UK Real Estate Outlook

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UK CRE appears on track for a positive year but retail facing challenges

UBS

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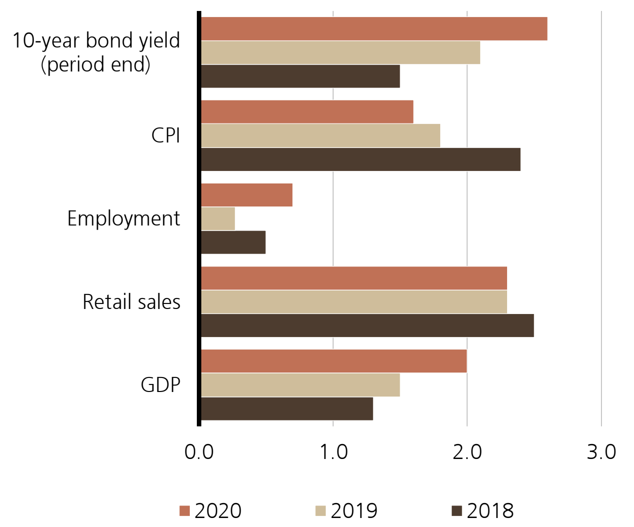
Much of the positive momentum from 2017 continued into the first half of 2018, with the annual total return at 2Q18 standing at 9.4%, only a slight slowdown from the 10.3% achieved the previous year. Storm clouds are, however, gathering over the troubled UK retail sector, and we are now seeing the first signs of a pricing and rental correction, which is forecast to accelerate into the second half of the year. The weakness within the retail sector is ultimately the driver behind the slight downgrade of our full year expectations to 6.1% from 6.5% six months ago. And while the industrial sector looks set for another stellar year, we are also seeing the first indications that the pace of growth on both the occupier and investment side is starting to ease back slightly as we move into the second half of the year.

Economic environment and expected occupier demand
Following the weak output of just 0.2% in the weather-affected first quarter, economic activity rebounded in 2Q18 to 0.4% which was back in line with the quarterly growth rate expected from the start of the year. However, there was little evidence in a recuperation of the lost output from 1Q18, and as such full year GDP expectations have been downgraded from 1.8% in February to 1.3% in August.

Despite the softening in economic data, the Bank of England voted unanimously to raise interest rates in August 2018 by 25 bps to 0.75%. The rise had originally been expected to come through in May but was delayed due to the exceptionally soft data release from 1Q18. But with inflation set to fall back below the 2% target in 2019/20, and wage growth still stuck at around the 2.5% mark despite the lowest unemployment rate since the 1970s, we expect the Bank of England to lean on the dovish side, with just one further hike forecast for next year.

On the political front, Brexit negotiations are moving into a critical phase, with the end of October considered to be the latest date that a withdrawal agreement could be agreed to give sufficient time for implementation, or preparation for the realities of having no-deal in place by March 2019. As noted in previous reports, the key sticking point remains the Northern Irish border. The full trade agreement itself does not have to be agreed by the end of October – this can be concluded within the transition period – but there needs to be a backstop agreement in place for what will happen on the Irish border should the two sides ultimately fail to agree to a trade agreement after March 2019.

