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UK Cross Sector
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Spotlight | 2018

UK Cross Sector Outlook

Investment trends for 2018 in the residential, commercial and rural sectors

Guidance in a changing market

Welcome to the 2018 *Savills Cross Sector Outlook*, in which our team of research experts forecast the top performers and key trends across each sector

"The uncertainty over the UK's future relationship with the EU will continue to cast a shadow over economic growth throughout 2018, leading to a more cautious outlook amongst investors across all sectors. However, although sentiment and activity may be subdued, it doesn't mean investment will stop.

Property remains a safe haven for capital preservation, and demand for prime, secure investments will be as keen as ever. Yields on many commercial property sectors, for example, are higher than those in much of Europe.

A shortage of prime stock is leading investors to seek income in alternative assets

Although the pace of recovery will be dictated, to a large extent, by Brexit, investors are exploring new opportunities. So, while the mortgaged buy to let sector is in decline, there is fresh impetus in the multifamily market. In the commercial sector, a shortage of prime stock is leading investors to seek secure income in alternative assets. Even in the rural and farming sector, which is highly sensitive to the outcome of Brexit negotiations, assets such as renewable energy and agritech offer potential for future gains.

Given the economic climate, making the right investment is crucial. This report outlines the findings of our expert research teams across the commercial, residential and rural sectors. We believe it will help inform your future investment decisions."

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Summary

Commercial
As risk aversion remains a major trend, income-producing asset classes such as warehouses and student accommodation will grow in popularity.

Residential
The decline in mortgaged buy to let investors will create opportunity in the build to rent market, while investment focus will shift to the regions.

Rural
With uncertainty dictating rural market sentiment into 2018, scale, efficiency and diversity of income will play a key role.

Salford Quays, Greater Manchester

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Opportunities in an age of risk aversion

With investor demand focused on secure income streams, our cross sector forecast looks at prospects for income yield and capital growth across a spectrum of assets

Lingering uncertainty has been a core theme of 2017, as the UK begins the transition out of the EU. Negotiations may be underway, but the market has yet to gain the level of clarity desired by many investors. Instead, risk aversion has become the overriding theme.

This has translated into resilient demand for prime assets and secure income streams, whether that be central London office space, large tracts of productive agricultural land, or institutionally backed build to rent residential developments.

Outlook and opportunities

We expect more of the same over the next five years, with long-life income streams becoming ever more highly prized. Indeed, income returns account for just over 60% of our projected total returns from property assets during the next five years. This is reflected by our muted capital-growth forecasts at this stage in the cycle, not least because we expect the cost of capital to increase over the next five years.

Consequently, in the commercial property market there seems much less room for yield compression than the recent past. In the residential sector, mandatory stress tests will constrain the amount of debt available to buyers. Uncertainty over the extent and nature of future support for agriculture has already made buyers of rural land more cautious and increased the land market's sensitivity to price.

So, where are the opportunities? In the commercial market we expect to see non-domestic investor demand continue to expand out from London and renewed enthusiasm for segments that fell out of fashion in 2016 and 2017 due to the negative impacts of the weakening of sterling. UK property still offers comparatively strong returns and lower risk against other geographies, and this will underpin demand from overseas buyers.

In the residential markets, the fact that the government has put housing at the centre of domestic policy should provide a platform for innovation, presenting significant opportunities for developers and investors. Despite extra funding for Help to Buy, demand for private rented properties will continue to increase. Together with the ongoing undersupply of affordable housing, this should underpin rental demand across a range of income groups. >

Despite extra funding for Help to Buy, demand for private rented properties will continue to increase

In the rural market we expect caution to eventually give way to renewed investor confidence as the outcome of Brexit materialises. Towards the back end of the next five years, the fundamentals that have historically underpinned the sector's performance should come back into play – shortage of supply, demand from competing uses, amenity offering and the tax benefits of ownership. Longer-term, we maintain our bullish outlook on forestry, energy and alternative food production.

Against a background of Brexit uncertainty, the bulk of investor demand will be for secure income stream across all sectors, presenting opportunities for investors who can create such product.

