# BEYOND 2016 – OUTLOOK FOR THE UK REAL ESTATE SECTOR

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It has been a very eventful year for the UK real estate sector. There was significant growth in 2015, with a considerable number of deals concluding throughout the year. At the beginning of 2016, however, the sector paused for breath. Transaction levels started to fall amid concerns that the market was topping out. In an already challenging environment, the EU referendum added more uncertainty.

Throughout 2016 UK real estate was also hit by a raft of policy shifts. Changes to stamp duty land tax rules and updates to income and inheritance tax cooled residential markets, particularly across central London. This was exacerbated by the recent rating revaluations due to come into effect in April 2017. The updates will have a material impact on occupational costs in some areas, squeezing rental levels and impacting on capital values for investors.

How did the sector fare in one of the most volatile years since the country surfaced from the global economic crash? After the referendum, listed real estate companies' share prices and property values have recovered, though not to pre-Brexit levels. Funds that prevented withdrawals after polling day have now reopened and a number of sale mandates pulled as confidence and liquidity returns.

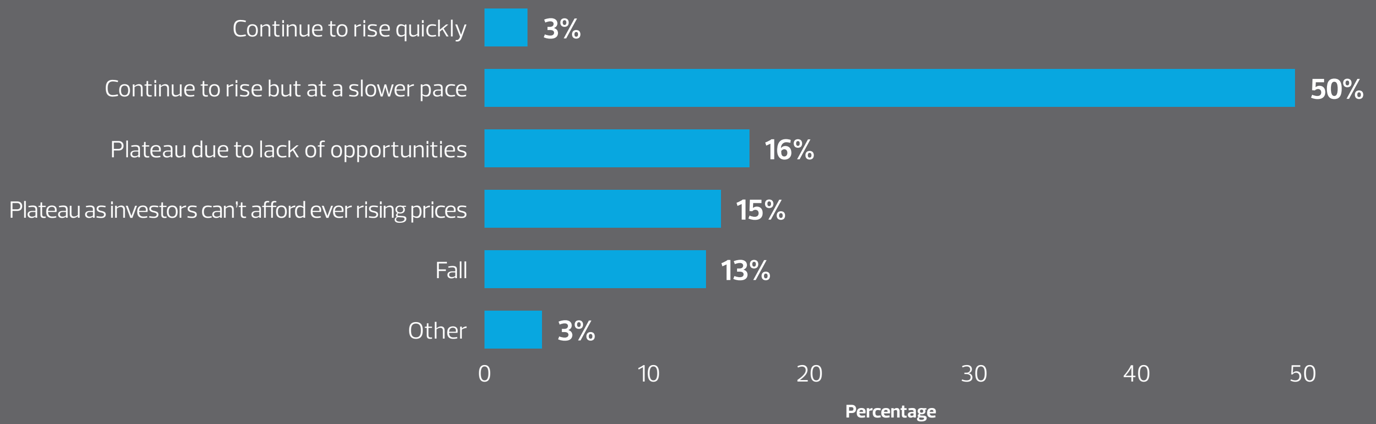
Looking forward, investor confidence will remain the greatest threat. Over the long-term, however, UK real estate remains one of the more favourable opportunities for both domestic and overseas buyers. Now, more than ever, investors and developers must focus on the fundamentals of property investment: location, type and quality of tenant. Those that hold their nerve and stick to these principles will reap the biggest rewards in the year ahead.

RSM's Beyond 2016 survey on the outlook for the UK real estate sector ran during October 2016. A cross section of real estate investors, developers and advisers involved in the sector took part, providing insights from across the UK.

