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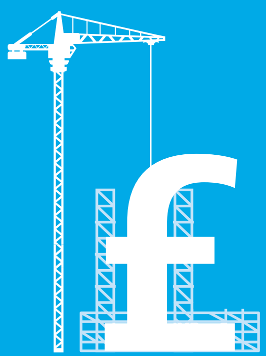
UK real estate predictions 2014
Expansion mode

The **economy** is on track to see the **strongest growth** since 2007

The **TMT** sector will continue to **drive London office demand** in 2014

Construction costs to **jump** in early 2014 as **pricing power** shifts to **contractors**



Taiwanese insurance companies to join the wave of **overseas investors** targeting the UK

E-fulfilment battle will drive a **sharp increase** in retailers' demand for **urban logistics** in 2014

Expect **strong capital value growth** in H1

Real estate steps up as a **key tool** in the battle for **talent**

2014: The year that the scale of the public sector **property disposals** starts meeting the **Government's ambition**

Vacancy (finally) **starts to fall** on the **high street** in 2014

Introduction

2013 was a better year for the UK economy than many expected or even hoped. However, the recovery in commercial property played out just as we predicted with capital values turning positive from the half year point. Indeed, we had a pretty good run with our predictions over the course of last year.

So, what is in store for 2014? Well, we expect that the momentum clearly building up in the transactions market during late 2013 will continue into the start of the year and that capital values will reflect this by increasing sharply over the first few months. Both domestic and overseas investors, including new entrants, are firmly in buying mode, helping to drive returns to levels not seen for a number of years. London will remain a key focus, but investors will become increasingly comfortable about a move up the risk curve as the improving economy will make opportunities outside London more and more enticing.

We also expect to see the acceleration of a number of structural changes in the real estate industry as the economy shifts towards growth. For businesses, stronger market conditions will make it harder to recruit and retain the best staff. We believe that doing so will require a more cohesive approach to workplaces, combining technology and human capital, as well as real estate, to create a compelling working environment which plays an active role in securing the best talent.

A different type of structural change will be seen in the logistics sector during 2014 as the operational demands of online retailing have a tangible effect on retailer distribution strategies, and competition over delivery times drives a requirement for urban logistics facilities. Yet the notion that further growth in online sales rules out a recovery in physical store retailing is likely to be misplaced – in fact, we expect 2014 to see a fledgling revival on the high street.

Despite an undoubtedly more positive outlook, however, a number of hazards remain: rental growth will need to pick up if the high level of returns predicted for the first half of 2014 are to be maintained, while a sharp rise in construction costs will put pressure on development viability.

In this fast changing and ever more complex market, we truly believe that the unique offer that Deloitte brings to clients through our combination of deep cross-industry insight, core property advisory skills and market coverage, strategic consulting, and global reach will help to deliver outperformance for those we work with.

As usual, we will be exploring the themes outlined here via our Twitter feed @deloitteUK_RE using #REpredictions. We invite you to share your own views, comments and predictions for the year ahead.

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The economy is on track to see the strongest growth since 2007

The UK enters 2014 in far better shape than at the start of 2013, and is now on track to see the strongest year of growth since 2007.

The UK recovery came earlier and faster than expected in 2013, with the UK going from being one of the rich world's growth laggards in January to one of its stronger performers by December.

Three factors drove the early stages of the rebound. The intoxicating effects of five years of rock bottom interest rates and quantitative easing are finally working their magic. A diminution in external economic risk, especially in the euro area, bolstered business prospects. And an estimated £12 billion of compensation payments for the mis-selling of payment protection insurance gave the consumer sector a shot in the arm.

So far this has been a classic UK upswing, with the consumer in the lead, and lower saving, increased borrowing and rising house prices fuelling growth. This is a long way from the balanced recovery which policymakers had hoped for, one with manufacturing, exports and investment in the driving seat. What happens next depends crucially on incomes and investment.

