CBRE RESEARCH

REAL ESTATE MARKET OUTLOOK

2017

UNITED KINGDOM

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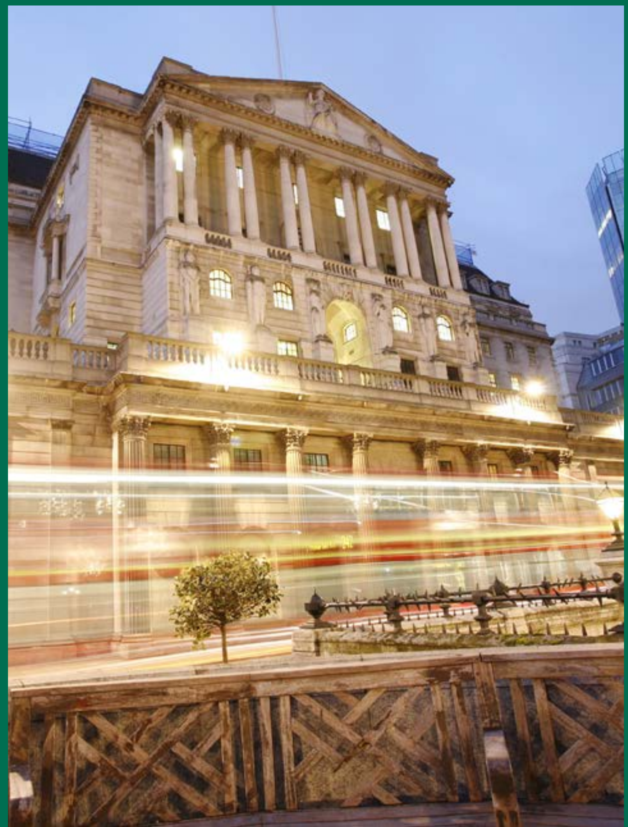
Economic Outlook

After a patchy 2016, the global economic outlook has improved somewhat and attention has turned back to inflation, particularly in the US. Fears about emerging markets have dissipated, but weak growth in the EU, including the UK, will polarise the global interest rate outlook. In the UK, Brexit effects will dominate 2017, with a weaker currency feeding through into higher inflation. Bond yields have already started to rise in anticipation of these effects.



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Political Outlook

2017 will open with continued wrangling over the Article 50 process for exiting the EU, and there will be further twists and turns in European politics too. 'Events' are likely to cause delay to the timetable for Brexit. Migration controls will be the political priority for the UK Government, with market access likely to be sacrificed to that. Brexit will take time, but the wheels of the economy will still turn. There will be progress in the development of strategic city governance across the UK.

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Investment Outlook

In the light of fears about the global economy and Brexit, UK real estate investment fell in 2016 compared with a very strong 2015. Total investment in 2016 is unlikely to top £50bn. Currency effects, which have supported investor interest, will be a double-edged sword. However, appetite for UK property remains strong, with Asian investors coming to the fore. At just 1.1% in 2017, total returns will rely much more heavily on income.

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NEW FOR 2017

Real Estate Finance

Real estate financiers are looking to de-risk. In the public equity markets, uncertainty over valuations looks likely to remain for some time, implying no quick recovery in stock prices. By contrast, balanced funds look likely to stay priced close to Net Asset Values. In the debt markets, rising gilt rates have come as a surprise, but borrowers are still locking in cheap deals with long maturities. Liquidity remains good but development debt will be rather harder to come by in 2017.

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Office Outlook

The outlook for offices in the UK in 2017 will be very much dependent on the eye of the beholder. Location and quality will be crucial determinants of how markets respond to pressures in the year ahead, particularly given the emerging impacts of Brexit on the market in the longer term. Weaker employment growth presents some challenges. But market support will be provided by public sector activity.

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Retail Outlook

A challenging economic outlook will make 2017 a difficult year for retailers. There will be significant new real estate and labour costs, and Brexit worries, though the impact will be felt differently across the country. Innovation and technological change in the sector will be relentless. New supply will be significant and rental growth will slow.

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Industrial and Logistics Outlook

Industrial and logistics property was an outperforming real estate sector in 2016 and we expect this to continue into 2017. Income returns will remain strong, even in the face of weaker economic growth. The sector will not be immune to uncertainty around the trade impacts of Brexit, and inflation is now a key risk, but supply remains weak. Further ahead, technological change in the logistics sector will continue to influence real estate preferences.

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Housing Outlook

Reflecting the weaker economy, price growth in the mass residential market will continue to slow. Investors will continue to be discouraged by Stamp Duty and other tax changes, but at worst we expect a plateau in prices rather than any significant falls. A favourable currency will help boost international investors.

Student Housing

In student housing, demand will remain strong, and development will be more focused on towns without adequate existing supply.

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SPECIAL FEATURE

Long Income

Long Income came to the fore in 2016, but there are contrasting views as to whether this market will develop further. Long Income is a safe haven in uncertain times, but inflation expectations suggest bond pricing will rise, eroding the advantage of real estate income. With plenty of demand for real estate yields, and the capital cost of holding real estate increasing, we think investors will continue to focus on this steady source of returns.

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Hotels and Pubs Outlook

Hotels will remain a strongly performing sector in 2017, supported by a weaker currency and innovation in hotel concepts. Operating performance will continue to diverge, with very significant new supply in some markets. But boldness among investors and operators will pay off. Higher yields and the end of the beer tie present new opportunities for pubs investors.

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Healthcare Outlook

The healthcare real estate sector continues to attract significant interest and funding, and the promise of greater integration between social care and healthcare throws up new opportunities. Retirement Living will continue to be an area of focus.

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NEW FOR 2017

Data Centres Outlook

The UK's data centre market (which really means London) will continue to grow in line with recent trends. Brexit is not a major issue but data protection issues will be of concern. The continued growth of cloud services will drive demand, with more firms willing to outsource to cloud service providers. There is a strong UK supply pipeline – which will help maintain market equilibrium given strong recent take-up.

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ECONOMIC OUTLOOK

THE RETURN OF INFLATION

After a patchy 2016, the global economic outlook has improved somewhat and attention has turned back to inflation, particularly in the US. Fears about emerging markets have dissipated, but weak growth in the EU, including the UK, will polarise the global interest rate outlook. In the UK, Brexit effects will dominate 2017, with a weaker currency feeding through into higher inflation. Bond yields have already started to rise in anticipation of these effects.

GLOBAL AND EUROPEAN OUTLOOK: THE RETURN OF INFLATION

The global economic background to 2016 was patchy. Worries about emerging markets and political events bore down on economic growth. Rarely seen, the Euro Area economy outgrew the US and equally so the UK almost grew as fast as the world economy but this looks set to change in 2017. Emerging market risks have dissipated. The US economy, accelerating since mid-year, looks set to continue the pace into 2017, with forecast growth of 2% compared to 1.5% in 2016. After a brief initial adverse reaction, markets now see the Trump presidency as being good for growth and forecasts for US economic growth are being revised up. That said, it will probably be later in 2017 before any fiscal boost can be enacted.

Growth in the EU, by contrast, even excluding the UK, is expected to slow – from 1.8% in 2016 to 1.6% in 2017 – largely a result of rising inflation on real incomes. The 'recovery economies' of Spain, Ireland and the countries of central Europe are expected to continue to be fastest growing.

Inflation is rising in the US partly because of: gently rising commodity prices, 'base effects' (as past falls in commodity prices drop out of the inflation calculation) and the steady erosion of spare capacity. For 2017, US inflation (CPI) is forecast to be 2%, up from 1.2% in 2016. Consumer demand bolstered by real wages, pushed by tighter labour markets from continued economic growth, will support growth. Euro area growth, by contrast, has been relatively weak and patchy. An acceleration in Eurozone inflation (from 0.3% to 1.5%) is forecast due mainly to imported inflation with 'core' inflation not expected to move far from its current level of 0.9%.

Inflation will have implications for interest rates. A December 2016 Fed funds rate hike of 25bps is expected and two, or more, further increases are foreseeable in 2017. US long-term treasury yields are likely to rise similarly and possibly by more and sooner.

The Europe case is not so clear. Inflation is lower and unemployment remains over 10% in many countries. The ECB's main refinancing rate will not increase (from 0%) while QE lasts. The current QE programme is due to expire at the end of March 2017, with commentators expecting an extension beyond March. However, QE and ZIRP are not universally liked by Eurozone countries with a possibility of some kind of taper starting during 2017. Either way, upward drift in Euro area government bond yields is likely, but not on the same scale as expected for the US.

"A December 2016 Fed funds rate hike of 25bps is expected and with two, or more, further increases are foreseeable in 2017."

Our more comprehensive views on the European and broader global outlooks will be available in our European Outlook (December 2016) and our Global Outlook (February 2017).

UK OUTLOOK: BREXIT EFFECTS DOMINATE

A new path for the British economy will begin in 2017 as the longer term impact of the vote to leave the EU starts to become clear and begins to feed into the real economy. In the absence of any hard policy direction economists are looking at the possible transmission avenues: demand, supply and productivity. Recent UK economic performance has been relatively strong, but not spectacular, with 2.2% GDP growth in 2015. The 2016 anticipated outturn is 2.1%. Surprisingly, this is only slightly below the January 2016 forecasters' consensus of 2.2%, and

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includes growth of 0.5% in Q3, which was a surprise for many who expected an immediate post-referendum slowdown. We forecast GDP growth of 1.5% in 2017.

> "Recent UK economic performance has been relatively strong, with 2.2% GDP growth in 2015. The 2016 anticipated outturn is 2.1%. Surprisingly, this is only slightly below the January 2016 forecasters' consensus."

The market 'shock' of the EU referendum result has shown itself in exchange rates. Interest rates and inflation expectations have moved higher as a result. At the start of 2016 CPI inflation for 2016 was expected to be 1.3%, so despite sterling's depreciation the consensus forecast is 1.3% for 2016. Rising commodity prices (generally priced in dollars), particularly oil, food and metals, will fuel inflation. Oxford Economics predict CPI inflation to rise to 2.7% in 2017.

In January, the forecasters' consensus for the UK base rate at the end of 2016 was 0.9%. No contributors predicted a fall in base rate. The current base rate of 0.25% is unlikely to change in the near term. We do not expect the first increase until early 2019. If we are right, then there will have been no base rate increase for over a decade. The fiscal loosening delivered by the 2016 Autumn Statement lessened the burden on monetary policy to do all the work of maintaining growth and stability. We expect monetary policy to be less active in 2017 unless growth surprises significantly on the up- or down-side.

However, the trajectory for long rates has moved upwards as inflation expectations have increased. These expectations are driven not just by the fall in the pound, but by the lower potential growth implied by future supply constraints, mainly from a reduced labour force and less investment.

