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Real Estate

Q3 2014

Property IQ

No summer slowdown this year

The UK economy is now in much better health, and is waiting to be taken off the support systems of quantitative easing and a historically low base rate. Quarter two's estimate of GDP growth met general expectations at 0.8%, and confirmed that the recovery remains strong.

Growing service sector activity continues to provide the backbone to this performance. Consumer spending is still contributing strongly, although wage growth has recently fallen back and there are signs that consumers are starting to worry about debt levels amid expected rises in interest rates. This is perhaps the chief perceived risk that will prevent output continuing to grow at the current rate.

So the economy has now recovered the ground lost since the financial crisis, but how has property performed? Capital values for All Property are still 31% below their peak. At sector level, offices are 26% below, industrials 28% and retail property 36%. The only subsectors to have recovered to pre-crisis levels are central London retail (now 25% up) and supermarkets (2% higher). Office property outside the South East currently stands more than 40% below its mid-2007 value.

But, like GDP, capital values are rising. Annual growth for IPD All Property is now above 10%, and recorded a 3.3% rise in Q2. Outside the central London office markets, the bulk of this remains driven by yield compression. However, rental growth is making a solid contribution to performance, and investors' pricing is assuming that there is more to come.

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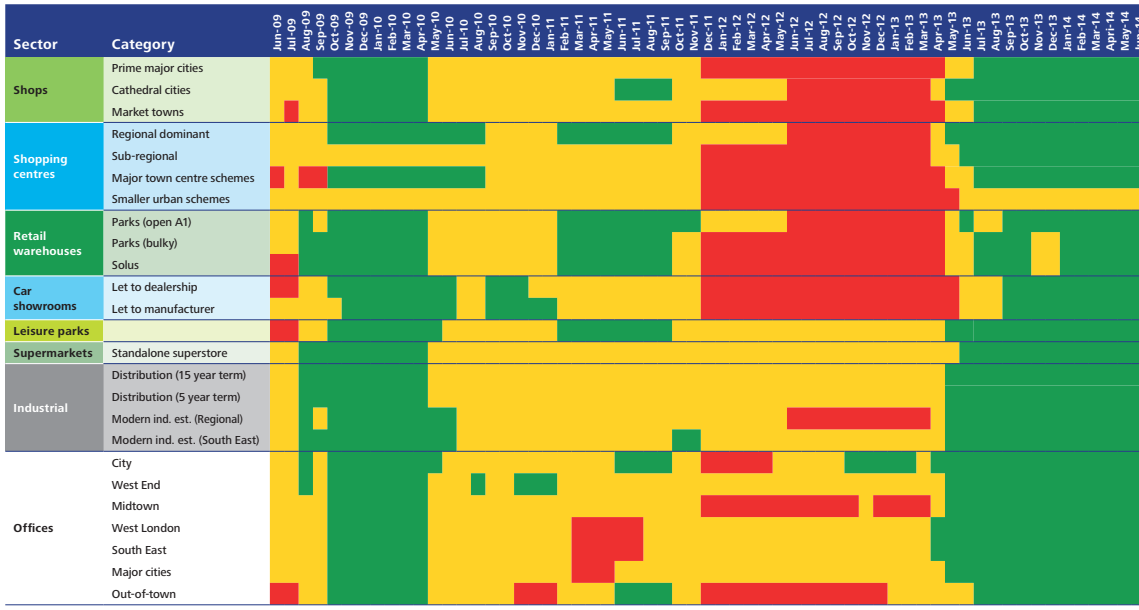
Deloitte Real Estate Yield Matrix – changing sentiment towards yields on prime property
All sectors of the market are now seeing positive investor sentiment



Sentiment indicator: Sentiment weakening No change in sentiment Sentiment strengthening

Source: Deloitte Real Estate

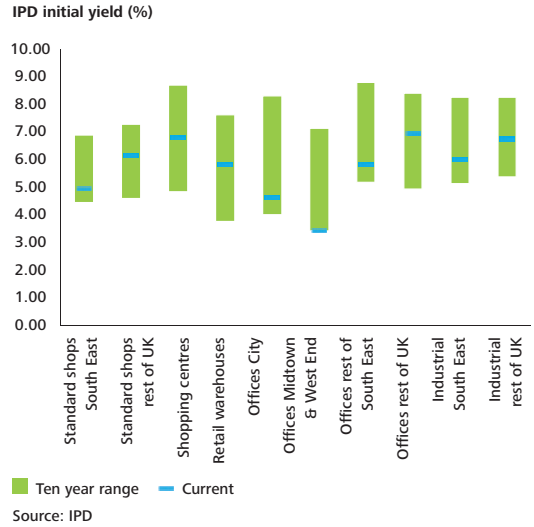
Respondents to the latest Deloitte CFO Survey expect the base rate to have risen to around 0.9% by mid-2015. This is in line with the governor of the Bank of England's forecast of 'gradual and limited' rises, hoping not to snuff out rising levels of business investment. The question is whether rental growth can pick up sufficiently to offset the expected drag on capital value growth.