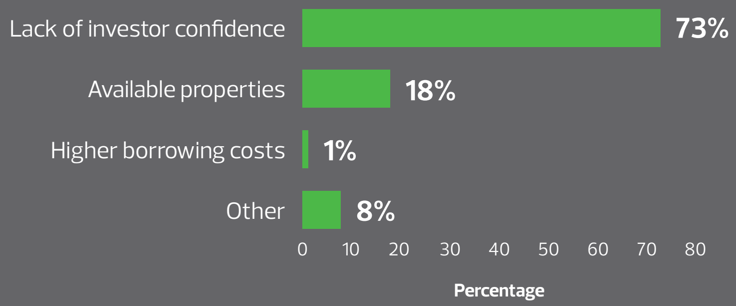
**Howard Freedman, partner and head of real estate and construction, RSM**

# THE REFERENDUM – WHAT IMPACT HAS IT HAD?

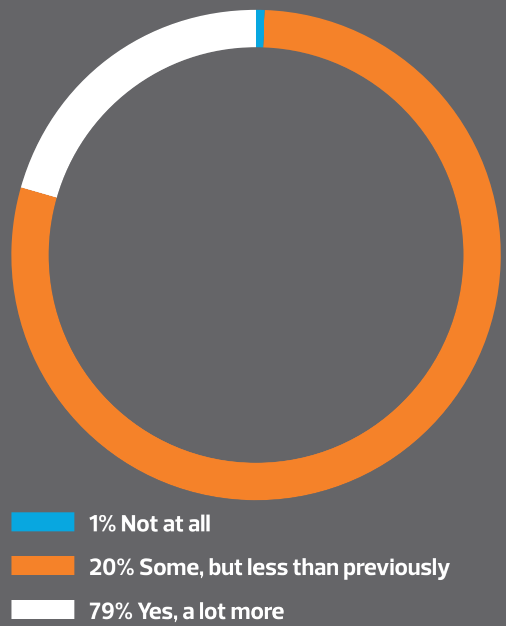
**As a consequence of the decision to leave the EU, do you think that over the next 12 months the price of London property will:**




**What challenges do you think the real estate sector faces following the referendum?**




**Given the decision to leave the EU, do you think investors will continue to invest in UK real estate?**



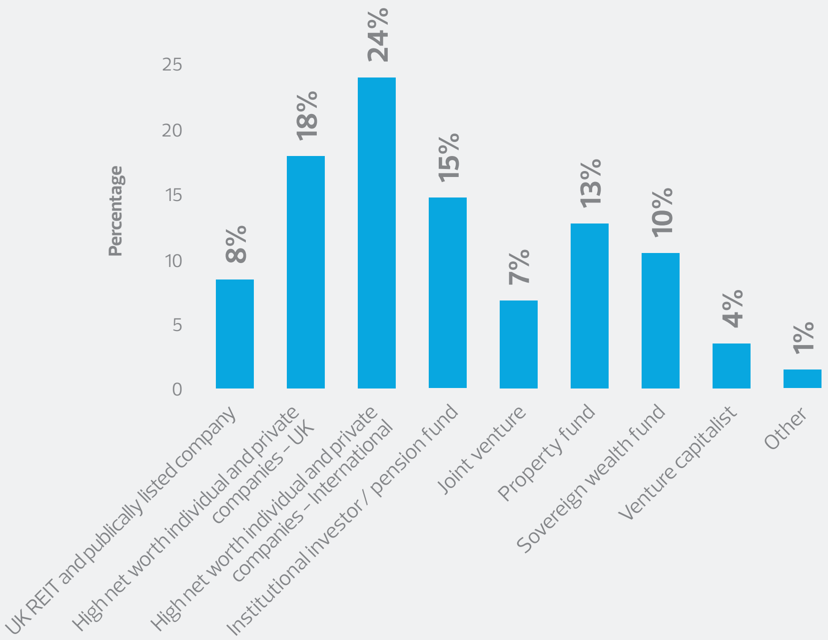
# INVESTORS WATCH AND WAIT, BUT OPPORTUNITIES REMAIN

There is little doubt that the past 12 months have been among the most turbulent since the country emerged from the recession. For much of the year, the EU referendum cast a long shadow over the sector. Ahead of polling day, confidence was hit, projects were paused and the number of transactions tumbled. The surprise vote for Brexit did little to allay concerns.

Amid the uncertainty, institutional investment scaled back. High Net Worth Individuals (HNWIs) and private companies have, however, continued to make their mark. With a greater appetite for risk, many have taken advantage of Brexit jitters and waning competition to snap up well-performing assets at a favourable price.

International HNWIs and private companies were the most active buyers, enjoying a double-digit discount on the back of shifting exchange rates and a drop in institutional demand. With uncertainty set to continue during EU exit negotiations, the UK is set to remain an interesting prospect for overseas buyers chasing a deal, particularly in the £20m to £100m range.

