# Research Blast

UK Real Estate Market, January 2018, Defying expectations

## How did the UK market exceed all expectations in 2017, and can we expect more of the same this year?

### Everyone has been surprised by the resilience of the UK market in 2017

**Taken by surprise**
If any UK property market forecaster had stood up at the start of the year and predicted that in December we would be debating whether the market will quite hit double digit returns for the year, not even the most bullish observer would have taken them seriously. In the February 2017 IPF Consensus Forecasts, the average expectation of the 25 contributors for the full year was 3.2%, the most optimistic of which was 7.0% compared to our current forecast of 9.7% for 2017. So as we move into a new year it would seem a suitable time to reflect on what has driven that exceptional level of outperformance, and crucially whether those drivers will be able to continue to support the market into 2018 and beyond.

**The Great Wall of Chinese Money**
The appetite for UK real estate from foreign buyers has been one of the big upside surprises this year. Chinese buyers have dominated the headlines with the purchases of trophy assets, but beneath these rather exceptional deals there has been a solid flow of foreign capital into the UK market, focused on Central London. The bulk of the money has come from Asia, and in particular Hong Kong where off-shore Chinese money is currently unaffected by capital controls, but there has also been a noticeable increase in activity from European and particular German investors. This is partly why most expectations for yields from the start of the year - to either be flat or edge out slightly - have been proven wrong as all sectors, according to MSCI data recorded inward yield shifts in 2017. We would note, however, that the foreign demand is heavily focused toward core income producing assets. This is the segment of the market which has driven the overall inward yield compression.

But whilst there is much weaker demand from both domestic and foreign buyers for more secondary assets and particularly those in weaker locations, there is not a significant amount of sell-side pressure in the market to force sales through at big discounts. So, despite the lack of liquidity vendors were generally able to hold out for higher prices, and when the expectations were not reached the assets were withdrawn from the market. With a limited level of transactional evidence in some secondary locations, valuations have been holding the levels stable despite the reality that a discount would need to be applied to achieve a sale in most cases. This can partly explain why we are seeing such a mismatch in pricing between the direct markets and the REIT markets, which are implying a discount to NAV of around 15% on average.

As such, the big question is will the flow of foreign money into core UK assets continue to deliver capital growth into 2018? It is likely the UK will remain an attractive destination for foreign capital. Despite being close to record low levels, prime yields in the UK are notably higher than other core European markets (e.g. 3% in Paris) and Asian markets (e.g. 2.8% in Tokyo). So with relatively attractive yields of 4%+ in the City for long term investors looking purely at an income yield, London will still be a key destination for this capital. And as 2017 demonstrated, short-term Brexit uncertainty or even the weak outlook for rental growth do not appear to be major drawbacks in these investors decision making. We do, however, expect the secondary markets to remain soft, particularly for retail and regional offices. Whilst the lack of sell-side pressure has helped support pricing in this sector, we're likely to see more deals come through in 2018 which do complete with a fairly substantial discount to NAV, which will put pressure on the valuations. The weighting between core and secondary assets within a portfolio will, therefore, be the key decider in whether the UK funds can deliver another year of positive capital growth.

There is one potential drag as we head into 2018 however – the chancellor's introduction of capital gains tax for foreign owners of UK real estate. As we explored in a recent research blast (to read the full publication click here), the impact could potentially be significant as footloose foreign capital may perceive the UK to be a less attractive place to invest on a relative basis. Time will tell whether there is a marked impact on foreign investor demand for UK assets, but either way, there is likely to be a hiatus in activity whilst investors await the outcome of a consultation period and some deals are already falling through or having prices chipped as a result of the uncertainty over the future tax arrangements.

