January 2016

Real Estate Market Outlook
UK

M&G REAL ESTATE

Part of the M&G Group

Executive summary

- Consumer spending to be the engine of UK economic growth in 2016
- Regional rental growth to strengthen
- Yields to show signs of stabilisation
- Income to return to prominence as a driver of investment performance
- Top pick for 2016: South East offices
- Value-add strategies offer potential for investors looking up the risk curve and to capitalise on occupier market strength

8.5%
returns expected for IPD All Property in 2016

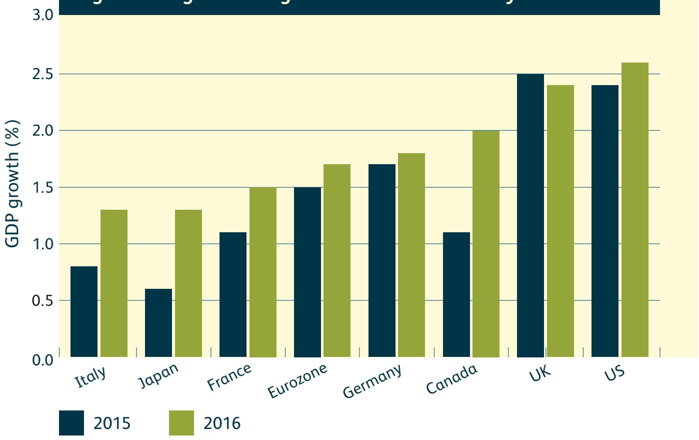
15 year high
forecast for rental growth in regional UK offices

400bps
yield premium on property vs government bonds

UK economy: growth continues apace

The UK economy looks set to record a healthy pace of growth in 2016, continuing to expand at a much faster rate than the majority of advanced economies.

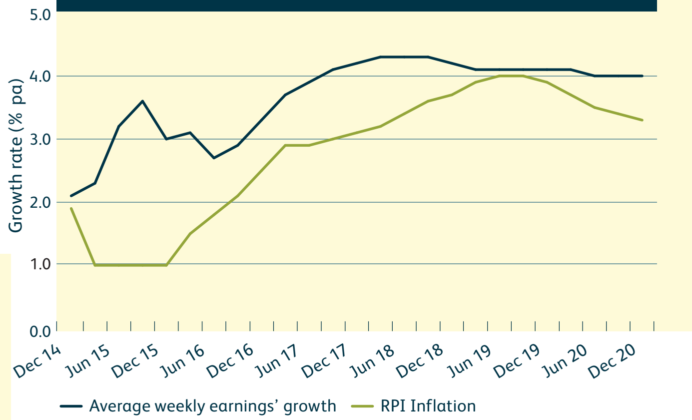
Fig 1: Strong UK GDP growth to continue this year



Source: Consensus Forecasts, November 2015.

UK unemployment continues to fall, average earnings are rising faster than prices, and the first hike in interest rates is not expected until the middle of the year. Together these factors are helping drive consumer spending, which in turn has emerged as the key engine of overall economic growth.

Fig 2: Consumers' wages rising faster than prices



Source: Experian, November 2015.

Potential headwinds do exist, however – primarily in the form of uncertainty over the future of the UK's membership of the European Union (EU), or the potential for 'Brexit', the vote on which could potentially come in the latter part of 2016. As yet, this is having little impact on economic sentiment, although early polls suggest that the in/out vote is fairly balanced, which will likely lead to uncertainty further down the line.

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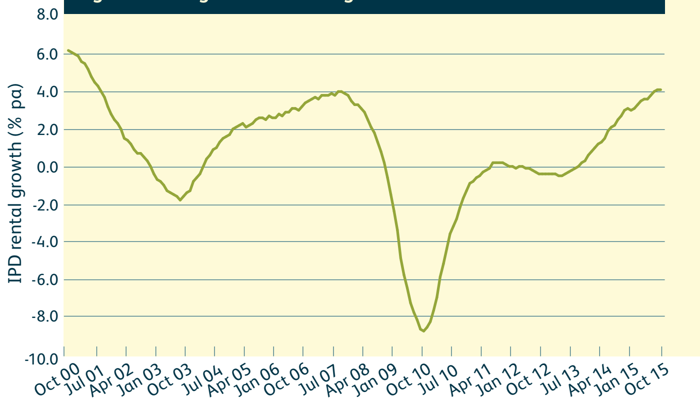
Rental growth powering UK property performance

