Over the latest quarter, both domestic and global economic indicators have delivered mixed signals.

The UK economy continued to improve in Q3 2015, growing 0.5% according to preliminary estimates, marking the eleventh consecutive quarter of economic growth. Although the pace was slower when compared to Q2, the outlook for 2016 has picked up with the consensus forecast suggesting the economy will expand 2.4% next year.

However, Deloitte’s CFO Survey reported that CFOs’ perception of external financial and economic uncertainty has seen the sharpest rise for five years. This was mostly a result of concerns over global growth prospects, with CFOs still taking a favourable view of the UK’s economic outlook. Emerging market volatility now ranks joint second, together with concerns about Euro area growth, on their list of worries. These concerns are not unfounded.

The weakening of emerging economies, especially China, combined with the strength of the pound has dented UK exports and this is feeding through to manufacturing output, which fell in Q3.

Recent news on domestic consumption has been much more positive. Retail sales increased 1.9% in September, household consumption continues to rise, and further real wage growth is being recorded as inflation remains virtually non-existent. The latest Deloitte Consumer Tracker also noted an improvement in consumer confidence now reaching a record high.

And so, the UK economy continues to perform well. PMI business activity suggested further expansion over the quarter, albeit at a slower pace than in the three months to June, and employment growth remains strong across the UK. Many parts of the UK reported record levels of employment in Q3, and the national unemployment rate has fallen to its lowest level since mid-2008.
Meanwhile, inflation fell again in September, below market expectations, and it now looks extremely unlikely that the MPC will vote for a rise in interest rates before early 2016.

What does this mean for UK commercial property? One thing for certain is that demand for UK property remains high. The volatility of the Chinese economy and other emerging markets, as well as ongoing concerns regarding the Middle East, are all acting as drivers of activity, with overseas investors turning to UK real estate for investment opportunities. Whilst US investors remain a major player in the UK market, for the first time ever Far Eastern investors accounted for a greater share of deals in Q3; 20% and 32% respectively. The London market in particular continues to attract new investors from Japan, Hong Kong, Taiwan and China, whilst Korean and Malaysian investors, who bought in a previous phase, have been realising strong capital value gains by selling in central London and moving on to other market sectors. Volumes in the nine months to September totalled almost £49bn, the highest level on record.

We also continue to note a stronger interest in non-traditional property types. Whilst last quarter we highlighted the significant increase in investment in student housing, this quarter it was the hotel sector that stood out. Investment activity in UK hotels reached its highest level since 2007, totalling £5bn in the 9 months to September. Once again, overseas investors dominated this sector accounting for 76% of total investment in the year-to-date. This was another example of foreign investors looking for low-risk income-producing assets within the UK to deploy their capital, and investors generally becoming more willing to invest in alternative property. It also suggests a confidence by cross-border investors in the UK economy and domestic tourism industry.

In performance terms, UK offices continue to top the table. Demand for prime office investments is still competitive and yields remain under downward pressure. Rental growth remains strong, predominantly driven by the London office market but Eastern offices recorded historically high rental growth over Q3, at 3.5%. In London, the latest Deloitte Crane Survey continues to report increasing volumes under construction. However, this is combined with strong early leasing activity, and therefore low supply is still a driver of rental growth. More generally, demand for space continues to increase as a result of employment growth.

Industrial property also continues to perform despite the problems in the manufacturing sector. Yields on both prime distribution and modern industrial estates outside London have fallen further in the last year.

Meanwhile, retail continues to fall behind the other main sectors. Although London retail is performing strongly as a consequence of exceptional rental growth and low yields in core locations, falling or flat rents in many regions has meant the sector outside London still lags. However, economic indicators look positive. The latest fall in inflation and rising disposable incomes are having a positive impact on retail sales and we expect consumer sentiment to improve as we head towards Christmas.