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International monetary conditions have also created upward pressure on bond rates. The Bank of England is trading inflation for output on the basis that there will be lost output and employment if the Monetary Policy Committee tighten too soon. The recent path of sterling suggests that markets have reassessed (to the downside) the UK's future trading arrangements. Forecasters expect only a minor appreciation of sterling over the next five years. However, the Bank will watch out for increases in inflation expectations from wages and passing on of input price rises.

"The recent path of sterling suggests that markets have reassessed (to the downside) the UK's future trading arrangements."

Job creation has been strong over the last few years but slowed during 2016. ONS's notified job vacancies series has stabilised at around 750,000 vacancies. Almost 32 million people are in work (a quarter employed part-time) with just under half a million new jobs being created over the year to September 2016. Regional Labour Force Survey data shows that London jobs grew faster over the period than other UK regions. The increase in jobs over the next five years will be less than over the last five years, with job creation being around a quarter of that of the past. We expect faster job creation in larger cities compared with towns and the conurbations outside big cities.

"The increase in jobs over the next five years will ease back on that of the last five years with the job creation being around a quarter of that of the past."

UK households have a high propensity to spend. Consumption has been buoyant during the uncertain second half of 2016. October's retail sales volumes (seasonally adjusted excluding fuels) posted another strong reading at 7.6% year-on-year, continuing the positive growth trend which began mid 2013. Internet sales have been stronger than overall sales and continue to expand their share of spending and account for over 15% of spending. But this positive volume picture hides significant discounting, with average store prices falling on a year-on-year basis for just over two years. In 2017 we expect a further squeeze on retailers' margins and a curtailment of spending as average earnings growth levels off (see page 19 for more on the retail outlook).

The outlook for real household disposal income is poor. Incomes will be more or less flat in 2017, at 0.1% compared to 2.4% in 2016, as inflation creeps up. Average earnings growth averaged around 2% growth during 2016. This pace of growth will slow in nominal terms and possibly be flat in real terms.

"Incomes will be more or less flat in 2017, at 0.1% compared to 2.4% in 2016, as inflation creeps up."

During 2016 the housing market has been resilient possibly on the back of cheaper mortgages, demonstrating a degree of confidence in job security. However, higher inflation expectations will now push long rates up. Mortgage rates will follow, creating another call on households' budgets which may hit housing activity (see page 23 for more detail on the residential outlook).

Manufacturing has done relatively well in 2016 with the Purchasing Managers' Index implying business expansion in all but a couple of months of 2016. It has picked up to well above average in recent readings. The post-referendum fall in sterling has made home produced goods relatively cheaper compared to imported goods and has helped to make export pricing more competitive: both increasing sales. Companies will be scrutinising supply chains to support margins and retailers will not be immune from higher costs and reduced margins. Some manufacturers are seeing a marked cost increase from higher import costs. The net trade position should be more supportive of growth over the next few years.

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POLITICAL OUTLOOK

BREXIT WILL DOMINATE BRITISH POLITICS

2017 will open with continued wrangling over the Article 50 process for exiting the EU, and there will be further twists and turns in European politics too. 'Events' are likely to cause delay to the timetable for Brexit. Migration controls will be the political priority for the UK Government, with market access likely to be sacrificed to that. Brexit will take time, but the wheels of the economy will still turn. There will be progress in the development of strategic city governance across the UK.

ARTICLE 50 WRANGLING COULD CAUSE DELAY

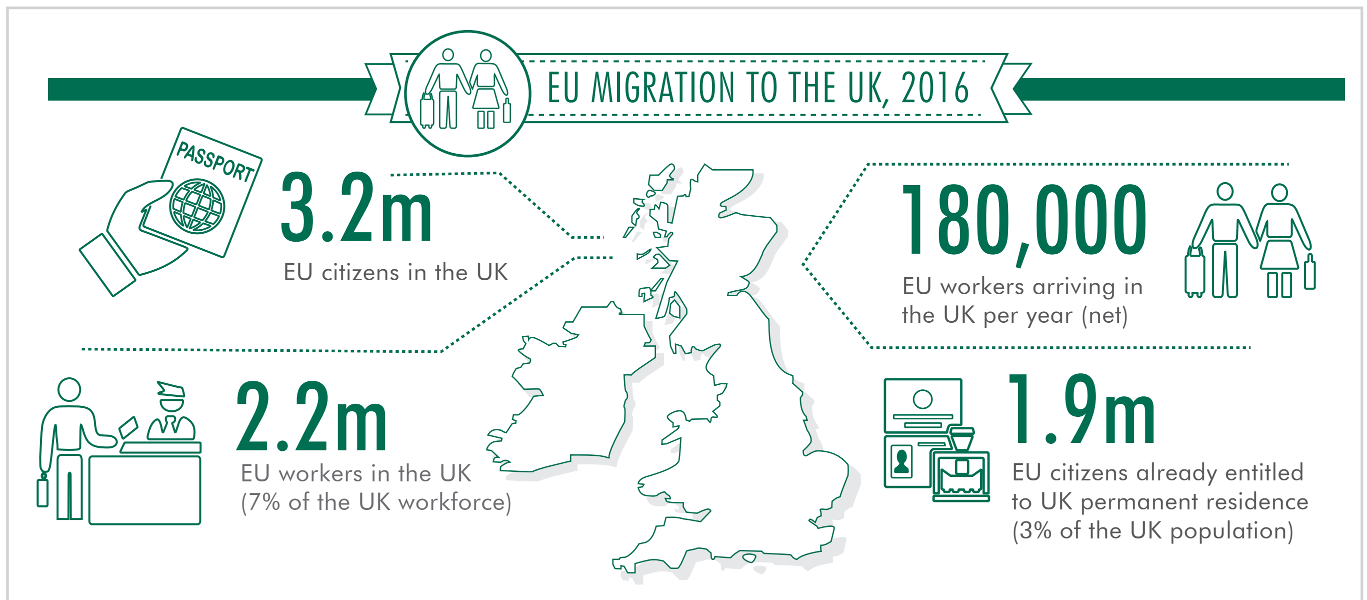
2017 will open with a continuing tussle between the Government, the judiciary and Parliament over the correct way to serve the Article 50 notice which begins the process of taking the UK out of the European Union. Prime Minister Theresa May has said that she wishes to serve notice before the end of March 2017. But that timetable could be placed in jeopardy if the Supreme Court rules against the Government on the matter and confirms the High Court's judgment that Parliament must give its approval.

"Q1 2017 will be a very uncertain time for property markets [with] further volatility in UK financial and currency markets, even if economic data shows the UK economy continuing to perform well."

If Parliament's approval is indeed required, a Bill looks likely. The Supreme Court was hearing the matter as we went to press. There is a significant chance that the Prime Minister's March 2017 deadline will not be met. So we can expect Q1 2017 to be a very uncertain time for property markets. There will be further volatility in UK financial and currency markets, even if economic data shows the UK economy continuing to perform well.

EUROPEAN POLITICS LIKELY TO PROVIDE FRESH TWISTS

The attitude of other European countries towards Brexit will not be very easy to discern until much later in 2017. A raft of countries face general elections: the Netherlands (March), France (April/May) and Germany (September/October). At least in France, a change of political direction looks likely. This, again, is likely to create an uncertain environment. The UK may



Source: ONS, Social Market Foundation estimates.

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by then be clear about its negotiating objectives, and have recruited the necessary negotiators. But there is not much information about how the new EU leadership will react, other than that it will refuse to compromise on the principle of market access depending on freedom of movement (and vice versa).

However, and despite much commentary about anti-establishment politicians coming to promience, we think that by the end of 2017 European politics won't look that different from how they look today.

And it will take time for the remaining member states to decide how to respond to Brexit. The Irish Government, for example, has already said that "any attempt to control the free movement between Britain and Ireland ... would be very damaging indeed." This implies that the Irish will fight hard for a 'soft exit', no matter how little other EU countries care about an agreement.

MIGRATION AND TRADE IMPACTS ARE THE MOST SIGNIFICANT FOR REAL ESTATE

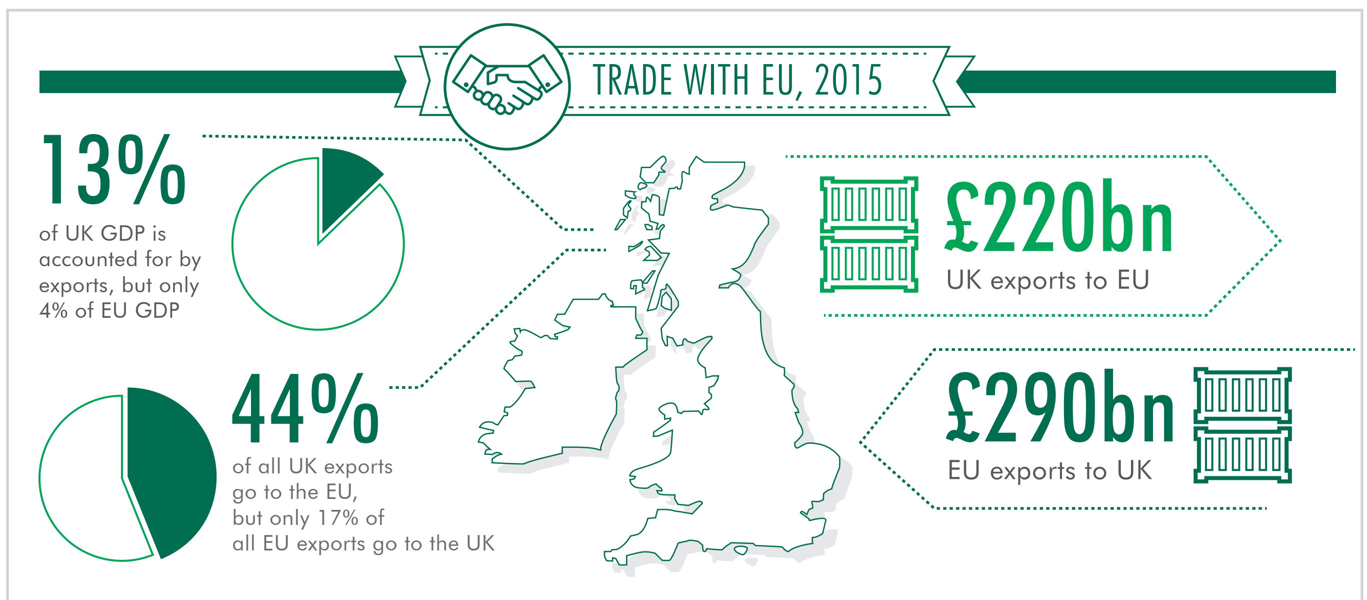
Turning to the effect on real estate markets, real estate decision makers will be paying attention to the impact of:

- migration controls on the UK labour market, economy and occupiers
- trade restrictions on the UK economy
- the return to the UK of its net budget contribution to the EU
- regulatory change

In the scheme of things, the UK's £8bn annual budget contribution is not economically significant. Although it might be spent on different things in the future, or perhaps be returned to the population in the form of tax cuts, we think these effects are likely to be marginal. Much of the returned money seems likely to be spent compensating those who lose out from EU exit, such as farmers, higher education establishments, and local and regional government.

