UK Residential, Commercial & Rural – 2019

SPOTLIGHT
Savills Research

UK cross sector outlook

Investment trends and forecasts for 2019 across the residential, commercial and rural sectors

Cross sector focus

Welcome to the 2019 edition of our annual Cross Sector Outlook. Our three heads of research, Emily Norton, Lucian Cook and Mat Oakley, present their forecasts for the coming year and give their hot picks for out-performance in 2019 and beyond.

With Brexit uncertainty imminent, calling the market for 2019 is no easy task. The autumn budget confirmed that there is slack in the system to support a shock to the economy, but political change and regulatory reform remain key risk factors. In this uncertainty, a flight to real-estate assets could be expected, but with capital growth lacking in the short term, seeking the best rental growth prospects means finding niches and meeting changing expectations. Attractive investment opportunities are still coming to the market.

This Spotlight helps identify where the best value can be found across the various asset classes in the rural, commercial and residential sectors to inform your future investment decisions.

Our expert knowledge and insight across all sectors are a tangible benefit to our clients, and – especially at times of uncertainty – our real-estate expertise has never been more important.

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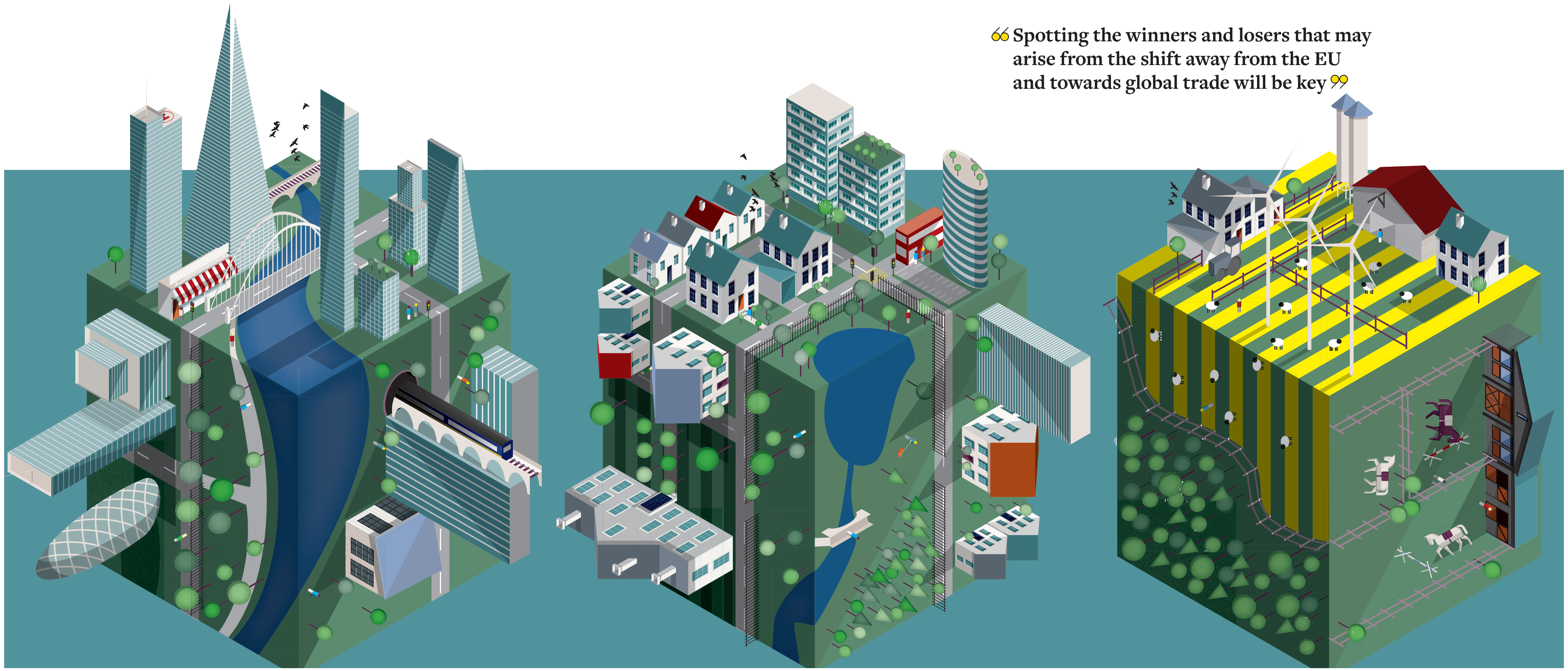


“Spotting the winners and losers that may arise from the shift away from the EU and towards global trade will be key”

Looking forward: three ways markets are evolving

Navigating an era of widespread uncertainty and social upheaval will require a focus on the long-term drivers of success rather than reacting to short-term trends

In an era of political uncertainty and technological innovation, it is easy to become reactive and risk averse. But it's not just political infighting and regulatory change that is causing uncertainty. It's also the huge upheaval in society enabled by technological innovation. There is no certainty about how well-established markets will react, so picking winners for 2019 won't be simple. But the tips in this *Spotlight* are based on a deep understanding of the fundamentals of our markets' economics. Not the reactive trends, but on the long-term drivers of success.

