The UK real estate market in the spotlight

What will 2015 bring about?

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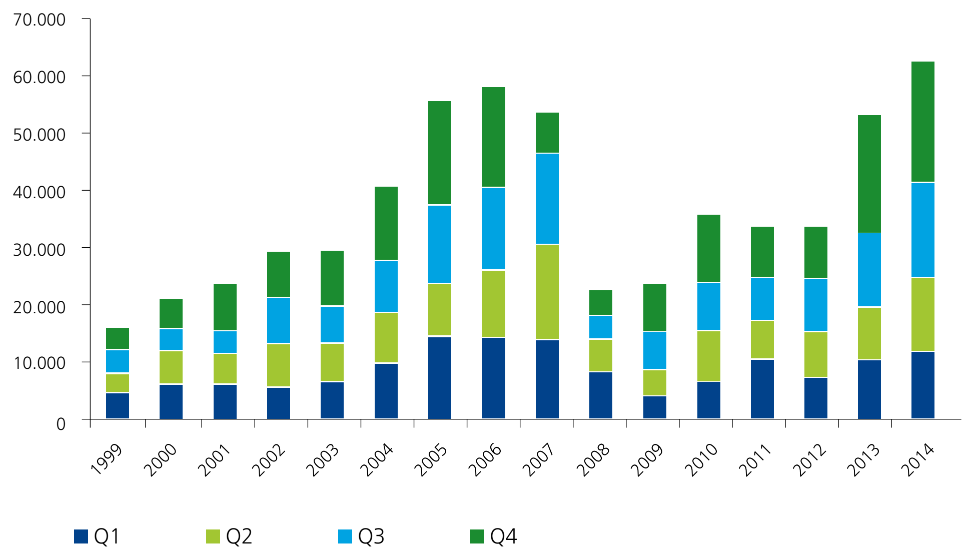
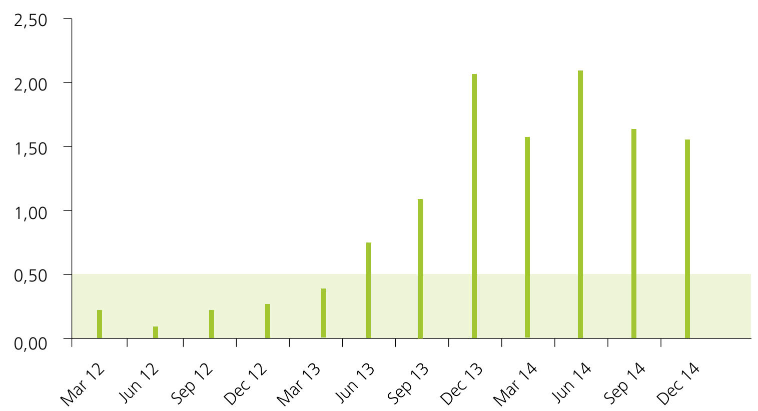
Now that the dust has settled on 2014, it is becoming clear just how strong a year it was for real estate returns generally and the UK in particular.

Headlines point to phenomenal performance with total UK returns reaching their highest level for many years, but behind this we have seen some fascinating developments. Waves of new investors, an occupier market changing at a rapid pace – driven by technological disruption and economic shocks, both positive and negative - the twists and turns of new regulation and evidence of increasing M&A activity in the sector are all part of what made 2014 a particularly exciting year.

UK investment volumes by quarter (£million)



UK Month-on-month total returns (%)



Given this backdrop, it is perhaps unsurprising that the consensus envisages a moderation in performance in 2015, but our view is that this cycle has further to run. We are confident the UK economy will show reasonable growth, even if the pace will be more measured than last year. This will provide a solid foundation for another year of robust performance, with further yield compression and improving rental growth.

