CBRE’s view on the year ahead

UK Property Market Outlook 2015
EXECUTIVE SUMMARY

This report sets out CBRE’s view on property market prospects for 2015.

• After a strong year in which total returns to property averaged nearly 20%, 2015 promises to herald the start of a gentle return to more sustainable growth rates across most sectors. CBRE forecasts total returns to property of just under 13% in 2015.

• General election uncertainty is thought by many to be a significant factor for 2015 in the minds of property market decision makers – an issue CBRE Research will explore further in the coming months.

• We predict more significant rental growth for most sectors in 2015 than in 2014; and we think there is potential for further falls in yields given the relative attractiveness of property investment and the weight of money entering the UK market.

• Prime London markets will continue to grow in 2015, but confidence and investor interest is now returning to prime regional markets; and we also expect secondary markets to fare better than in recent years – in all cases characterised by a lack of a good quality new supply.

• Prospects for retail properties remain among the most uncertain, with few sure signs just yet that stable growth is returning to consumer spending, and cost pressures and distractions across the sector, particularly in grocery retailing – though again, prime retail destinations will remain a safe bet.

• Industrial property has performed very well and a dearth of supply means we predict that this will continue to look like an attractive sector;

• Price growth in the housing market looks likely to ease somewhat in 2015 – we predict price growth of around 6% in 2015; we think transaction levels have peaked for the time being.
INTRODUCTION

2015 promises to be another intriguing year for property markets. Whether or not a ‘new normal’ prevails, a welcome stability has returned to the market. CBRE forecasts a return to more normal conditions, with much of the economy – and the property market – returning to a more sustainable and stable pattern of long term growth. Regional markets are beginning to pick up, reflecting increased economic confidence, and although substantial challenges or uncertainties remain – particularly in the retail sector, and in the political outlook – we think the UK property market is set for a promising and prosperous 2015.

‘... the UK property market is set for a promising and prosperous 2015.’

In this document we set out our views on the key economic and market trends we expect in 2015. One apparent uncertainty which many property commentators have already identified for 2015 relates to the outcome of the UK general election on 7 May. CBRE will be commenting on the impact of general election uncertainty in more detail in the coming months.

SOME TRENDS THAT SHAPED 2014

- **The Scottish independence debate** – which has sparked a far wider debate on where political control over property taxes should rest: though aspirations for devolution ran rather ahead of government appetite.
- **A remarkable overlap of benign domestic economic factors** – low inflation, low interest rates, rising employment, real wage stabilisation and strong GDP growth – which have given the UK an unrivalled ‘feel good factor’ compared to other G7 economies – something that could not have been taken for granted even in 2013.
- **The year when commercial real estate finally came back in from the cold** – relative pricing and a newly established confidence that rents are bottoming out (even growing in some markets) tempted investors in to almost all kinds of commercial real estate. Yields fell in prime and secondary markets. There were even some signs of rental growth, though largely confined to prime property.
- **The weight of money** entering the property sector, both domestically and globally, which has pushed yields to new lows in some sectors, and firmly sent growth out of London for the first time, with investors going up the risk curve both sectorally and geographically.
ECONOMIC OVERVIEW

2014 has been another good year for commercial real estate performance with a near-doubling of total returns in 2014 compared with 2013 (20% and 10.5% respectively, based on the IPD Quarterly Index).

As usual at this stage of the cycle, returns are dominated by capital growth; rental growth outside Central London and parts of the South East has been muted. Interest rates remain very low. Against expectations at the start of the year, long-term interest rates are now substantially lower than they were a year ago (10-year gilts were priced at over 3% at the start of the year and are now less than 2%). As a result, property continues to be highly attractive to investors. Investment appetite is further fuelled by the falling cost of finance.

‘There is more to the property recovery than just low interest rates ... the difference is a renewed confidence in occupier demand.’

But we believe there is more to the property recovery than just low interest rates. After all, rates were even lower in 2012 when total returns barely scraped past 2%. The difference is a renewed confidence in occupier demand, first evident in 2013 and strengthening in 2014. After a five year recession in commercial construction, it has been realised that a growing economy can easily lead to a situation where demand exceeds supply and where rents rise. Rents have probably reached their lowest point for all prime and most better secondary properties. This is a far more attractive proposition to potential investors than the chance of economic obsolescence and perpetually falling rents for all but the best properties.

The underlying strength of the UK’s economic recovery has also been crucial. Recent survey and official data remain encouraging and the UK economy compares well to its European peers.