Regulatory change also looks likely to be minimal even in the medium term, not least because of the Government's commitment to bring the entire body of existing EU law into UK law at the point of exit. So, the migration and trade impacts are the least certain and are likely to have the biggest effect.

> "The migration and trade impacts are the least certain and likely to have the biggest effect."



Source: ONS, fullfact.org. EU export figures exclude exports from one non-UK EU member state to another.

MIGRATION CONTROLS IMPLY LABOUR SHORTAGES AND INFLATION

Migration effects could be significant. At face value, the Government's target to cut net migration to below 100,000 people per year could not be achieved even if absolutely all EU migration were stopped, because (according to the ONS) non-EU migration currently counts for about 150,000 people per year. And it is already clear from statements by Philip Hammond that the Government will allow high skilled EU migrants to continue to come to the UK, but it is not yet clear how that will be achieved.

If cuts in migration are indeed delivered, real estate occupiers dependent on lower skill workers could experience staff shortages and wage increases which will lead to inflation and dampen growth. We cover sectorally-specific labour market impacts elsewhere in this report – hospitality (page 27), food and retail (page 19) risk being particularly affected. A general impact on the construction industry also looks likely.

Whatever the effects, they will not materialise any time soon. Brexit is likely to take some years to achieve, and it is quite possible that new EU migration controls will barely have started operating by 2020, if at all.

> "It is quite possible that new EU migration controls will barely have started operating by 2020, if at all."

RESTRICTIONS ON MARKET ACCESS LOOK LIKELY

Trade impacts will also take some time to be felt. We judge that it is essential politically for the Prime Minister to show that new migration controls will be introduced after EU exit. Assuming that the EU position on 'no preferential trade without migration' holds, EU market access would be worse than the UK has now.

> "Assuming that the EU position on 'no preferential trade without migration' holds, EU market access would be worse than the UK has now."

Quite which markets the UK might lose access to, even partially, is not yet clear, though car manufacturers and financial services providers have had more public reassurances from Ministers than other industries. These reassurances seem very likely to prompt 'me too' calls from other sectors, but it is far too early to tell whether they will be heeded. Trade negotiations are notoriously detailed and complex, with many parameters, especially when 27 other Governments are involved. For now, all we can reasonably conclude is that EU market access will be restricted to some extent once we leave.

BREXIT WILL BE A 'LONG GOODBYE'

Although we expect some delays to longer-term investment decisions (see pages 12-13), occupiers typically have shorter planning horizons and there is good evidence, particularly in the retail sector, that they are continuing to take space. Financial services occupiers (whom we cover in greater detail in our office outlook on pages 16-18) also seem to be willing to continue with 'business as usual' for now, while waiting for the picture on financial services exporting rules to become clearer.

We argued in our June 2016 report *The Long Goodbye?* that exiting the EU will be a long and complex process with many twists and turns. In the spring of 2016, property firms were planning for Article 50 to be served in June 2016 (according to former Prime Minister David Cameron). Now they are planning for it to be served by March 2017 – a delay of up to nine months. We fully expect similar delays to the remainder of the process. A further Eurozone crisis would be a low-probability but high-impact example.

> "We think it more likely than not that the UK will, in the end, secure an agreement with the EU and thus that a 'hard exit' will be avoided."

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We think it more likely than not that the UK will, in the end, secure an agreement with the EU and thus that a 'hard exit' will be avoided. Even if the UK and EU cannot agree on new terms of trade and migration controls, there would probably be a minimal transitional agreement to limit the damage of failing to agree on the substance. But whatever the agreement, it is probably wrong to assume that the UK will leave the EU the moment that the ink is dry in spring 2019. This is because it will take time for citizens and firms to adjust their affairs. It is normal practice for there to be a transitional period before such agreements come into force, and this very large change won't be an exception.

Furthermore, some commentators suggest that any new EU-UK trade deal will be struck after the withdrawal agreement is signed, rather than before it, and that the EU will agree to postpone exit until such time as that deal is done. We are not sure about this, because Article 50(2) makes it a legal requirement for the withdrawal agreement to "take account of the framework for [the UK's] future relationship with the EU". Either way, we predict that the transitional period could be as long as two years, to manage such a significant change, implying a Brexit as late as 2021.

DON'T FORGET: POLITICS AS NORMAL

Quite apart from Brexit, 2017 will see other developments in the political sphere. The Scottish Government's fresh push for independence will result in continued uncertainty about the Scottish political scene, about which we have written in a separate CBRE Viewpoint, *Referendum Overload?* That debate is now inextricably linked with Brexit and will act as a headwind on real estate investment north of the border. Brexit also affects the direction of Northern Ireland devolution given concerns about how the border with the Republic will be dealt with.

> "The Scottish Government's fresh push for independence will result in continued uncertainty about the Scottish political scene."

In England, too, devolution issues remain a hot topic. London, which voted to Remain in the EU, has a new mayor agitating for more power and money to protect the capital's future once outside the EU. Khan's opposition to the expansion of Heathrow is not likely to affect the timetable for a third runway at this stage.

Political influence on markets outside the capital will change further in the year ahead. On 4 May 2017, the first elections for so-called 'Metro Mayors' will take place. These new roles, leading newly formed Combined Authorities in many of England's city regions, will provide a new strategic approach to transport and planning across the urban area as a whole. In many ways these new mayors will mimic the function of the Mayor of London, but with fewer powers initially. Leading the way will be Manchester, Birmingham, Liverpool and Bristol. The opportunity to elect a mayor for Tyneside and Wearside has been shelved by the Government, whilst the Leeds City Region has still to settle on the geographic extent of any future elected mayor in West Yorkshire.

The main beneficiaries of initiatives such as the Northern Powerhouse and Midlands Engine will be those areas with mayoral Combined Authorities. However, we doubt that calls for tax devolution to English cities will make much progress, for the reasons set out in our January 2016 report, *Core Cities, Core Strengths.*

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INVESTMENT OUTLOOK

WEAKER INVESTMENT, BUT SUSTAINED INVESTOR APPETITE FOCUSED ON INCOME RETURNS

In the light of fears about the global economy and Brexit, UK real estate investment fell in 2016 compared with a very strong 2015. Total investment in 2016 is unlikely to top £50bn. Currency effects, which have supported investor interest, will be a double-edged sword. Appetite for UK property remains strong, however, with Asian investors coming to the fore. At just 1.1% in 2017, total returns will rely much more heavily on income.

INVESTMENT FELL IN 2016 COMPARED WITH A VERY STRONG 2015

Our report on the 2016 outlook, published in December 2015, argued that 2015 was likely to represent the peak in UK real estate investment volumes for the current cycle. Two main factors have conspired to deliver that outcome: an all-time record of £69bn for total property investment in 2015, and Brexit. There is clear evidence of hesitation and weakness in the UK investment market from mid-2015 onwards. Other factors, including Chinese financial market turbulence, reduced global capital flows, causing investment levels to fall across the EU. But the Brexit effect is undeniable, especially once the June 2016 referendum date was announced in February 2016.

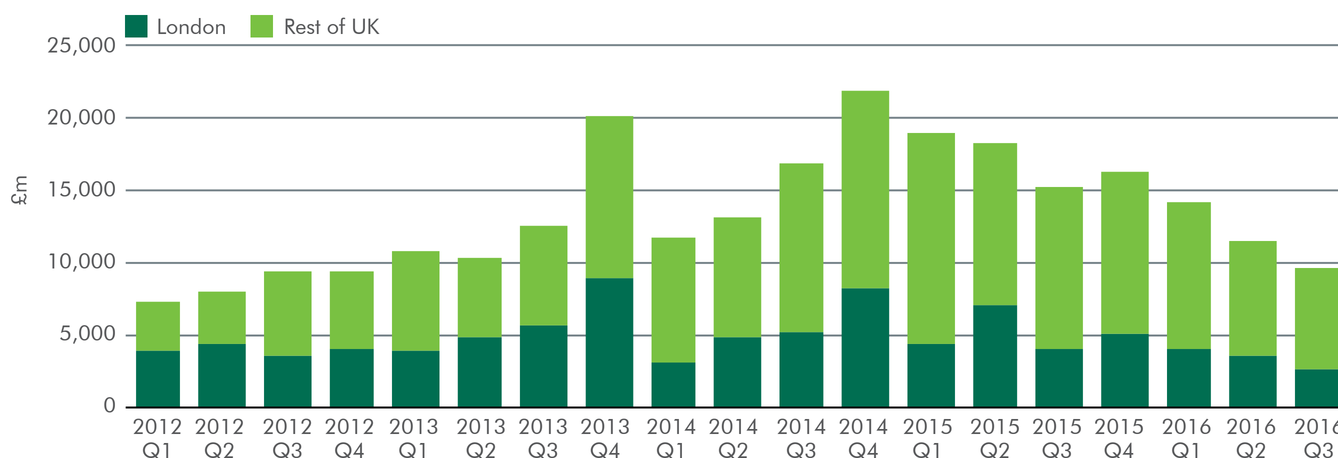
2016 INVESTMENT OUTTURN LIKELY TO BE AROUND £49BN

Our forecast for the 2016 investment outturn stands at around £49bn, 30% down on 2016. This is certainly lower than we anticipated in late 2015, and the lowest level of investment since 2012 (2013: £53bn). However, this weakness should not be interpreted as structural. It is strongly informed by uncertainty in the UK economic outlook deriving from the EU referendum – which can even be regarded as something of a 'lightning rod' crystallising a range of other implicit (and rather more global) risks to UK investment.

> "The EU referendum – which can even be regarded as something of a 'lightning rod' crystallising a range of other implicit risks to UK investment."

2017 looks like it may be weaker still, though as we argue on page 7, the UK's economic fundamentals remain strong. This will underpin investor confidence in 2017. And we anticipate a recovery in investment volumes from 2018 onwards, as Brexit-related uncertainty reduces.