Much therefore now hangs on the strength of the rental growth story. In London, certainly, and in prime parts of the South East, growth is well established, but we now expect that this will spread further around the major regional centres, albeit gradually as the recovering economy drives occupier demand. IPD's Q2 data shows that rental growth is variable outside London: for offices, only five of the ten regions recorded an improvement on the first quarter; for industrials the picture is similar. Take-up remains patchy around the regional cities but vacancy levels remain relatively high. Support should come from the scarcity of development across the UK which has been very low since 2010. Indeed, this has brought forward an increased number of plans for speculative development.

So what about the investment market? We see activity remaining strong over the rest of the year. Inflows to retail funds are rising sharply, increasing their purchasing power, and the range of different investor types competing for stock – industrial assets and shopping centres in particular – also suggests there is plenty of unsatisfied demand in the market. A key aspect of the market this year has been the highly acquisitive activity of UK institutional funds – strong net investors in each of the last three quarters.

For overseas investors, London remains an attractive location for their cash, with new entrants continuing to join the market, Taiwanese insurance fund Cathay Life being one of the latest to buy into the City. However, the proportion of deals in the London market has been falling since spring last year as more purchasers seek better value outside the capital.

What might be the concerns for investors? Political uncertainty is one factor – around the Scottish referendum for some, around the general election next May, and also a potential EU membership vote further out. But another is whether there is still sufficient potential for growth in values, given the movement in yields already seen. Comfort should come from the fact that in many segments current initial yields are still some way above the bottom of their long-term historic range – notably in the shopping centre and retail parks, as well as the regional office and industrial sectors. Good secondary property is now outperforming prime and the yield gap between the two is narrowing as investors' quest for better value and higher returns causes secondary yields to fall faster.



Source: IPD

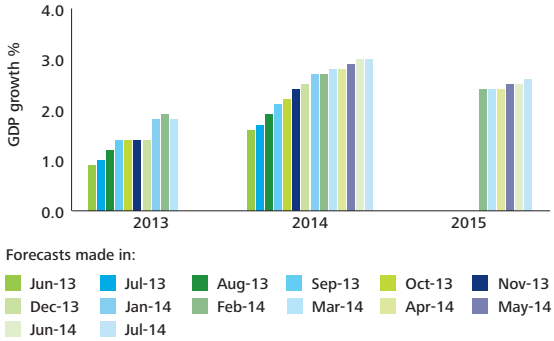
The elements all seem to be in place for commercial property to deliver a continuation of the recent relatively strong performance, albeit with the potential for it to come from a broader range of sectors and asset qualities. Demand driven by growth in the real economy appears set to provide the rental growth to support further strong returns.

But what are the forecasts saying? The consensus view suggests that 2014 will be the peak in the current cycle. The latest view for returns in 2015 is 9.7%, against this year's expected 13.7%, as capital value growth is set to fall back to 4.0% next year and despite improving rental value growth.

The economy

Momentum in the recovery remains strong

Changing consensus forecasts for GDP growth

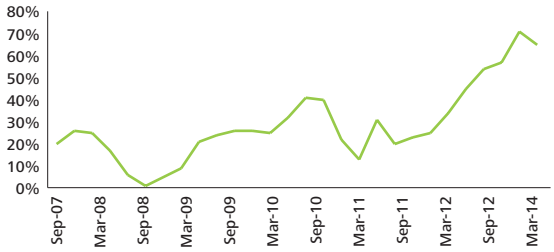


Source: HM Treasury

Q2 data confirms robust economic growth

- Estimates of output growth in the second quarter put the annual rate of expansion at 3.2%, broadly in line with current consensus expectations for the outturn for the year as a whole. Growth next year is expected to be lower, but forecasts have been rising.
- Figures for the construction and manufacturing sectors were revised up in the second estimate, closer in line with the current strong business survey data, and suggesting that the recovery is broadening out.