Five-year projected performance
At the top of our table sits the urban logistics sector, which delivers the highest income yield and strongest capital growth prospects. Secure income is popular, and pressure on land, particularly inside London from other uses, will maintain undersupply and deliver extra rental growth.

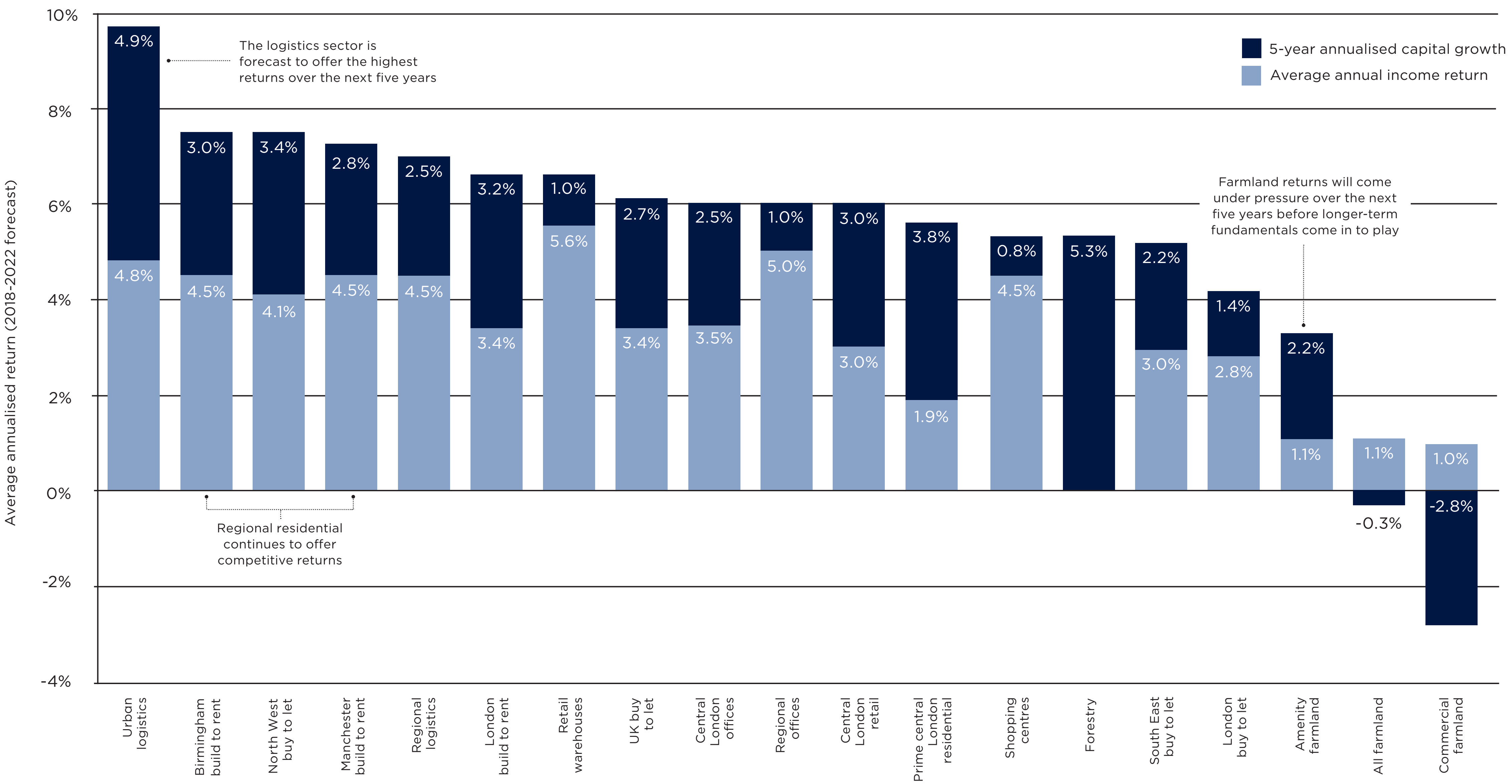
Not far behind sit the residential markets of the North West of England and the West Midlands, which retain the capacity for house price growth by reason of fewer affordability constraints. Corresponding higher-income yields should underpin performance in this part of the housing market cycle.

