UK Residential, Commercial and Rural – 2020

SPOTLIGHT
Savills Research

UK Cross Sector Outlook

Investment trends and disruptors for 2020 across the Residential, Commercial and Rural sectors

The uncertainty isn’t over: but don’t be afraid of it

Times have been turbulent since the Brexit referendum, but it hasn’t all been bad news. And while the uncertainty will continue into 2020 and beyond, it does present opportunities for investors

One of the most common questions we have been asked over the past year is ‘how is Brexit uncertainty affecting the market?’ Generally, the expected answer is one of falling prices and slowing transactional volumes. While this is true in some parts of the UK, it is by no means the whole story. This in turn raises the questions why some parts of the real estate market are proving more resilient in the face of waves of uncertainty than others, and what will happen when that uncertainty diminishes?

Perhaps the first question we should be asking is whether businesses and consumers are actually significantly more uncertain than usual. The received wisdom is that this must be the case. Measures of business uncertainty such as the CBI’s Business Optimism Indicator have not only been more volatile since 2016, but have also indicated a lower level of confidence. However, the story on the consumer side of the economy is more nuanced, with the GfK Consumer Confidence Index pointing to significant negativity about the prospects for the UK economy, but relative stability – and indeed optimism – when people are questioned about the outlook for their own financial situation.

The impact of Brexit

The logical extrapolation of these trends would lead you to believe that if businesses are worried, then surely they will not be leasing more premises or buying more land.

However, 2016 to 2019 has blown even these simple assumptions out of the water, with record levels of office leasing activity, better than expected levels of housing turnover, and weak agricultural

Uncertainty and disruption were our buzz words in 2018 and 2019. The question is whether this will change for 2020.

Although the result of the general election has reduced political uncertainty, there can be no doubt that Brexit-related uncertainty will remain throughout this year.

However, what the past few years have shown is that real estate is an asset class that investors still turn to in times of uncertainty. I believe that this will remain true in 2020 and beyond.

With the global trend in interest rates remaining ‘lower for longer’, direct assets such as property will remain popular. The UK still offers transparency and security that is not available in many other parts of the world. This, combined with the recent plateau or falls in capital values in the UK, will make us look even more comparatively attractive.

Disruption is now the norm, and it’s here to stay in 2020. Change creates opportunity, whether that’s in logistics and data centres, multifamily and senior housing, or vertical farming and natural capital. I am confident that our clients will capitalise on these and other trends in 2020.

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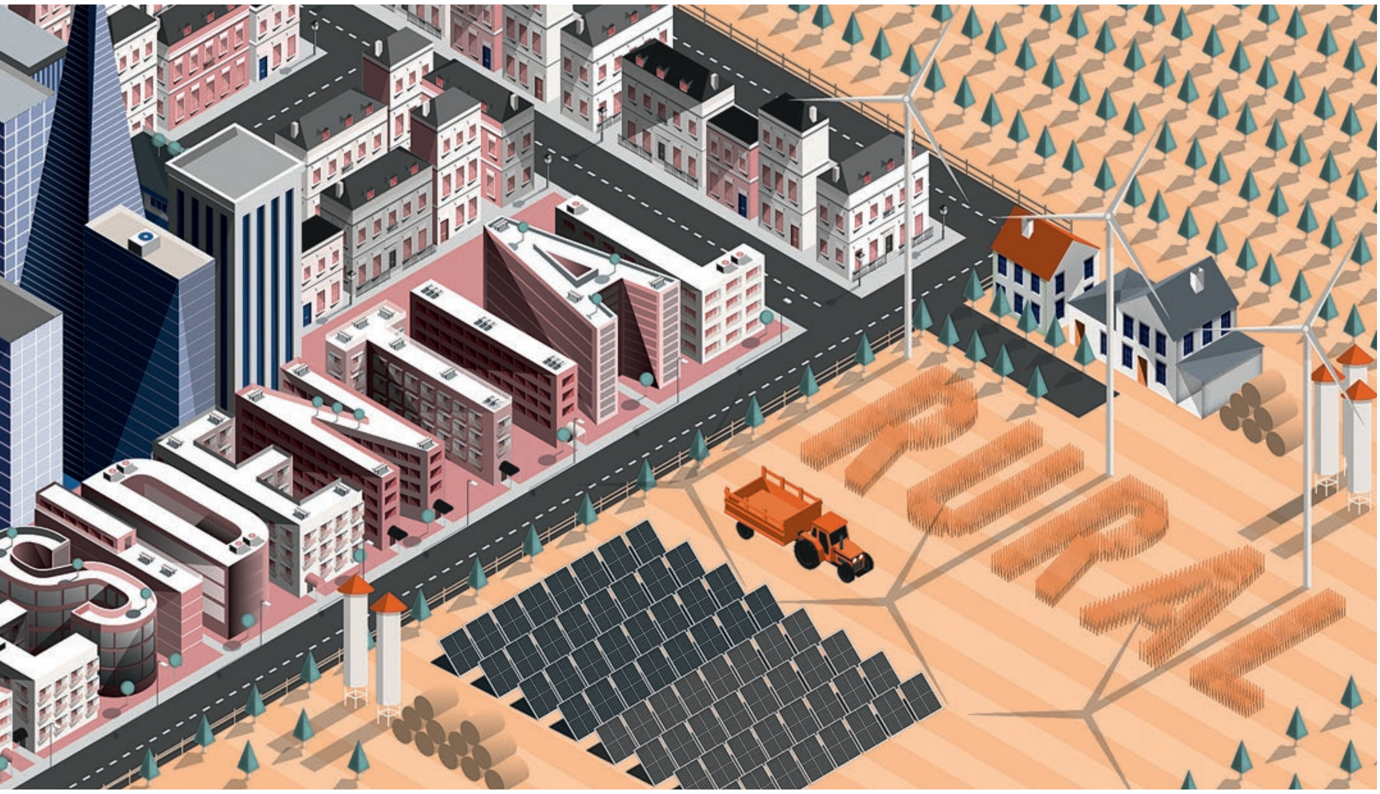
> **It is difficult to have a strong bounce when many markets are functioning at normal, or better than normal, levels**



