A **Bilfinger Real Estate** company

Research

EPMR

Economic and property market review

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Economic trends

UK economic output rose by a provisional 0.5% in the fourth quarter, and is now around 3% above the previous peak reached in 2008. Manufacturing output growth slowed to 0.3% in Q3, its slowest pace since Q1 2013, but construction output is still showing a robust pace of growth at 1.6% in Q3, and is 5.7% up on Q3 2013.

Recent CIPS/Markit Purchasing Managers' Survey results remain positive, with the weighted average across the manufacturing, services and construction sectors reading nearly 56 in December, well above the 50 mark indicating expansion, although down from a high of 60 in August.

Employment growth was remarkably strong in 2014, with 512,000 added to the UK's labour force in the period September-November compared with the same period last year. The bulk of this job creation has been in full-time rather than part time jobs, although it has been focussed towards lower paid jobs. 2015 should see further gains (see first chart), albeit at a noticeably slower pace than 2014, and this will help to maintain property occupier demand, particularly in the office sector.

The **unemployment** rate reduced to 5.8% in November, representing a significant fall from 7.1% a year ago. Whilst this reflects the rapid pace of job creation, it is particularly impressive given the strong increase in the UK's working population. We expect unemployment to fall further in 2015, although at a slower rate.

CPI **inflation** fell sharply in December to just 0.5%, compared with 1% in November, below the lower limit of the Bank of England's target range of 1-3%. The sharp fall in the oil price is a major factor, and this is likely to be a feature well into 2015. However, accelerating wage growth means that in contrast to the Eurozone, the risk of a damaging period of falling prices in the UK is low.

With falling inflation, forecasters have been pushing back the likely timing of the first **base rate** rise to the final quarter of 2015, and this will probably be by only 25 basis points, with further rises waiting until 2016.

Earnings growth has overtaken inflation for the first time in five years. Average weekly earnings (including bonuses) rose by 1.7% pa in November, well ahead of CPI inflation. Wage growth should continue to accelerate in real terms in 2015 (see second chart) and this will increase consumer spending power, and provide some welcome good news for the high street retail sector.

Falling inflation, a return to real wage growth and strongly rising employment were **key economic themes** of 2014, and these trends will continue to underpin healthy occupational demand for commercial property in 2015. Growth remains heavily reliant on the consumer, but we expect business investment to increase during 2015, and this should provide a welcome boost to the UK's productivity.

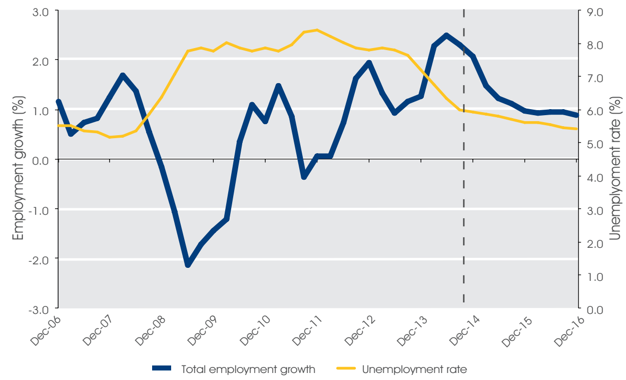
We think the **biggest risk** to UK growth is the potential for a recession in the Eurozone, our main trading partner, where growth has stalled, deflation is becoming a greater possibility and the threat of a Euro break-up is rising. May's UK general election also adds an element of uncertainty to the outlook, with a coalition government of some form the likely outcome.

Tax revenues have not risen in line with the pace of economic recovery, partly due to the employment growth being centred on low-paid jobs, and the deficit remains stubbornly high. Whichever party or parties win the election, austerity policies will continue for much of the next parliament.

Economic growth was 2.6% in 2014 as a whole, in line with the long-term average. Similar growth is forecast for this year with a modest deceleration likely in 2016 (see third chart), as increased public sector spending cuts and higher interest rates take effect.