Pressure is on agricultural property – most at risk from the decision to leave the EU and uncertainty around future agricultural policy. Nonetheless, we expect holdings of scale with options to diversify income away from agricultural production to remain sought-after.

The mainstream London residential market also sits at the lower end of the table. This reflects relatively stretched affordability that leaves it exposed to fickle buyer sentiment and an affordability squeeze as the cost of debt rises. It sits in contrast to prime central London, where the market has already seen a double-digit price adjustment and, separately, the growing build to rent sector that is underpinned by the fundamentals of an undersupplied rental market in the capital. ■

Footnote: how we compare income returns
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.

Comparative returns Income accounts for 60% of total return on average across the forecast period



Source Savills Research

Our key investment opportunities

Commercial

Urban logistics
Strong tenant demand and competition for sites from other uses will ensure strong rental growth. The strongest growth will be inside the M25, but we expect to see this spreading to big regional cities.

Affordable offices
With business uncertainty rising as we move closer to Brexit, we expect that clever property decisions will be popular with occupiers. The best locations will be accessible and affordable.

Residential

Multifamily in the regional cities
With the build to rent, or multifamily, sector gaining traction and expanding beyond London, large regional cities, such as Manchester and Birmingham, offer an opportunity to capture higher yields with good prospects for underlying capital growth.

Strategic land in the South East
Pressure to increase housing delivery and set objective targets for housing need at a local level are likely to open up opportunities to bring strategic land through the planning process. Areas without an up-to-date local plan, or an insufficient five-year land supply, offer the greatest potential supported by a range of measures to encourage house building set out in the recent budget.

Rural

Reducing risk through diversification
As the agricultural sector faces turbulence during the medium term, units with the potential to derive alternative income streams will remain attractive. Reducing exposure to a single enterprise will counter heightened volatility and price risk. We expect demand and capital values to remain resilient in this sector.

Growing returns from woodland
Strong demand fundamentals support our bullish outlook on forestry. Marginally productive agricultural land could offer an opportunistic purchase with value added by either expanding existing plantations or establishing new woodland. Current financial incentives would bolster cash flow within the first three to five years of the cycle, and longer-term prospects for capital uplift look positive.

CROSS SECTOR FORECAST

Break from the crowd

New opportunities are emerging for investors prepared to explore beyond the increasingly scarce pool of prime or secure assets

While 2017 was characterised by forecasters revising their numbers up rather than down, investor and occupier reaction to Brexit turned out to be more of a shrug than an exodus. With investment volumes and leasing activity in some locations likely to have hit record highs, is a more opportunistic investment strategy for 2018 likely to pay off?

Domestically and globally, risk aversion among investors has risen, and we expect this to remain a major trend in 2018 and beyond. However, this does not mean people stop investing. It just affects what they invest in.

Any investment branded as core, prime, or secure will remain hotly sought-after, and the quirks of the UK commercial property lease mean that, in comparative terms, we will always look less risky than some other domains, regardless of local political issues such as Brexit.

Non-domestic investors will be attracted to the UK by comparative risk, and also by comparative returns. Prime yields on many commercial property sectors in the UK are now higher than those in much of Europe and Asia-Pacific. We do not expect this story to change in 2018 and beyond.

Domestic investors are likely to remain cautious in 2018 because of home bias, and also as they tend to see local political issues as more important than they actually are.

The biggest beneficiary of the shortage of prime mainstream stock will be the plethora of income-producing assets classes that used to be lumped together as alternatives. Whether that asset is a pub or cinema, warehouse or student house, the attraction to investors will be the bond-type characteristics of the asset.

Of course, as an increasing number of investors herd towards a comparatively scarce pool of assets, an opportunistic window opens. Our core pick for high returns remains development or asset management across all subsectors of the commercial market – namely, turning short, risky income into long, secure income.