Chart 1: Key economic indicators



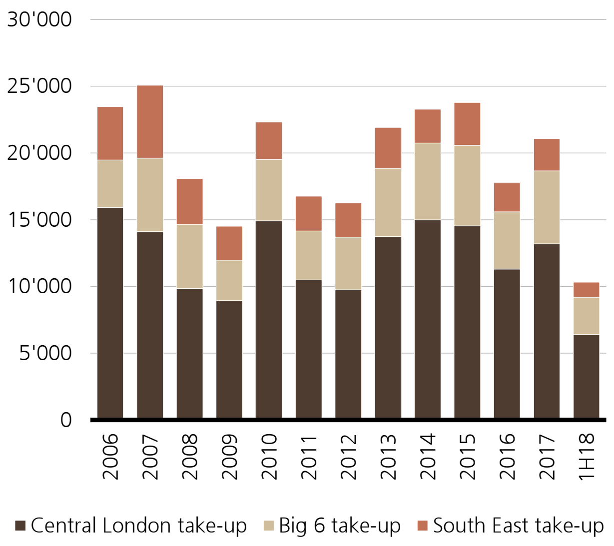
Source: Oxford Economics, August 2018

And here lies the issue. A return to a hard border has been a political red line from the DUP who ultimately enable Theresa May's to stay in government, so the current backstop proposal states that should no deal be in place the UK will continue to adopt all of the EU rules and regulations on trade to keep the border open. This is an arrangement which is likely to be unpalatable to the Eurosceptic conservative MPs forming the European Research Group, and with the government's wafer thin majority (including the DUP), even a small rebellion from this section of the party would be enough to block the withdrawal agreement from the EU, should it come back to parliament. This would leave Theresa May requiring support of Labor MPs to pass the bill, which is of course far from guaranteed or even likely. From here any combination of a leadership change, general election, extension of the March 2019 deadline, or ultimately a no deal scenario remain distinct possibilities.

For the purposes of forecasting it should be noted that the numbers referenced in this paper refer to our main case economic scenario, which assumes that the two sides do reach an agreement in October 2018 over the Withdrawal Bill. Our assumptions for what would happen under a no deal scenario will be discussed separately should this become the more likely outcome.

The uncertainty surrounding the Brexit arrangements do not appear to be having any negative impact on office occupational demand at present. Aggregate take-up for the major UK markets in 1H18 rose by 11% on 1H17. The strengthening demand was universal across nearly all the markets – only Edinburgh saw weaker take-up in 1H18 but this is somewhat distorted by the major public sector deal which completed in 1H17. Take-up in Central London has remained above trend and increased by 7.1% on the first half of 2017. This was helped by the return of serviced office providers, with over 20 deals signed in 2Q18 accounting for over 700,000 sq ft of take-up – although as noted in previous reports we remain skeptical as whether this should count as true take-up. Even taking serviced providers aside however the strength of demand in Central London since the referendum result has been a positive surprise – and as we head into 3Q18 the amount of space under offer is at an 18-year high, so assuming we do end up avoiding the feared no deal scenario we should see a strong finish to the year.

Chart 2: Annual office take-up
('000 sq ft)



Source: CBRE Erix 2Q18

The UK retail market continues to face testing market conditions. From an economic perspective, demand has been mixed. Retail sales volumes rebounded in 2Q, rising by 2.1%, which was the strongest performance since 1Q04. Household spending has been recovering as CPI inflation reduced from the 2.7% peak in 2017, which caused a meaningful squeeze on household incomes. CPI is expected to continue to reduce to 2.4% this year and further in 2019 to 1.8%. However, despite the help of slowing inflation household budgets will be affected by ongoing welfare reforms, higher interest rates and softer employment growth. Consumer spending for the year is forecast to slow from 1.1% in 2018 to 0.9% in 2019.

The mixed economic picture is reflected in UK consumer confidence. The GfK consumer confidence index recorded a further decline in July to -10, despite several "feel good" events in 2Q including the World Cup, Wimbledon and prolonged warm weather. The Overall Index Score has been at zero or negative since February 2016. Concerns about personal financial situations, and especially the general economic outlook have contributed a prolonged slump.

As such, against the backdrop of weaker demand, the retail market continues to adapt to the changing consumer landscape. Fundamentally, the way we all consume has changed due structural factors such as e-commerce. However, in addition, the UK has also had to deal with several elements during the past year or so that have exacerbated difficult trading conditions in the retail sector. Three main market events can be identified namely; business rates revaluation in 2017, increases in the UK minimum wage and Brexit-related factors. These factors have translated into a higher cost base for physical store retailing, while retailers were already grappling with the challenges of delivering seamless and profitable online retail experience. In addition, many domestic UK retailers have had to deal with significant legacy store portfolios. Generally speaking, historic UK retail leases were long (10+ years), which has meant UK retailers have been unable to actively manage their store portfolio (and cost base) to adapt to changing market conditions. Unfortunately, the hangover of historic leases has been partly responsible for the distress in the market. In recent months, there has been a spike in retail administrations and CVA activity. Affected retailers came from a broad range of sectors including fashion, toys, department stores, household goods and food and beverage including: New Look, Toys R Us, House of Fraser, Carpetright, Homebase, Multiyork, Strada and Carluccio's.