Consumer spending accounts for 60% of the economy and it is hard to imagine the UK recovering without continued growth, even at subdued rates, in consumer activity. We think that in 2014 earnings growth will outstrip inflation for the first time since 2009. This should be enough to sustain a continuing, if modest, growth in consumer spending.

The other missing link in the recovery is investment, which has flatlined since a huge recessionary contraction in 2008-09. However, a growing body of evidence suggests we are approaching a turning point. Survey data indicate that firms are not operating with huge amounts of spare capacity. If the capital stock is worn out, returns to investment, particularly at current low borrowing costs, ought to be attractive.

With the *Deloitte CFO Survey* reporting that risk appetite among chief financial officers is at the highest level in six years the stage seems set for a rebound in corporate investment and spending more generally.

Before we get carried away we need to put the UK growth picture in perspective. On average economists forecast the UK will grow by about 2.5% in 2014. Before the financial crisis that would have been regarded as a solid, if unremarkable, rate of growth. But after five years in which the economy has shrunk, 2.5% growth looks relatively good and, if realised, would represent the strongest growth since 2007.

The UK's surprising recovery has left the Bank of England with a dilemma. Last summer its governor, Mark Carney, suggested that the Bank was likely to leave interest rates on hold until mid-2016. Unemployment has subsequently fallen far faster than expected. Mr Carney's pro-growth Forward Guidance policy was designed to bolster activity, but has been launched into an economy that is recovering faster than expected. Interpreting when the Bank of England might raise interest rates, and in what circumstances, has become more difficult, but our hunch is that rates are likely to start rising in the first half of 2015.

Continued growth requires an absence of the sort of external shocks – especially in the euro area – which derailed an incipient recovery in 2011. To maintain the pace of recovery, and to ensure a better balanced pattern of activity, the UK needs a strong rebound in capital spending and consumer incomes. Macro and financial uncertainties have reduced, but have not been eliminated. Nonetheless, the UK enters 2014 in far better shape than it entered 2013.

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UK commercial property: expect strong capital value growth in the first half of 2014

The stage is set for a period of strong performance from UK commercial property. With the market picking up significant momentum towards the end of 2013, as a widening pool of investors become increasingly willing to move further up the risk curve, we expect to see capital values rise sharply over the next six months.

For the last few years the UK commercial property market has been characterised by the weight of money, led by overseas investors, chasing prime assets in London. However, this has now changed. The second half of 2013 has seen an increase in the range both of the types of investors active in the market and in the products that they are looking to purchase, as well as a rising appetite for speculative development. This has driven a resurgence in demand for commercial real estate across the UK and, with the significant pricing differential that still exists outside London, this correction is proving to be rapid.

Overseas buyers remain, and will continue to be, an important part of the market, with further new entrants expected in 2014 (see our separate prediction on this topic). Meanwhile, private equity investors are exhibiting the signs of a traditional mid-cycle play: some 'first-movers' who bought into the recovery early are now taking profits while others continue to chase higher-yielding opportunities and remain active buyers.

Importantly, the institutional funds, which had largely retrenched into core south east and London markets until mid-2013, are now bidding on, and winning, higher-risk assets across the UK, as greater optimism amongst wealth managers translates into an increasing allocation of capital to real estate.

The improving market is also giving investors greater confidence to take on additional leasing risk. For many this means looking outside the London market to sectors such as south east offices, logistics, and prime property in the UK's key regional centres. In particular, business parks, shunned by the market until recently, are now being traded frequently with prices rising rapidly. We have also seen a pick-up in demand for development sites and a growing number of investors kicking off speculative development across a range of property types.

We expect that this increase in demand will have a significant impact on pricing for real estate outside the capital, and we foresee that UK regional performance will outstrip London for at least part of 2014. Indeed, this could already be underway. The shift in values beginning to show in the reported index numbers is likely to be lagging the transaction market.

However, we do not predict that the forecast strong performance will flow forward unchecked throughout the next twelve months. Capital value growth may slow or even stall from midyear: as pricing corrects, the need for rental value growth to drive performance becomes increasingly important. While investors may be prepared to 'forward buy' some of the expected recovery in occupier demand and therefore rents, caution is likely to prevail as more heroic assumptions on performance are required to compete for appropriate opportunities.