**Where do you think investment is coming from in the UK commercial property sector?**




> International HNWIs and private companies are leading the way.

**Howard Freedman**
Head of real estate and construction, RSM

Central London has so far been the biggest beneficiary of the overseas spending spree, but attention is now turning to opportunities further afield. Over the past 12 months, Asian and Middle Eastern investors have bought into residential and commercial schemes across major regional cities.

## Look for long-term gains

Opportunities remain for domestic and international investors. Those buying in Euros or US Dollars still have the chance to make substantial savings. Amid volatility, investors should look beyond short-term gains and focus on transactions that will provide steady returns over the long-term.

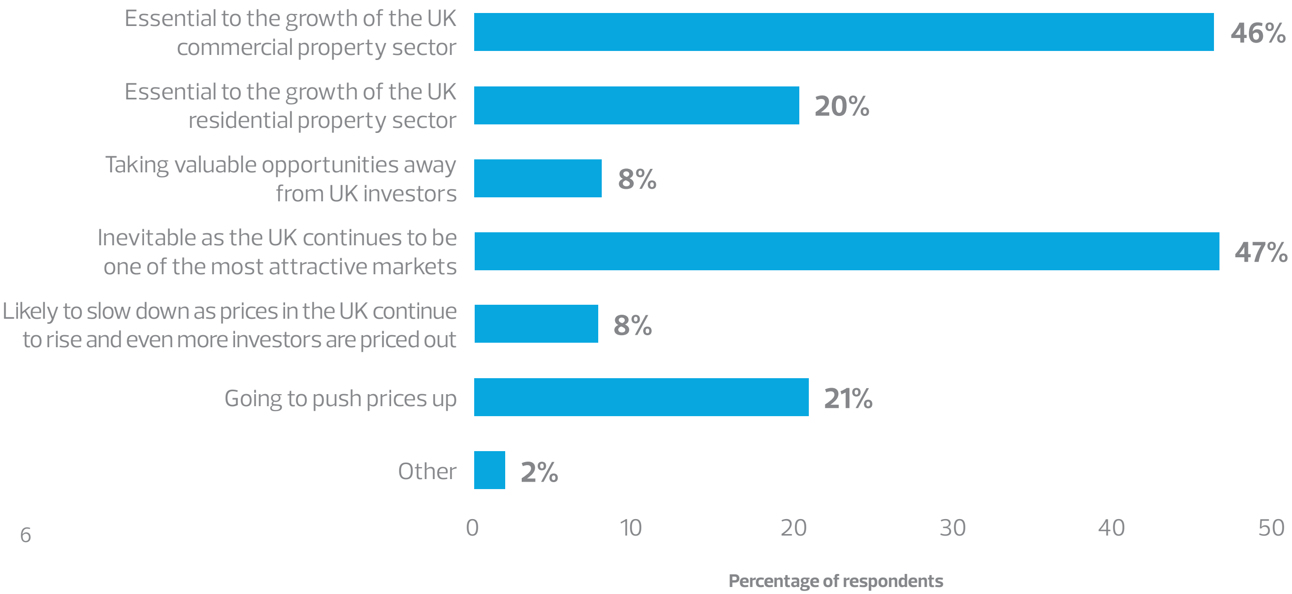
## Core assets provide stable opportunities

UK and overseas investors will continue to look for property in traditional locations with secure covenants and longer unexpired lease terms. These assets will meet investor appetite for both stability and future deal prospects.

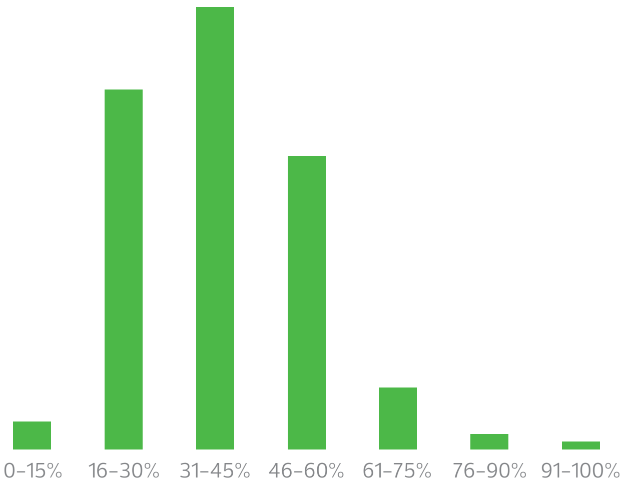
Despite rumbling concerns that overseas interest is pushing prices up and taking valuable opportunities away from UK investors, it is widely seen as an inevitable ending to years of untethered yields.