The other area of emerging opportunity also springs from herding biases. There are still sectors in the commercial property market where we believe that the received wisdom on that sector's prospects is incorrect. Whether this applies to the impact of internet shopping on retail or Brexit on London offices, there are opportunities for investors to behave counter-cyclically. ■

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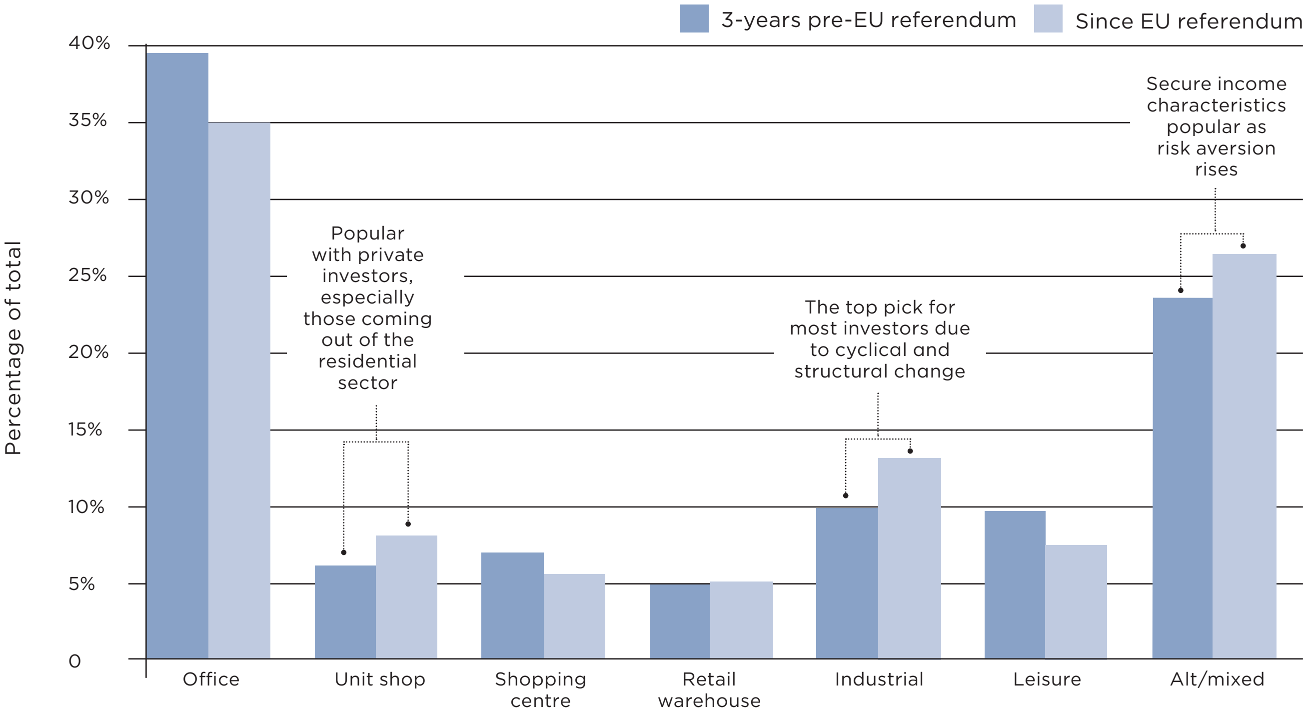
Investor appeal The change in popularity of commercial assets since the EU referendum



Source Savills Research from Property Data

Commercial outlook: six trends for 2018

As demand for prime remains strong, alternative assets will grow in significance

Non-domestic demand

With the pound staying weak and UK commercial property yields now looking high in comparison to prime European and Asian markets, we expect non-domestic investor demand for UK commercial to remain strong in 2018.

Value beyond prime

With risk-averse domestic and global investors dominating the market in 2018, there will be less competition and even falling prices in secondary and tertiary markets. This will be a great opportunity for value-add and opportunistic investors as they turn short income into long.

Alternative appeal

The unifying theme among the plethora of alternative asset classes is their long-term secure income streams and popularity among risk-averse investors. So, 2018 will be the year that alternative becomes mainstream.