Taiwanese insurance companies to join the wave of overseas investors targeting the UK

Following significant and increasing inflows from China and the Middle East as well as European and US investors, the next new entrant into the UK market will be Taiwanese insurance companies which were permitted to invest in real estate outside Taiwan in mid-2013.

Overseas investors accounted for 42% of commercial real estate investment transactions during 2013. This demand has come from a wide range of geographies with our database recording 35 different nationalities completing deals.

Indeed, demand has proved stronger than we expected: last year we predicted that combined overseas investment into commercial and residential property would exceed £20 billion, yet as it turned out, this figure was reached through commercial property investment alone.

China has been a key talking point in the UK real estate market as the deregulation of Chinese insurance companies has allowed them to invest outside their domestic economy and into a broader range of assets, including real estate. Add to this the increasing instances of both Chinese state-owned enterprises and Chinese development companies focusing more attention on overseas investment, and the UK in particular, and a sizeable wave of money continues to head towards the UK. We expect to see further significant investment transactions from this part of the world, be they more complex assets, or opportunities further up the risk curve including development and infrastructure.

What is clear is that this flow of overseas capital is not slowing. Indeed, it will continue to be reinforced by new investors from geographies yet to buy into UK real estate in any significant way, but with an appetite to increase their exposure. Some of these investors will be wealthy individuals or families, but they will also be joined by a further cohort of institutions keen to follow in the footsteps of those from other countries that have already diversified into the UK.

We predict that one of these groups will be the Taiwanese insurance companies, which since mid-2013 have been allowed to invest in real estate outside Taiwan. We expect that initial investments will be focused on prime London assets, as has been the case with previous new entrants, but that a move to other parts of the UK will follow as experience is gained.

Construction costs to jump in early 2014 as pricing power shifts to contractors

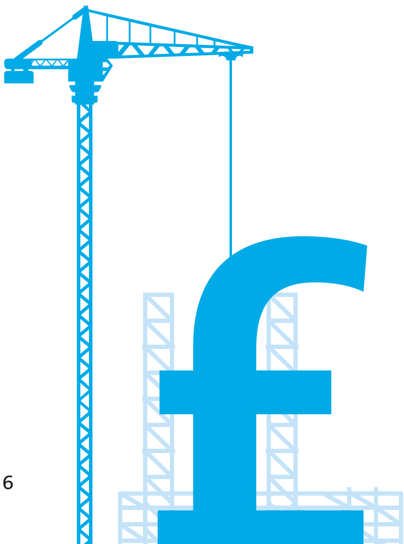
The signs of an impending spike in construction costs are becoming increasingly apparent with estimating departments busy, demolition contractors 'sold-out' and contracts for small or complex jobs beginning to become hard to place.

The construction industry has been hit hard since the peak of the market in early 2008. Over the last five years, activity in many sectors has fallen to the lowest levels on record, prompting fierce competition for the contracts that have been available. Part of the response to these conditions has been innovation in delivery models and material technologies, but the general upshot has been significant downward pressure on margins as contractors compete hard for work at the same time as labour and materials costs have continued to rise.

With construction activity now growing and expected to increase further as economic conditions improve, contractors are becoming more selective about which jobs they take on and the price at which they commit to delivering. We expect that this will soon translate into a sharp upward shift in the overall construction cost index as margins return to a more 'normal' and sustainable level. This will be seen first in the early stage construction processes such as demolition, groundwork and concrete trades, as well as in the smaller, complex jobs that are less attractive to contractors. It will also be multi-speed depending on sector and geography, with the hot markets such as London commercial and residential, and national distribution warehouses, seeing prices rising earlier.

While this pick-up in activity and pricing is important for contracts not yet placed, it may actually have a far more significant impact on projects currently underway. Jobs priced and committed in the past few months run a risk of being unable to hire subcontractors and trades at the costs expected in the original tender agreement. There is a real possibility this will result in increasing contractor M&A activity as businesses falter, or even a complete corporate failure. This threat will fade as the balance of work shifts to projects agreed more recently, but should be closely watched over the next six months.