land turnover. Maybe the real impact of Brexit has been on sentiment-based decisions (those that do not need to be actioned), while needs-based decisions still have to be made, even during a sustained period of uncertainty.

One of the reasons some investors are so interested in uncertainty is that they see it as an opportunity. However, aside from the period immediately after the referendum in 2016, there have been relatively few real estate bargains to be had in the UK (unless you can take advantage of the weakness of sterling). The low cost of finance has made refinancing of debt relatively cheap and easy, and, apart from the retail sector, there has been remarkably little distress in the property market over the past few years.

Prospects of a bounce

Another reason behind the obsession with uncertainty is the hope that, when it diminishes, the market will heave a sigh of relief and bounce back in terms of prices and transactional volumes. While there are undoubtedly some quite significant groups of investors who have been less active in the UK than usual since 2016, we do not expect that the 'Brelief bounce' will be as significant as some people are hoping.

The first reason for this relative caution in our outlook is that it is difficult to have a strong bounce when many markets are functioning at normal, or indeed better than normal, levels.

The second reason is that, where prices have fallen substantially, there are more factors at play than just uncertainty. For example, while retail property has undoubtedly been affected by uncertainty over Brexit, the more significant driver of falling prices and transactional volumes has been the structural challenges around online and omni-channel retailing.

Future challenges

Similarly, in the mainstream residential property market, the weakest performing areas have been where affordability has been stretched to its limits, and economics are expected to continue to drag on the market going forward, regardless of an end to Brexit-related uncertainty.

The final reason why we do not expect UK real estate to see a strong rebound in activity or pricing in 2020 is the fact that, whatever happens on 31 January, it will not dramatically diminish uncertainty over our relationship with the EU. Whether we leave and enter the maelstrom of WTO regulations, or enter a period of negotiation with the EU over everything from agricultural tariffs to zoo breeding programmes, the simple fact is that uncertainty will not disappear. This, above all the other reasons listed above, will limit the upside for 2020 and beyond, both in terms of pricing and transactional activity.

The return to the market of those buyers who have stayed away may well put upward pressure on prices where there are limited sellers, but when Brexit slides into the history books, we will still have to deal with a wide variety of old and new structural, economic and legislative challenges.

All of these trends and disruptors present opportunities for investors in real estate, and we examine these in more detail in the remainder of this report.

> “The underlying shortage of good-quality office space, especially in London, is set to underpin the rental growth prospects in that sector”

Relative returns

Property cycles and structural change will ultimately dictate returns over the next five years

Halfway through the 1978 blockbuster *Superman: The Movie*, Lex Luthor turns to his sidekick and opines, “Son, stocks may rise and fall, utilities and transportation systems may collapse. People are no damn good, but they will always need land.”

This phrase will have resonated with property investors in the past three-and-a-half years: perhaps as much as in any of the 41 years since Christopher Reeve emerged from a phone box clad in spandex.

By contrast, the subsequent assertion of Luthor, the fictional supervillain, has been severely tested. Since the EU referendum, it has been far from clear that people will always ‘pay through the nose to get it’.

During that period, national house price growth has slowed dramatically, agricultural land values that peaked in 2015 have softened by a further 2%, and commercial investors have become far more selective in both the sectors and individual assets they will acquire.