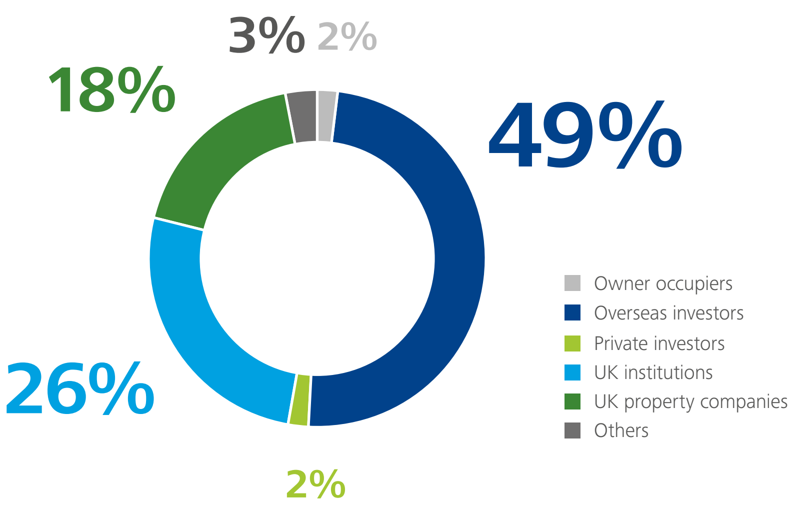
Indeed, rising occupational demand is taking hold as the economy expands, and not just in London. Deloitte's recent 'Businesses Leading Britain' report found that two thirds of the UK's fastest growing medium-sized companies are now based outside London and the South East.

So far, however, new office construction is struggling to keep pace with demand in some locations, and this scarcity will support rental growth prospects.
The relatively low pipeline of new office space in London is now well understood, but our research shows that a similar picture exists in a number of regional markets.

For example, our recent Manchester Crane survey showed that, although office construction is rising, delivery over the next two years will be modest, and availability of Grade A space has dropped to less than half its 2009 level. Our Leeds Crane survey shows a more marked rise in projected office completions over the coming years, although just as in Manchester, a period of very weak construction activity means availability of Grade A space remains limited.

Neither do we see any signs of a let-up in demand from the wide range of investor groups targeting UK real estate: be it domestic institutional investors, overseas pension and sovereign wealth funds or the man on the street topping up his savings in retail funds, enticed into property by its recent track record. Amongst those increasingly active in the UK we single out UHNWIs (Ultra High Net Worth Individuals) as ones to watch in 2015. Having quietly built their share of investment transactions to a sizeable level, family offices now represent a significant force in the market.

Share of investment by investor type Q4 2014



We are also witnessing investor interest in a broader range of property types. In addition to fierce competition for office stock, demand for industrial and logistics property institutions has increased, with institutions and funds particularly active buyers. Meanwhile, shopping centres have also been the focus of strong investor interest and an increasing number of transactions have been conducted off-market as vendors have been confident of achieving asking price.

With so much competition for UK property, some investors will inevitably find it difficult to deploy capital quickly and efficiently. Those with large allocations to UK property may decide that it would be easier to purchase an existing real estate investment vehicle, with a management team in place, and the recent Songbird (Canary Wharf) bid supports this thesis.

Like many, we still have concerns over particular parts of the market. Alarm bells are ringing for superstores - the race for space has left some retailers over-exposed to large out-of-town sites at a time when the consumer appetite for convenience increasingly favours the high street, and discounters are stealing a march. We expect that a continued rise in small, frequent shopping trips will support convenient locations that form part of people's daily transport routes: local high streets, stations or other major transport hubs, for example. These will become the ultimate convenience shopping pitches.

The evolving demand for different types of space is not limited to retailing. In fact, we believe that the UK's office sector is beginning to feel the effects of the tech revolution that is already rapidly transforming both retail and industrial property. Our recent research has highlighted the potential for a third of UK jobs to be automated and that future employment growth will be focused on more cerebral, creative and collaborative job types.

The current regimented style of office accommodation will not be the best fit for employees in these jobs, who benefit from being able to work in a variety of spaces depending on the task at hand.

We are starting to see office design respond to some of these needs, but it is becoming increasingly apparent that creating high quality working environments requires the close alignment of a company's talent, technology, location and building strategies. Most organisations will not see this integration completed in 2015. In fact, many are only starting on this route, but they will recognise that the office is a hugely valuable component in their overall offer to staff.

As we look to what 2015 has in store, one thing is for sure: it looks set to be another dynamic year. Success will be measured by the ability to navigate through the fast changing world in which we now find ourselves.