Retail therapy

In 2017, a perfect storm of negativity hit retail. For 2018, we will see better news about real earnings growth, and a less homogenous attitude to retail with investors. Some segments will be a good buy due to their defensive characteristics, while others just look cheap.

Brexit balance

With London's office market shrugging off the worst of the pre-Brexit negativity, 2018 will see more balance in the assessment of how much, where and when occupational risks will rise.

New-tech tools

While wellness and staff satisfaction will continue to increase in importance for many employers when choosing buildings and locations, some businesses will start to look at offsetting the costs of delivering wellness by using the margin-enhancing tools of artificial intelligence (AI).

Market movers

With mortgaged buy to let investors feeling the pinch, the market is opening up for cash buyers and a rapidly expanding multifamily sector

Since the late 1990s, the residential investment market has been almost entirely associated with the buy to let investor. Rightly or wrongly, the ills of the UK housing market – most notably the difficulties faced by first-time buyers – have been laid at their door.

The summer budget of 2015 marked the point at which politicians sought to discourage buy to let investment through tax policy. And the squeeze continues as mortgage regulation spreads across both small-scale and portfolio landlords. Interest rate rises and progressive cuts in tax relief will limit investor opportunity.

According to UK Finance, the number of buy to let mortgages granted for purchasing a property was 75,300 in the year to the end of August 2017 – 47% lower than in the year to March 2016. The growth in the number of outstanding buy to let mortgages is lower still, at just 24,800, and there is evidence that some investors are shedding stock as shown in the graph below.

Irrespective of the support provided by the Bank of Mum and Dad and Help to Buy, little has changed for the deposit-constrained first-time buyer and the demand for rental stock will continue to grow.

Cash investors, however, remain far more active. The quarterly stamp duty land tax statistics suggest that in the year to September 2017, the additional 3% surcharge was paid on 245,000 purchases.

While some of these will be second home purchases, people buying for other family members or people buying their new home before selling their old one, the majority will have been investment buys.

Looking to 2018 and beyond, the decline of the mortgaged buy to let investor will open things up for the growing multifamily or build to rent market, led by the likes of Sigma and institutions such as L&G, M&G, and LaSalle, who have contributed to the delivery of more than 17,000 units so far.

At the end of the third quarter of 2017, our joint research with the British Property Federation showed that there were almost 79,000 such units in the development pipeline, a number that has increased by 40% in just six months. Of these, some 24,000 are under construction in a rapidly evolving sector that has embraced offsite construction and is rapidly changing the nature and range of rental options available to tenants. All of the evidence suggests this will gather pace through 2018. ■