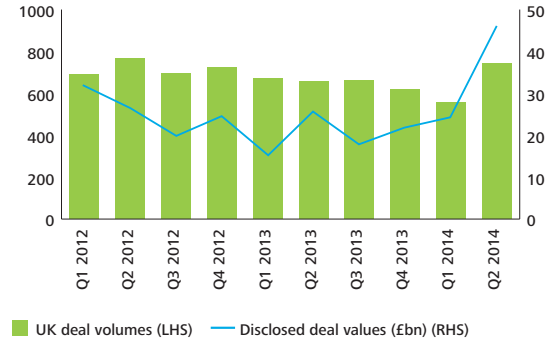
Risk appetite
% of CFOs who think this is a good time to take greater risk onto their balance sheets



Political risks rise up the agenda

- The results of the Q2 Deloitte CFO Survey show that large corporates' level of uncertainty over external and financial risks has fallen to a four-year low. Instead, concerns are now more focussed on the policy uncertainty associated with the general election and a future EU membership vote.
- Nonetheless, the proportion of CFOs who consider now a good time to take more risk onto their balance sheet remains high at 65%, and those prioritising expansionary strategies continue to outnumber those with more defensive plans.

UK M&A deal volumes and values (£bn)



Source: Deloitte

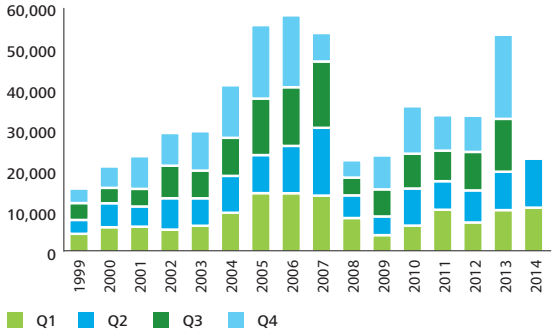
M&A activity uplift in second quarter

- The value of UK M&A deals rose 73% in the first half of 2014 compared with the same period the previous year. For real estate M&A transactions the comparable rise was 27%, with £8.8 billion of deals completed during the first half of 2014.
- Overseas buyers have been eager to tap into the UK's now established economic recovery, the attractive corporate tax rates and related tax inversion opportunities.

UK commercial property

Investor demand shows no sign of flagging

Property investment by quarter (£ million)

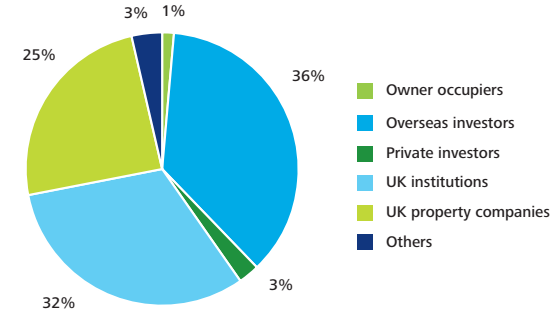


Source: Property Data

Investment market finishes H1 on a high

- Following a couple of quieter months, June saw over £6 billion of investment transactions, pushing the total value of deals in Q2 to just over £12 billion, a little ahead of the Q1 total.
- The number of deals was close to the Q1 total at around 530, but well below the 790 transactions completed during Q4 last year.

Share of investment by investor type Q2 2014

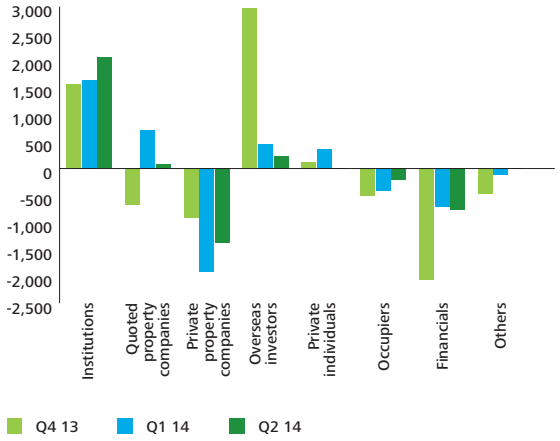


Source: Property Data

Property companies more active in the market…

- UK property companies' share of the investment rose from 21% in Q1 to 25% in Q2, with quoted companies spending the most cash. Meanwhile UK institutional funds have maintained their strong presence in the market.
- Overseas investors have also increased their share over this period. Q1 saw US investors dominate this sector and Middle Eastern buyers particularly quiet, but now the picture looks more balanced with Far Eastern and US investors accounting for 60% between them.