Figure 1: UK investment volumes, 2012-2016 Q3, quarterly, Central London and Rest of UK



Source: CBRE, PropertyData

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CURRENCY EFFECTS HAVE YET TO PLAY OUT

Superficially, it is a compelling argument that the pound's depreciation will underpin the attractiveness of UK real estate. Since the EU referendum, the pound has fallen by 17% against the US dollar and 11% against the Euro. To this currency discount can be added the 4% fall in all-property capital values during Q3 2016. Therefore there is very strong overseas interest in purchasing UK property, particularly property in supply-constrained markets with long income and good covenants.

> "There is very strong overseas interest in purchasing UK property, particularly property in supply-constrained markets with long income and good covenants."

However, there are not many sellers in the UK market. Transaction levels in the capital markets remain subdued in the light of the uncertain political outlook, despite the structural strength of the UK investment proposition. Sellers are deciding to wait out the current uncertainty rather than accept a lower price. And some of them are foreign themselves, in which case they are victims, rather than beneficiaries, of currency weakness. Their investment strategies and horizons thus point to a 'hold' strategy almost irrespective of Brexit. So many bargain-hunters in the UK market are likely to be disappointed. We forecast that at the all-property level, prices will fall by a further 4-5% over the coming year as occupier demand is affected by a weaker UK economy (see pages 6-7).

But we expect a pricing recovery thereafter. And some sectors will be much more resilient than others, depending on their exposure to that weakness and Brexit-related uncertainty.

ASIAN INVESTORS TO THE FORE

2017 will see a change in the composition of capital inflows into UK real estate. North American investors, who have typically represented about 10-20% of capital inflows, are likely to represent only around 10% of inflows in 2016. The first three quarters of 2016 saw around £3.1bn of investment originating from that region compared with £9.3bn in the same period of 2015. However, opportunistic private equity from the US will play a more active role in the market in 2017.

Asian and European investors are proportionally much more prevalent now, driven by currency. Indeed, Asian investment into UK real estate in 2016 may even exceed that achieved in 2015.

Investment from the Middle East is – relatively – a little subdued. This looks likely to continue in 2017. In 2015 we reported shifts in Middle Eastern investment, with sovereign wealth playing a lesser role and private wealth coming to the fore. However, the oil price has since recovered a little, and CBRE agents report strong interest in London from sovereign wealth funds.

TOTAL RETURNS TO RELY ON INCOME THROUGHOUT 2017

Falls in real estate capital values mean that average total returns, though still positive, are likely to be low this year and next. As we predicted a year ago, income will be the most significant driver of returns, though rental growth will also contribute in some sectors. For investors used to the double-digit returns experienced over the last three years, this may feel like a turning point, but we do expect returns to recover to healthy levels of around 6-7% on average from 2018 onwards.

In any case, the comparison between real estate and other asset classes will continue to be relevant to investors. We discuss the bond yield and property equities position on the following pages. But, for as long as interest rates remain at all-time lows, the bond-like characteristics of prime property will help it continue to shrug off some of the uncertainty surrounding the UK, with yields of 3-5% easily outstripping other asset types and exhibiting a comfortable cushion to reflect risk. Prime office yields in competing EU cities are lower (Paris – 3.2%; Munich – 3.3%; Berlin – 3.5%) implying that UK cities will continue to look attractive.

REAL ESTATE FINANCIERS MOVE TO DE-RISK

Real estate financiers are looking to de-risk. In the public equity markets, uncertainty over valuations looks likely to remain for some time, implying no quick recovery in stock prices. By contrast, balanced funds look likely to stay priced close to Net Asset Values (NAVs). In the debt markets, rising gilt rates have come as a surprise, but borrowers are still locking in cheap deals with long maturities. Liquidity remains good but development debt will be rather harder to come by in 2017.

PUBLIC EQUITY: UNCERTAINTY OVER PRICES AND VALUATIONS WILL STAY WITH US FOR NOW

Over the last year projections for slower economic growth, concern about Brexit and rising rates expectations have taken their toll on real estate equities.

Secure income from less cyclical sectors has outperformed the more economically exposed. Stocks exposed to Central London have fallen further with more value-add and project finance type stocks falling the most. This mirrors the divergence in real estate pricing in the physical markets.

These are rational reactions to uncertainty. But for most stocks the valuation corrections implied by prices far exceed current market expectations. This reflects an uncertainty-amplified vision of the 'income plus growth' return requirements of equity investors. If investors need, for example, 4% income and 4% growth and have low confidence about growth, they will need a discount to grow into. If they are uncertain about where the spot valuation is, they will want to see a yet bigger discount.

It is probably less valuable to comment on whether the equity markets are leading the physical market, and instead consider what might trigger a re-rating of the sector back towards asset valuations. The crucial factor will be a decrease in uncertainty and an increase in conviction. Given the European political calendar, the unknown course of Brexit and a new policy stance in the US, neither seems likely in the short term. De-risking thus seems likely to continue.

PRIVATE EQUITY: TRADING NEAR NET ASSET VALUE FOR NOW

After a short hiatus following Brexit, most open-ended balanced funds are trading at or near parity to NAV, albeit NAV has generally been revised down. Intrinsically, balanced funds are at a premium to the REIT sector, but investors seem willing to pay a higher price for predictable and unlevered returns.

Conversely, specialist sector funds, especially those employing gearing or exposed to development risk, have also witnessed an expansion in the discounts to NAV, often by in excess of 10%. These funds are typically closed-ended or provide constraints on primary liquidity and are therefore more readily compared to listed REITs. The exception to this rule is the alternative sector, whether that is student housing, healthcare (see pages 25 and 31 respectively) or other forms of social infrastructure. These remain in strong demand.

We don't foresee a material change in the supply and demand balance in 2017. In the balanced fund sector demand is likely to be sufficient to maintain secondary pricing close to NAVs. Redemptions will be limited. However market fundamentals will make it difficult for managers to create more units at an offer price premium (typically above 5%). As we argue on page 26, long income funds will be the sector to watch. These funds have been inundated with pension fund capital looking for liability-driven investment strategies. A steepening in the yield curve, particularly at the 'long' end, could reduce the demand imbalance, resulting in lower direct asset pricing.

PUBLIC DEBT: RISING RATES, BUT BORROWING STILL VERY CHEAP, WHILE CMBS STAYS LARGELY DORMANT

Gilt yields started climbing in October 2016 as investors reassessed their view on government debt and inflation expectations. In the US, the expectation of a change from a low growth environment to a fiscally generated reflationary world has grown. Rates are still ultra-low by all conventional historical standards, but the recent rise was unusual. Perhaps markets are

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too used to rates moving one way only in response to negative news. This serves as a reminder that when monetary policy runs out of steam, we remain as exposed as ever to inflationary risks.

The borrowing outlook is still very positive. The total cost of funding remains at cyclical and historical lows. Rates seem likely to stay low even as inflation takes hold. In the corporate bond market, both UK and European REITs have locked in low borrowing rates with longer term bond issuances. There were issuances in the second half of 2016 by Klépierre, Gecina, Capco, and LondonMetric, with maturities in the range of 8 to 15 years.

In the CMBS market, Barclays issued 'Griffon Funding'; a multi tranche £2.4bn CMBS, an incredibly large volume by recent standards. This was largely a regulatory capital driven trade with limited new money. There were no other new issues but issuers are still eyeing future CMBS as an exit mechanism. However the conditions for a well-functioning and liquid CMBS market look likely to stay absent for now.

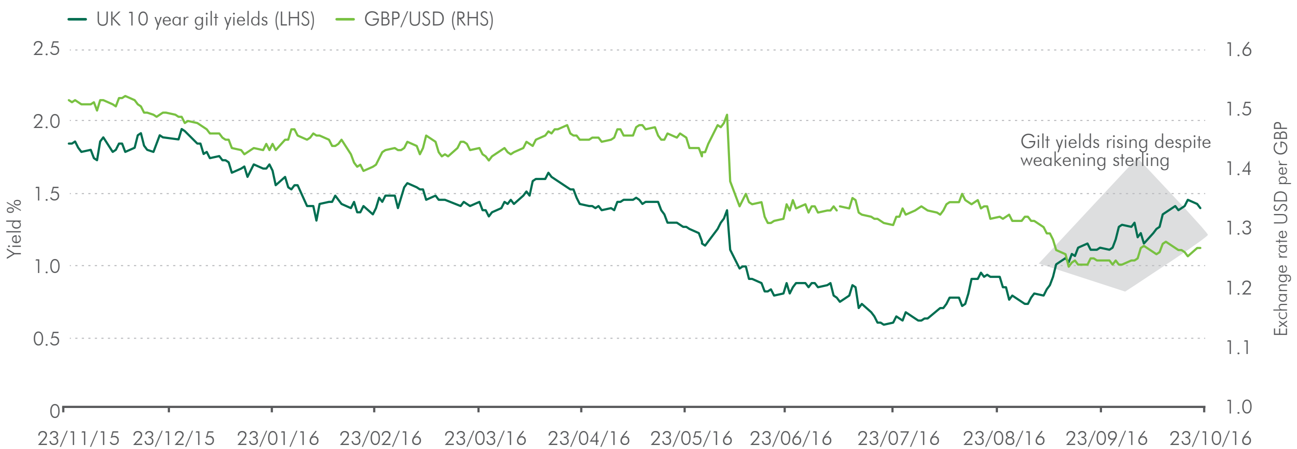
PRIVATE DEBT: PLENTY OF LIQUIDITY BUT DEVELOPMENT FINANCE MORE TRICKY

At the moment, the UK traditional lenders have sustained appetite for loans on prime assets and pricing is still competitive on the whole albeit leverage has come in slightly since the Brexit vote. The UK clearers are largely relationship focused, but all still have large targets so actively lending across various asset classes but on a conservative basis. German lenders, funds and insurers are increasingly more competitive for prime assets in good locations at 'normal' LTV rates. The market is very liquid and we don't see that changing for 2017 across various leverage points.

Value add, development debt is slightly more difficult to source from traditional lenders; this offers good margins and opportunity for the alternative lender market which as mentioned is becoming increasingly more active. Development debt is still largely available but lenders are looking at the end user market and pipeline or the particular market in more detail. Speculative commercial development finance is harder to fund without a very strong investment proposal, we see this trend continuing for 2017.

For more detail on our predictions for the coming months, see our latest report on the 'four quadrants' of investment activity, *The Art of De-Risking*.

Figure 2: 10 year gilts vs USD/GBP exchange rate



Source: Bloomberg

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WEAKER EMPLOYMENT GROWTH AND BREXIT WORRIES WILL BE OFFSET BY RESURGENT CREATIVE INDUSTRIES

The outlook for offices in the UK in 2017 will be very much dependent on the eye of the beholder. Location and quality will be crucial determinants of how markets respond to pressures in the year ahead, particularly given the emerging impacts of Brexit on the market in the longer term. Weaker employment growth presents some challenges. But market support will be provided by public sector activity.