However, not all pressure on pricing will be upward. The flexibility of the UK labour market means that pressure on wages is not expected to be as severe as we have seen in the past, although senior positions and skilled trades will continue to remain in short supply and so will buck this trend. In addition, globalisation of resources means that there is increasing competition amongst suppliers of certain materials, with new entrants such as Asian cladding contractors beginning to establish themselves in the UK market. Also, the innovation in processes and materials that have been pursued during the last five years will continue to deliver shorter construction periods at reduced cost. Following the sharp correction we are predicting for early 2014 it is likely that the market will return to a more normalised period of cost price inflation.



Vacancy (finally) starts to fall on the high street in 2014

We predict 2014 will be the year that vacancy rates start to fall in certain locations and the revitalisation of the high street begins.

Our recent *Deloitte Consumer Review: Reinventing the role of the high street,* highlighted that, while much has been written about the future of the high street, no clear consensus has yet emerged on how our town centres are to be revived. There is a chance that we are all so absorbed in discussing the demise of the high street that we may miss the first, fledgling signs of recovery.

Despite the undoubtedly high vacancy levels that are still being seen, a number of structural issues are setting the scene for recovery. High street vacancy rates continue to vary widely across the country, but we predict that 2014 will start to see growing evidence of demand for empty units for a variety of different reasons.

Firstly, the economic backdrop has finally begun to improve. Our latest *Deloitte Consumer Tracker* is showing steady improvements in consumer confidence, and this is forecast to continue during 2014. Consumers have started to spend more, and while wage growth remains low, a reduced level of financial uncertainty means that a smaller proportion of household income is being diverted towards precautionary savings.

Of course, there is no guarantee that additional consumer spending will necessarily flow to the high street. Indeed, recent retail sales growth has been almost exclusively via online channels. In order to win or maintain market share high streets need to play to their strengths and 'convenience' is seen as chief amongst these according to our consumer research. The recent proliferation of high street convenience stores, therefore, shows that at least some high streets are evolving to better reflect the demands of consumers.

The growth of the convenience sector can have a knock-on effect on the high street, as convenience formats can revive footfall to an extent that encourages other business to return. However, they cannot, by definition, carry large ranges, and therefore there may be opportunities for specialists such as butchers or bakers to fill the gaps.

Other reasons to visit the high street are emerging. While much of the growth in retail sales is taking place online, the distinction between different retail channels continues to blur, and physical stores will still play a strong role, not least in showcasing products. They are also being used as click and collect points for orders placed online. Deloitte estimates there are now over 20,000 pick-up points across the UK – many on the high street. Indeed, retailers see click and collect as an increasingly important driver of store traffic and sales.

Much has been written about the future of the high street and there has been some deep soul-searching on how to approach the problems that clearly exist. However, as economic conditions improve and the dynamics of the interplay between online and physical retail continue to evolve, the future for the high street could be brighter than many imagine. While not ignoring the significant problems that still exist, we believe there will be some glimmers of light in 2014.

E-fulfilment battle will drive a sharp increase in retailers' demand for urban logistics in 2014

For retailers competing for online market share, a key differentiator is how quickly and efficiently they can get their products to customers. As the delivery promise becomes more important and, at the same time, increasingly complicated, real estate strategies are changing fast.

Retailers have long grasped the benefits of a compelling online offer, but it remains an extremely challenging and competitive marketplace in which to operate. A crucial difference from physical stores is the far greater ease with which consumers using the internet can compare prices. Competing on price alone is therefore much harder, and so customer service and convenience have become critical points of differentiation.

The speed at which goods can make the journey from warehouse to doorstep is emerging as a major battleground. To improve service, next-day delivery is now commonplace, with options to place an order late the night before – or even the same day as delivery – now required to stand out from competitors. In London and other major cities, delivery times are increasingly measured in hours or even minutes, not days.