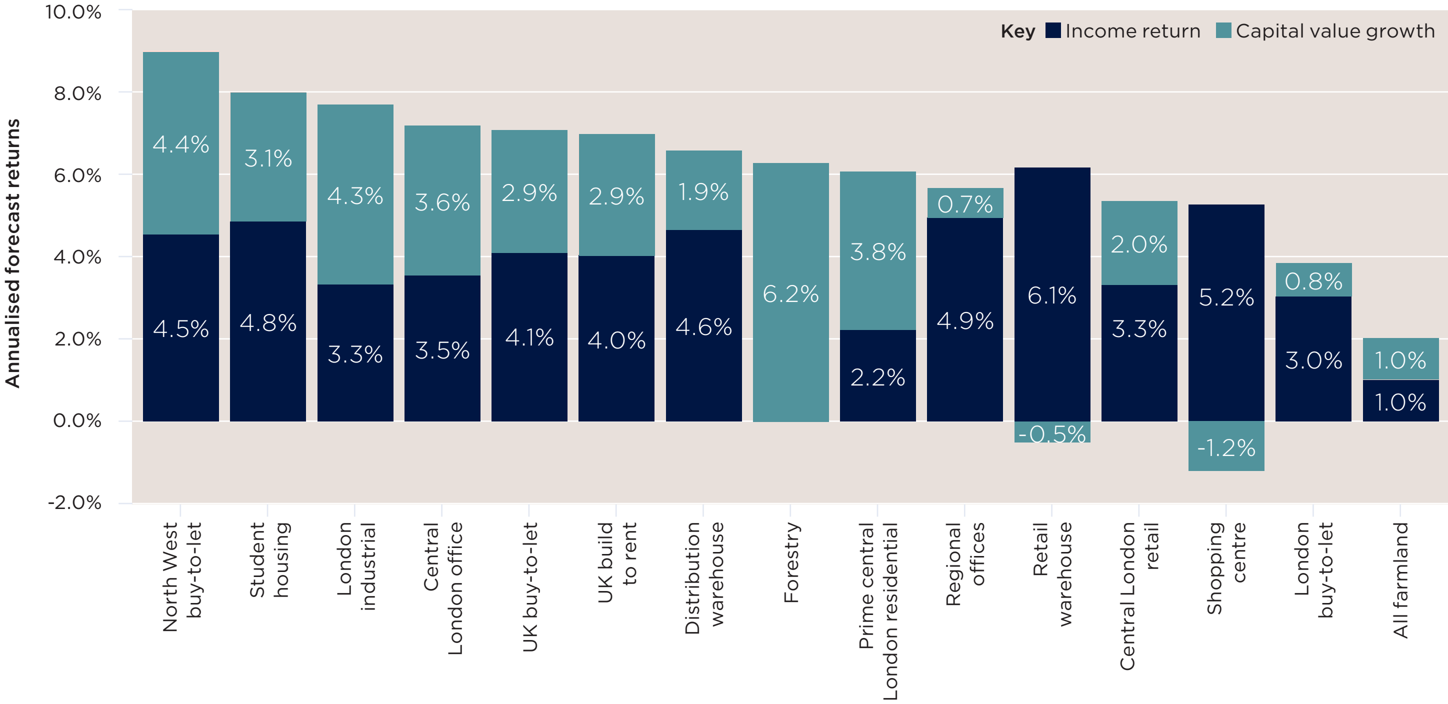
As we look forward to the next five years, we believe that greater political and economic certainty will underpin positive investment returns across the different property asset classes. However, the scale of those returns will reflect where we sit in the property cycle and some of the structural changes we are seeing in different sectors.

Within the residential sector, properties in the Midlands and the North offer both higher income returns and prospects for capital appreciation at this stage in the cycle. However, for the private investor, the regulatory and tax environment means buy-to-let is not a venture for the faint-hearted. Institutional investment will play an increasing role, with those championing build to rent learning lessons from a more established purpose-built student housing sector.

Commercially, structural change in the way we use the high street will continue to influence where the weight of investment falls. But, as we set out elsewhere, those who adopt a simple logistics good/retail bad mentality risk throwing the baby out with the bath water. Meanwhile, whatever the travails of WeWork, the underlying shortage of good-quality office space, especially in London, is set to underpin the rental growth prospects in that sector.

From a structural perspective, agriculture faces a great deal of regulatory change over the coming five years, though indications are that policy evolution will be gradual rather than sudden. Continuity in the support and trading business environment, and scarcity of supply, in the medium term at least, is likely to underpin land values. However, competition from other land uses is likely to be the key driver of capital appreciation. In that respect, Lex Luthor nailed it.

Comparative returns Forecasts for the next five years



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 commercial, residential and rural assets

Commercial top picks

City of London offices

Low vacancies, strong and diverse tenant demand, and a steady influx of new businesses from the West End will drive rents in the core City. Low- to mid-rise buildings with great accessibility and a strong local retail and leisure infrastructure will outperform.

Hybrid retail parks

Bulky goods and food retail are likely to be least disrupted by internet shopping. This, combined with recent price falls, retailer-friendly low rents, lots of car parking and comparatively low vacancy rates make this segment look attractive.

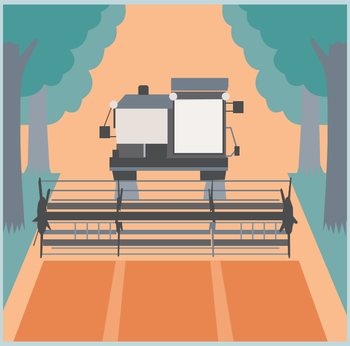
Residential top picks

Prime Central London

Prices of prime residential property in Central London have fallen by 20.4% over the past five years, leaving the sector looking good value in both a historic and global context. During the same period, the number of global ultra-high-net-worth individuals (worth $50m+) has risen by 30%. Despite a less accommodating tax environment than in previous recoveries, we expect a recovery to take hold in 2021, as the risk of onerous wealth taxes recedes at a time when the value of sterling bottoms out.