The solid economic backdrop has been paying dividends for real estate investors through rental growth, which accelerated sharply throughout 2015. According to IPD's Monthly Index, UK rents rose by c. 4% in October 2015, reflecting occupiers' strengthening confidence and increased demand in the face of restricted space. This is the strongest rate of growth for just over 14 years, demonstrating the huge turnaround seen in the occupier market following several years of post-financial crisis sluggishness. We expect this buoyancy to continue through 2016, with some of the regions taking over from central London as the strongest performers.

Fig 3: Rental growth at its highest level since mid-2001



Source: IPD Monthly Digest, October 2015.

Office market focus turns to the regions

Offices in both the City and the West End of London have already seen a rebound in rents of c. 50% since growth resumed in 2010. With demand potentially impacted by affordability constraints and with a healthy level of development already in the pipeline, we expect a more muted path for rent rises in the short to medium term (with the exception of fringe areas undergoing regeneration).

The UK regions, in contrast, are at an earlier stage in the recovery cycle and are on track to post above-average growth this year as occupier demand rises and construction remains limited.

Regional offices in particular are benefiting from a 'spill over' in demand as London-based companies take advantage of the lower costs by relocating certain functions away from the capital. Recent examples include moves to Birmingham for Deutsche Bank and HSBC, as well as to Manchester for TalkTalk and Freshfields. The appeal of the northern cities such as Manchester may increase further as the government's Northern Powerhouse initiative takes off, which aims to provide improved transport links and create high value jobs (see box below).

In focus: Northern Powerhouse

The Northern Powerhouse is a government initiative to address the widening North-South divide. Key to the scheme's success will be the improved interconnectivity between major Northern cites – such as Liverpool, Manchester, Sheffield and Leeds – so that they work together as a single economy rather than competing against one another. To enable this, money has been allocated to improve local transport infrastructure, though further investment is likely to be needed. A more concrete initiative to back the region's economy has been the creation of the Sir Henry Royce Institute (the "Crick of the North", as the Chancellor has referred to it) and the National Graphene Institute at the University of Manchester to help drive research and innovation in the area. The ultimate aim is to create a cluster of industry and high value-add jobs. This in turn should help to underpin occupier demand for real estate (across all sectors) and thus investment activity, leading to improved performance prospects for regional offices.

This concept of "North-shoring" (moving functions away from central London, not necessarily to the North), is gaining traction within the major regional cities, particularly for back office roles, and is thus boosting office demand and underpinning rental growth. As a result, we expect rental growth in the rest of UK office market to accelerate to a 15-year high of almost 4% this year.

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Long-awaited recovery in retail

Rents are also finally on the rise in the regional shops market, following seven consecutive years of falls. Large chains are increasingly taking up space across the country (albeit selectively) and there is a more optimistic outlook from retailers overall. As a result, almost all parts of the beleaguered retail sector are now seeing rents stabilise or even grow.

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Fig 4: Rental story improving in the retail market

Source: IPD Quarterly Digest, Q3 2015.

The outlook is also more optimistic than it has been for a long time as consumers continue to take advantage of rising real incomes and retailers feel more able to adapt to and absorb the sector's structural change. With the development pipeline likely to remain restricted, this suggests that the retail sector could begin to make up some of its recent losses and move away from the London-centric story of the last few years.

While things are looking brighter for many retail markets, more secondary locations and assets continue to face significant headwinds that could restrain their recovery for some time to come.

Speculative development returns to industrial

In the industrial sector, we expect the recent heady rates of growth will continue. Rents are now rising by around 6% pa in London and the South East and 3.5% pa in the regional markets, according to the IPD Monthly Index (October 2015), well above their 10-year averages of 0.3% pa and -0.4% pa, respectively. This reflects limited availability of space but also strong demand, particularly from high-profile online retailers such as Amazon and Ocado as well as from discounters.

As a result, it is no surprise that investors and developers are starting to build speculatively again. Importantly, though, construction activity is so far largely focused on the distribution warehouse sector and limited to areas where demand can support the new supply. Although we expect industrial rental growth to ease slightly in 2016, the pace is set to remain well above historic averages.