Today, international investment is a central element of the UK real estate market and widely seen as essential to the future growth of the commercial property sector. As domestic institutional investors watch and wait in the wake of Brexit, positive sentiment towards overseas buyers will likely continue in the year ahead.

**International investment in UK real estate is: (multiple choice)**



**What percentage of investment in UK commercial property will come from overseas investors over the next 12 months?**




# FUNDERS HOLD THEIR NERVE, FOR NOW

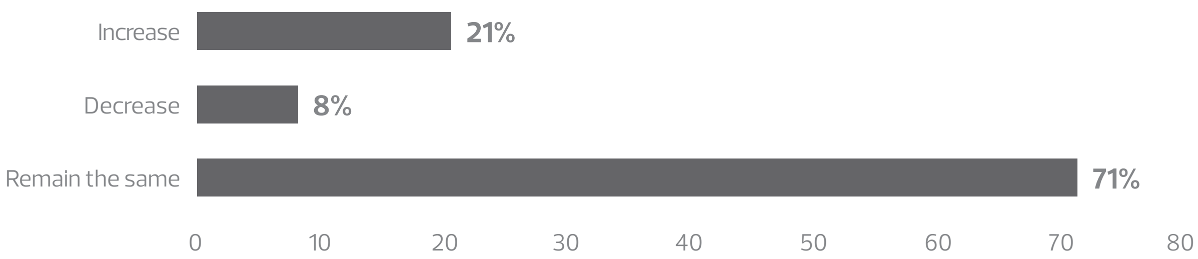
Despite prevailing uncertainty, funding prospects look bright. In the year ahead, the sector expects the cost of borrowing to remain stable. The Bank of England's recent commitment to cut interest rates to a record low of 0.25 per cent has no doubt allayed short-term concerns.

Over the past 12 months, capital has been freely available. Banks showed the greatest willingness to lend – traditional loans were the most readily accessible funding option throughout the year, albeit at conservative gearing levels. As the cheapest source of finance, they were also a primary funding source for acquisitions.

However, alternative finance has continued to grow in popularity, creating new routes to equity, mezzanine and debt funding. Over the past 12 months, alternative debt became a major contributor to acquisitions as buyers sought to raise finance in a riskier landscape.

Other new routes to finance are yet to make their mark. Crowdfunding this year overtook more formal types of private equity to become the third most available funding option. Despite its accessibility, it has so far failed to impact on purchase activity. However, its fortunes may change in the year ahead if banks start to withdraw funding on the back of continued political and financial volatility and the anticipated increase in inflation takes effect.

**Over the next 12 months do you expect the cost of borrowing to:**



**In any property acquisition you have made/been involved in over the last 12 months, which source of funding has been used? (multiple choice)**


**Over the last 12 months, which sources of funding appear to have been more readily available? (multiple choice)**


> "Alternative funding is more readily available and accessible, but not necessarily used."