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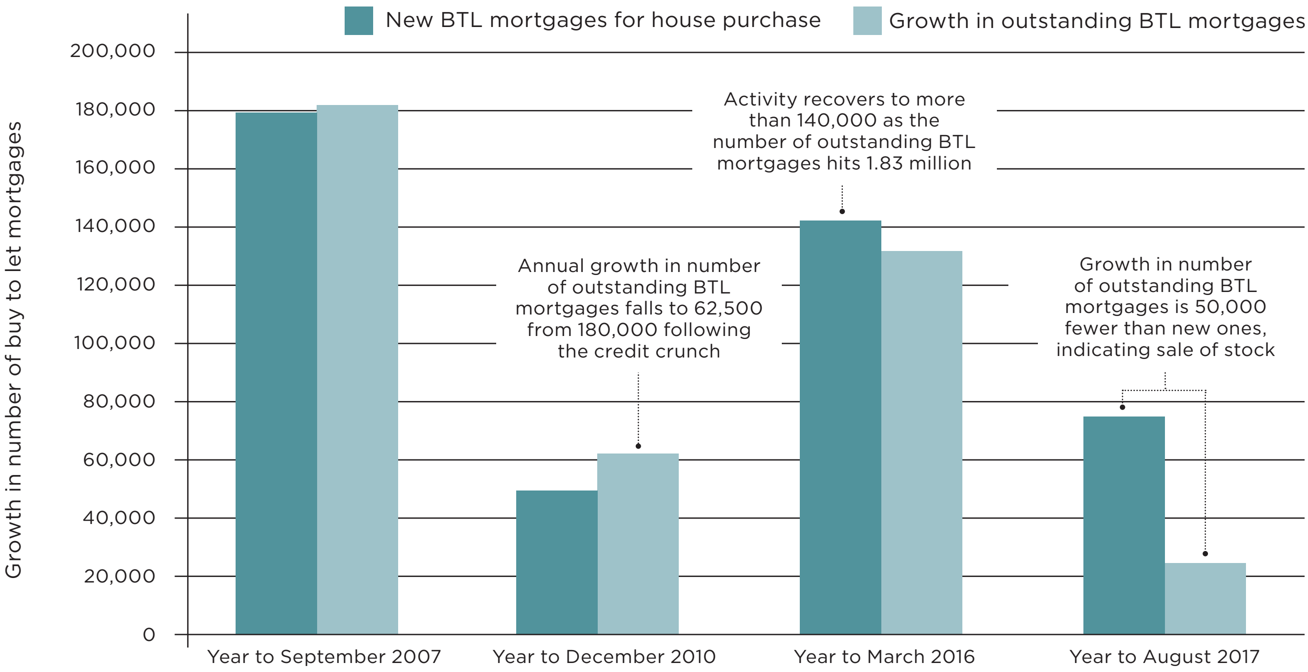
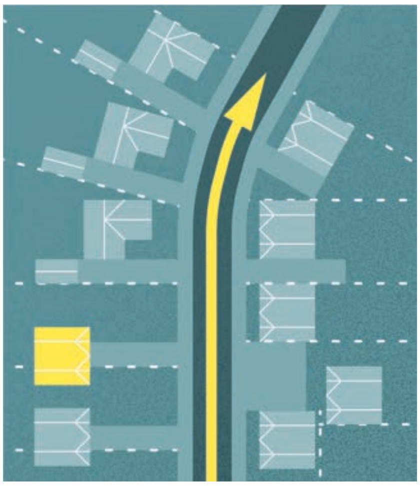
Feeling the pinch Low growth in the number of outstanding BTL mortgages suggests stock is being sold



Source Savills Research, UK Finance

Residential outlook: six trends for 2018

Investment opportunities in regional residential, build to rent and for cash buyers



Development in demand

Continued reform of the planning system is likely to provide more opportunities for development. The recent government consultation on objectively assessing housing need suggests much greater focus on increasing land allocation in areas where housing affordability is most stretched.

Broader investment

We expect the range of investment opportunities to increase. These include more joint ventures with housing associations, more private-sector products aimed at those struggling to get a foothold on the housing ladder, and greater focus on retirement housing.

Pressure on buy to let

The squeeze on mortgaged buy to let investors will continue as mortgage regulation spreads across both small-scale and portfolio landlords. Rising interest rates and progressive cuts to tax relief on mortgage interest will limit the ability of investors to expand their portfolios.

Cash remains king

Investment will be led by cash-rich private buyers and institutional investment in the multifamily (build to rent) sector. Overseas wealth will be pointed at prime central London, where prices have fallen by more than 15% since 2014. The tax environment will temper any bounce in values.

Subdued price growth

Short-term prospects for capital growth will be limited, as economic uncertainty feeds through into buyer caution. Medium-term prospects for house price growth in London and parts of the South East will be constrained as buyers hit up against debt ceilings.

Rise of the North West

The investment focus will shift towards regional conurbations that offer higher income yields and better prospects for growth. We expect the North West to deliver the strongest house price growth over the next five years, tempered by the economic and lending environment.

Investing in change

With uncertainty continuing to dictate market sentiment into 2018, greater efficiency, diversification and natural capital will play key roles in the long term

Near-term, we believe UK farmland transactions will remain subdued as existing and would-be commercial operators delay entering the market until more is known about farming's future prosperity. Supply volumes are unlikely to reach the long-run average and the bid to guide price spread depending upon location and quality. Declines in average values are not forecast to go beyond a -5% annual dip.