Labour market

Source: ONS, Experian

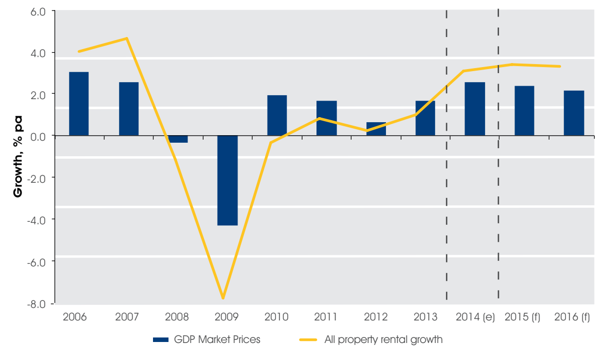


Earnings and inflation

Source: ONS

Economic output and all property rental growth

Source: IPD, REFL, ONS, Treasury, Experian



Latest consensus forecasts, January 2015

Source: HM Treasury (compilation of forecasts), GVA

	2014	2015	25 year trend
Economic growth (GDP)	2.6%	2.6%	2.6% pa
Private consumption	2.3%	2.9%	
Employment growth	2.4%	1.3%	0.7% pa
Bank base rate (Q4)	0.5%	0.8%	
CPI – Inflation (Q4)	0.9%	1.0%	
RPI – Inflation (Q4)	2.0%	1.9%	
House price inflation (Q4)	8.8%	5.0%	

Occupier market

Offices – A robust end to 2014 saw the central London office market record its highest annual take-up since 2001 at 12.1 million sq ft, 15% up on 2013. The market has been driven by pre-letting, which accounted for almost a third of take-up during the year, with lettings on newly completed space accounting for an additional 20%.

The strong demand for brand new space has eroded the development pipeline. 60% of space delivered to the market during 2014 was let by the end of the year. The story for 2015 is likely to be the same, with 40% of space likely to complete already let.

Rental growth for central London offices remains strong, rising by 11.4% during 2014, according to the IPD Monthly Index and we expect further strong gains in 2015. Prime rents across central London as a whole increased by 7.7% during 2014, with some submarkets seeing growth in excess of 20%. The GVA Central London index is now over 10% above its previous Q4 2007 peak.

Across the regional office markets, take-up was exceptional in the final quarter of 2014, taking the total for the year to 5.6 million sq ft, 23% above the five year average and the highest since 2008. This underscores the bounce back in both developer and investor interest in the regional office markets.

We have already seen the effects of tightening Grade A supply levels both in asking and achievable rents and the activity bodes well for the increasing level of speculative development across a handful of regional UK cities. Net effective headline rents among the big nine cities have increased by an average of 5.8% over the past year.

IPD data indicates that average rental growth for the office sector outside London and the South East has yet to see a significant pick up with 1% growth for 2014, (IPD Monthly Index) but this is forecast to accelerate this year to 2.5% and by over 3% pa between 2016 and 2019.

Retail – Retail sales remained relatively healthy throughout 2014, although were slowing towards the end of the year and retailers own trading reports have suggested a mixed performance. However the retail sector is expected to benefit from an increase in consumer confidence as wages rise above the rate of inflation and the effect of falling prices, particularly for fuel takes hold. Online retailing continues to grow at over 10% pa, with click and collect being the key driver.

Prime locations are still seeing the highest demand, and particularly within central London, with strong demand from international operators. The development pipeline in the short-term remains subdued, although is picking up. Nationally, vacancy rates are improving slowly but a north-south divide still persists.

Strong central London retail rental growth of 10.7% last year (IPD Monthly Index) is expected to slow to 5.5% this year. This is much stronger than other retail sub sectors, with standard shops rental growth of 1.8% last year increasing to 2.6% pa by 2018.

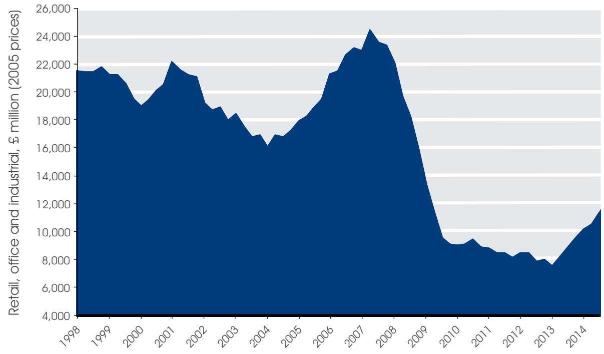
Industrial – In the industrial sector the dwindling supply of good quality space is impacting on rental growth as robust demand continues from retailers, manufacturers and urban logistics, particularly in the Midlands and the South East.