This presents the retail supply chain with a significant challenge. Originally designed to provide stores with regular, bulk deliveries, many retailers' logistics operations do not yet feature the right mix of infrastructure to compete effectively on delivery times or to deal efficiently with returns.

In recent years, many retailers have driven efficiencies by using fewer, but larger distribution centres. Indeed, the consolidation of multiple regional warehouses into a smaller number of national facilities is a trend that is still ongoing and evolving for some distributors. However, retailers with a small number of large national distribution centres will struggle to make rapid, cost-effective, deliveries across the country unless they combine these with smaller hubs located near to large conurbations.

Many of the UK's retailers and e-fulfilment specialists are now acutely aware of the need for urban distribution hubs, and the second half of 2013 saw a flurry of leasing activity on distribution facilities close to major cities. This demand is only set to build as online operations escalate and pressure on delivery times intensifies, but the supply of well-located stock of appropriate specification is likely to be far from sufficient. 2014 therefore promises to see rents on such property rising, and yields being forced down.

2014: the year that the scale of public sector property disposals starts meeting the government's ambition

After a series of policy announcements, 2014 will finally see the introduction of an annual target for government property disposals, and equally importantly, a structure under which public sector bodies can achieve this.

The economic benefits from streamlining the public sector's property portfolio are widely recognised, but asset sales have been held back through a lack of clarity on the methods of disposal, public demand to retain facilities, and a misalignment of incentives.

However, under changes to be enacted in 2014, these stumbling blocks will start to be addressed. Firstly, the Homes and Communities Agency (HCA) will be mandated to manage the disposal of central government property.

Secondly, as an incentive, local authorities will be allowed to retain up to £200m of receipts on the one-off costs of reforming services and disposing of property. This is likely to be an especially popular measure in asset-rich, income-poor boroughs. Elsewhere however, where land or asset values may be low and any proceeds from sales relatively small, the main financial gain could come from removing the obligation to maintain or operate the land or assets in question.

Some in the public sector have also been reluctant to sell property while the market has been low, but the introduction of these new measures is timely: as we cover elsewhere, the commercial property market has finally found a floor, and we expect to see values rise during 2014, potentially lifting the values achievable on disposals. Meanwhile, many parts of the country continue to experience a housing shortage, and the sale of government property or land could play a role in boosting supply.

Meeting the disposal targets will not be easy, however. Public sector property sales are often fraught with difficulty, as the public's views on perceived landmark or symbolic buildings, or key facilities, can be strong.

Central government has set a striking precedent for landmark disposals through the sale of Admiralty Arch and the old War Office building in Westminster. However, much of the public sector's real estate optimisation to date has taken place within non-public facing areas, such as offices, where future targets for lowering space per full-time employee have the potential to release further space back to the market.

Many of the 'easy wins' have therefore already been achieved, and future disposals could prove progressively more difficult. One way to address this problem may be to review some of more peripheral services offered by government, and outsource entire functions, rather than just rationalising property assets.

Ultimately, the large-scale release of assets will be a marathon rather than a sprint. But a more buoyant market, effective incentives and centralised support should make 2014 the year that the government's property disposal ambitions start to be realised.

Real estate steps up as a key tool in the battle for talent

While the importance of the physical workplace has been clear to many employers for years, 2014 will see an increasing number looking closely at how well their real estate, location and technology strategies really do support their crucial talent agendas.

There is growing recognition that a carefully aligned talent, technology and workplace strategy is becoming increasingly fundamental to attracting and retaining staff, as well as encouraging greater productivity. This will inevitably drive changes around the real purpose, use, location, design and specification of new workplace developments.

Organisations are looking hard at how to fully leverage their investment in staff, in their technology infrastructure and in their real estate. With human capital, technology and real estate typically their three highest operating costs, employers recognise that balancing the right headcount model, in the right locations, supported by the most appropriate technology, real estate assets and cost base, is key to driving smart growth and enterprise success.