Retirement housing

The fundamentals of supply and demand are overwhelmingly attractive. The population aged 75+ stands at 5.4 million and is due to grow by 1.9 million over the next 30 years. There are 726,000 dedicated retirement dwellings in the UK. On this basis, we estimate the sector is as much as 45% under-supplied, even before factoring in a high risk of obsolescence of the stock that exists. Legal & General, AXA, and Goldman Sachs have already committed to the sector.



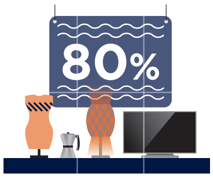
Rural top picks

Strategic land

Strategic land has been the investor's UK land class of choice where it's been available. But in a limited market, opportunities are few and far between. Ambitious housebuilding targets underpin faith that opportunistic capital returns will still be available, even if biodiversity net gain takes an additional nibble out of land value uplift.

The offsetting market

Offsetting land may present the most interesting income opportunity, as development pushes catchments to their limits and the private sector becomes increasingly interested in the services that land management can offer them. Location is everything, unless it's the slowly emerging UK farmland carbon market, which presents a tantalising opportunity to attract major investment into some pretty remote and otherwise unappealing rural assets.



More than 80% of everything we buy in the UK touches a shop in some way

Structural change

As political uncertainty diminishes, some unexpected areas could offer opportunities for 2020 and beyond

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A quick scan through the main commercial property market indicators for the period since 2016 suggests that uncertainty has not been particularly bad for business. Office leasing has been driven by pre-letting and the technology, media and telecoms (TMT) and serviced office sectors, logistics by omni-channel retailing, and overall investment by comparative risk and yields on a global stage.

This suggests that, when political uncertainty diminishes, there may not be the bounce some commentators have predicted. There are, however, some areas where a bounce may occur – and they might not be the most obvious places.

The first is the return of non-domestic institutional investors who have chosen to stay out of the UK due to Brexit. These funds, predominantly from Europe and Japan, have considerable amounts to invest and an increasing bias towards property due to low base rates in their home countries. We expect the bulk of this money to be focused on larger, secure-income assets, centring on London and a handful of prime regional city offices, as well as logistics.

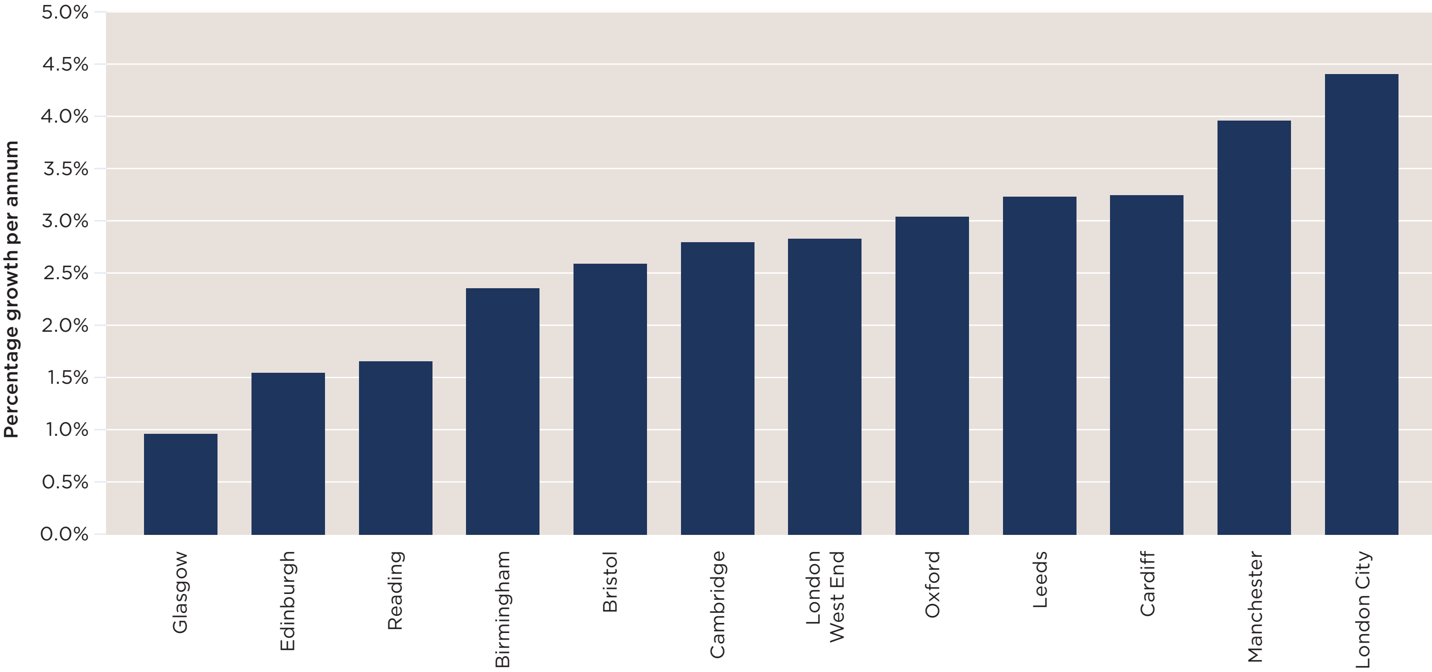
Limited stock

The challenge for these investors is that the traditional lifecycle of such assets has become rather broken in recent years. Development activity in the office market is close to record low levels, and future supply of prime long-leased stock will be tight. Unlike previous periods of uncertainty, there has been very limited distressed selling, with many investors choosing to refinance rather than sell assets.