During this process, we identified three common themes.

1. Societal need

The most dominant trend for investment success in 2019 is around meeting the basics of human needs. Across the spectrum, social media has created a new way for the people to hold those in power to account. We see enhanced social responsibility across multiple property investments as a result. Office space has to offer a people-first environment. For rural places, welcoming visitors remains a good way to diversify income streams, but the experience is more important than the view. For both commercial and rural trading investments, focusing on meeting customer expectations in generating secure trading or rental income is essential. Getting the service element right in retail should be a central focus of commercial property investors in 2019. Online competition is a threat, but one need only ask, “What can Amazon *not* do?” to start generating interesting and investable concepts for trading enterprises.

In the residential sector, the current Housing Minister's Twitter mantra of #MoreBetterFaster only hints at a wider policy shift towards more diverse housing delivery that is more closely linked to need. Much of that is being channelled through a planning system under ongoing reform. This comes at a time when major house builders have been put on notice that Help to Buy only has a limited life, the pioneers of Build to Rent have developed the models that will underpin the future expansion of this sector, and providers of affordable housing have been given more support to deliver on their development aspirations.

2. Environmental gains

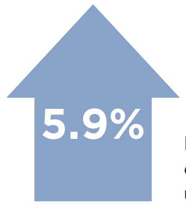
Driven by regulatory changes in rural land use, we predict that ‘net environmental gain’ and ‘offsetting’ will be the buzzwords in land use for 2019. The 25 Year Environment Plan for the UK should be brought into legislative effect during 2019 via an Environment Bill. It will set out the environmental principles and governance that will guide all land use in the UK. Climate regulation and the ongoing attempt to meet the COP21 Paris commitments will act as drivers in policy making and corporate social responsibility. Demand from corporate landlords and tenants for renewable energy and on-site energy points to more interaction between commercial and rural assets. This is expected to lead to the development of more mixed-use portfolios.

The rising influence of corporate investors in Build to Rent also reflects this. Corporates are now creating diversified products that better integrate green space and energy accountability. The economies of scale in these developments pave the way for enhanced well-being, stronger community and better design. Critically, from a financial perspective this should create a marketing advantage.

3. Planning long-term

The third strand brings the others together: financial resilience, which we predict will be based on lower capital appreciation and a renewed focus on income generation than in previous years. Despite stellar rises over the past 10 years, the uncertainties over the medium term mean capital growth cannot be taken for granted. Longer term, we remain confident that the underlying market fundamentals will remain strong, but a clear plan for riding out short- to mid-term instability is essential. The Treasury remains confident of its key performance indicators around employment and growth in any Brexit scenario. But as we reach a stage of trade uncertainty post-Brexit, keeping an eye on broader demographic trends in regional employment is more important than ever. A more liberal global trade agenda remains a key driver for post-Brexit Britain. Spotting the winners and losers that may arise from the shift away from the EU and towards global trade will be key.

Of course, social, environmental and financial performance are the central pillars of any sustainability plan, but they are also the central tenets of business resilience. Measuring and managing risks across these categories, with a renewed focus on the human and environmental aspects, has never been more important in spotting synergies and new opportunities, and thus for creating successful long-term investment plans.



Five-year annualised capital growth in urban logistics

Growing pains

Despite economic and political unpredictability, attractive investment opportunities are still coming to the market

Our projections of five-year investment returns for different asset classes have a similar shape to last year. If anything, there is now even more emphasis on the fundamentals of supply and demand to support secure income streams and greater reliance on rental growth to deliver capital appreciation. This reflects the uncertainty surrounding the economic and political backdrop.

To arrive at our numbers we have had to make assumptions as to the outcome of Brexit. First, we have assumed it will occur. Second, we have assumed that whatever the outcome it will not signal the end of uncertainty, which will persist through the first few years of the forecast period. That should mean that interest rates will continue to gradually rise through the forecast period, essentially meaning that we have seen the end of widespread yield compression across the sectors.

Urban logistics sits at the top of the pile, driven by the weight of money attracted to what has become the darling of the commercial property sector on the back of structural change and strong rental growth.