Into the medium-term, the implications of not agreeing a Brexit deal and moving on to WTO rules and a reduction in agricultural subsidy could erode farm earnings, particularly for bottom-quartile operators. While existing subsidy levels are initially guaranteed by the UK Government, we have little clarity on either the amount of support or the distribution mechanism that will be adopted post 2020. Early indications do, however suggest a shift away from area-based basic payments with the bulk of funding allocated to environmental objectives with natural capital becoming a main priority for agricultural policy. Many operators will have to work hard to adjust to the new environmentally linked income streams, although the pace of transition is likely to be manageable.

The impact of different trade arrangements and a reduction in agricultural subsidy will vary across the sector as scale, efficiency and income diversity will all play a role in the future success of a business.

Our scenario-modelling suggests the livestock sector (beef and sheep) is particularly vulnerable. Any increase in borrowing costs will exacerbate the situation for businesses operating with high levels of debt. Where a shortfall in profitability cannot be balanced out by subsidy income, asset disposal may be the only option.

Longer-term, with greater clarity on our trading position and the structure of subsidy, the outlook is encouraging, as certainty will engender recovery and opportunity. Renewed confidence in the sector will encourage a recovery in trading volumes post 2019 and a return to consistent capital growth across all sectors. Less profitable businesses should find new ways to operate, albeit under new configurations.

In addition, we see upside from energy and forestry where there is potential to realise short- to medium-term gains in asset performance. The attractiveness of farmland as a safe haven for wealth preservation, as an amenity asset and a long-term strategic investment will remain, particularly in times of heightened volatility. ■

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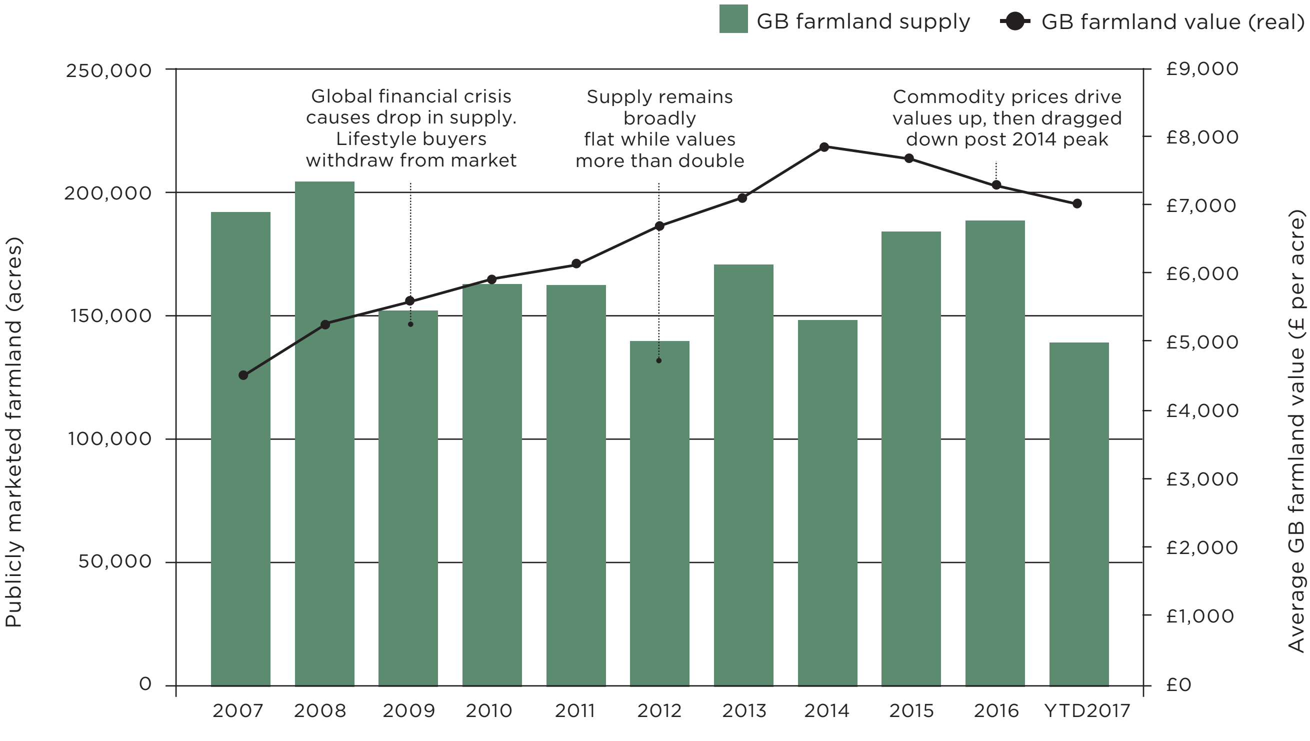
Supply and value Change in values leading up to current Brexit-related uncertainty