While yields on these kind of assets are historically low, they are high relative to other global markets, and this will be enough to convince some investors to increase their weightings to the UK. There is also an argument that parts of the UK market, most notably central London offices, have missed out on the rental growth seen in other European cities. For once, London is following rather than leading the occupational cycle,

> “We do expect to see a rise in office development starts from 2020, but this will not be enough to satisfy demand”

City limits Prime office rental growth for 2020 to 2022 across key UK cities



Source Savills Research

and this will enable investors to justify paying cyclically low yields for another few years.

If the traditional build-let-sell lifecycle has been damaged by the global financial crisis and Brexit, then the obvious strategy for the early 2020s is to consider speculative office development. None of the UK's top nine office markets has more than 1.5 years of Grade A supply at average annual levels of take-up, and this does not look likely to change.

We do expect to see a rise in office development starts from 2020, but this will not be enough to satisfy demand. Developers' margins will be challenged by rising site prices, construction costs, and the cost and availability of development finance.

Rethinking retail

The prevailing wisdom of the past few years has been that selling retail and buying logistics should be at the core of every investor's strategy. However, the outlook is not quite so simple, and the returns from tactical buying of retail could exceed those from paying record low yields for hotly competed-for logistics property.

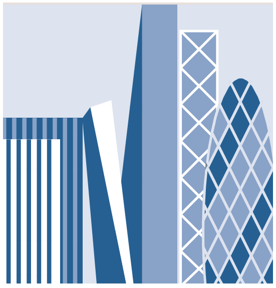
While there is nothing wrong with buying good logistics, investors should take note that, not only are yields at record lows, but also that the sector faces its own structural challenges, including staff availability, the rise of autonomous trucks, and competition for land from housebuilders.

Retail is undoubtedly a cold, hard place to be in at the moment, but 2020 will be the year when we start to see some investors capitalise on the falls in prime yields. Retail is not dead: even in the UK, where we shop online with a fervour that is unmatched in most other countries, more than 80% of everything we buy touches a shop in some way. With capital values on prime retail schemes having fallen by 20% or more in the past two years, the point at which a major investor calls the bottom of the cycle may not be far away.

We expect to see a major opportunistic investor take a large position in the UK retail space in 2020, attracted by price corrections big enough to allow a rebalancing of rents to a level that is acceptable to struggling retailers. Such a deal would call the end of the stalemate between vendors and purchasers of retail on pricing.

Commercial outlook

Three trends



LONDON OFFICES BOUNCE

The central London office market has had a resilient pre-Brexit period. Take-up has been boosted by TMT and serviced office providers, and we expect tenant demand to be sustained. Vacancy rates are low and the forward pipeline tight. While rental growth has been limited by landlord caution, we expect this to change in 2020-24.

LACK OF PRIME STOCK WILL DRIVE PRICING

A reduction in uncertainty will increase the number of buyers in the market, but it will not result in a similar increase in sellers. Refinancing will remain cheap, and alternative homes for any equity raised from a sale will be challenging to find. Expect to see price rises in the most sought-after segments of the market.

GOOD RETAIL BOTTOMS OUT

While there is still a marked valuation gap in the retail market, 2020 will see prime values begin to bottom out. Opportunistic investors will focus on good schemes where rents have already rebased, or where the capital value discount they are getting allows them to rebase rents.

Three disruptors

PENSION FUNDS AND SHIFTING DEMAND

Most developed countries are facing rising populations of retired people and hence pension liabilities. Real estate has traditionally offered a good annuity match, but changing occupational behaviour in retail and offices will lead to shorter leases just as the world's pension funds need more long income.

LAST-MILE LOGISTICS

The battle among retailers for the ultimate convenience offer will intensify, and this will continue to drive last-mile logistics requirements. Competition for suitable sites will remain intense, so expect to see more multi-level logistics as well as reuse of other urban assets.

UNCERTAINTY WILL NOT DISAPPEAR

Whatever happens on 31 January, it will not be the end of political uncertainty in the UK. A key question for the future is whether that level of uncertainty is more or less than investors would be facing in their home or other markets.

Political values

While economic factors underpin the prospects for price growth, politics will continue to shape investor and developer appetite

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Politics has had a much greater impact than economics on the UK housing market over the past three-and-a-half years. Fuelled by uncertainty, modest price falls first witnessed in London have progressively spread across the capital's hinterland. So, despite low levels of unemployment, relatively robust wage growth and mortgage interest rates at around 2.0%, annual house price growth stood at just 0.8% across the UK at the end of November.