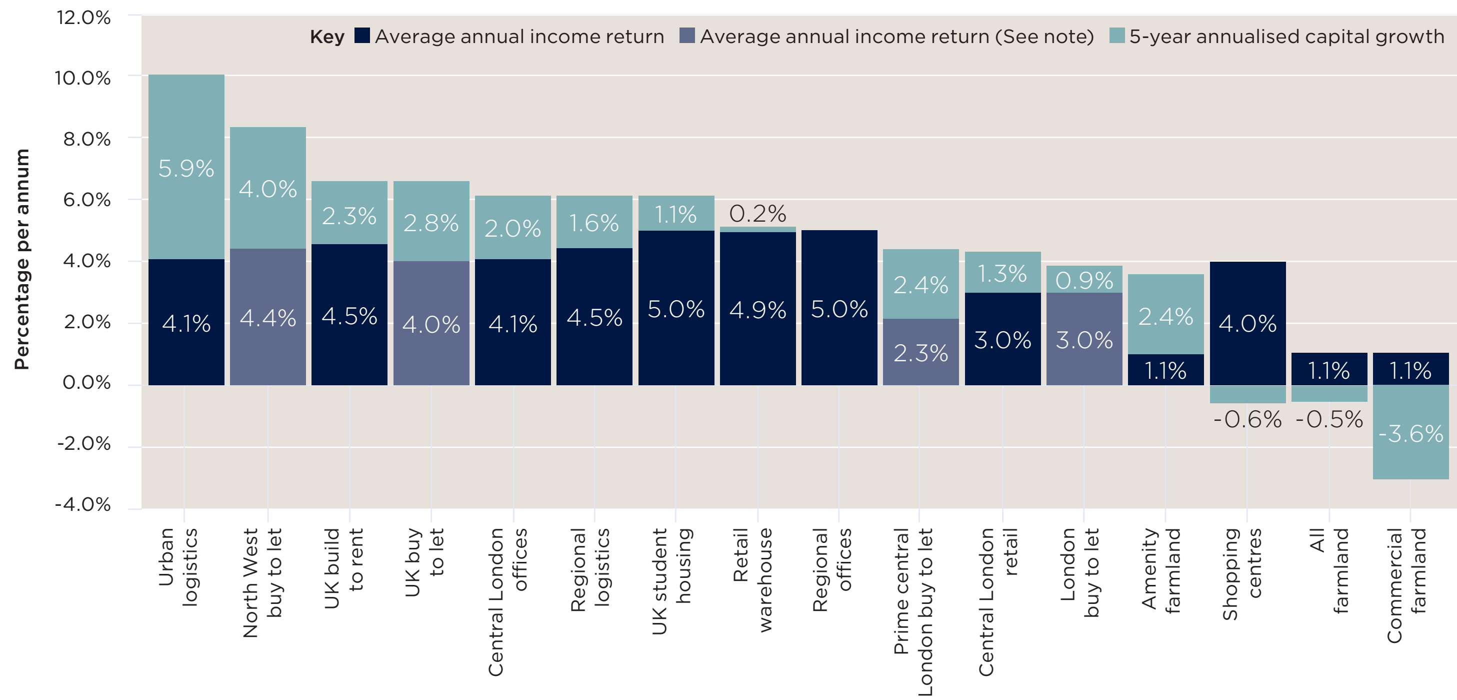
In the residential sector, a continued undersupply of homes for rent underpins our expectation of continued rental growth. Restrictions on the tax relief available to mortgaged buy to let investors make it more difficult to compare returns against other asset classes, or indeed the growing build to rent sector.

This less-attractive investment environment for private investors will limit the stock hitting the rental market, particularly in the lower-yielding markets where it is more difficult for them to make the maths work. This will generally shift investment focus further north where house price growth prospects are greater, now that we have entered the second half of the housing market cycle.

That said, investment levels from wealthy overseas buyers of prime central London property are expected to improve over our forecast period. Assuming the outlook becomes more certain, we expect buyers to increasingly take advantage of the price adjustments seen in this market since 2014, albeit not to the same degree as in previous cycles.

Uncertainty over the shape of future agricultural policy and the impact of prospective trade deals on commodity prices indicate that price growth on rural assets will be confined to more diversified holdings or those where amenity value is a key component of value. While the returns on this asset class look uninspiring, demand is likely to continue to be underpinned by the tax benefits of ownership and the need for those looking to expand their landholding to enter the market as and when a scarcely traded asset comes to the market.

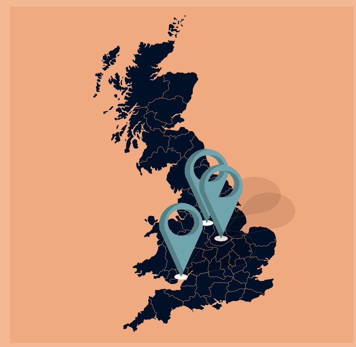
Comparative returns chart The next five years: outlook for annual income and capital growth

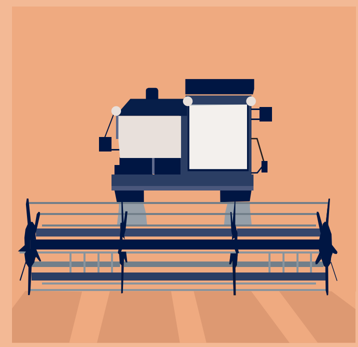


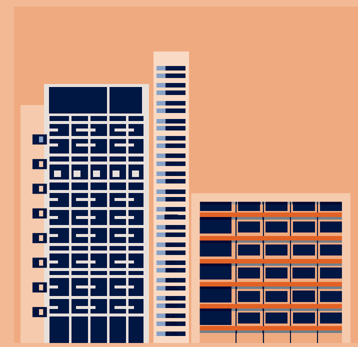
Note In a world of data, it is surprisingly difficult to arrive at comparative income returns for different asset classes. For residential buy to let investments, our model uses a combination of data from the valuation office, the Land Registry and Rightmove. We have then had to take into account that while commercial property income streams will often be underpinned by full repairing and insuring leases, in the residential markets these are the responsibility of the landlord. Agricultural tenancy obligations sit somewhere in the middle. For consistency, we provide figures net of all irrecoverable costs in line with IPD industry standards. No account has been taken of the restricted tax relief available to private buy to let investors using mortgage finance (which would reduce effective income returns for some investors). **Source** Savills Research

