Front cover photo: Hardman Square, Manchester.
Executive summary

- Economy shrugs off initial Brexit-related hit to confidence, sentiment rebounds
- Demand/supply imbalance to support a healthy industrial occupier market
- Investor concerns abating after turbulent summer
- Moderate outlook for performance although downside risks remain
- Defensive investments likely to hold investors in good stead over the short term

Economy proves resilient in face of Brexit uncertainty

Initial fears of a sharp uncertainty-driven slowdown in the economy have, as yet, proved unfounded, with GDP continuing to grow at a healthy 0.5% pace in the third quarter of 2016. This healthier-than-expected picture of growth has echoed across various economic indicators. Sentiment in particular has bounced back after slumping initially in July 2016, following the June vote to leave the European Union, so it would seem that British consumers and businesses are looking to carry on pretty much as usual despite the Brexit vote. At the same time unemployment has continued to fall and in October 2016 retail sales grew at their fastest annual rate for 14 years.

There remains little conviction around what sort of relationship the UK will eventually have with the EU, although with the government seemingly taking a hard line against the free movement of EU citizens to the UK the probability of a “soft Brexit” may be more limited than previously anticipated. That said, negotiations are yet to begin and speculation is constantly evolving. So with the only certainty in this process being uncertainty there is still significant hope that a mutually beneficial agreement will be reached. Whatever does happen, both the UK government and the Bank of England have made it clear that their primary focus throughout will be to maintain the stability of the British economy, whether through accommodative monetary or fiscal policy. The Bank’s policy interest rate, for example, has already been cut to a new historic low of 0.25% and is likely to remain at that level for the foreseeable future, something that will be supportive of the country’s underlying economy and real estate markets.

Although economic conditions remain healthy for the time being, the consensus view continues to be that we shall see a slowdown in 2017’s activity. However, the expected slowdown is relatively modest, with economic activity seen to be easing to levels more akin to the UK’s larger European neighbours.
Occupier demand remains resilient...
Fundamentally, nothing has really changed in the property occupier market since the EU referendum vote. IPD All Property rental growth has shown some signs of moderating, from 3.3% p.a. to 2.6% p.a. in 2016, but remains healthy. There is also significant divergence across different parts of the property market: much of the slowdown to date, for example, reflects the weaker Central London office market, something that was anticipated well ahead of the referendum due to more market-specific factors.

... although some caution evident in the Central London office market
Central London offices, and the City in particular, are likely to be at the epicentre of any more significant weakness in the overall occupier market. With the City likely to suffer the most from the impact of Brexit on EU-related trade in the financial and business sectors (particularly if passporting rights are lost), we expect occupiers to hold off from taking space in the short term. Indeed, post-referendum take-up is already relatively subdued, with Brexit, affordability concerns, and rising supply all placing pressure on the occupier market. We think this may lead to falls in rents, or at least rising incentives, but we expect these falls to be relatively limited (in the region of only c. 5-6%) thanks to the wider economy's continued growth, which should underpin general demand for space, and a scaling back of the development pipeline.

continued support for industrial rents
Despite the recent political uncertainty, occupier sentiment for the industrial sector has remained upbeat. This reflects, at least in part, the fact that a large share of current and expected demand is from companies such as e-tailing giant Amazon, which are looking to take advantage of the ongoing structural change in the sector. This race for space shows no sign of slowing as yet, so demand continues to exceed supply even though it has encouraged some speculative development as investors and developers try to meet the need for new space.

Recent events have led to a slowdown in new starts, particularly in the case of distribution warehouse developments. Those that are in the pipeline remain firmly focused on core hub locations, where the supply of existing quality stock is particularly acute and demand for space remains strong, such as London and the South East. Meanwhile, availability for multi-let units is at record lows, adding to the pressures in the sector. As a result, we expect rental growth to remain strong in the short term.

Mixed outlook for retail
The recent recovery in the retail property sector and strong retail sales are likely to be curtailed by a number of headwinds that are expected to impact the sector over the next couple of years. These include higher inflation, the introduction of the national living wage, business rate revaluations, and an increasingly competitive retail environment. These headwinds are set to occur during a period in which retailers have continued investing in supply chain and omni-channel capabilities. However, different retail types and geographies are expected to be impacted by these headwinds to differing degrees.

We expect the polarisation between prime and secondary schemes and locations, which is already evident within the retail sector, to become more palpable in the near term. Occupier demand is likely to remain focussed on the best retail pitches, while
increased retailer consolidation and a withdrawal from weaker towns looks likely to lead to more secondary space coming back onto the market.

That said, the return of a more cautious approach to development, given the uncertain political and economic backdrop, is likely to apply to the food store and retail warehouse sectors – which should lend support to rents. Indeed, we expect supermarkets to hold up better, given the defensive nature of their occupier base and the prevalence of long inflation-linked leases.