**Damian Webb**
Restructuring advisory partner, RSM

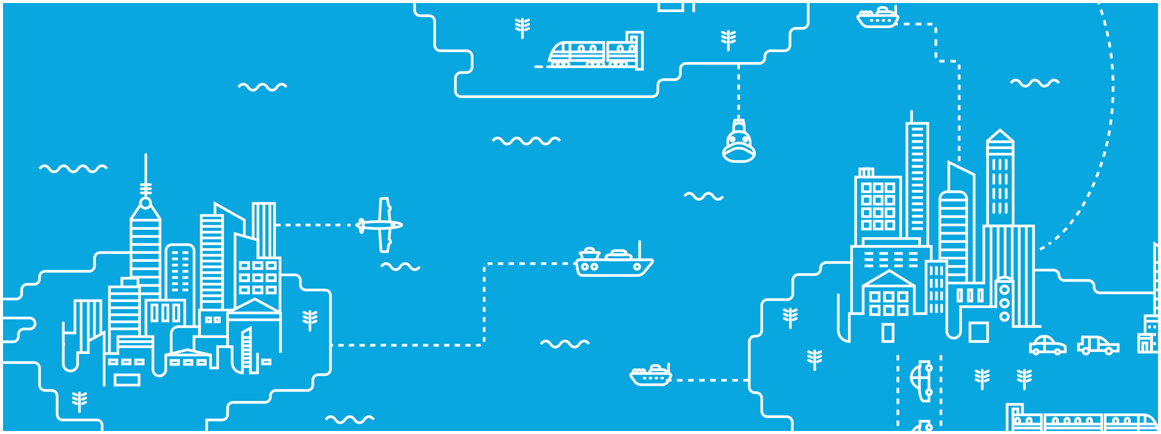
# INVESTORS LOOK BEYOND LONDON

London has long been the hot spot of the UK real estate sector. But after years of unrestrained growth, the market showed signs of overheating at the start of 2016. While new stamp duty rules and changes to income and inheritance tax have had a cooling effect, particularly in the prime residential sector, investors are now turning their attention to other parts of the UK.

The South East is an attractive prospect for many. Rising rents and house prices in the capital have created a domino effect in surrounding areas. Priced-out businesses and households are sustaining robust demand across the region, providing continued opportunities for investors. Yields will likely remain healthy in the year ahead, especially around the controversial third runway at Heathrow.

The North West has also stamped its ground over the past 12 months. Offering affordable housing options and strong employment opportunities, particularly in fast-growing industries like technology, the region's major cities are becoming an ever-more attractive option for young professionals. The £1bn transformation of Manchester Airport is also set to spark interest from further afield.

The government's Northern Powerhouse initiative will likely fuel further investor activity in the short to medium-term. Recent commitments to improve connectivity between the region's cities will offer new commercial and residential opportunities around major transport nodes. For investors, the region offers some of the biggest opportunities in the year ahead.



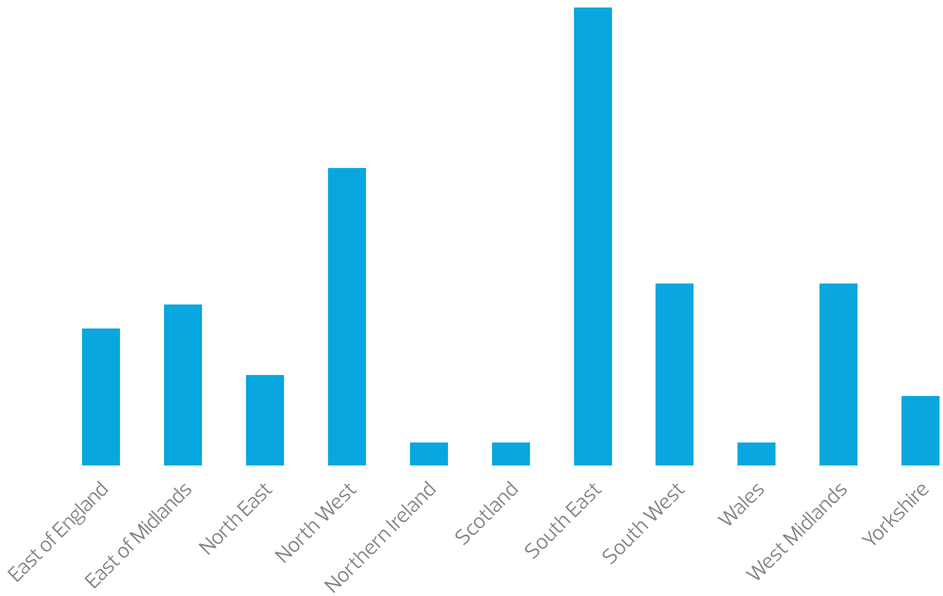
**Which regions (outside of London) do you think have attracted most investment in real estate over the past 12 months? (Top five results)**