Our key investment opportunities

Where to find value across various asset classes







Residential top picks

Development land in demand

The sweet spot in the development-land market appears to be for smaller sites in local authorities with high housing targets who may struggle to meet the housing delivery test. Demand will come from better-financed small and medium sized house builders and Housing Associations.

Urban investment

There is potential for buyers to stretch loan-to-income ratios in second tier cities and towns in the Midlands and the North that are well connected to major regional centres or have a diverse local employment market. They are likely to offer investors a less-crowded marketplace compared with, for example, Manchester and Birmingham.

Rural top picks

Diversified income

A key aspect to future-proof rural businesses remains diversification of enterprises. Estates in the South East of England profit from greater residential, commercial and trading enterprise demand than those in other parts of the UK. This reduces their exposure to returns from farming. Analysing the demographic context of an investment is crucial to understanding income growth potential and capital value stability.

Quality shines through

The top-performing farms in the UK have been forecast to thrive under any potential Brexit scenario. Where structural issues, such as soil quality and location, inhibit this performance, values may be affected. However, for good-quality land and certain livestock enterprises, productivity and market alignment mean that performance should be resilient to the evolving policy and trade environment. Structurally sound but poorly managed rural assets could be an attractive pick.

Commercial top picks

New London developments

The strong occupational trends and falling levels of development activity in the London office market look like they will leave the capital with a severe undersupply of Grade A office space in 2021 and beyond. However, some large new development opportunities will come to the market in 2019, and we expect them to be strongly contested.

Contra-cyclical investment in retail

The unremittingly negative news about retail has led to sharp (and unscientific) repricing of the sector across the UK. Prime assets will remain prime, and opportunistic investors would do well to run a forensic eye over UK retail to identify good assets that could be bought comparatively cheaply.

6.2%
is the vacancy rate in both industrial and retail property

Back to basics

It's human nature to be attracted to the next big thing. But don't take your eye off the essentials of your sector

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During the past two years, the commercial property market has been in countless discussions about co-working, company voluntary arrangements (CVAs) and Brexit, and rather too little about market fundamentals and what customers want.

The most successful investors will be those who look beyond the noise and focus on the underlying signals. Key questions for commercial property investors must always be around how a building aligns with a tenant's needs, and what drives those needs.

In the office market, we should question why businesses are drawn to 'workspace as a service', and what we can learn from that. Is it about the rise of tech companies? Or Brexit-related insecurity? Or is it a rejection of the strictures of the traditional lease, where everything is the tenant's problem and the landlord does as little as possible? Arguably, commercial property may be the last sector to grasp that customer care is a differentiator.

There are other, more basic, issues we have yet to address. For example, it is astonishing that only 58% of workers say their workplace enables them to work productively, and that 70% say noise and temperature are a problem in their office. Perhaps we need to focus less on what is new, and more on fixing these basic issues that have been around for decades.

In the retail property sector, people are yet again announcing the death of the high street. However, in retail more than any other sector, change is continual as each new generation changes its values and behaviours. As Steve Dennis of *Forbes* magazine says: "Physical retail is not dead; boring retail is."

Retailers and retail environments often fail because they don't deliver what the customer wants. Shoppers have always wanted experiences and convenience, and always will. However, prime retail is not a one-size-fits-all designation, it varies from catchment to catchment. A luxurious experiential mall will trade badly in a modest catchment regardless of how fabulous it is.

> "We need to focus less on what is new, and more on fixing basic issues that have been around for decades"

My rule of thumb for what defines prime retail remains something that is dominant and fits its catchment.