**"They're paying what price?" Investors desperate to get a piece of the industrial sector**

Expectedly at the start of the year all forecasters had industrial as the top performing sector – but no-one came close to predicting the scale of outperformance. The most optimistic total return expectation was 11.1%, whilst we now expect the sector to deliver in excess of 18% in the full year numbers. The rental growth was largely factored in, although it has been slightly stronger than expected – the perfect combination of shrinking land availability at the same time as structurally high demand stemming from last-mile logistics requirements has driven particularly strong growth for urban logistics locations. But the big surprise has come on the pricing side with capital growth set to hit 12.5% for the year. It has become a bit of a catch 22 – the sector has become such a significant outperformer that funds that have a below benchmark exposure to the sector have come under pressure to increase their allocation, which in-turn drives pricing growth and leads back to the outperformance. Asking prices for good, and sometimes even much lower quality industrial space are regularly being exceeded by over 100 bps and transactions around London and the South East have been completing with sub-4% yields. Whilst there is an element of reversion in those deals, even with that factored in (and it is not guaranteed the levels will be achieved of course) the yields would still only be just above 4%. In any kind of historical context these prices would seem crazy.

The industrial sector we believe, will be the ultimate driver of the overall performance of the market in 2018 – if it is taken out then the total return level for 2017 would drop from around 10% to 5.4%, much more closely aligned with expectations from the start of the year. We believe that pricing, particularly in the South East, is already stretched and we cannot envisage a significant amount of further yield compression to support further strong yield driven capital growth in 2018. However the occupational story remains very positive and combined with the higher income yield, we expect returns from the industrial sector to continue to lead the market for the next three years, at least.

**Brexit is going sort of well?**

Without meaning to be too positive on this point, we can be happy that the economy clearly has not imploded. 1.5% GDP growth is hardly exceptional but it is far from disaster and employment levels remain healthy. On the occupational side, we have seen a slowdown in demand within the office and retail sector with industrial seemingly largely unaffected. The biggest upside surprise that we have seen is the limited knock-on effect of the uncertainty to the investment market. This is perhaps even more surprising considering events throughout the year which have followed what would, at the start of the year, been expected to have negative implications for sentiment: Theresa May outlined a strategy which alluded to a harder Brexit, we had a surprise general election and up until the final month of the year, there was very little positive movement in the negotiations in Brussels. Even though talks can now move onto the future trading arrangement, we still see the Irish border issue as being unresolved and there will be many more hurdles to cross before we arrive at a final deal.

So what have we learnt from this and how may it affect the market in 2018? Perhaps the key lesson is that the impact of political uncertainty on real estate markets can be overstated, not just in the UK  but also, we point to a similar lack of negative reaction to political events in the US and Europe. Investors motivation should also be considered and on a relative basis – a lot of the money which has supported the UK this year has come from countries with political situations that make Brexit look like a storm in a tea cup, and if investors are looking at a longer term horizon and income security the potential short-term volatility created by Brexit is a relatively minor concern. As has been the case for several years, with interest rates and returns on fixed income remaining at such low levels, core UK real estate continues to offer an attractive spread to other asset classes and other real global real estate markets, and within this environment it is difficult to see what would drive any significant outward yield shift, even if we do not see the compression that has boosted returns in 2017.

A key factor that might change this and trigger an outward shift in yields would be a build-up of pressure on the sell-side, but with leverage and Loan-to-Value (LTV) levels remaining in comfortable territory it is difficult to see this coming from the financing side. Perhaps vendors who have been holding off in the hope of better pricing will have to start bringing prices down more aggressively if they are serious about selling, which would mean yields in the secondary markets may start to adjust. For core, income producing assets, the weight of demand makes it hard to see a significant outwards shift in yield levels over the course of the next 12 months. With yields for most sectors expected to stay stable rather than move over the next twelve months, the total return levels next year will inevitably be lower than in 2018, particularly if we start to see downward pressure on rental values in some segments of retail and central London offices. Nonetheless, we are certainly facing the new year from a position of strength and a level of returns which twelve months previously would have been considered almost completely unrealistic.

Data Sources: Propertydata,  MSCI, CBRE, Oxford Economics, IPF, UBS Investment Bank Research, UBS Asset Management Global Real Estate Research & Strategy

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