Demand/supply imbalance favours residential

Beyond commercial real estate, the outlook for the private rented sector (PRS) remains extremely favourable, supported by the excess of demand for rental properties over their supply in the larger cities and particularly in Greater London. This imbalance may only be exacerbated by the recent decision to increase stamp duty on Buy-to-Let properties by 3%, which is likely to deter some potential individual investors and may therefore reduce future rental supply. As such, our forecast for rental growth in London, away from the very core markets, remains very strong for 2016. Although still positive, we believe that prospects for rent rises within the most central parts of London are somewhat weaker, in large part due to pockets of new supply.

Meanwhile, in line with the encouraging story for commercial property in the regions, we see room for residential rental growth to strengthen away from London as well, albeit in those cities with a solid PRS base which are not already seeing a strong supply response.

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With virtually all parts of the property market expected to see healthy rental growth or, at least, set to return to growth this year, the occupier market looks set to be the fuel for the engine of capital growth in the UK property market going forward.

Victoria Square, North Acton, London
Build-to-rent developments, such as this one, are expected to deliver strong returns against the backdrop of a growing population and limited supply.

A return to the norm in 2016?

We have now seen three consecutive years of double-digit total returns and a rise in capital values of c. 45% in the UK property market during that period, according to the IPD Quarterly Index. With prime yields at or close to historic lows in many markets and secondary yields having already come in significantly, albeit with some room to move further, it is inevitable that some of the recent heat will leave the market as investors sit back and take stock.

As a result, the composition of investment performance looks set to change from the yield-driven supernormal returns of recent years. While we do expect some further yield compression in 2016, in general we see yield levels starting to stabilise, with rental growth, our knight in shining armour, taking over as the primary driver of capital growth. This suggests a return to a more sustainable level of investment return, with income once again the main attraction for investing in real estate. Even so, with a total return projection of c. 8.5%, investors in property will by no means be going home empty-handed this year.

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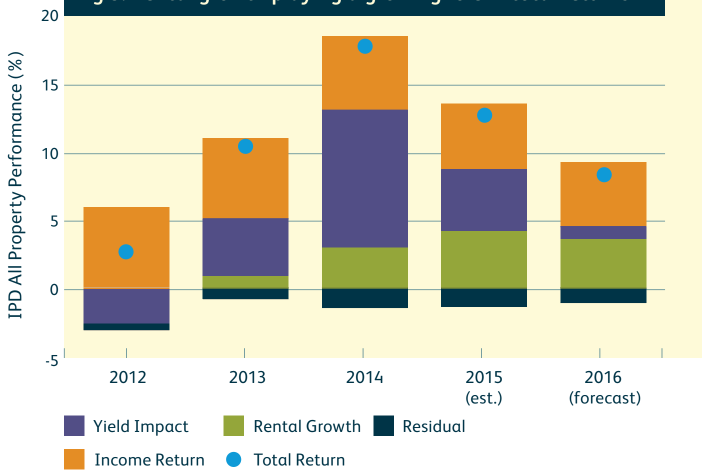
Fig 5: Rental growth playing a growing role in total returns

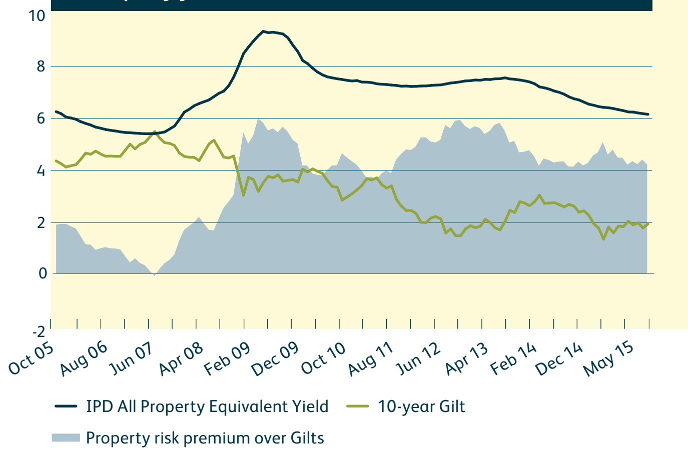


Source: IPD, M&G Real Estate.