But the UK’s prospects cannot be separated from those of the international economy. Doubts over the strength of the Eurozone recovery continue. The big news, however, has been coming from outside of Europe and, for once, it is positive. In mid-June, the price of crude (Brent Blend) was around $113 per barrel. Since then, it has fallen to just $65 – a fall of over 40%. Other than a blip induced by the 2009 credit crunch, this has brought prices in real terms down to levels not seen since before the recession.
These low prices could be with us for some time. If so, there are big implications for the world economy, and European economies in particular. Falling oil prices affect petrol costs, eventually also affecting other costs. This depresses inflation and pushes up real incomes. Real income growth has been extremely weak recently, so this new effect is welcome, particularly by retailers awaiting an upturn in consumer spending. Negative contributions to inflation from oil price falls will also keep interest rate rises at bay. Estimates show that the oil price fall could boost GDP by as much as ½ a percent, possibly more. For a European economy struggling to grow as 1% a year this is quite significant. It would also affect the UK, although in either case the full effect will take time to feed through.

‘We forecast total returns to property investment of around 13% in 2015’

Overall, our view of UK economic growth in 2015 is optimistic. We forecast total returns to property investment of around 13% in 2015, with slightly lower returns in subsequent years.

Chart 1: CBRE’s forecasts for total returns, 2015 to 2017

Source: IPD, CBRE
2014 was a year of very substantial change in the UK real estate capital markets – though admittedly many of the changes which the markets have experienced were already in evidence at the end of 2013.

In the direct market, the total value of commercial real estate investment activity was similar to last year at about £55 billion, but with a substantial geographic shift. Activity was reduced in Central London, but increased in the rest of the UK. Prime yields continued to fall, but the biggest yield shift was recorded in secondary property. Debt markets also opened up substantially with a much higher level of lending, and significant falls in margins.

The great uncertainty for 2015 is the evolution of interest rates. The current trend in long-term interest rates, even in the UK, is down rather than up, as a result of speculation over QE in the Eurozone and the impact of weaker commodity prices on inflation expectations.

‘Few forecasters now expect a move in interest rates before June 2015 ... Autumn 2015 is much more likely’

Rates will increase at some stage, although expectations on the date of the first increase are being continually pushed further into the future. Few forecasters now expect a move before June 2015; our own view is that Autumn 2015 is much more likely. Long-term interest rates may reach their lowest point and start to move up before then. When the increase in base rates does come, it will be the first since July 2007 – and thus will herald a longer-term change in monetary conditions to come.

There is still an exceptional spread between real estate yields and government bond yields. So substantial increases in rates can be absorbed before there will be upward pressure on real estate yields. Indeed we expect some further downward movement in prime yields in 2015, although the scope for further decline, particularly in the London markets, is very limited.
Secondary yields have considerably more room for further falls; despite downwards movement over the last year, the spread between prime and secondary yields is still more than a percentage point higher than its long-term average. We expect this spread to close further in 2015. However, looking further ahead, increased occupancy and rental value growth will take over as the drivers of capital value growth in 2016-17. Greater availability of debt for investment in secondary property will be an important factor in the further closing of the prime-secondary yield gap.

‘Secondary yields have considerable room for further falls...’

The introduction of new, institutional lenders has driven down lending margins on prime, central business district properties. So the traditional lenders are looking elsewhere for higher margin opportunities. The total value of transactions in 2015 is harder to forecast. A lot of investment property came onto the market in the UK in October and November 2014. The extent to which this sells will set the trend for the year ahead. If it sells well – and the signs are that it will – it will encourage more owners to bring properties to market.

In 2014 UK institutions have been particularly active investors, with US funds also very important players. In 2015 we expect to see Asian institutions becoming more active again. Japanese and Taiwanese pension funds and Chinese institutions have been investigating UK opportunities and are now expected to accelerate their transaction activity. However, limited investment stock, particularly at the prime end and in Central London, risks frustrating demand in the coming year.
OFFICES

The Central London office leasing market gathered pace in 2014, with above-trend levels of take-up observed in most Central London markets. Over 3.6m sq ft is under offer, helping sustain leasing levels in the first half of 2015. We anticipate that unusually high employment growth of recent years, in addition to continued economic growth, will result in expansionary demand, led by the creative sector. Lease events will add to this demand. Some occupiers, mainly from the financial and professional sector, will seek pre-let space well in advance of their break or expiry date, due to currently limited levels of supply and rising occupational costs.