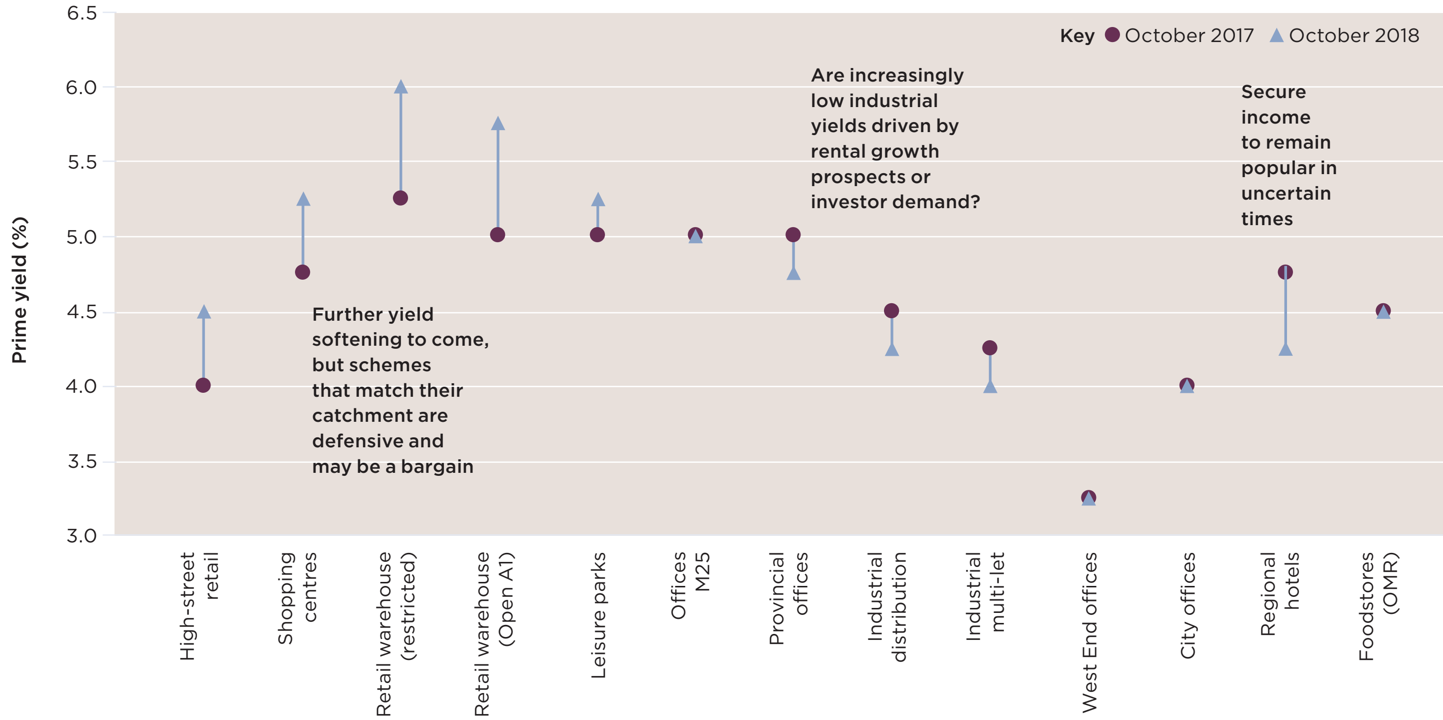
Even in the logistics sector, there is arguably too much focus on drones and robots when the basic challenges that distributors face are more about staffing and fuel costs.

Successful locations will continue to be those where people want to be, and successful workplaces will be those that enable people to do their work as painlessly as possible.

Looking ahead, the smart investor in commercial property could do a lot worse than ignore the hype and ask themselves whether the asset they are buying or delivering is something that someone wants to pay for – and keep paying for.

Chasing trends and reacting to events is difficult, taking the time to talk to and understand your customer is much easier, and all too often ignored.

Investor appeal Changes in commercial property yields by sector



Source Savills Research

Commercial outlook: six trends for 2019

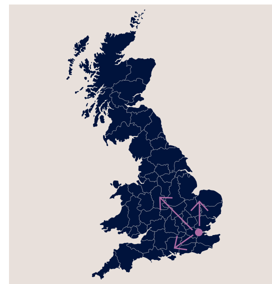
CUSTOMER CARE
The growth of workspace as a service, co-working and serviced offices was the talk of the commercial property markets from 2016 to 2018. Its growth reflected a need for a better customer experience for tenants. The best landlords and buildings will be those that look after their customers best, whether they want a six-month or 15-year lease.

GLOBAL CAPITAL
London remained the world's most popular destination for cross-border investment into real estate in 2018 and we do not expect this to change in 2019. Yields are high in the UK compared with most of Europe and Asia, and the possibility of more opportunistic deals will bring some North American buyers back into the market in 2019.

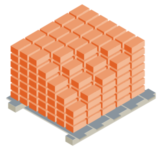
RETAIL REPURPOSING
Not all retail is prime, and a major theme for 2019 and beyond will be what you do with a vacant shop. We expect retail landlords to look harder at mixing uses and bringing more services into their schemes. Residential, hotels and even warehouses will be popping up in retail schemes across the country.

THE RISE OF LOGISTICS
Logistics is already the most popular commercial property asset class, and yields have fallen below those of offices and retail for the first time in history. Occupier and investor demand will remain strong, and industrial developers will start to build upwards to satisfy demand in the most constrained locations.

LONDON IN DEMAND
London was seen as being most exposed to Brexit, but the strength of tenant demand for London offices has contradicted this view. With only a year's supply of office space in the City and the West End, investor's eyes will turn towards how to capitalise on this.



REGIONAL GROWTH
The major regional cities are generally undersupplied with new office development, and are forecast to see continued employment growth. This, combined with a stronger house price and consumer confidence story than the South East, will keep them high on investors' wish lists in 2019. Mixed-use development, in particular, looks interesting in these markets.