Masked by the past years of recession, competition for the best talent is fast becoming as ferocious as it has ever been. The results of the latest *Deloitte CFO Survey* show that 70% of CFOs expect to increase hiring in 2014 and the overall “workplace” offer is becoming a major talent battleground. Our recent *Human Capital Trends 2013* report showed that workplace flexibility is an important factor in job choice. It also highlighted how Generation Y will represent 75% of the workforce by 2025 – a generation that believes that greater opportunities for mobile working will improve productivity. Expectations are changing fast and employers are questioning whether their working environment is sufficiently supportive of their talent agenda.

This evolution, unsurprisingly, is moving at different speeds. It is most evident in the ‘hot’ sectors, such as the London technology industry, where this changing talent agenda is most acute and where some of the most imaginative forward-thinking on the workplace can be found. But it certainly does not end there, with banking likely to be another industry to see a strategic imperative to focus on workplace strategies. Our recent *Deloitte Talent in Banking Survey 2013* recorded “a creative and dynamic work environment” as one of the biggest career attractions for business graduates; but, crucially, less than 40% of students associated this with a career in banking. So something has to change.

While we are by no means predicting the end of the traditional office, we do expect a new focus on a combined and well-coordinated talent, technology and real estate strategy evolving during 2014. The consequences will take a variety of forms. For some it will simply mean a redesign of their existing real estate to reflect changing workforce patterns, while at the other end of the scale it will mean a completely new way of thinking about where and how people work.

Cost and convenience are still important to office occupiers. However, factors such as how the real estate works hand in hand with the technology strategy to support the talent agenda will start to override the traditional siloed drivers of real estate decision making and the narrow focus on real estate as just a cost. The world of work is changing fast and real estate has yet to fully respond.

The TMT sector will continue to drive London office demand in 2014

Accounting for 70% of all London office pre-let leasing deals in 2013, the TMT sector will continue to play a key role in the London property market and economy in 2014.

TMT (technology, media and telecommunications) has continued to be the focus of attention for the London office market. The sector has been expanding aggressively, driving leasing activity across the capital, often in locations that, until now, have been seen as secondary or even fringe and prompting significant regeneration and value shift. Transactions have ranged from small units for start-ups through to some of the largest leasing deals on record.

This activity is unsurprising given the global importance of London as a TMT hub. The 2013 Deloitte report on the sector *Enabling a world leading digital hub* highlighted the significance of TMT to the London economy: supporting around £125 billion of output annually for the UK, equivalent to 8% of GDP and accounting for 10% of London employment (c.440,000 jobs). In addition, the sector occupies 13% of the central London office stock totalling 25 million sq ft of floorspace.

The Deloitte *Globaltown: Winning London's crucial battle for talent* report as part of our 'London Futures' initiative reiterates this national and global outperformance: London is ranked as the leading global city for TMT based on employment rankings, ahead of Los Angeles, New York, Singapore and Hong Kong.

Importantly, the sector continues to grow and, crucially, London is a magnet for this growth. Our *Deloitte 2013 UK Technology Fast 50* report highlighted the increasing concentration of technology companies in the London economy. Of the 50 fastest growing tech companies in 2013 (ranked on revenue growth over the last five years) 40% are based in London (75% of these in central London). Interestingly, in 1998 London and the south east accounted for just 16% of the winners; today that is 64%.

The outlook for TMT in London continues to be very positive. Our *Globaltown* report suggests that the sector is likely to be one of the fastest growing in London over the next five years as London continues to build on its global leadership and place as one of the of the world's largest digital economies. This growth will undoubtedly translate into continued demand for office space as companies expand, new global entrants are attracted to the capital city and fresh start-ups appear. In addition, a key driver of TMT office take-up is likely to be demand from established UK 'corporates' which are looking to set up or enhance their digital platforms. With a market-leading digital strategy now an imperative for almost every company, the war for the best talent means that we will continue to see 'non-TMT' companies making strategic investments in areas like Tech City in order to attract the best digital staff to drive this part of their business. We expect another year of strong TMT transaction activity for London.

Notes

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