FINANCIAL SERVICES ARE THE MAIN AREA OF BREXIT UNCERTAINTY IN THE OFFICE SECTOR

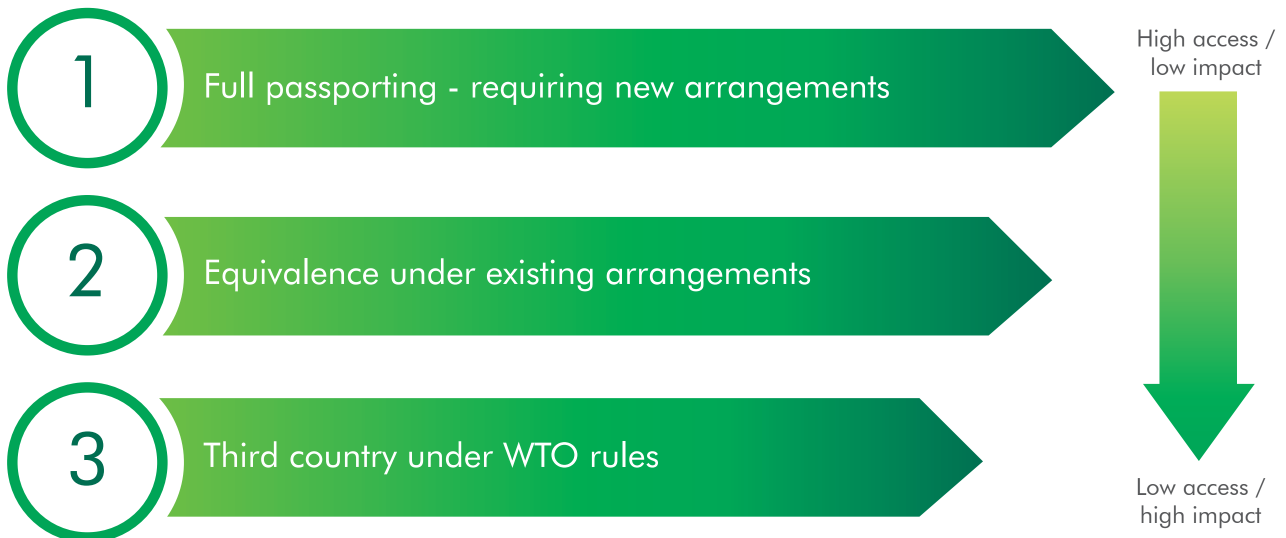
Whilst we do not expect any material changes to the UK's trading status during the year, clues are likely to emerge as the year progresses regarding the future form of the country's relationship with the EU.

Across key UK markets, but particularly within London, banking and finance occupiers will be watching this process closely. Many currently benefit from access to the Single Market, particularly the ability to 'passport' their services into other EEA countries. An alternative scenario may see London retain some of its access to European markets, via the equivalency regime, which would permit access to the EU market provided the UK regulatory environment remains similar to the EU's.

The worst case scenario would see the UK forced to negotiate under WTO rules, resulting in low levels of access. Under this scenario, where 'passporting' rights are lost, we would expect a negative impact upon banking and finance headcount in London, leading to a corresponding fall in occupational demand.

However, it will take some time for these issues to be resolved. So we do not expect 2017 to repeat the experience of financial services real estate during the 2008-09 financial crisis. Far from it. Unlike the period leading up to the crash, banking and finance firms have not recently been acquiring much space (see Figure 4 on page 17). Instead they have collectively been reducing their occupational footprint. So even in the worst-case scenario, the potential for large-scale releases of secondhand space during 2017 is limited.

Figure 3: Brexit's impact on financial services will depend on the level of access granted



Source: CBRE Research

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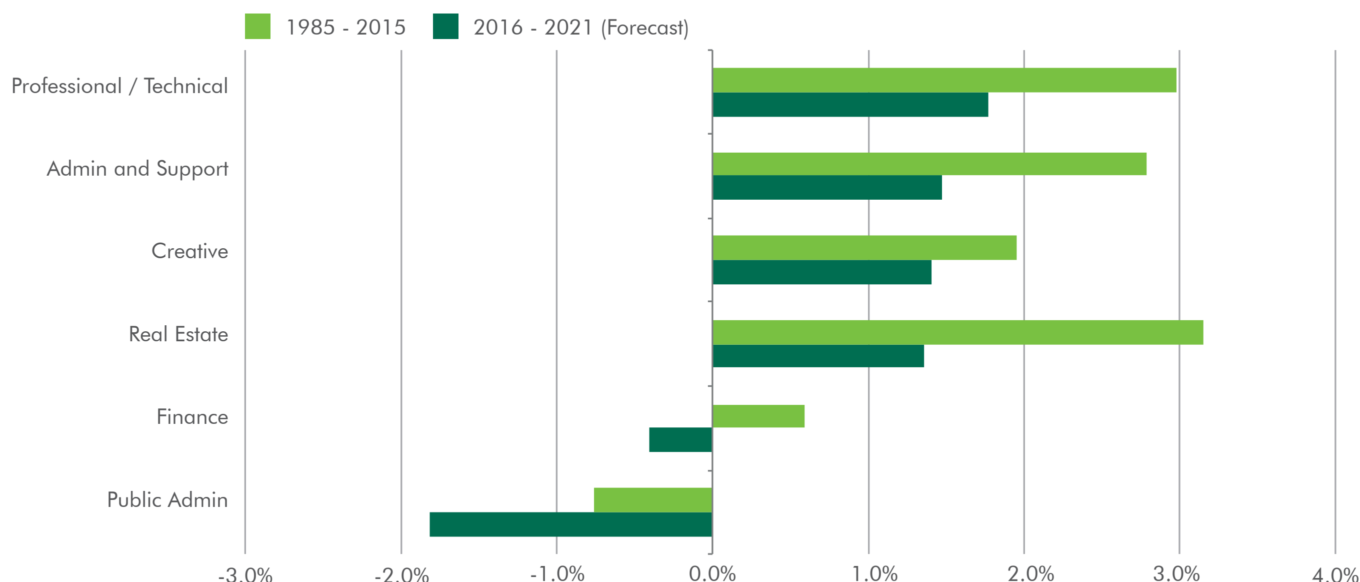
Figure 4: UK office based employment growth, %, 1985 - 2021



Source: Oxford Economics

PUBLIC SECTOR REQUIREMENTS WILL SUPPORT REGIONAL DEMAND

Brexit-related uncertainty will lead to a weakening in demand for office space in London. In contrast, many of the regional city office markets are likely to break new records for annual take-up, but for one reason alone. 2017 is expected to be the year when most of the current requirements from the Government Property Unit (GPU) are resolved, in many instances with the signing of new pre-lets. Almost all the major cities around the UK have substantive requirements for office space from the GPU. In a number of cases these are very large by each city's standards. Indeed a single GPU pre-let will be enough for some cities to achieve their annual average take-up. These will very much be single, one-off deals, and are unlikely to reflect underlying occupier sentiment. For London, this will mean the public sector will continue to see a net decline in employment, as more government functions are decentralised, although some lower cost locations within the capital might well benefit.

BUSINESS CONFIDENCE SURPRISES ON THE UPSIDE, WITH TECH AND CREATIVE SECTORS PROMINENT

Nevertheless, we expect broader occupier sentiment to remain relatively robust at the start of 2017. Evidence from the Purchasing Managers Indices at the end of 2016 has shown a UK wide rebound in confidence since the EU referendum, with particularly strong business confidence across the North of England and in the West Midlands. Underlying demand in the South East and regions is therefore expected to result in take-up broadly in line with the recent average. However, with weaker UK GDP forecast for the next couple of years, we are likely to now see a pause in any significant rental growth across all UK office markets. With London arguably ahead in the cycle compared to the regional markets, it is likely that the major regional cities will outperform the capital in terms of rental growth.

The tech and creative sector is likely to be at the forefront of demand. Occupiers in this industry have represented a large proportion of Central London take-up over the past few years, and are becoming a growing presence in many regional

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markets. At the turn of the year, the creative sector was a dominant feature of active demand in London and this should translate into strong levels of take-up in early 2017. The sector has also been the focus of many major corporate announcements in recent months, with plans from some of the world's largest tech firms to expand their presence in London. Elsewhere, Edinburgh has stood out as a city experiencing rapid growth in the local tech sector, to the extent that home-grown businesses are now attracting global attention, notably the recent acquisition of Scotland's Skyscanner by Chinese travel tech firm Ctrip. Around the rest of the country Manchester stands out as one of the best placed cities to benefit from future growth in the tech sector, as well as the more traditional locations in the Thames Valley such as Reading.

BUSINESS RATES WILL CHANGE THE OFFICE COST LANDSCAPE

From the start of April 2017, the business rates revaluation will come into effect. In Central London, the result will be an increase in rates payable across all major office locations, albeit to varying degrees. Average increases in rates payable will range from as little 4% in Docklands and 5% in Knightsbridge to 46% in Farringdon and 67% in King's Cross.

The 2017 revaluation will have a greater than usual impact upon occupational costs due to the harsher than usual transitional relief arrangements. The transitional relief increase cap is set at 43% rather than the usual 12.5% meaning that almost all Central London occupiers outside of King's Cross and Farringdon will be liable to pay for the full increase immediately.

One of the immediate impacts of the EU referendum result will be the curtailment of starts of new speculative office developments. Nevertheless, with supply levels in many markets close to their cyclical lows we expect opportunities to emerge for high quality refurbishment projects to be delivered into many markets, providing a flow of much needed prime space during a more fallow period for new development. Our report *Refurbish To Reinvent* explores this trend in more detail.

SWINGS AND ROUNDABOUTS: INVESTORS WILL REMAIN INTERESTED IN PRIME OFFICE STOCK

We expect investors to continue to target UK offices. The depreciation of sterling, the repricing of values following the referendum and a desire for diversification have all boosted the attractiveness of the UK. The weight of equity targeting opportunities in the UK is still substantial. For example, we estimate that, as we enter 2017, there is £38.5bn of equity seeking to invest in London real estate. This has already translated into a number of recent transactions, particularly for larger lot sizes, where activity was relatively limited in Q3. We anticipate that this momentum will persist into 2017 as German property funds and Middle Eastern and Asian private investors become more active.

Where available, investment stock in prime locations with long income is expected to outperform non-core stock. The relative attractiveness of Central London property is likely to persist throughout 2017 as interest rates remain very low. Whilst prime yields in the City and West End are likely to remain unchanged in 2017, average equivalent yields are forecast to increase by 20bps to 5.5%. Similarly long income stock will prove attractive in the regions, with the added bonus that yield differential between London and the regions remains wide, particularly in comparison to the position a decade ago.