The current strength of the market has clearly exceeded the majority of expectations, and the IPF consensus forecast for total returns this year has consequently been raised further to 13.9% in the latest report. This more optimistic outlook extends to 2016 as well: the average total return for next year has risen from 8.2% in February’s survey to 9.2% in August 2015. The capital growth forecast has also improved over the year. The office sector is still anticipated to lead the way in 2015 and 2016, predominantly due to strong rental growth in the City and West End. The forecast for the retail sector has slipped back over the year. The big difference for 2016 is that, even with ongoing investment demand, downward yield shifts are unlikely to factor so highly as a driver of performance. Returns will become more reliant on rental growth, and whilst a number of the economic drivers remain in place to support this, our expectations are that performance overall will ease back.
Growth despite softer global indicators

Output recovery continues in Q3

• The economy continued to improve in Q3 2015 growing 0.5%. It marked the eleventh consecutive quarter of economic expansion. Although growth slowed over the quarter, as a result of softer global demand, the outlook for 2016 has picked up with the consensus forecast suggesting the economy will expand 2.4% next year.

• Agriculture, services and production output all expanded over the quarter, however manufacturing output decreased 0.3%. Retail sales growth picked up in September increasing 1.9%, and household consumption continues to increase.

Employment levels at record highs

• PMI business activity continued to point at growth over the quarter albeit at a slower pace than in the three months to June, a likely consequence of concerns surrounding the stability of the global economy and the impact of China’s stock market volatility.

• However, employment growth is still strong across the UK with many regions reporting record levels of employment, while the national unemployment rate has fallen to its lowest level since mid-2008.

• Looking ahead, London is forecast to achieve the highest average output growth over the next decade, whilst the North East is expected to achieve the weakest.

Sharp rise in business uncertainty

• The latest Deloitte survey reported that CFOs’ perception of external financial and economic uncertainty have seen the sharpest rise since we first asked this question five years ago. This was mostly a result of concerns over global growth prospects, with CFOs still taking a favourable view of the UK’s economic outlook.

• Emerging markets now rank joint second, together with concerns about Euro area growth, on CFOs’ list of worries. According to the survey, firms are adopting a more defensive stance. In particular, the outlook for hiring over the next 12 months has deteriorated noticeably, along with that for capital expenditure, as the emphasis on cost cutting increases.
UK commercial property

Far Eastern investors increase share

Third quarter slowdown in investment deals

• Investment deals totalled over £48.89bn in the nine months to September; the highest level on record. However, over the latest quarter activity slowed. The £13.3bn of transaction activity recorded in Q3 was the weakest level of investment recorded in over a year.

• By sector, office investment continued to dominate, accounting for 43% of activity. Investment in ‘other’ property remained strong whilst retail and particularly industrial investment lagged behind.

• Portfolio deals remain popular amongst funds looking to invest large amounts of capital into real estate.

Far Eastern investors start to dominate

• Overseas investors remain the dominant investor type in the UK real estate market, accounting for 44% of all investment in the quarter.

• Whilst US investors have remained a major player in the UK market, their share of investment dropped significantly in Q3 to just 20%. For the first time ever Far Eastern investors accounted for a larger share of activity, at 32% in Q3.

• The London market continues to attract new investors from Japan, Hong Kong, Taiwan and China, reflected in the high levels of activity by Far Eastern investors in Q3. Korean and Malaysian investors, who bought in a previous phase, have been realising strong capital value gains by selling in Central London and moving on to other market sectors, typically shopping centres.

UK institutions as net sellers

• After two quarters as net investors, UK institutions joined private property companies and owner occupiers as net sellers in Q3, taking advantage of high property values.

• Listed property companies, private individuals and overseas investors remain net buyers over the quarter.
UK commercial property

Offices rental growth high

Yield gap remains an attractive feature

• All Property initial yields contracted another 8bps to 5.06% in Q3 2015. Although this was the lowest initial yield recorded since November 2007, the fall in yields continues to slow. The 5-year swap rate, at 1.42%, meant that the yield gap increased over the quarter to 364 bps.