478%
total pipeline growth
of build to rent stock
over the past five years

New kids on the block

Purpose-built, institutionally owned build to rent stock has become a significant component of new housing delivery

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Until recently, small-scale private landlords dominated the residential property market, with a small number of large-scale private and institutional investors sitting on legacy portfolios.

Around 2000, buy to let investment ballooned, driven primarily by the promise of inflation-busting house price growth. An income return was the icing on the cake. At its peak, in 2007, more than 183,000 mortgages were granted for the purchase of buy to let stock. That represented an increase of 22% in the number of such mortgages in existence – in just one year.

After the Global Financial Crisis (GFC), the number of buy to let mortgages granted fell and private cash investors became the dominant player. While the number of households in the private rented sector continued to grow at the rate of between 200,000 and 250,000 per year, larger institutions looked on. While they understood the fundamentals of a mismatch in supply and demand, they fretted over the entry barriers.

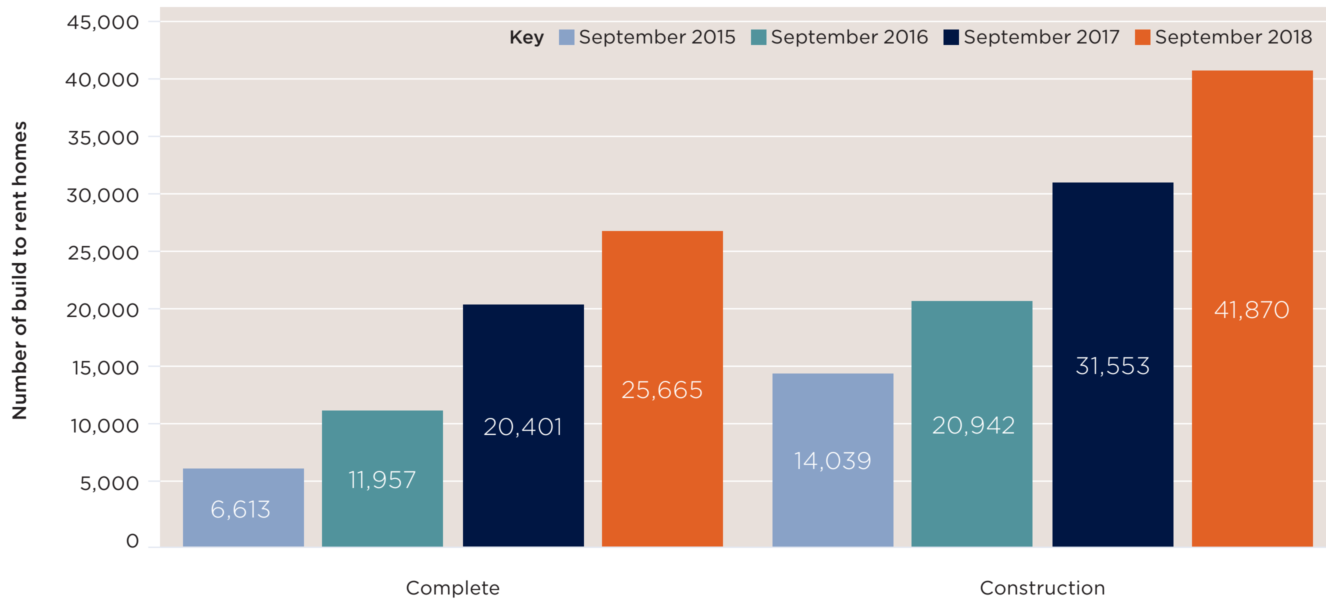
That is no longer the case. Pioneered by the likes of M&G, Delancey, Sigma, Quintain, Long Harbour and Grainger, purpose-built, institutionally owned build to rent stock has become a significant and increasingly important component of new housing delivery.

To put this into context, in the year to the end of September 2018, the number of outstanding buy to let mortgages grew by just 1.1%. The number of build to rent units either complete or under construction rose by 30%.

There has been innovation in planning, design, delivery, management and branding, laying the foundations for future growth. Equally, there appears to be plenty of capacity for an increasingly diversified offering.

> “There has been innovation in planning, design, delivery, management and branding”

On the rise Build to rent continues to gather momentum



Source Savills Research using BPF, Molior

The number of operational build to rent units remains a tiny fraction of the nation's private rented stock. And, while the range of investors has grown, some of the largest owners of multi-family in the US remain noticeable by their absence in the UK, as do the big pension funds.

The focus has also shifted from an investment perspective. In this new age of residential property investment, the emphasis has shifted to delivering a competitive long-term income stream. Since 2011, there has been a healthy margin over gilts, though achieving that has required investors to take on the risks inherent with developing and delivering a new product and matching that to demand.

With interest rates and gilt yields expected to rise gradually over the next five years, all property asset classes will see some upward pressure on yields. Even though there are acknowledged risks around regulation, what sets build to rent apart is a potential for rental value growth underpinned by structural change in how we live, and compression of the risk premium as the sector evolves and matures.