Net investment by investor type (£ million)



Source: Property Data

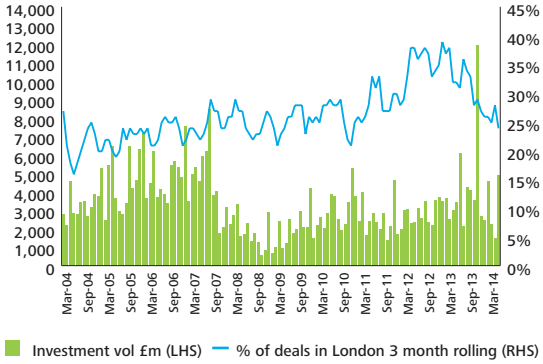
…but UK funds biggest net investors

- Property companies have not only been active purchasers, but also very active sellers of commercial property. Over each of the last three quarters private companies have been significant disinvestors as they actively realign their holdings.
- UK institutions on the other hand have been heavy net investors over this period, revealing a strong appetite to increase their exposure to commercial property.
- Following Q4's buying spree, overseas investors have been selling almost as much as they have been buying.

UK commercial property

Activity increasing in the regions

Investment volumes and London share of the market

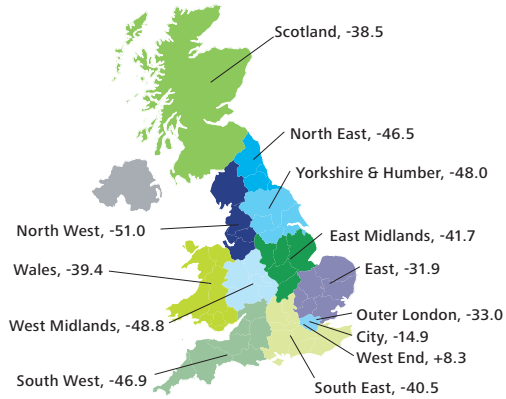


Source: Property Data

Investor focus shifting to the regions

- The proportion of UK investment deals in London has been falling over the last 15 months or so, from around 38% of the market to 25% on average over the last three months.
- Evidence from our Transactions team shows the increasingly strong demand for South East office stock in particular. Growing interest in shopping centres, retail warehouses and industrial property will have also helped shift this balance.

Offices capital values: % difference from 2007 peak

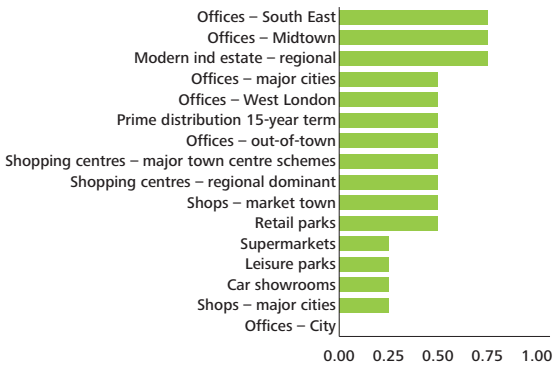


Source: IPD

Regional values still below their peak

- Compared with the peak reached in mid-2007, capital values for offices are still lower across the country except in the London West End submarket.
- On average, values are 43% below the peak for offices outside London, with those in the Eastern region faring best (32% below) and those in the North West the worst, still 51% down.
- Outside London, the highest year-on-year growth is in the Eastern region where values are 15.1% up, in the South East (14.4%) and in Wales (12.3%).

Fall in prime yields, year to date percentage points (selected)



Source: Deloitte Real Estate

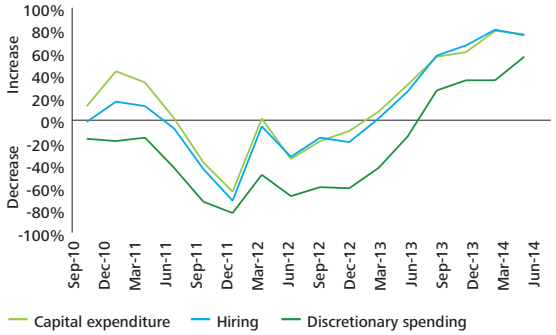
Prime yields continue to compress

- Our own data shows that July saw prime yields fall across most segments of the retail sector, as investors' sentiment improved, especially for shopping centres. However, over the year to date the biggest falls have been seen in South East offices and multi-let industrial estates outside the South East.
- The 75bps yield shift on these segments has also been shared by London Midtown offices, where demand has been boosted by the prospect of Crossrail opening from 2016.