Availability peaked in mid-2013, and has declined sharply in each quarter since, falling to 11.4m sq ft in November 2014 compared with the 10-year average of 15.7m sq ft. We anticipate that the high levels of demand forecast in 2015 will absorb the limited new supply coming through, causing availability to fall further. The imbalance between supply and demand has already pushed up office rents in most parts of Central London. We forecast strong rental growth across Central London office markets in 2015, with the strongest growth in the Docklands and City, albeit from a lower rental base.

Chart 2: Central London Prime Rental Outlook

In the Central London investment market, transaction levels in 2014 are unlikely to reach the record breaking £19.9bn transacted in 2013. Nonetheless, continued overseas demand, led by Asian and North American investors, is expected to support another strong year for Central London offices.
The weight of overseas capital chasing Central London assets has also helped maintain price pressure, with prime yields in the City and West End currently very low at 4.50% and 3.75% respectively. We don’t rule out further yield compression on the best buildings, due to high demand and the small number of buying opportunities. Secondary assets with short-term incomes, or yields on buildings in non-core locations, are more likely to see yield compression, as purchaser demand increasingly turns toward less prime assets in order to exploit the growing recovery in the occupier market.

Having lagged behind the occupier recovery in Central London, 2014 was the year when demand for regional offices returned, not simply in the South East but across many other parts of the UK. There was a noticeable shift in appetite from investors for value adding opportunities. A greater proportion of deals in the regional office market took place on higher yielding properties. This trend will continue in 2015, particularly given the keen pricing on some prime regional assets. Manchester, for example, has been the target of significant investment in 2014.

As a result, in those markets where yield compression for prime assets is close to reaching the previous cyclical trough, we expect the yield spread with secondary assets to close further in 2015.

‘2014 was the year when demand for regional offices returned…’

In those markets which were the target for significant equity in 2014, vendors were quick to release stock. Not all cities were able to benefit from this improved liquidity. Nevertheless, more cities will benefit in this way in 2015 as the economic recovery becomes more evident in second tier cities. This should present interesting purchasing opportunities in cities such as Newcastle, Nottingham and Sheffield.

With economic growth forecast to remain at, or above, trend rates in 2015, occupier markets will also continue to benefit. Markets in the Midlands and South of England that have recently performed below average will see activity levels finally pick up. At the end of 2014, there are already a number of known large requirements for space in the South East. 2015 will also see the beginning of a wave of demand driven by lease expiries, particularly of 15 year leases signed during an exceptionally active year in 2000. Occupiers will have an opportunity to acquire high quality new space and mitigate the risks associated with continuing occupation of second-hand, older buildings.
Should pre-letting emerge, it will be in a wider national office market that is already experiencing a new wave of speculative office development. With confirmation from Argent and its partners in Birmingham that the first phase of Paradise (a major mixed used regeneration scheme in the heart of Birmingham city centre) will commence in early 2015, speculative development will be underway in all of the UK’s major regional centres for the first time in almost a decade.

It has been so long since modern Grade A stock was last delivered, that these new developments could set new prime headline rents. Indeed, at the end of 2014 this is already the case in both Bristol and Manchester, two cities with new buildings close to completion. With lease incentives now also significantly narrowing, the prospects for significant rental growth, both headline and net effective, will be high in 2015 across the UK.
RETAIL PROPERTY

Prospects for the retail sector in 2015 are perhaps the most uncertain of all sectors. ONS reported that in the year to September 2014, retail sales increased by 2.7%, making it the 18th consecutive month of year-on-year growth, and the longest period of sustained year-on-year growth since May 2008. However the British Retail Consortium reports that, despite strong ‘Black Friday’ trading, like-for-like retail sales fell by -0.5% between September and November, highlighting some potential for continuing weakness in UK sales growth. Consumers in London and the South East remains significantly more positive than elsewhere in the UK about the economy, personal financial prospects and planned retail expenditure.

‘Market conditions remain very tough for retailers...’

But with over 75% of chain shopping located outside the South East, the heavily London-centric nature of prosperity growth is not yet showing through in a wider confidence or spend across the UK. Although we do expect the rest of the UK to grow in 2015, there is a risk of a two-speed consumer economy: London, and everywhere else. For retail markets to prosper, growth needs to be sustained and broadly-based.