Industrial space continues to remain in demand from a wide variety of occupiers, with the first half of 2018 especially strong. At the halfway point of 2018, occupational take-up has shown a 16% increase on the same period the previous year. Online retailers came back to the market after a relatively quiet year in 2017 accounting 32% of all take-up. Take up was especially strong in the east Midlands emphasizing the strategic importance of this area as a distribution hub. Of the space transacted, over 80% of it was new build, a significant proportion of which was of a bespoke design. This emphasizes the increased specialization within the logistics sphere where occupiers are requiring ever more sophisticated units to meet their needs. By size, the focus of demand was on the XXL format (over 500,000 sq ft), which was sufficient to drive speculative development in this space for the first time since 2007. Gerald Eve noted that in 2Q alone there were five deals on sheds in this size category, mainly to retail and e-commerce tenants.

Supply and income growth expectations

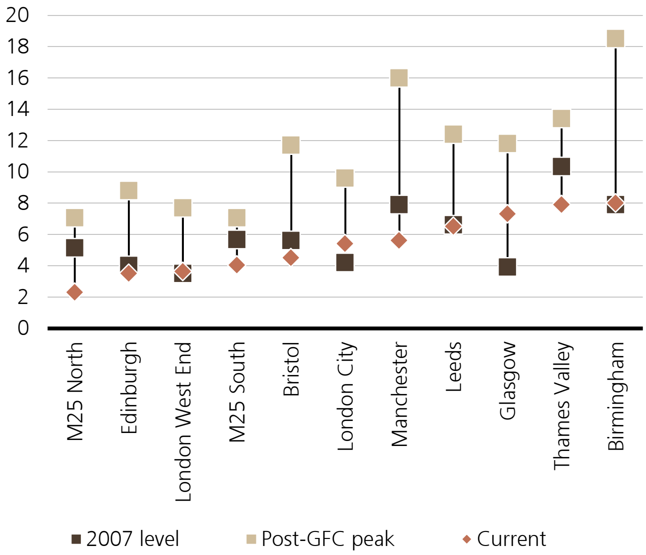
Availability in the Central London submarkets is becoming polarized, with vacancy rates in the West End, Midtown and Southbank now relatively stable at between 3.5-4%, while the City (5.4%) and Docklands (8%) have seen sharper increases. The development pipeline has become heavily concentrated in the City, and of the schemes over 100,000 sq ft which are currently under construction in Central London, over 50% of these are located in the sub-market despite only having around 30% of the total Central London stock. The increase in the vacancy rate would have been sharper but for the relatively strong levels of demand for the newly-built space, although we note that there may be a significant amount of "hidden" vacancy within the serviced office providers portfolios. Although there is not significant development taking place in the Docklands sub-market, this location is particularly exposed to the structural changes facing the finance industry and potential Brexit relocations – and it will also have to absorb circa 250,000 sq ft coming back onto the market when the European Medicines Agency relocates to Amsterdam in 2019.

Despite anecdotal evidence clearly indicating a softening in rental values, MSCI ERV data continues to portray a stable picture with City ERVs increasing marginal by 0.3% in 1H18, whilst the West End was down by -0.2%. Miraculously, according to the MSCI valuation data, rents in the City (+1.8%) and West End (+2.3%) are higher than before the EU referendum – this compares to prime rents that are -2.1% and -12.5% below respectively. Unfortunately with the divergence between valuation data and market sentiment it is becoming difficult to ascertain an accurate picture of the underlying rental market, and anecdotally we are observing that rental performance can vary significantly on a building-by-building basis.

In the South East and main regional centers the supply situation remains relatively benign – vacancy in most locations continues to edge down as demand remains strong and new supply is limited. The one exception is Birmingham where some major regeneration work within the City Centre will deliver a sizeable injection of new office space to the market over the next 2/3 years. MSCI ERVs for the South East and Rest of UK markets appear more in-line with the market fundamentals, with moderate rental growth of 1% and 0.6% respectively for 1H18.

Chart 3: Vacancy rate

(%)