With average IPD All Property equivalent yields offering a premium of c. 4% above UK 10-year government bonds, the relative attraction of real estate remains firmly intact. That differential should help cushion the property market from any negative impacts that could be associated with a higher cost of lending, certainly in the short term. And, while the Bank of England's base rate is finally forecast to rise in 2016 after nearly seven years at 0.5%, the magnitude and pace of any increases are expected to be both limited and measured. Therefore we do not see this real estate risk premium being eroded to a significant degree until much further down the line.

As interest rate rises will only come against a healthy economic backdrop, buoyant rental growth should also act to help counterbalance any resulting upwards pressure on yields, particularly towards the more prime end of the market where yields are close to/at historical lows.

Fig 6: A significant premium continues to exist for All Property yields above Gilts



Source: IPD, M&G Real Estate.

The key market event in 2016 is likely to be the UK's referendum over its continued membership of the EU. The vote may take place in the second half of this year, although it could slip into 2017. ICM opinion polls taken in December show a marginal majority of 1% for staying 'in'. However, if 2014's referendum on Scottish independence is anything to go by, opinion may well swing several times in the run-up to the vote. The prospect of the referendum will thus create uncertainty within the investment community as the year progresses, potentially dampening investment activity as some investors opt to "wait and see" which way the public turns.

Top three investment themes for 2016

2016 looks to be another good year for property investors, with a number of interesting opportunities.

1. In a continuation from 2015's views, we see **offices away from Central London** as offering the strongest short-term performance potential. We expect capital growth to exceed income return in 2016 for these markets, with the bulk of the increase in capital values to result from buoyant rental growth. This year, we expect the best performance to come from South East offices, with projected performance of c. 11%, with the rest of the UK then taking the lead into 2017.

2. With pricing on prime and even good secondary assets having shifted significantly, investors are increasingly looking further up the risk curve for value. When aligned with today's improved occupier fundamentals, this suggests that **asset management plays, or value-add property,** are likely to provide significant performance potential in the short term. Investors must be wary though – such opportunities remain very sector specific, with offices and industrial showing more potential in general. Regional secondary offices, for example, continue to yield almost 400bps more than their prime counterparts and more than 300bps versus their cyclical lows. In contrast, while there is a greater premium still for secondary retail, the risks from that sector's weaker underlying fundamentals still appear too significant to be offset by likely returns.

3. **Alternative sectors** will continue to attract significant demand as investors look to diversify their portfolios away from mainstream property. The PRS is likely to remain a key driver of this: projected total returns look attractive away from the very expensive Central London market where increasing supply looks likely to suppress future return potential. Although the government's recent move to increase stamp duty could cause some concern within the investment community, it should be noted that this higher tax rate does not apply to large-scale investors. Indeed, the specific exclusion of these investors from the hike and comments made during its announcement suggest that the government is trying to actively encourage the creation of a more professional, institutionally-driven PRS market. This can only be beneficial for institutional residential investment prospects in the medium to long term. Meanwhile, despite record-breaking investment volumes in 2015, there is still a significant number of buyers looking to move into the **student accommodation** sector, which should also underpin healthy returns in the short term.

In conclusion

This looks set to be a year where the property market returns to fundamentals – we expect healthy underlying economic activity to lend support to the occupier market, providing an opportunity for rents to continue rising at their strongest pace for many years (especially away from London).

This buoyant rental growth is becoming the main driver of capital growth as the pace of yield compression starts to slow.

Investor demand is expected to remain healthy, albeit perhaps not as 'hot' as in recent years, and this should lead to a return to more normal – and sustainable – performance levels in 2016.

Away from the headline numbers, we still favour markets outside of prime central London as investment picks. This reflects the better relative pricing available as well as the greater potential for rent rises as healthy economic demand meets restricted supply pipelines. Emerging London localities, the South East and regional office markets in particular look set to deliver solid performance this year. Looking past the mainstream markets, we see alternatives, and the PRS in particular, continuing to attract demand throughout 2016, while for investors looking further up the risk spectrum, value add strategies are also expected to bear fruit.

One Forbury Place, Reading
South East offices are forecast to enjoy some of the strongest rental growth over the coming year.

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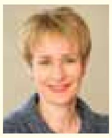

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