We expect a continuation of a trend that emerged following the referendum, for greater market share from overseas buyers, and interestingly, UK local government. The first major office transaction after the referendum saw Leeds City Council acquire 3 Sovereign Square in Leeds city centre, a building that would have typically been a prime institutional purchase. Since then, many local authorities have been actively purchasing investment properties, given their ability to borrow at historically low rates, which benefit from great revenue generation for increasingly tightening council budgets. We expect both groups to feature strongly in the market during 2017.

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INFLATION, TECHNOLOGY, E-COMMERCE AND NEW COSTS WILL MAINTAIN THE RETAIL REVOLUTION

A challenging economic outlook will make 2017 a difficult year for retailers. There will be significant new real estate and labour costs, and Brexit worries, though the impact will be felt differently across the country. Innovation and technological change in the sector will be relentless. New supply will be significant and rental growth will slow.

2017 WILL BE CHALLENGING FOR RETAILERS

The 2017 outlook for the retail sector is challenging. By the end of 2017, inflation could be as high as 4%, according to the National Institute of Economic and Social Research. This could considerably weaken consumer spending power. But wage growth will lag inflation, causing a decline in disposable income.

The CBI forecasts that consumer spending growth will fall by more than half in 2017, from 2.7% in 2016 to 1.2% in 2017. Retailers who were initially insulated from the drop in value of the pound following the EU referendum will experience higher costs as foreign currency that was purchased at a higher exchange rate beforehand runs out. A proportion of these increased costs will be passed on to consumers.

Rate revaluation will also affect retailers, particularly in Central London. Retailers in some locations will experience rateable value increases of over 100% from April 2017, and bills could increase by as much as 45% in 2017 alone as a result. However, the effect on retailers who have a national presence will be less severe as these increases will be offset by decreases in other areas of the UK. The National Living Wage, which came into force in April 2016, and the Apprentice Levy, coming into force in May 2017, will add further to retailers' costs.

RENTAL GROWTH WILL SLOW COMPARED TO 2016

In Central London strong demand will cause average rents to grow further, albeit more slowly than in 2016. For the rest of the UK, rents will fall in some secondary locations. However, there will still be modest growth in the prime retail locations outside London (see Figure 5).

OVER 3.5 MILLION SQ FT OF NEW RETAIL SPACE IS EXPECTED TO OPEN

In 2017 over 2 million sq ft of new Shopping Centre space is expected to open, the highest amount of new space since 2013. Westgate in Oxford, The Lexicon in Bracknell and a large extension to Westfield London represent the majority of new space. The remaining space will be delivered via extensions and redevelopments.

1.2 million sq ft of new Retail Park space is expected to open in 2017, an increase of a third compared to 2016. Retailers are increasingly aware of the attractiveness of opening stores on retail parks. Their popularity has increased due to their ease of access, excellent tenant mix and free parking. As a result occupier demand for units on Retail Parks will continue into 2017.

The number of new superstore openings from Tesco, Sainsbury's, Morrison's and Asda will be similar to 2016. The most active operators will be M&S Simply Food, Aldi and Lidl. These three operators combined will open over 70 small sized supermarkets in 2017. In the convenience sector the Co-op will open more stores than any other operator, matching their 2016 target of 100 store openings.

TECHNOLOGICAL ADVANCES WILL CONTINUE TO IMPROVE THE SHOPPING EXPERIENCE FOR CONSUMERS

The UK retail market is already one of the world's most innovative. In 2017 new technology will further improve the shopping trip. There will be additional choices in alternative payment methods – for example paying by fingerprint or facial recognition. According to the UK Card Association there are now over 100 million contactless payment cards in circulation. 300 million contactless transactions are now made each month, an increase of more than 200% over last year.

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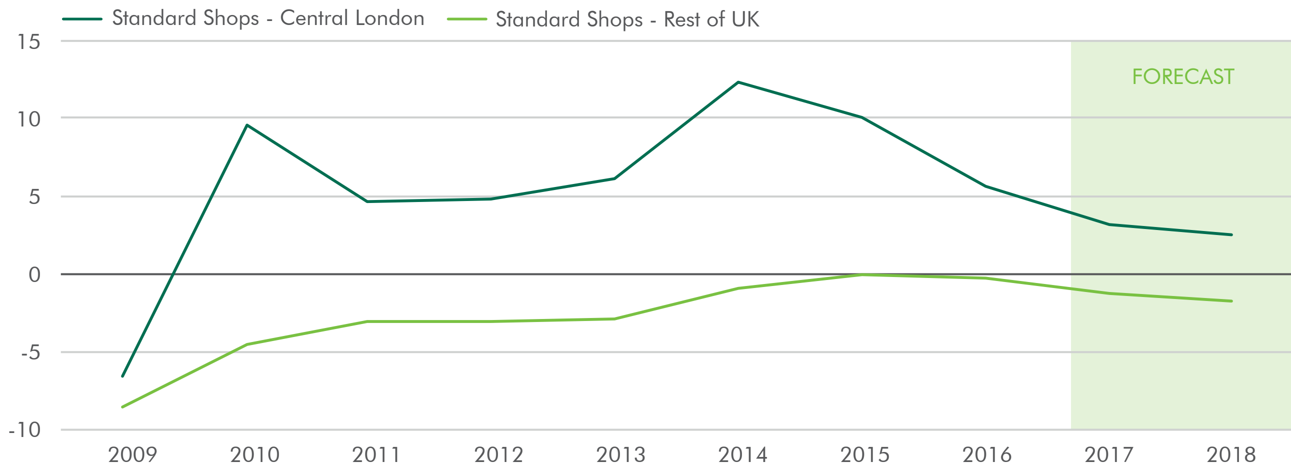
Figure 5: Standard Shops: % Rental growth Central London vs. Rest of UK, 2009 - 2018



Source: IPD, CBRE Research

The popularity of Virtual Reality is likely to increase further, particularly for the gaming industry, but also in the travel industry where it will be used to help holidaymakers choose the perfect destination. Linking technology and fashion will continue to grow in importance. Recent collaborations such as that between Henry Holland, Visa and Blippar technology will be used to allow people to buy direct from the catwalk with 'one click.'

THERE WILL BE AN INCREASE IN THE NUMBER OF ONLINE ONLY RETAILERS OPENING PHYSICAL STORES

Online retail has undoubtedly caused major structural change in the sector. Online sales represent circa 15% of total retail sales in the UK. Online sales will continue to increase in 2017 and we expect to see 17% of all sales being made online by the end of the year.

Our research shows that consumers still prefer to shop in a physical store if given a choice (*The Consumer Experience*, June 2016). A large number of retailers such as Missguided, Made.com and Bonobos have all opened physical stores to complement their online offer. Having a physical store presence increases brand awareness as well as directly driving sales. Online retailers will increasingly move into bricks and mortar, particularly in prime locations that benefit from high footfall; or as concessionary space in large format stores.

Luxury retailers will become more engaged with online. Some have been reluctant to launch transactional websites because of the perceived impact on exclusivity and authenticity; but this behaviour is likely to change. Luxury retailers will also interact more with social media sites such as Snapchat and Instagram to raise their appeal among 'millennials'.

THE GROWTH OF FOOD & BEVERAGE OUTLETS WILL CONTINUE TO GROW

The number of Food & Beverage outlets is expected to grow at approximately 6%, a similar level to 2016. The trend towards healthy eating, especially in the 'Food to Go' sector will result in increased openings from operators including Leon, and Pret with their Veggie Pret concept.

"Online sales represent circa 15% of total retail sales in the UK...We expect to see 17% of all sales being made online by the end of the year...Luxury retailers will become more engaged with online."

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OUTPERFORMANCE AND CHANGE IN A BREXIT WORLD

Industrial and logistics property has been an outperforming real estate sector in 2016 and we expect this to continue into 2017. Income returns will remain strong, even in the face of weaker economic growth. The sector will not be immune to uncertainty around the trade impacts of Brexit, and inflation is now a key risk, but supply remains weak. Further ahead, technological change in the logistics sector will continue to influence real estate preferences.

INDUSTRIAL AND LOGISTICS PROPERTY HAS PERFORMED WELL...

The resilience of the industrial and logistics sector was exemplified by its performance in 2016. Despite a regular conveyor belt of events that could well have destabilised the market, the sector very much continued in a 'business as usual' mode. Indeed, with the rise of uncertainty amongst investors, the sector became the first port of call for many, particularly in the immediate wake of the Brexit vote, as viability of other commercial real estate sectors was questioned.

The search for income is a key concern to a large number of investors and the underlying attractiveness of industrial real estate will ensure that the sector is one that this group of buyers will continue to turn to. Whilst weaker economic growth may lead to weaker rental and capital growth overall, higher income returns will ensure the sector outperforms wider commercial real estate, generating superior returns to both the office and retail sectors.

...BUT IT IS NOT IMMUNE TO BREXIT EFFECTS

Nevertheless, the sector is unlikely to be completely immune to the impact of the EU referendum. However, it may take much longer for the full effects to materialise. Over the longer term, as bi-lateral trade agreements are negotiated, there may be impacts on the global movement of goods, in particular if the source on UK imports changes significantly. This may also affect UK exporters, already benefiting from the effects of a lower valued pound. Nevertheless, the UK remains an island nation, and there will continue to be a need for goods to be transported across the country, which favours logistics uses.

Speculative development activity will slow, despite favourable underlying demand conditions. The availability of ready-to-occupy logistics space remains a major issue for the market. This is only likely to escalate during the year ahead, should new development not keep pace with occupier demand. This is the root cause of the recent period of rental growth in the sector, where annual growth pushed above 9% in London by mid-2016.

"Given persistent low supply we expect further rental growth in the year ahead: averaging at 3.1% for the UK as a whole... There is only around three-quarters of a typical years' supply in many of the core regions."

Given persistent low supply we expect further rental growth in the year ahead: averaging at 3.1% for the UK as a whole during the year, still ahead of the current rate of inflation. At the time of writing there is only around three-quarters of a typical years' supply in many of the core regions. So rental growth is likely to continue and may act counter to some of the economic drivers, particularly in parts of London and the South East.

RETAIL INFLATION IS AN ISSUE FOR INDUSTRIALS TOO

Inflation will be a key risk to the sector. Over the past year and a half, low inflation has provided an additional boost to soaring rates of rental growth. More importantly, low inflation has coincided with a period of high consumer confidence, some of the highest recorded since the last recession. However, inflation

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is set to increase in response to the fall in the pound. During the financial crisis, periods of high inflation coincided with the lowest levels of consumer confidence. So we expect inflation to have some impact on consumer confidence, particularly if there is any increase in unemployment at the same time. Eventually these factors will feed through to the supply chain for retail goods during the course of 2017. Love it or hate it, but the October price dispute over Marmite may be the flavour of things to come. For more on our retail outlook, see page 19.