With the outcome of the general election providing a pathway to #getbrexitdone, we expect price growth gradually to return, as households feel more secure about their finances. That said, given the complexities that remain in securing a trade deal with the EU, a Brexit bounce is likely to be short-lived, with investors having to wait until 2021 to see capital appreciation gain a foothold in the UK housing market.

As the economy improves, the chances of a gradual rise in interest rates will increase. That caps the scale of potential price growth in the mainstream housing market, even as political uncertainty clears. Economics, primarily in the form of affordability, will also dictate the pattern of mainstream price growth over the next five years, favouring the North of England over London and the South.

The future role of politics

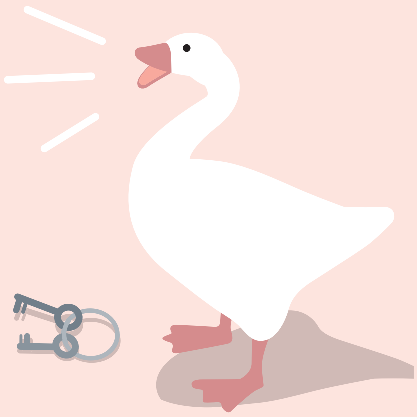
Politics will continue to play a major role in the housing market if the Conservatives' policies are taken at face value. Though the threat of rent regulation has receded, tenants will benefit from increased security of tenure via the abolition of no-fault evictions. Ultimately, investors will have the liquidity of their investment protected though the

> "Affordability will dictate the pattern of price growth in the next five years"

WHERE NEXT FOR STAMP DUTY?

Over the past five years, we have become accustomed to taxation being used as a tool to meet the government's housing aims. From a stamp duty perspective, George Osborne's overhaul in December 2014 has been followed by a 3% surcharge for buyers of additional homes and a relief for first-time buyers. During that time, the annual sums raised by stamp duty on residential property have increased by £600m to £8.2bn per annum.

The Tory Party manifesto included proposals for a further 3% surcharge for non-resident buyers, a figure at the top end of the range put forward by Theresa May in 2018. That is likely to temper the exuberance of overseas investors looking at UK residential property, making them more price sensitive. More importantly, it suggests that stamp duty cuts for the wider market have been put on the back burner.



"The art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the smallest possible amount of hissing."
Jean-Baptiste Colbert, 1619-1683

right to recover possession on sale, but this will leave them with less management flexibility and put a greater focus on ensuring future tenants provide good covenant.

In a manifesto heavily weighted towards encouraging home ownership, the plan to introduce lifetime fixed-rate mortgages at a 95% loan-to-value ratio aims to 'slash the cost of deposits'. If successful, that could substantially impinge on tenant demand. But that is a very big 'if'. Much depends on the appetite from lenders, and how the Bank of England deems such mortgages should be treated from a regulatory perspective. This will determine whether they are truly a viable option for first-time buyers, who otherwise seek sanctuary in the private rented sector.

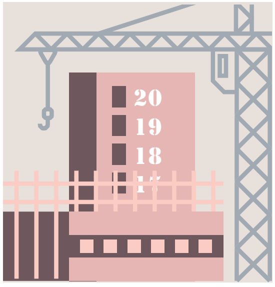
The role of Help to Buy in supporting first-time buyer numbers is far more secure, and will continue until the scheme closes in 2023. With a heavy reliance on the private sector to meet a restated target of delivering 300,000 homes a year by the mid-2020s, and at least a million more over the life of the next parliament, continued support seems likely.

Achieving housing targets

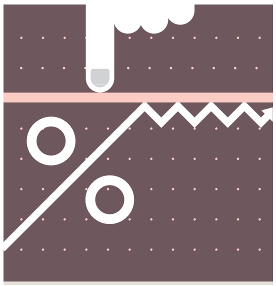
That continued support is likely to come with strings attached. A focus on the design quality and environmental credentials of new housing will add to development costs, while a proposal for delivery of discounted homes for first-time buyers is likely to be implemented as a condition of planning. These proposals sit against the backdrop of a wider debate around land value capture and increasing the diversity and environmental credentials of the homes being built. This is likely to cap the development gains enjoyed by landowners, even if the planning environment has become more conducive to unlocking development opportunities.

Residential outlook

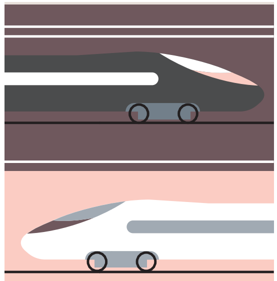
Three trends



POLITICAL CHANGE
While a more stable political environment should underpin a market recovery from 2021, the increased politicisation of housing is likely to continue to dictate the nature and scale of opportunities. All of the signs are that this will favour larger-scale build to rent investors over smaller private landlords.

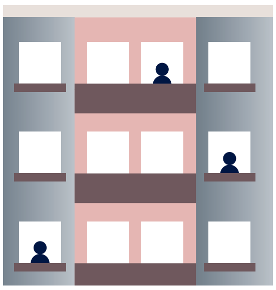


DEBT COST AND AVAILABILITY
Bank base rate is forecast to rise gradually over the next five years to 2.0%. We expect this to put a lid on the loan-to-income ratios lenders can offer, capping potential price growth. For buy-to-let investors, this will be compounded by restrictions on mortgage interest tax relief, putting cash investors at a comparative advantage.