UK commercial property

Improving job prospects support office sector

Outlook for capital expenditure, hiring and discretionary spending



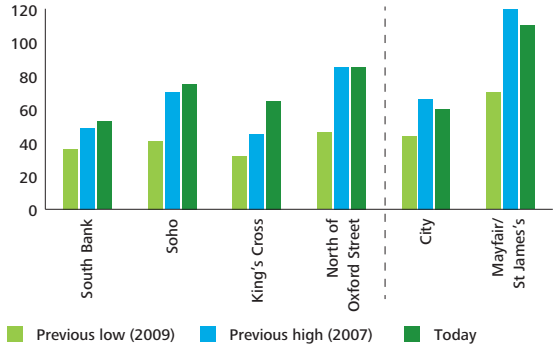
Net % of CFOs who expect UK corporates' capital expenditure, hiring and discretionary spending to increase over the next 12 months

Source: Deloitte CFO Survey Q2 2014

Corporates remain strongly positive on hiring

- ONS data shows that professional jobs are growing at over 7% a year, and administrative & support services at almost 6%, which should provide continuing support to office take-up and rental growth.
- Meanwhile the Deloitte CFO Survey continues to record increasing hiring expectations among large corporates.
- Take-up of new office space in central London was close to six million sq ft in the first half of the year, similar to the total for the same period in 2013 but above the five-year average. Corporate and financial occupiers have been driving this demand, ahead of the TMT sector.

Central London submarket rents
£ per sq ft

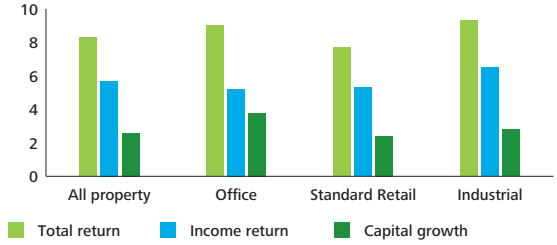


Source: Deloitte Real Estate

Fringe areas leading central London office rent rises

- This strong demand, coupled with a more flexible attitude to location among occupiers has resulted in stronger rental growth in previously less fashionable locations.
- Record-breaking rents have been set in the South Bank and King's Cross office submarkets, a clear indication that they are establishing themselves as sought-after locations. Elsewhere, Soho and the North of Oxford Street markets are seeing rents meet or exceed previous peaks, in contrast to the traditional core office submarkets in the City and the West End.

Total return outlook by sector
IPF consensus forecast annualised total returns 2014–18 (%)



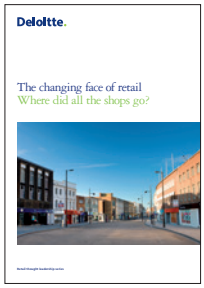
Source: IPF Consensus Forecast Report May 2014

Prospects for industrial edge ahead

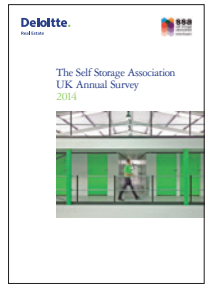
- Over the medium term, the superior income return produced by industrial property gives it an annualised forecast total return of 9.3%, slightly ahead of the office sector.
- The best capital growth over the next five years is expected to come from offices, with 3.8% per annum. The outlook for retail has improved but it remains the weakest of the main sectors.

Recent research

Recent publications



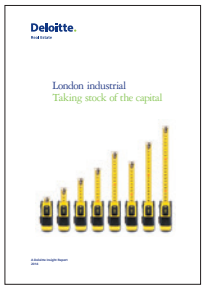
The changing face of retail: Where did all the shops go?



The Self Storage Association UK Annual Survey 2014

M&A Index Q2 2014

CFO Survey Q2 2014



London Industrial: Taking stock of the capital

London Office Crane Survey Summer 2014

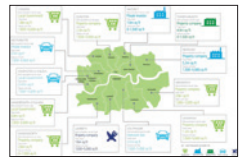
Deloitte Consumer Tracker Q2 2014

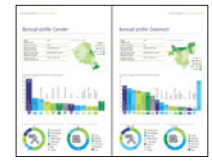
The shed of the future

London industrial
Taking stock of the capital

This report offers a granular view of industrial stock across 14 London boroughs. To achieve this Deloitte Real Estate have undertaken an extensive research programme, surveying these areas street-by-street. We have identified each industrial property and recorded its key details to create a unique database, the results of which can be found in this report.

Our research highlights a wide mix of occupier types, unit sizes and ownership types, giving a detailed view of central London's industrial property sector today.





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