"Love it or hate it, but the October price dispute over Marmite may be the flavour of things to come."

TECHNOLOGICAL CHANGE AND A 'FLIGHT TO PRIME' WILL COME TO THE FORE

It is clear that both occupiers and investors will be subject to a 'flight to prime'. New buildings, even design-to-build options, are in greatest favour with occupiers at present. With a growing number of such assets, many of which will be let on long leases, logistics will continue to be popular, particularly amongst the major platform builders.

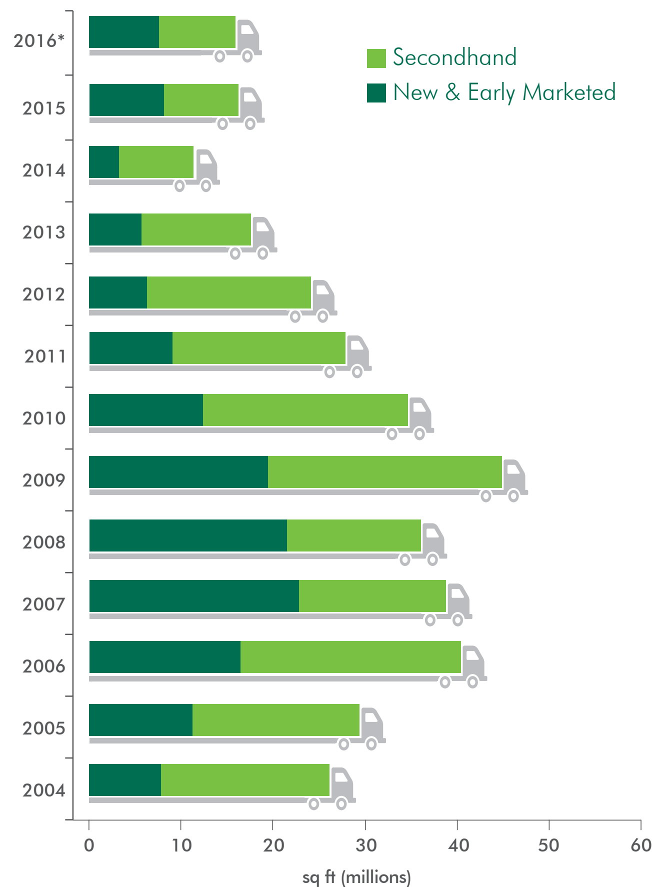
Rapid technological change will continue to influence the sector in 2017. During the first half of 2017 a new multi-floor warehouse will complete in Essex, only the second of its kind in the UK, albeit with lift access to the upper floors, as opposed to vehicle ramps. Elsewhere there are plans emerging for underground facilities in west London, and in the capital the prospects for mixing warehousing space with other uses on the same site, including residential, could well begin to emerge during 2017.

Many of these solutions are actively being considered in areas of high population density, in order to facilitate further the growth of online retailing, and in particular the need to successfully complete the so called 'final mile' to the end consumer. The market will be watching closely to see how other logistics operators rate this type of accommodation. Whilst it won't suit every location, it could well become more commonplace around London.

Technology more generally will be a key theme for the logistics sector in the year ahead, both inside and outside of the warehouse. Advances in stock picking and selection within the warehouse will continue apace, led by the leading online retailers and those offering rapid turnarounds from order to delivery.

We also expect further developments in the field of autonomous driving during 2017, both for the personal vehicle market, but also for articulated trucks. Government sanctioned trials are already taking place. The concepts behind convoying are already proven in mainland Europe, so the sight of driverless trucks on UK motorways may not be that far away.

Figure 6: UK Logistics Availability 2004 – Q3 2016 (100,000 sq ft + units)



Source: CBRE Research

*2016 numbers reflect availability at 30 September 2016.

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HOUSE PRICE GROWTH TO SLOW, BUT CURRENCY EFFECTS PROVIDE SUPPORT. STUDENT HOUSING A GROWTH SECTOR

Reflecting the weaker economy, price growth in the mass residential market will continue to slow. Investors will continue to be discouraged by Stamp Duty and other tax changes, but at worst we expect a plateau in prices rather than any significant falls. A favourable currency will help boost international investors. In student housing, demand will remain strong, and development will be focused on towns without adequate existing supply.

The market slowed in 2016, mostly as a result of Stamp Duty changes. Average monthly transactions are down 14% over 2015. House price growth, while still hovering around 7.5% annually, has been losing pace as the year has progressed. We expect the market will plateau in terms of both price growth and transactions, largely reflecting the broader economic outlook, with weaker earnings and employment growth. We are, however, expecting renewed interest from international buyers, partly reflecting currency differentials.

OUTER LONDON AND THE REGIONS LIKELY TO OUTPERFORM

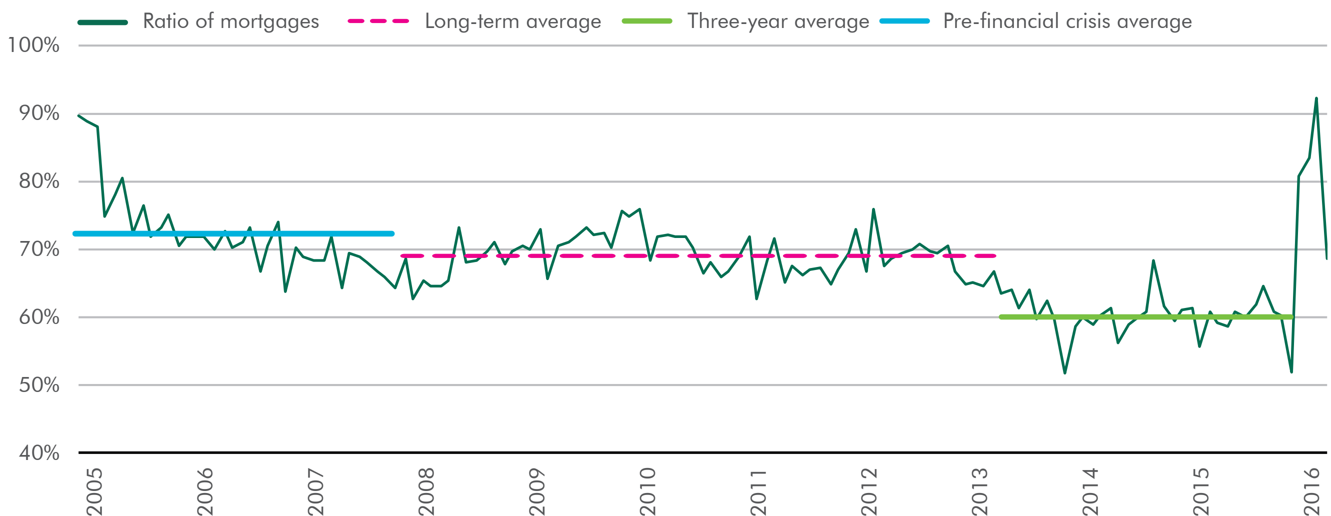
Marking a departure from a decade long trend, there has been a notable ripple out of activity from inner London, with new build sales performing better in outer London in the last year. This is reflected in prices, with the outer London boroughs posting faster rates of growth over the last year than inner London boroughs. For example, the outer London boroughs of Walthamstow, Barking & Dagenham and Newham have recorded some of the highest rates of growth recently. This partly reflects the more active domestic buyer market, which typically buys in peripheral locations, and investors looking for a better yield.

> "There has been a notable ripple out of activity from inner London, with new build sales performing better in outer London in the last year."

We expect this trend to continue into 2017, and so the atypical outer London price growth 'gap' (see Figure 8) seen over the last two years will persist.

There is also a pick-up in regional centres such as Manchester, Birmingham and Edinburgh. According to Nationwide three regions (Outer Met (9.6%), Outer South East (8.0%) and East

Figure 7: Ratio of mortgages to house sales (%)



Source: Land Registry, CML

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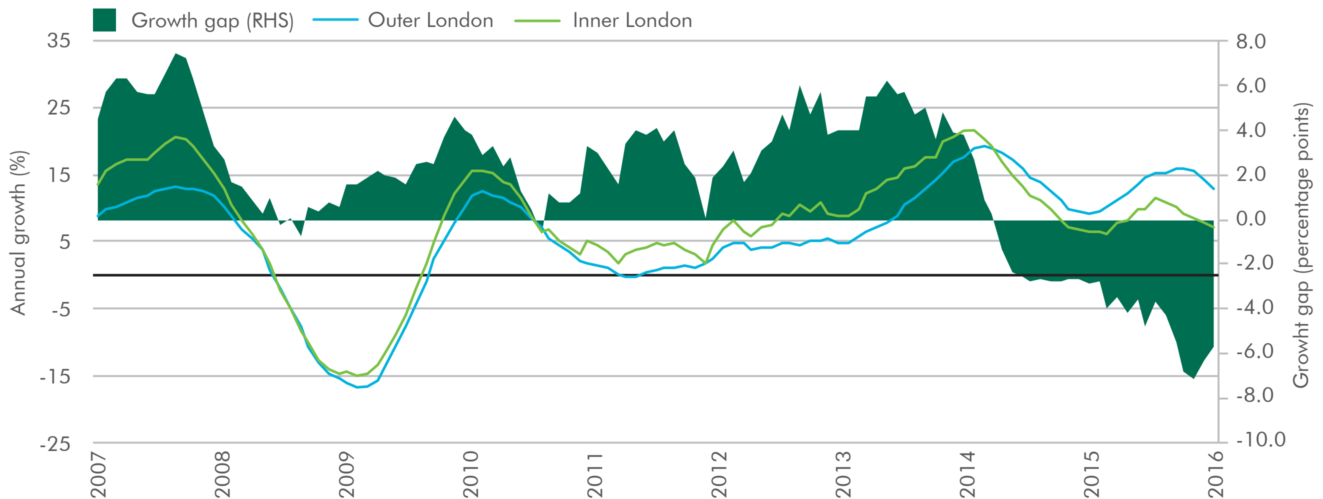
Figure 8: Annual house price growth rates: Inner vs. Outer London Boroughs



Source: Land Registry, 'Growth gap' refers to the difference between Inner and Outer London growth rates.

Anglia (7.3%) saw annual house price growth during Q3 2016 greater than that in London (7.1%). This placed London outside the top three growth regions for the first time in seven years.