Residential outlook: six trends for 2019

SENTIMENT TO HOLD SWAY

In 2019, house price movements are more likely to be dictated by buyer confidence than affordability. Uncertainty regarding what final Brexit negotiations mean for household finances is likely to result in continued buyer caution, providing little impetus for house price growth at a national level.

REGIONAL REBALANCING

Evidence suggests we have moved into the second part of the current housing cycle where the markets of the Midlands and North of England outperform those of London and the South. We expect this to be reflected in investor focus through 2019 and the next five years.

FOCUS ON INCOME

With the potential for house price growth limited by the prospect of increasing interest rates and mortgage regulation, we expect investors to pay closer attention to the income stream delivered by their residential investment. This is expected to be accompanied by a shift from private to corporate investment.

BOOST FOR BUILD TO RENT

By the end of Q3 2018, there were 15 institutional build to rent schemes with plans to deliver more than 1,000 homes each. We expect large-scale investors who are keen to exploit operational economies of scale to deliver more large, but increasingly diversified, offerings to the private rental market.

PRESSURE ON PLANNING

Measures to standardise the calculation of housing delivery targets and hold local authorities to account for the homes built in their area through the planning system are likely to gradually feed through into more planning consents in areas of high housing need.

DIVERSITY ON LARGE SITES

A slowing housing market in areas of highest housing need will mean greater diversity tenures will need to be delivered to meet housing targets. As highlighted by the Letwin Review, this could include more build to rent product and affordable housing.

£11.9bn
The natural capital valuation of Forestry Commission England's woodland (2015)

Natural selection

The importance of natural capital will require farmers and landowners to prioritise sustainability

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Natural capital is gaining credence as the future foundation of public investment in land management. The concept offers a broader range of possibilities for landowners than public money alone, with new offerings in private finance for green investments coming to the market with increasing frequency.

The concept of natural capital has gained a foothold in the UK rural economy through the work of influential academics such as Professor Dieter Helm, chair of the Natural Capital Committee, which advises the Government on its environmental performance. The natural capital concept underpins the 25 Year Environment Plan, and the 'public money for public goods' elements of the Agriculture Bill.

Natural capital can be defined as the stock of natural assets, including geology, soil, air, water and all living things. From these assets we derive the goods and services that make human life possible, including food, drinking water, building materials, climate regulation, flood defence and pollination. Collectively, these are known as 'ecosystem services'.

The 25 Year Environment Plan is significant. It is expected to be the basis of the forthcoming Environmental Bill and, based on the Government's ambition, could create an entirely new baseline in environmental regulation for the UK. The Plan sets out three key principles for the future of all land management in the UK: public money for public goods, the 'polluter pays' principle, and a net environmental gain on all new developments.

Despite lobbying efforts, it has been made clear that food (or food security) is not considered to be a public good, and there is no mention of income support in the Agriculture Bill, unlike the Common Agricultural Policy (CAP). So, we predict that some farming businesses are likely to receive less in the way of public support in the future. Instead, the proposal in the Agriculture Bill is for public money to be invested in classes of natural services that would not otherwise be supplied privately, such as climate mitigation and biodiversity.

> "The concept of natural capital has gained a foothold in the UK rural economy"

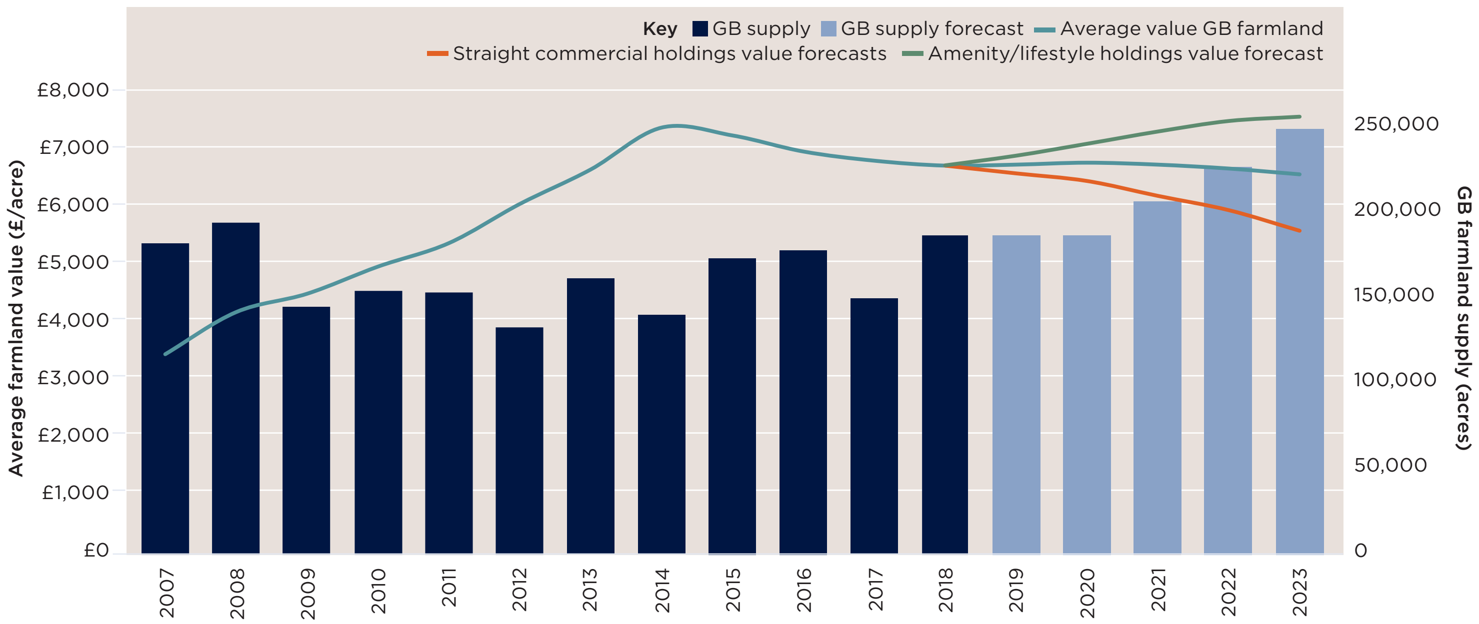
There have been a number of well-publicised partnerships between water companies and land managers that have paid farmers to change their farming practices to avoid causing pollution. However, one concern is that a strict application of the 'polluter pays' principle would undermine the viability of this fledgling 'market in avoided costs'. Certainly, this type of private investment implies a perverse incentive to pollute. Avoiding flooding and mitigating consumer and trade pollution through water filtration services remain areas to consider.