Source Savills Research

Rural outlook: six trends for 2018

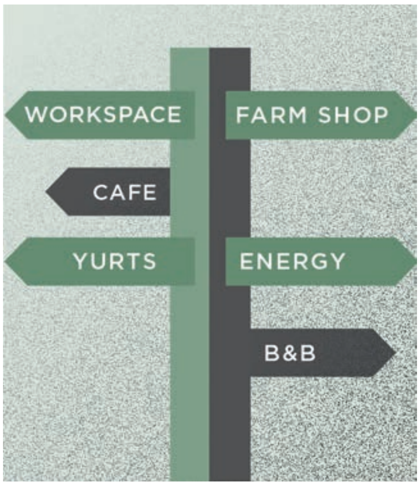
Brexit looms large, but forestry, agritech and renewable energy suggest future gains

Farmland in favour

Farmland remains a safe haven for wealth preservation, particularly in times of higher volatility. Factors such as amenity, buyer's motivation and scope for diversification from agriculture will continue to create polarisation within the market leading to capital growth in some scenarios.

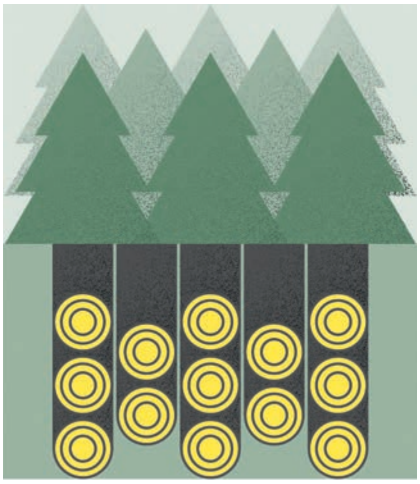
Brexit brake on activity

Brexit negotiations will dictate sentiment, prompting constrained supply and muted pricing as would-be participants wait for greater clarity. We expect supply to plateau over the next 12 to 18 months, but with little material downside to land values as long-term fundamentals remain resilient.



Diversified income

Unfavourable post-Brexit arrangements for trade and a potential reduction in subsidy levels are risks to profitability, specifically for those farms with marginally productive land. Bottom-quartile businesses could be pushed into financial distress unless they become more efficient or diversify income.

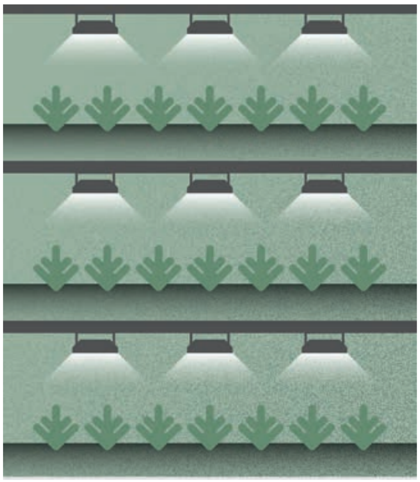


Forestry growth

The demand for biomass feedstock and construction-grade timber supports an upward trend in pricing. Government commitment to increasing housing stock strengthens our view, with timber a cost-effective material. The greening of subsidies may trigger more woodland planting.

Boost for renewables

We see upside with renewable energy as long as financial incentives remain favourable and cost deflation continues. Integrated energy solutions are likely to emerge in the next wave of projects – renewable power generation with energy storage to create balancing capacity.



Precision farming

Advances in agritech are starting to yield results in terms of sustainable output. New businesses are making use of former commercial premises to house alternative horticultural production methods, often catering to niche markets previously serviced by imports.

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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