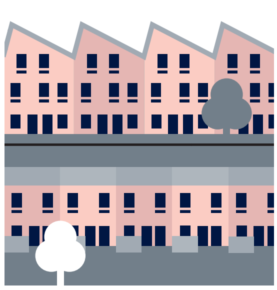
INFRASTRUCTURE UPLIFT
With house price growth constrained, investors are expected to focus on areas where infrastructure improvements are set to unlock latent value. The Oxford-Cambridge Arc, Midlands Rail Hub and Northern Powerhouse Rail all offer opportunities, while 2020 should also be the year when the future of HS2 is determined.

Three disruptors

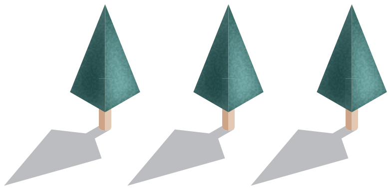


DEMOGRAPHIC PRESSURES
According to the ONS, the number of single-person households aged 65+ has risen by over 750,000 in the past 20 years, topping four million in 2019. There are 3.5 million households in this age bracket with two or more spare bedrooms, says the English Housing survey. Yet we continue to provide a dearth of retirement housing.

THE ROAD TO ZERO CARBON
The UK's commitment to become zero carbon by 2050 is likely to affect where new housing is built, primarily to reduce emissions from private car use. But it should also support an increased role for modern methods of construction, given the energy efficiency of units and the minimisation of waste during construction.



TACKLING AFFORDABILITY
Despite the best efforts of housing associations, the delivery of affordable housing appears capped by the extent to which it can be cross-subsidised, balance sheet capacity and the amount of government grant available. So we have seen the emergence of for-profit registered providers, bringing in equity from outside the sector.



200%
The increase in standing softwood prices during the past 10 years

Restricting growth

Without a more collaborative and integrated approach, tree-planting targets are in danger of being missed

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There's a saying that there are two good times to plant trees: 25 years ago, or today.

Timber values certainly underpin the merit of having mature woodland, with standing softwood prices up 200% during the past 10 years. Plenty of landowners are fortunate enough to own wooded areas planted by previous generations. For others, making the long-term decision to convert to woodland seems a step too far. Things need to change if the UK is to get anywhere near its tree-planting ambitions.

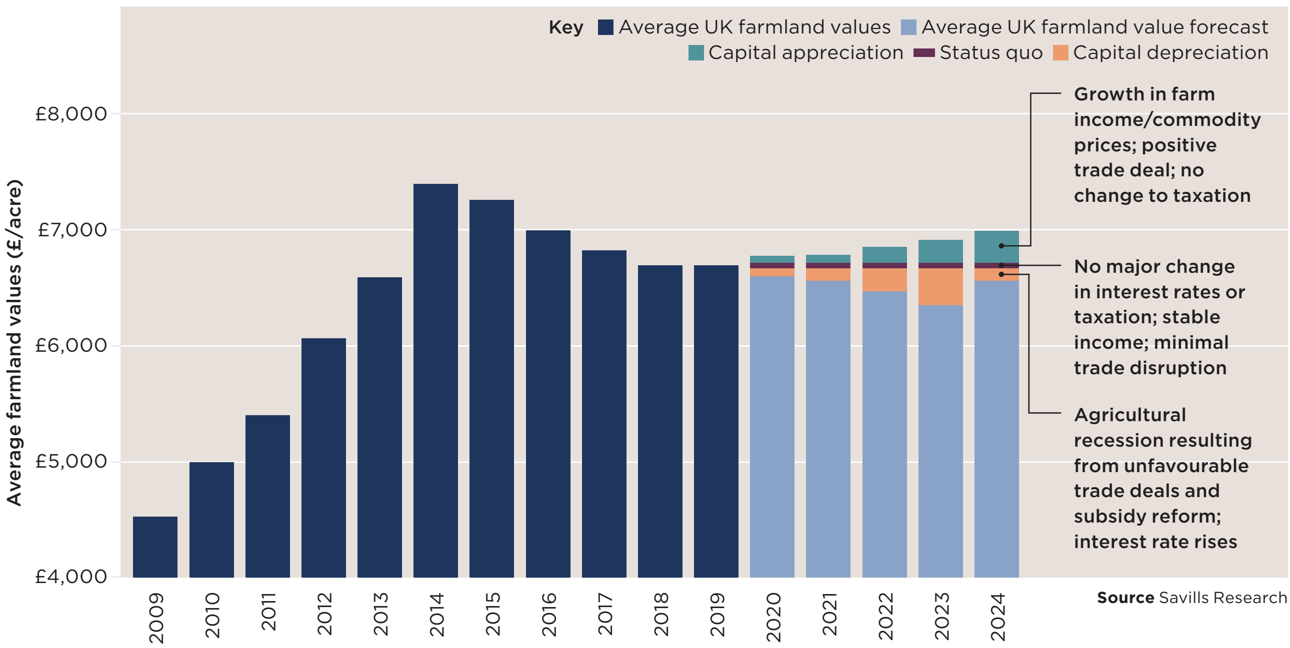
First, there are financial disincentives to woodland creation. These derive from the poor interaction between land use policy support and the economics of sustaining active woodland management. In England, Common Agricultural Policy payments are lost when land is converted to forestry, and the regulatory status of mixed-use systems like agroforestry is unclear. In Scotland, the regulatory framework is better, but grant availability and economic returns do not always align with environmental ambitions.