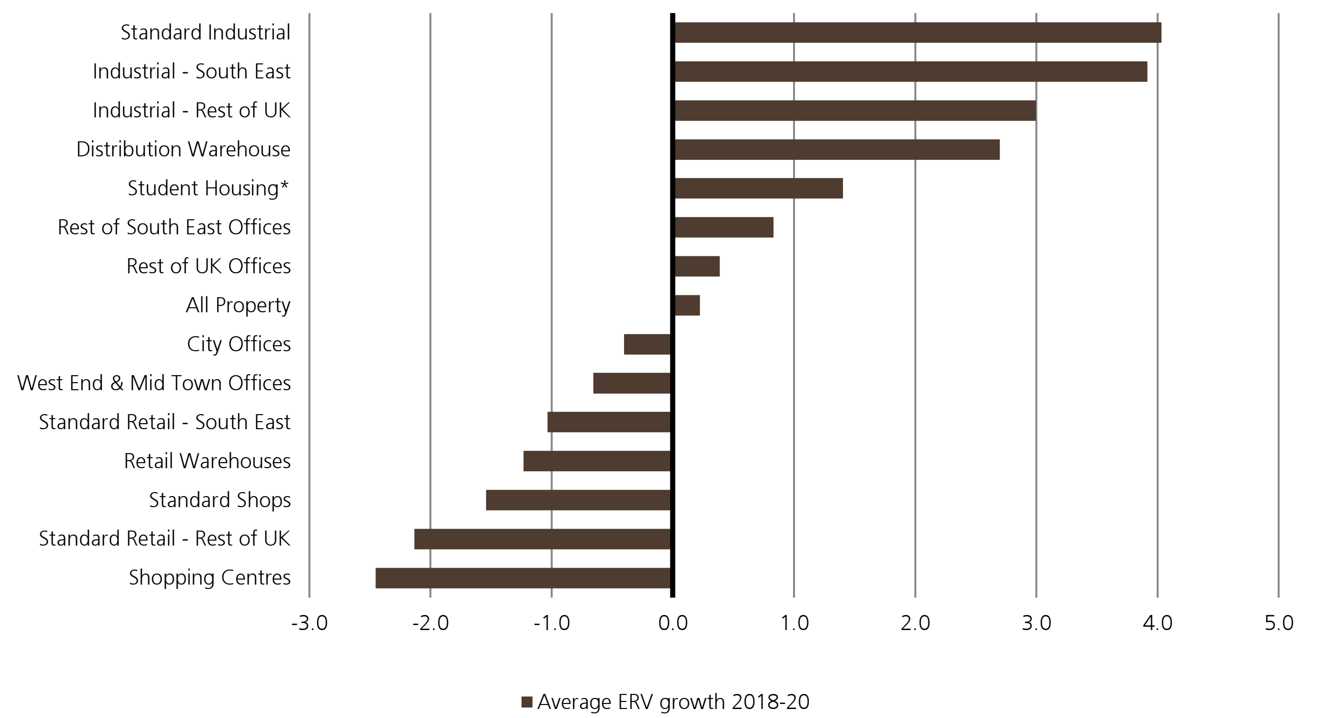
Source: CBRE Erix 2Q18, JLL 2Q18

As a consequence of retail distress, demand for space remains muted and negotiations with retailers are difficult. The balance of power has most definitely shifted in favour of the tenant. Of course, as has been the case in the recent past, the strongest retail offers (high street, retail warehouse or shopping center) are seeing the greatest level of demand and more rental stability. Prime locations are becoming increasingly important across the UK as consumers are now more selective over the retail destinations they opt to visit. According to CBRE, prime high street rents fell during the past year, down 2.7% outside London and -1.1% across the country as whole. However, there have been some good news stories. Prime Edinburgh rents increased 9.1% to GBP 250 per sq ft ITZA, closely followed by Liverpool with 4%. Meanwhile, the average vacancy rate for prime pitches also reduced to 10.7% across major UK destinations in 2017.

A big driver of demand for industrial space has been the growth of ecommerce, which has driven leasing in the distribution warehouse sector. However, the majority of industrial operators are not the likes of Amazon, rather smaller occupiers occupying units on industrial estates. These are companies operating in the light industrial, food and beverage and catering arenas, to name a few and they are really feeling the pinch of a combination of ecommerce and competition from residential. As such, rents for standard small-format units on industrial estates have risen much faster than distribution warehouses, whose relatively bespoke nature and often reliance on a single tenant reduced the landlord's ability for bargaining. Moreover, the development of such estates has been very low, due to the relatively high costs compared with single-let sheds and as such the availability for such schemes has waned significantly, standing at around 5%. On the back of this, it is hardly surprising we continue to see rental growth across the spectrum for both prime and average stock.

At the big shed end of the market, development remains disciplined although far more common. Availability increased in 2Q as speculative development has returned to the market and a significant amount of second-hand space returned to the market following various high profile retail administrations. As outlined above, this vacancy may be stickier as older distribution units may well prove unsuitable for modern occupiers.