**Higher house prices underpin demand for private renting**

In contrast, rental growth in the private rented sector (PRS) has been strengthening in recent months, albeit gradually. Tenant demand has continued to improve across much of the country as the Brexit uncertainty reduces people’s willingness to buy and high house prices affect their ability to do so. In addition, the supply of rented property has actually weakened, adding to pressure on rents.

The picture in London is more mixed. Activity in Outer London and the main commuter areas, driven by young professionals and families, remains healthy, underpinned again by a lack of affordability for would-be first-time buyers and the Brexit uncertainty. In contrast, the more prime, inner areas of the city are seeing increased supply coming onto the market at a time when demand is being tempered, leading to falls in rents.

On balance though, away from Central London, the PRS remains, and should continue to remain, relatively resilient in the face of economic headwinds.

**Initial investor Brexit concerns abating**

Unsurprisingly, the EU Referendum result led to some unease amongst investors: retail investor funds saw net outflows of c.£2.3 billion in 2016, triggering property sales as those funds looked to meet these redemptions. This selling pressure and the uncertainty generally led to capital values slipping over the summer months. Nevertheless, the declines were seemingly over before they began, with values falling by a limited 2.4% at the All-Property level (IPD) in 2016. Indeed, capital values have already started to rise again, albeit tentatively, as renewed confidence and the desire to keep calm and carry on has allowed stability to return to the market.

UK property yields have risen by about 25 basis points in 2016, leaving the spread above 10-year UK government bond yields at around 500 basis points above where it started 2015 and well above its historic average. That will continue to provide a healthy cushion for pricing in the short- to medium-term.

There are other reasons to be relatively positive about the UK property market. Capital values are, on average, almost 25% below where they were at their 2007 peak, before the global financial crisis. Debt is also at considerably lower levels whilst the number of forced sellers in the market is still relatively low.

One additional and important factor is that overseas investors do not seem to have been deterred by the idea of Brexit and its potential implications for the UK. If anything, the post-referendum depreciation of sterling has made UK property look more attractive from an international perspective. Property in London, in particular, now looks more attractive on a relative basis, given that prime London yields have risen by c.25bps, while yields elsewhere in the world have stayed the same or even compressed over the same period.

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lead to a deceleration in the housing (sales) market, the PRS is likely to benefit as would-be buyers instead choose, or are forced, to remain in an already supply-constrained rental market. This should maintain, or even strengthen, rental growth, helping to offset any weakness in the owner-occupier market.

• Quality over quantity
In times of unease, well-located property with secure income streams tend to prove most attractive to investors looking to minimise risk. As such, focusing on prime and good secondary property should provide the potential to outperform in the short term.

• Central London at greater risk
Overall, we believe that central London offices will be affected to a greater degree, as this is where the change in our relationship with the EU will be most visible, as well as being the area where pricing looks most expensive relative to fair value. This is also the part of the market where we see the greatest probability of falls in rental values. Similarly, we expect Central London residential to underperform, reflecting the fact that, alongside the potential impacts from Brexit, the sector is also seeing high levels of supply and weak investor demand in the face of significant stamp duty changes introduced in early-2016.

• Maintain a balanced, diversified portfolio
With uncertainty likely to be the watchword of 2017, if not for the next few years as Brexit unfolds, investors should look to limit risk by maintaining a portfolio that is balanced and well-diversified in terms of both geography and market segment.

Conclusion

On balance, the UK property market appears to be in a much better position than we were expecting in the summer, shortly after the EU referendum. We now look to be entering 2017 from a position of relative strength and with a modicum of optimism. However, it is clear that there are definite and significant headwinds in place that may affect the market over the next two years. As such, taking a defensive stance in terms of portfolio strategy should prove beneficial.
For more information

Emma Grew  
Research Manager  
📞 +44 (0)20 7548 6676  
✉️ emma.grew@mandg.com

Richard Gwilliam  
Head of Property Research  
📞 +44 (0)20 7548 6863  
✉️ richard.gwilliam@mandg.com

Christopher Andrews, CFA  
Head of Client Relationships and Marketing, Real Estate  
📞 +65 6436 5331  
✉️ chris.j.andrews@mandg.com

Lucy Williams  
Director, Institutional Business UK and Europe, Real Estate  
📞 +44 (0)20 7548 6585  
✉️ lucy.williams@mandg.com

Stefan Cornelissen  
Director of Institutional Business Benelux, Nordics and Switzerland  
📞 +31 (0)20 799 7680  
✉️ stefan.cornelissen@mandg.co.uk

www.mandg.com/realestate
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