Improving the range of markets for forest products to encourage planting diversity, and forest management that supports public access and biodiversity, could help reduce the long time period before income returns from woodland creation. Favourable income tax rules that previously drove substantial (although not always appropriate) investment into tree planting have also been lost.

Second, woodland creation requires prior planning approval as a change of land use from agricultural production. The planning process is complex with large afforestation projects often taking well over 12 months to reach approval. A permissive system that created a bias in favour of woodland creation would help speed up decision-making and investment. Woodland creation is also a permanent change: at the end of a production

> “There is a new sense of urgency to tree-planting ambitions”

Farmland forecasts Value variation and how different factors may influence future growth



Source Savills Research

cycle, woods need to be restocked rather than reverted back to farmland. As many farms seek economies of scale to reduce overheads, finding new space for forestry could mean major restructuring of farm businesses.

Finally, the availability and suitability of planting stock remains a concern. Tree health is a long-term bet against the uncertainties of climate change, pest control and border biosecurity. Choosing resilient varieties that also meet the needs of timber customers is not straightforward, and nurseries have been cautious about setting large numbers of plants in an uncertain market. Government may not care about longevity provided planting targets are met – but for woodland investors, risks have to be minimised.

Climate change

Of course, all of these problems exist before we even consider the influence of the climate crisis and emerging demand for carbon offsetting. There is a new sense of urgency to tree-planting ambitions as a result, but there are issues with this becoming a viable option for land managers. Currently, a sale of carbon credits from forestry or peatland accrues to the benefit of the purchaser, not the grower, and agriculture has to get its own carbon impact in hand first. The availability of generous grants and the 'additionality' rule in carbon accounting mean most planting schemes don't claim the carbon credits, and the Woodland Carbon Code is too expensive for small-scale schemes. The market for carbon-accredited timber also needs clarification. The recent Carbon Guarantee (for England only) supports a carbon price, but will be ineffectual at driving new planting unless the other barriers are addressed.

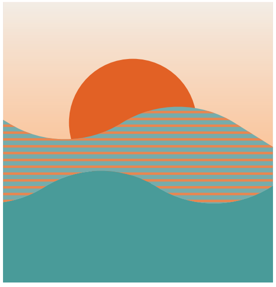
The danger is that single-issue targets drive inappropriate land use outcomes. Until the issues are tackled in a collaborative and integrated policy approach to land use, tree-planting targets may remain little more than political bluster. Nevertheless, overall market sentiment is clear: competition for UK land use is becoming fiercer, with an increasing role for environmental service delivery challenging traditional productive norms. The diversity of income streams available may be increasing, but the role of the farmer in keeping everyone happy is unlikely to get any easier.

Rural outlook

Three trends

ENVIRONMENTAL INCOME

Government agri-environment policy will take time to catch up with the emerging private market demand for environmental offsetting services, such as carbon storage, biodiversity net gain from planning, and nitrate neutrality. Land managers need to start looking at what they've got and who might be interested in it.



LATENT VALUE

For those with long-term horizons, playing the odds on development potential or waiting for the capital value uplift on the cessation of a protected tenancy remain viable investment propositions. Income from let land is lower than other asset classes, but the bigger wins are there for the patient.

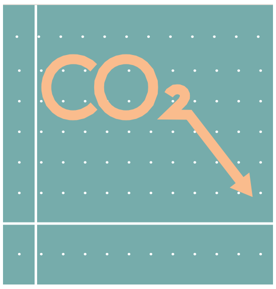
GLOBAL SECURITY OF UK LAND

Global players looking to shelter hard-earned wealth continue to eye UK amenity farmland for its security of property rights, privacy and exclusivity. Savills reports that more than 50% of land sales over 500 acres went to overseas buyers last year. Even with the volatility of sterling, we see no sign of demand abating.

Three disruptors

CONNECTIVITY AND INFRASTRUCTURE

Rural connectivity remains a challenge for countries like the UK, which seeks to upgrade old infrastructure rather than leapfrogging to new solutions. The full economic potential of rural places can only be realised through localised energy networks, full rural broadband and mobile signal, and functioning rural public transport/services.



DECARBONISATION

For the next parliamentary term, there has been a commitment for an equivalent spend on agricultural policy, but the focus of the spend is still to be determined. Devolution presents one area of uncertainty, but a bigger concern is that emerging agricultural policy has yet to catch up with the net zero challenge. Clear policy is essential for planning.

FOOD-TECH DISRUPTION

Farmers are encouraged to focus on changing markets to ensure profitability, but the basics remain. Whether it's targeting emerging market demand for oats, quinoa or hemp, new entrants risk market volatility. Having an agreed contract in place with an end-user remains the best way to ride out uncertainty.

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