| 2016 commercial | 2015 commercial | 2016 residential | 2015 residential |
|---|---|---|---|
| **29%** SOUTH EAST | **39%** SOUTH EAST | **40%** SOUTH EAST | **51%** SOUTH EAST |
| **21%** NORTH WEST | **31%** NORTH WEST | **17%** NORTH WEST | **15%** NORTH WEST |
| **14%** WEST MIDLANDS | **9%** WEST MIDLANDS | **11%** SOUTH WEST | **8%** SOUTH WEST |
| **8%** EAST MIDLANDS | **5%** EAST OF ENGLAND | **7%** WEST MIDLANDS | **6%** EAST OF ENGLAND |
| **7%** SOUTH WEST | **4%** SOUTH WEST | **6%** EAST OF ENGLAND | **5%** WEST MIDLANDS |

> "Large infrastructure projects, such as HS2, Crossrail and Manchester Airport, are driving regional growth throughout the UK."

**Andrew Westbrook**
Assurance partner, RSM

**Which regions (outside London) will attract most investment in real estate over the next 12 months?**




Infrastructure commitments are also stimulating investor interest across the West Midlands. The planned High Speed 2 rail project has already boosted activity around the planned phase one terminus in Birmingham. The recent confirmation of the second phase to Manchester and Leeds will likely spur further investor interest across the West Midlands in the year ahead.

This year, sentiment towards residential opportunities in the South West continued to climb. Since the referendum, the region has performed well. Property prices have increased by nearly 10 per cent since June. With a large number of professional services firms opening in Exeter and Bristol, demand will remain strong as more skilled workers push for a better work-life balance.

Which type of investor do you anticipate will spend most in the regions (outside London) during the next 12 months?

## UK

- 27% High net worth individual and private companies
- 17% Institutional investor/pension fund
- 16% Fund
- 15% UK REIT and publically listed company N/A
- 8% Joint venture
- 7% Public property fund
- 5% Sovereign wealth fund
- 4% Venture capitalist
- 1% Other

## International

- 33% High net worth individual and private companies
- 15% Institutional investor/pension fund
- 17% Fund
- 4% UK REIT and publically listed company N/A
- 5% Joint venture
- 2% Public property fund
- 17% Sovereign wealth fund
- 6% Venture capitalist
- 1% Other

# WHERE NEXT FOR THE UK OFFICE MARKET?

It has been a turbulent year for the UK commercial office market. Over the past 12 months, investor interest has waned as Brexit concerns, cooling occupier demand and rental pressures collided.

Sentiment remains dulled in the year ahead. While respondents expect residential to remain the favoured asset class for investors, offices rank fourth as student housing and healthcare become more attractive prospects.

There are further pressures on the horizon. As house prices across London and the South East continue to rise, many expect more office to residential conversions. There is a widespread expectation that this will lead to a shortage of office space and hikes in rents.

The prime office sector will likely take a hit as businesses move and change their operations to avoid spiralling costs. Many occupiers have already reviewed how they use their office space and the growth in agile working now appears to be the norm for many businesses. The forthcoming updates to business rates in April 2017 will create further pressure for this change, with the overall affordability of space coming into focus as occupational costs increase.

Non-prime locations are set to experience an upswing, however. Outside London, Reading has become a hive of activity for American firms looking for a European base. The serviced office and co-working sectors will also benefit. Technology start-ups have been particularly active in this space, but interest could spread to other commercial sectors. With a new breed of tenants demanding flexibility, traditional landlords that push for lengthy contracts could be left behind.

**Which property sector will see most investment growth in the next 12 months?**

**Top 4 in 2016**

1 RESIDENTIAL

2 STUDENT HOUSING

3 HEALTHCARE

4 OFFICES

**Top 4 in 2015**

1 RESIDENTIAL

2 OFFICES

3 STUDENT HOUSING

4 INDUSTRIAL

**40%**

say a significant increase in commercial to residential conversions will lead to a shortage of office space

**44%**

say a significant increase in commercial to residential conversions will increase office rents

**51%**

say businesses will reduce operating costs by promoting at home working

**45%**

say businesses will reduce operation costs by increasing the use of serviced offices rsmuk.com