Chart 4: Annual average ERV growth forecasts
(2018-20)



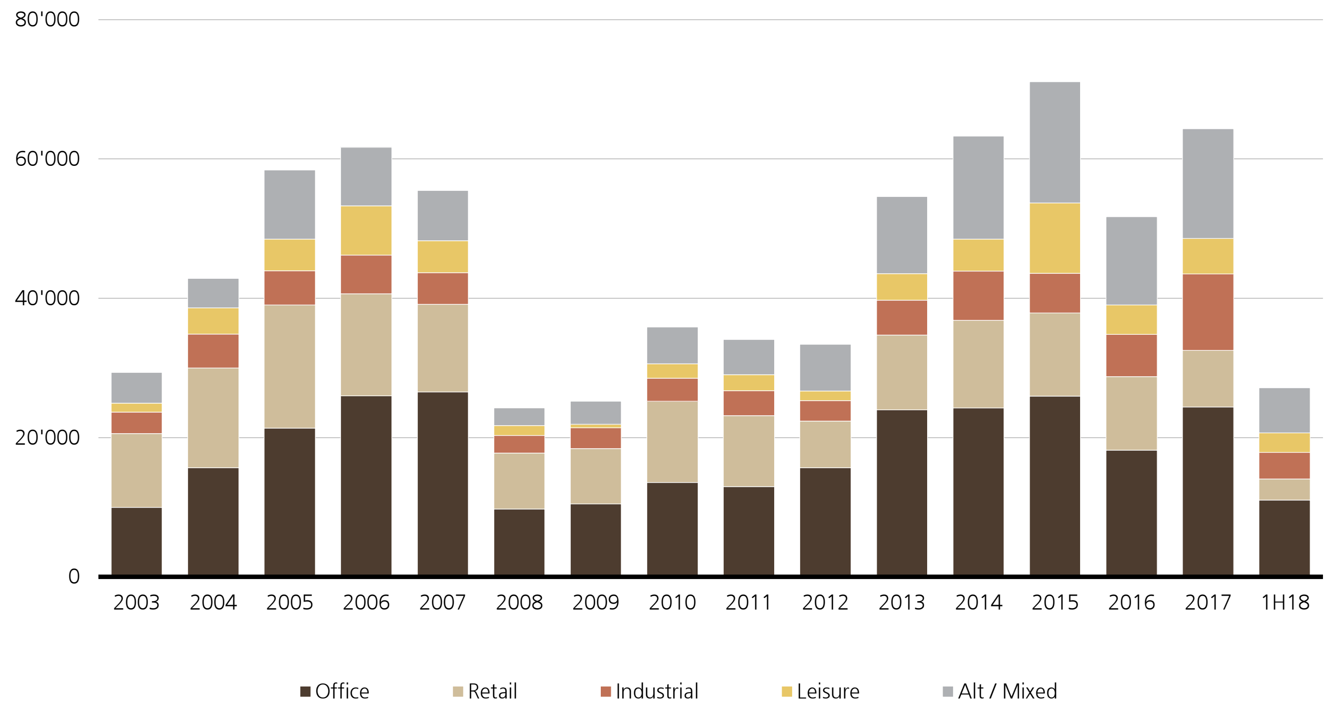
Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy, August 2018 *Student Housing PMA Summer 2018 forecast

Capital markets

Overall investment volumes have eased off slightly in 1H18, reaching GBP 27.2 billion which is a 4% decrease on 1H17. But drilling down into the sectors reveals that the slowdown in activity was almost exclusively driven by unsurprising weakness in the retail sector, where volumes dropped from GBP 4 billion in 1H17 to GBP 3 billion and the weakest half yearly volume since 2012. Given the challenges facing the sector, it is unlikely there will be a rebound in activity until a genuine repricing takes place, which may attract opportunistic buyers back towards the sector. Industrial investment volumes were virtually unchanged – sentiment remains extremely strong but the very high levels of pricing are making the sector inaccessible to investors with more conservative underwriting assumptions for rental growth. And the office market remains fairly active, again helped by foreign demand for core Central London assets – but while 2017 was dominated by Hong Kong buyers, this has eased off slightly in 2018 although we have seen a return of South Korean investors to the UK, buying GBP 1.1 billion in the first half of the year with an additional deal in the pipeline which would double this figure.