Industrial construction output (factories and warehouses) has picked up strongly, albeit from a low base in 2013. Growth of 12% is estimated for 2014 and a further 27% over the next four years to 2018. The warehousing subsector will lead this growth, being closely correlated to growth in the economy, consumer spending and internet shopping.

The industrial market is showing the strongest rental growth of the three sectors outside London. According to the IPD monthly index, UK industrial rents have increased by 2.9% over the year to December. We forecast rental growth of just over 3% pa over the next five years.

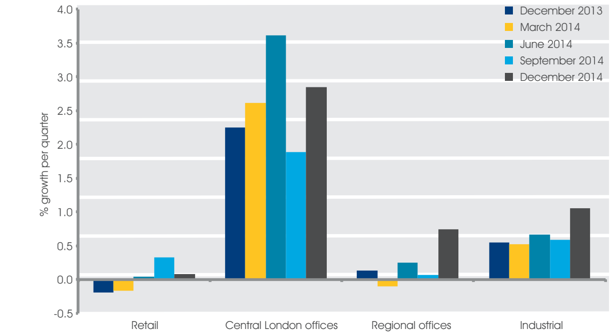
New construction orders (2005 prices)

Source: ONS, GVA



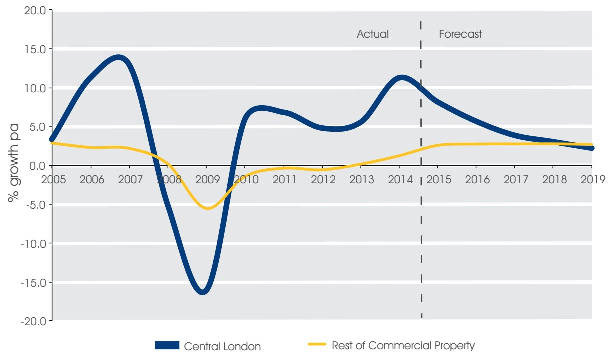
Average quarterly rental growth

Source: IPD, GVA



Annual average rental growth forecasts

Source: IPD, REFL, GVA



All property rental growth forecasts

Source: IPF, REFL, GVA

	2014	2015	2016
IPF Quarterly Consensus (November 2014)			
Maximum	3.7%	6.0%	5.0%
Minimum	2.3%	2.0%	1.3%
Average	3.1%	3.3%	2.9%
GVA (January 2015)	**3.1%**	**3.4%**	**3.3%**

Investment market summary

Recent performance

2014 finished with a flourish, and more than £20 billion was transacted in the final quarter according to Property Data. This has taken the total value of UK investment transactions for the whole of 2014 to more than £62 billion (deals reported to mid-January). This is the highest total on record, just ahead of the previous strongest year of 2006 (when values were 25% higher than today), and comfortably above the 2013 total of £54.5 billion. These trends are shown in the first chart.

Overseas buyers and UK institutions were both heavy net buyers in 2014, increasing their exposure to UK commercial property by a combined £15 billion. Overseas buyers accounted for 42% of the value of UK purchases in 2014, with UK institutions making up 29%. Buyers from the US were particularly active in 2014, buying commercial property worth nearly £11 billion, with Far Eastern investors the next most active at nearly £5 billion and purchasers from the Middle East buying property worth £3.3 billion.

In the central London market overseas buyers now account for well over half of transactions, with UK institutions and REITs priced out of many buying opportunities.

With this level of demand and a limited supply of investment opportunities, 2014 saw a marked downward shift in yields (see second chart). The all-property average equivalent yield moved in by 76 basis points on the IPD Monthly Index, but some sectors saw much sharper falls. Average UK industrial yields tumbled by 116 basis points and offices outside London and the South East fell by nearly 160 basis points.