• The swap rate has hovered around 1.2% – 1.7% since the start of the year, under little upward pressure as mixed economic data is doing little to pressurize the MPC to raise rates earlier than generally envisaged, around Q2 2016.

Eastern office rental growth emerges

• UK office rental growth picked up again in Q3 according to MSCI. Although it is predominantly driven by the London office market, Eastern offices also recorded historically high rental growth over the quarter, at 3.5%.

• The latest Deloitte Crane Survey continues to report increasing volumes of new space under construction in central London. However this is combined with early leasing activity, and therefore low supply is still a driver of rental growth in this market.

• Demand for space continues to increase as a result of employment growth, however the latest CFO Survey suggests CFOs have scaled down their expectations for growth in hiring.

• The IPD All Office annual total return stood at 19.5% in September, of which capital value growth contributed 14.6%.

Retail rents still below peak

• Despite an improvement in retail sales and consumer confidence, retail remains the weakest of the three main property sectors with a total return in Q3 of 9.5% pa. This is mostly a result of weak rental growth.

• Outside London, rental value growth has been flat over the last three years and retail rents have not yet recovered to pre-crisis levels. West Midlands and South West retail recorded further falls in rental growth in Q3 2015. Shopping centres and retail warehouses have performed more resiliently than standard shops.
UK commercial property

Hotels back in favour

Industrial sector activity slower in Q3

- The industrial property total return was only marginally weaker than the office sector in the year to September, at 19.1%, predominantly driven by capital growth of 12.9%.
- Prime distribution yields have fallen 75bps in the 12 months to September 2015, and 50 bps for modern industrial estates outside London.
- Transaction levels in Q3 were down 27% on Q3 2014 and total volumes for the full year look set to be lower.
- Institutional funds were the predominant buyer type, accounting for 44% of transaction volumes over the quarter, followed by listed property companies.

Hotel investment hits a high

- The level of investment activity in UK hotels has reached its highest since 2007, totalling £5bn in the nine months to September.
- Overseas investors have been the most active in this sector accounting for 76% of total investment in the year-to-date.
- There have been a number of large portfolio deals in the sector over the last year, and the investment levels suggests a confidence in the UK economy and domestic tourism industry by cross-border investors.
- Regional hotels in particular have performed strongly, with Glasgow and Leeds both seeing robust average daily rate growth over the year to June 2015, at 11.6% and 9.2% respectively.

Improving prospects for 2015

- The outlook for property performance in 2015 increased further to 13.9% according to the latest IPF consensus report. This more optimistic outlook extends to 2016 as well: the average total return for next year has risen from 8.2% in February’s survey to 9.2% in August 2015.
- The capital growth forecast has also improved over the year with a 8.1% rise in values expected, compared to 7.0% in February.
- The office sector is still expected to lead the way in 2015 and 2016. This is predominantly due to strong rental growth in the City and West End. The forecast for the retail sector has slipped back over the year.
Recent research

Recent publications

Technology and people: The great job-creating machine

The Deloitte Consumer Tracker UK: consumers shrug off global turmoil

The State of the State 2015-16: Recalibrating government

The Deloitte Consumer Review: Made-to-order: The rise of mass personalisation

From brawn to brains: The impact of technology on jobs in the UK

London Office Crane Survey: Construction activity boost

www.deloitterealestate.co.uk/Research.aspx

The Deloitte CFO Survey

Key findings:

• CFO perceptions of uncertainty at a two-and-a-half-year high.
• Risk appetite down, following equity market sell-off.
• Rate rise and emerging market weakness top corporate worry list.
• Majority of CFOs think Chinese slowdown will negatively affect their business.

This is the 33rd quarterly survey of Chief Financial Officers and Group Finance Directors of major companies in the UK.

The Deloitte CFO Survey is the only survey of major corporate users of capital that gauges attitudes to valuations, risk and financing.

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