Reflecting the imbalance in investor demand, it is unsurprising that capital growth continues to be highly polarized between the industrial sector (6.7%) and retail sector (-1.4%) in 1H18. Although the first half of the year was clearly a turning point for retail values, this likely to just be the start of a downward correction. And the office markets continue to surprise on the upside with +1.0% in 1H18 – while we acknowledge the ongoing demand from overseas capital in core Central London assets we believe the segment of the market these investors are looking towards is relatively thin, and we're surprised that capital appreciation is evidently still being recorded outside of the core segment.

Chart 5: UK investment volumes
(GBP '000)



Source: Property data August 2018

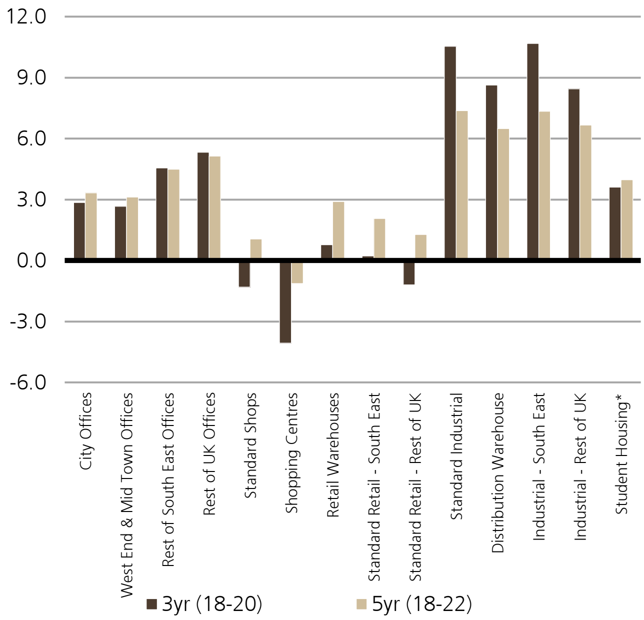
Office market outlook
The main change in our office forecasts from six months ago relates to expectations for Central London rents, which we are now forecasting to just have a very marginal decline next year (City -1.5%), (West End -2%). We were previously factoring in a circa 4-5% decline in the City and West End submarkets, but since the EU referendum we have been confounded by the numbers reported by MSCI which have not shown any decline emerging despite new supply coming through and weakening occupier demand. Given that under our main scenario we are factoring in a withdrawal agreement being signed by the end of October – if anything boosting the market – we cannot identify what could occur to change the direction of valuations in Central London. Outside of Central London our expectations remain broadly unchanged – with modest rental growth coming through in both the South East and Rest of UK markets which is reflective of the fairly limited new supply of office space. Yields in Central London are forecast to stabilize this year and next, before edging out slightly from 2020, whilst the South East and Rest of UK markets are expected to see some moderate compression this year before following a similar trend as Central London, but with a softer outward movement towards the end of the forecast period.

Retail market outlook
We have been cautious on the retail sector for a while now and this position remains unchanged given the growing challenges. Performance of assets is becoming more intrinsically linked to the quality and dominance of retail offers and proximity to prime pitch in the case of the high street.

Rental growth at the aggregate MSCI level will be impacted negatively by ongoing structural changes in demand over the next three and five years. In general terms, with believe rents in all retail segments will be impacted negatively by changes in demand. We are more positive on retail warehouses due to the higher income return and affordability of space. However, we remain more downbeat on secondary high streets and in particular the shopping center segment due to high amounts of capital expenditure required to keep canters relevant.

Logistics market outlook
Overall we expect industrial to remain the outperformer over the next five years as the factors that have driven recent performance have by no means abated; however, we are expecting these returns to not be much more muted than those to which we have become accustomed. In terms of rental growth, we expect 2018 to remain almost as strong as 2017 (6%+) but to tail off somewhat thereafter as occupiers are increasingly stung by affordability constraints. Added to this, we expect yields to hit a floor next year, and start gradually moving out over the five-year period meaning capital growth will be very limited over a three-year period and more or less flat over five years. In terms of relativities, we expect standard industrial to continue to outperform distribution warehouses, largely due to the more favorable supply-side dynamics in the small format sector. We also expect the dominance of the South East to come to an end, with the rest of the UK to outperform by 2019. Overall, however, we are still expecting industrial to continue to outperform the all property average, both on a three-year (+330 bps) and five year (+80 bps) basis.

Chart 6: Annual average total returns (%)



Source: UBS Asset Management, Real Estate & Private Markets, Research & Strategy, August 2018 *PMA Summer 2018 forecast

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