The pace of downward yield movement has started to ease, and although rising rental growth is increasingly adding to performance, annual returns now appear to have peaked. The IPD Monthly Index recorded a total return of 20.1% in October 2014, which has now fallen back to 19.3% in December. Capital values rose by 12.4% pa in December.

Outlook for performance

UK government bond yields remain extremely low by historical standards, and have actually fallen over the last six months, with 10-year gilt yields currently circa 1.6%. This suggests a fair amount of scope for gilt yields to rise before this begins to act as a constraint on the level of property yields.

The UK's regional markets are still looking an attractive opportunity, and although the yield gap between London and the regions narrowed during 2014, it remains historically wide. This is reflected in increasing investor interest in the regional markets.

Low bond yields, accelerating rental growth, a considerable weight of money globally looking to invest, strong demand from the UK institutional investors and retail funds plus continued recovery in the lending market are all combining to make a very positive outlook for the UK investment market in 2015.

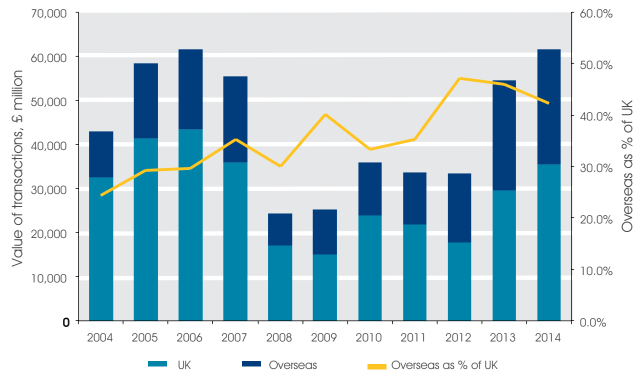
Good quality stock should continue to attract strong competition, and this should drive further yield compression. However, the pace of yield compression experienced in 2015 is clearly not sustainable, and it is likely to moderate further.

We forecast a double-digit all property total return of 11.5% for 2015, with a combination of yield compression plus rental growth in excess of 3% driving up capital values by more than 6%. Our forecasts are shown in the third chart.

We expect the distribution sector to outperform in 2015, with strong occupational demand, that is as much reliant on the continued structural shift to internet retailing as on the economic growth cycle.

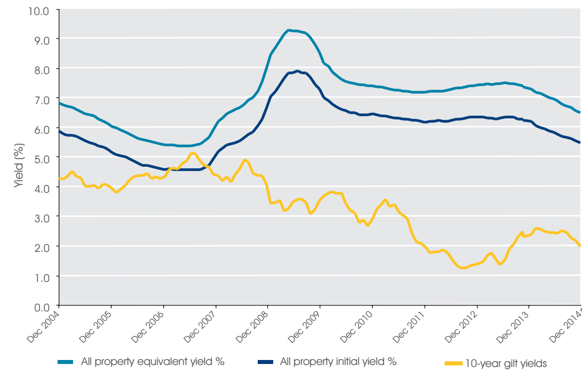
Annual investment transactions

Source: Property Data, GVA



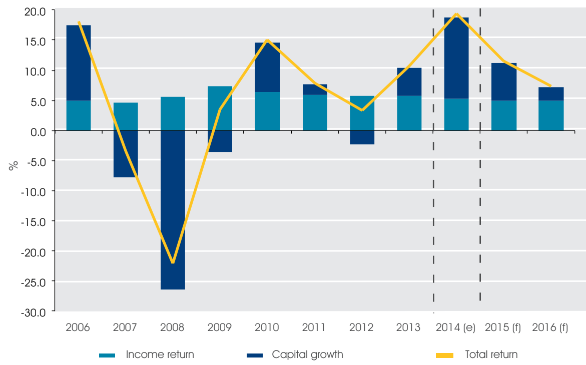
Property and gilt yields

Source: IPD, FT, GVA



Forecasts for property performance

Source: IPD, REFL, GVA



All property total return forecasts

Source: IPF, REFL, GVA

	2014	2015	2016
IPF Quarterly Consensus (November 2014)			
Maximum	21.2%	17.7%	10.4%
Minimum	15.6%	6.3%	-0.7%
Average	18.9%	10.8%	6.6%
GVA (January 2015)	**19.5%**	**11.5%**	**7.0%**

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