second half of 2015 to 5.25% and 5.5% respectively. Likewise, good secondary yields moved in 25 bps in the eight months to February to 6.5%. Looking ahead to 1H15, we expect demand to be maintained. However, given the strengthening occupier markets it is likely that we will see increased activity in the secondary segment and properties with shorter income profiles. We anticipate that the yield gap will narrow further in 1H15 as the recovery continues and competition for stock intensifies.

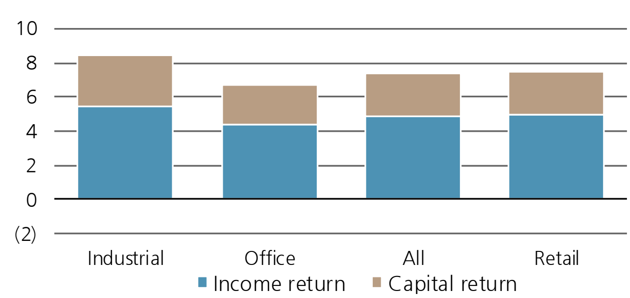
Summary

UK real estate continues to attract both domestic and international investors, with the latter benefitting from improved exchange rates. The weight of capital in the UK market is likely to be strong in 1H15 and it is likely that investors will increasingly turn to higher yielding and more asset management intensive strategies to maximise returns. However, investors remain more sensitive to asset risk and property location, particularly in the retail segment given the ongoing structural change occurring in this market. Central London Offices will remain in focus, particularly with international investors, although it is becoming more difficult to find appropriate opportunities especially as competition is strong. Similarly, well-located value-add regional opportunities will be highly sought after. Investors remain cautious on high street shops and secondary shopping centres although it is likely there will be selective opportunities.

We believe investors will look to maximize returns in 2015 and look for higher yielding assets with asset management opportunities outside the core space.

UK expected three-year returns

(% p.a.)



Source: UBS Global Asset Management, Global Real Estate Research; February 2015
Note: Returns based on an IPD portfolio

Total returns in 2015 are expected to be strong – but not as high as the exceptional levels in 2014 – as the commercial real estate market remains robust. The yield gap between prime and secondary properties will continue to narrow further due to the weight of capital in the UK market. We continue to believe investors should focus on market fundamentals and asset management. Over the next three years, we prefer the industrial sector. Central London Offices also remain attractive this year, especially those in more emerging sub-markets, as do regional offices offering attractive income returns in a strengthening occupational environment. However, market fundamentals still support strategies in the core to core-plus segment, with the exception of Central London Offices where there may be selective value-added opportunities, although is timing critical and the development pipeline is looking full.

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