What is clear is that government is looking for ways to attract private investment into ecosystem services, and to blend this with public investment. Carbon credits and the forestry agenda is an obvious case in point. At present, this market is dysfunctional and would benefit from reform to facilitate investment.

The issue is that in many cases nobody really owns the natural capital asset. That is indeed why these assets have been exploited rather than preserved.

What is it going to take for these new assets in natural goods and services to be valued and traded as commodities in their own right? A regulated marketplace is key, but certainty over property rights is more important. Blending public and private sources of investment will then be possible and perhaps crucial to developing valuable multifunctional landscapes and income opportunities for land owners.

GB farmland forecasts Divergence of potential

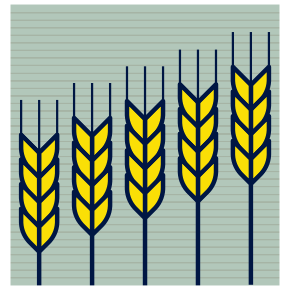


Source Savills Research

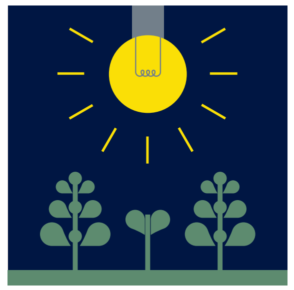
Rural outlook: six trends for 2019

REGULATORY CHANGE
The new agricultural and environmental regulatory landscape will impact rural businesses in 2019 and beyond. Preparing for life without, or with reduced, public subsidies means that a focus on business resilience is vital and natural capital may become an important income generator. The impact on the performance of let land will be one to watch.

EXPERIENTIAL DIVERSIFICATION
Appetite for countryside fun remains solid, but think of experiences rather than shows and events. Park runs, flower fields, Frisbee golf and Halloween fright nights all make the most of the available space, unique landscapes and atmosphere of country estates, while competing for the attention of cash-pressed, image-conscious millennials.

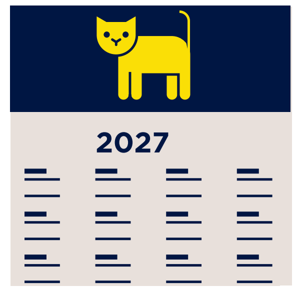


COMMODITY STRENGTH
In 2018, there were big increases in farmgate prices for UK cereals crops. An increasing global population means that commodity consumption is not predicted to abate any time soon. Subject to careful management of trading and market risk, such as exchange rates, the outlook for commodity prices is positive.



AGRITECTURE
Managing increased climatic risks – both shock events and seasonal fluctuations – could be the turning point in the economic viability of controlled environment growing systems, such as hydroponics. There are options beyond commercial scale too: integrating smart growing systems into the built environment offers engaging experiences and enhanced well-being in residential spaces.

LAND VALUE CAPTURE
Greenfield uplift values have to be competitive to encourage landowners to bring land forward for development, but land value capture remains one to watch for 2019. 'Net environmental gain' is pitched as a way to extract funding for environmental offsetting from development, but this sits alongside other measures that already capture significant land value, including much-needed affordable housing.



INCREASED LIQUIDITY
The regulatory reform position has announced the end of the Basic Payment Scheme by 2027. This means that many rural businesses will be evaluating their 10-year succession plans. We predict that this will bring more land to the market than has been the case recently.

Savills Research
We're a dedicated team with an unrivalled reputation for producing well-informed and accurate analysis, research and commentary across all sectors of the UK property market.

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