That said, prospects for retail property markets are determined by sector profitability more than they are by aggregate sales trends or indeed consumer confidence. The grocery market and parts of the non-food market remain deflationary. Internet price comparison and the inability of many retailers, particularly grocers, to claw back online fulfilment costs, is putting further pressure on margins.

Unsurprisingly given margin pressures, chain expansion remains at a recessionary low. Rental growth (outside London) is difficult to discern, and the shops development pipeline continues to contract across all sectors (shopping centres, parks and grocery) as landowners try to find alternative uses for surplus capacity. In grocery markets, full-line grocery operators are diverting monies originally earmarked for store expansion to sustain the grocery price war that has broken out with hard discounters.

The number of chains going into administration might be small compared to 3-4 years ago, but market conditions remain very tough for retailers.

On the plus side, if economic growth is as sustained through 2015 as most forecasters predict, and if real wages growth continues, we consider that stronger retail sector performance will finally be seen. Furthermore, primary stock availability is continuing to fall: this is a precursor to both rental inflation and a shops development upturn, when broadly-based national spending growth resumes.
INDUSTRIALS

A severe shortage of stock, especially in areas of highest occupier demand, continues to influence the industrial market in the UK. Speculative development will only go so far to address this situation, with a mismatch in some regions between what is being developed and what requirements exist.

As a result 2015 will continue the current trend for occupier decisions to be driven by where supply is located, rather than their ideal location - but only if they are not prepared to wait for a ‘Built To Suit’ unit.

Chart 3: Rolling 12-month industrial rental value growth

From a landlord’s perspective these are all positive signs for the industrial market, not least because rental growth is increasingly becoming a part of overall total returns, especially so in the South East and primary Midlands markets. IPD’s Monthly Index puts annual rental growth to the end of November in London at 4.2%, in the Midlands at 2.9% and across the North and Scotland at 1.6%. Given the current low inflation environment, this is some of the first real rental growth the industrial sector has seen since 2000.
RESIDENTIAL PROPERTY

Although the wider economy strengthened over 2014, home buyers are increasingly sensitive to price, particularly as there has been little or no real wage growth over the last five years. Rising property prices, and concerns over interest rate rises in the next few years are naturally softening demand, although the fact that house prices have been rising faster than earnings for more than a decade (indicates that substantial pent-up demand remains unmet.

So our forecasts remain broadly unchanged from our previous (summer 2014) forecasts; we expect UK house price growth of around 6% in 2015, with slightly lower annual price increases thereafter.

‘We expect house price growth of around 6% in 2015’

The London residential market tends to outperform the wider UK. However, the differential has been particularly marked recently; in the year to December 2014 London experienced house price growth of 21% compared with the UK average of 10.5%. This reflects a divergence within London itself, with the city’s performance primarily driven by a buoyant central market. However, over the past year, growth in Greater London has picked up (at 16% annualised) and is now more on a par with the central market (18% annualised).

Transaction volumes dropped considerably in the wake of the financial crisis as confidence fell and buyers naturally retreated from the market. Now, with a new set of prevailing market conditions, we believe this lower transaction environment has become the ‘new normal’ for the UK housing markets. In the decade prior to the financial crisis, property sales in the UK averaged 1.53 million per year, reaching a peak of 1.7 million. However, they plummeted during the recession to below 800,000. Although transactions have subsequently increased, they are still at around two thirds of the pre-crash levels, averaging at just under 1 million transactions per year. Over the past year they have reached around 1.3 million, which we expect to be the new peak level.

CBRE will shortly be publishing a more detailed look at the prospects for residential property in 2015.
This report has been prepared by the CBRE UK Research team. For more information about our forecasts and predictions for 2015, please contact us.

Miles Gibson  
*Head of UK Research*  
+44 20 7182 2738  
miles.gibson@cbre.com

Jennet Siebrits  
*Head of UK Residential Research*  
+44 20 7182 2066  
jennet.siebrits@cbre.com

Mark Teale  
*Head of UK Retail Research*  
+44 20 7182 3611  
mark.teale@cbre.com

Kevin McCauley  
*Head of Central London Research*  
+44 20 7182 3620  
kevin.mccauley@cbre.com

Andrew Marston  
*National Offices, Regions and Logistics*  
+44 20 7182 3907  
andrew.marston@cbre.com

Ruth Hollies  
*Economics, Investment and Forecasting*  
*UK Research*  
+44 20 7182 3871  
ruth.hollies@cbre.com