A MIXED BAG FOR INVESTORS WITH FEWER CASH BUYERS

In April 2016 an additional 3% Stamp Duty charge was introduced for investors in second homes. This had a marked impact on investor activity, causing a spike in sales in March and a drop off subsequently, particularly among cash buyers. In the last three years the share of cash buyers has moved from its long-term average of 30% to nearer 40%. However, they all but disappeared from the market in the second quarter of 2016 (see Figure 7). Although the latest data shows a return of some cash buyers, the new tax has discouraged some investors and so we do not expect cash buying to return to its previous high levels any time soon. Furthermore, in 2017 leveraged investors will face additional tax on rental income as tax relief on mortgage payments is phased out. This is also likely to discourage some buy-to-let borrowers.

However, the continued favourable exchange rate will ultimately entice a return of foreign buyers; the lower currency means house prices for overseas purchasers will look exceptionally attractive and virtually negate the increased Stamp Duty.

A reduction in uncertainty about the EU referendum will also help. In addition, anecdotal evidence suggests a pick-up in interest from US purchasers following the election result there.

SHIFT IN HOUSEHOLD COMPOSITION AND TYPE: SHARING TO BECOME MORE PREVALENT

The recent shift in tenure of a decline in owner occupiers and a rise in private renters has been well documented. However, shortfalls in housing have also led to a marked increase in sharer households, particularly in London, where affordability is most constrained. Households with three or more adults have grown by 28% in London over the ten years to 2011, compared with growth of 17% in England and an overall household growth of 8% over that same period. Households with parents and older children (over 18 years) living together have increased by 16% over the decade in London, compared with an increase of 11% in England as a whole. This suggests that young Londoners in particular have a hard time finding a new place to live.

This trend looks unlikely to reverse any time soon. A recent CBRE study found that 40% of 'millennials' (aged 20-29) in the UK are still living at home with their parents. With rents and house prices (deposits) continuing to grow, flat and house sharing will endure, particularly in London.

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BIGGER GOVERNMENT INTERVENTIONS IN HOUSING SUPPLY

The Government has announced four new funds totaling over £10bn in an effort to increase housebuilding rates: the 'Accelerated Construction' scheme, a new Home Building Fund, a Housing Infrastructure Fund, and new money for social housing. Combined, these are expected to increase housebuilding by circa 155,000 per annum across the UK, although money and delivery will be back-loaded to 2018-2020.

For the first time in many years, the Government has signalled a shift in policy away from a focus on home ownership. For example, the housing minister has indicated that affordable rental homes may now be included in their targets for starter homes. These announcements taken together imply a new push from the Government on housing supply of all types.

DEMAND CONTINUES TO UNDERPIN STRONG STUDENT HOUSING PERFORMANCE

Student accommodation is proving resilient to concerns about Brexit. After 2015's unusually high investment volume of £5.6bn, predicted investment volumes for 2016 will be about £3bn, exceeding all other previous years. Our valuation index of nearly 50,000 bedspaces nationally showed total returns of 10.16% in the 12 months to September 2016, significantly outperforming IPD. It also showed 1.88% net rental growth nationally, compared to IPD ERV growth over the same period of 0.2%. Yields are stable.

Confidence is further illustrated by the recovery of share prices of listed student sector companies since the referendum, with ESP Plc, GCP Student Living and Unite-Students outperforming peer group indices.

Meanwhile there has been another year on year increase in the intake of students. This may be as a result of the weak pound making the UK attractive to overseas students, but is also evidence of ongoing demand for UK higher education. It seems likely that visas will be introduced for EU students as a result of Brexit; however, only 6% of the UK student population are EU domiciled, so the impact is likely to be low.

"It seems likely that visas will be introduced for EU students as a result of Brexit; however, only 6% of the UK student population are EU domiciled, so the impact is likely to be low."

The growth of large owner-operator platforms is a key trend. They are now dominant investors. Institutions are not currently active, partly due to changes in the accounting treatment of university leases. These changes require the NPV of the whole rental commitment to be shown as a liability on balance sheets, from 2015. But private equity players and major international investors have re-entered the market. They are hungry for more stock to add to their portfolios, by investment or development. Established manager-operators have grown significantly in size this year, and several new ones have been established. Increased competition means increased cost certainty and service for investors, which also help them to invest. Lending appetite for both investment and development remains keen.

Acording to HESA, 118,000 students lived in private halls and 330,000 in provider-maintained halls in 2014-15, together representing 26% of the student full-time population of 1.7m. So nationally there is still headroom against a 'rule of thumb' saturation point of 40% of students living in purpose-built student accommodation. Some towns are already well-supplied. So investors will target universities with big investment and relocation plans. We expect greater focus on towns with low supply. Where older stock can be purchased at below build cost, refurbishment will be attractive, to short-circuit planning restrictions. Planning policy in London has frozen development so development will be focused elsewhere. We also expect to see greater overlap between the student and PRS markets through the sharing of best practice between the two sectors.

The outlook remains very positive, with the sector continuing to have wide investor appeal. For more detail about student housing, please read our report *Student Accomodation Comes Up Trumps In Brexit Year.*

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A SECRET WEAPON FOR OWNERS OF OPERATIONAL REAL ESTATE

Long Income came to the fore in 2016, but there are contrasting views as to whether this market will develop further. Long Income is a safe haven in uncertain times, but inflation expectations suggest bond pricing will rise, eroding the advantage of real estate income. With plenty of demand for real estate yields, and the capital cost of holding real estate increasing, we think investors will continue to focus on this steady source of returns.

The role of Long Income in mergers and acquisitions within the operational real estate investment class became the trend of 2016. Many corporate transactions were structured with Long Income leases. Typically, buyers have carved out 75+ year leases paying 10-15% of EBITDA which have been sold at Net Initial Yields ranging from 2.5 to 4.0%. Alpha Real Capital Partners led the way in 2016, working with purchasers of operating businesses to potentially unlock over £650m of corporate acquisitions.

There are two contrasting views as to how this trend will evolve in 2017.

On the one hand, in uncertain times smart money goes for safe havens. Real estate on long, indexed leases at the right rent to the right tenant is the ultimate safe haven. Secure Income REIT, PHP and Assura are all trading well because their leases are longer, more of their rent is rising with inflation and they are focused on specialist assets. Long Income will become embedded as the preferred capital structure for acquiring real estate heavy businesses.

On the other, the stars have gone out of alignment. Government borrowing is set to increase, providing more options for investors who have seen real estate as a proxy for bonds and other instruments that have been in short supply. And 10 year gilt rates have increased from 0.65% to 1.22% between September and November 2016. However tenuously, long income real estate pricing does reference bond pricing. As interest rates rise (see page 6 for our forecast), Long Income will slowly become a less attractive option for owners seeking to use real estate as part of their capital armoury. So buyers and sellers will retreat from the market.

Which view will prevail? As we argue in the following sections, real estate investors are turning to the operational real estate classes as a hunting ground for growth when returns in core markets are less obvious. There is no slowing of buyer demand with over £2bn of Long Income transactions by institutional investors during 2016. With fund inflows building, the demand for smart, safe deals will provide market momentum in 2017.

"Real estate investors are turning to the operational real estate classes as a hunting ground for growth when returns in core markets are less obvious."

On the supply side, as the cost of capital increases so too does the cost of holding real estate. Freehold-heavy operating businesses have increasing difficulty meeting investor returns aspirations. Long Income transactions are an efficient way of retaining flexibility and control whilst releasing capital for higher-return customer-facing capital projects. If more traditional freehold-owning businesses see long leases as a route to returns rather than a potential drag, so pace can pick up in the market.

We see 2017 as the year Long Income becomes the focus for investors entering the market, or reviewing their real estate strategy in operational real estate.

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CURRENCY EFFECTS, INNOVATION AND CHANGE CREATE OPPORTUNITY IN HOSPITALITY SECTORS

Hotels will remain a strongly performing sector in 2017, supported by a weaker currency and innovation in hotel concepts. Operating performance will continue to diverge, with very significant new supply in some markets. But boldness among investors and operators will pay off. Higher yields and the end of the beer tie present new opportunities for pubs investors.

2016 was something of a turbulent year for investors in UK hotel real estate. As predicted in this report last year, deal activity decelerated following a dizzying 2015 and Brexit-induced hesitation compounded the slowdown. Yields held stable following the referendum, with a weaker pound stimulating interest from international capital. However, the numerous unhedged, overseas funds already invested in Britain remained reluctant to exit until the pound recovers. Fortunately, provincial trading performance proved forgiving, with capital values buoyed by widespread growth in regional hotel profitability. London, on the other hand, grappled with hefty additions to supply and average market revenue fell, albeit from a particularly high base.

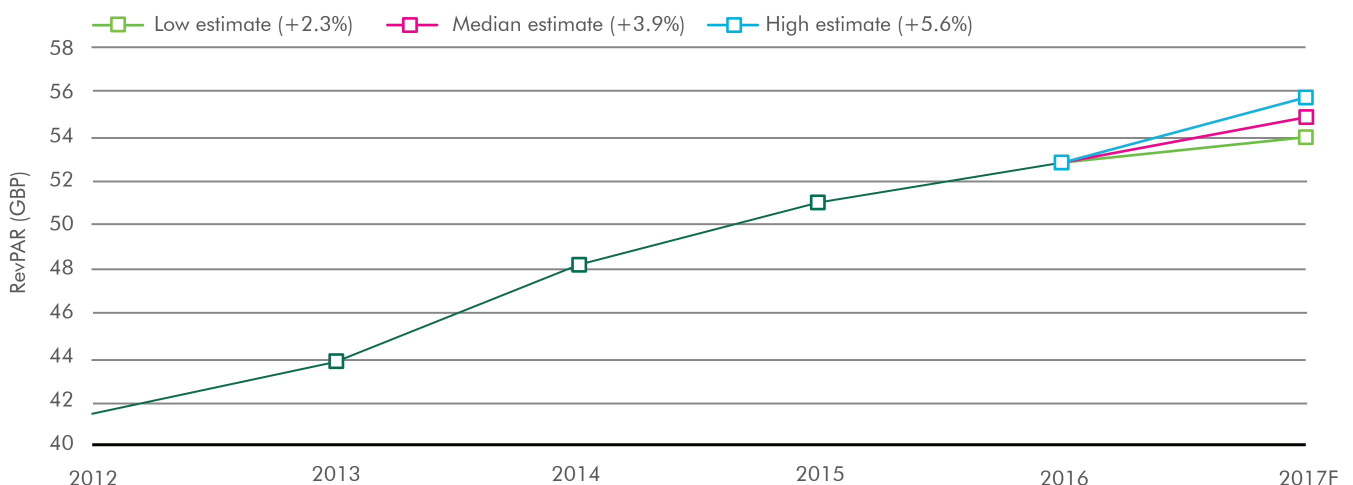
"Investors and operators will tackle the uncertainty by delivering fresh, innovative, trendy hotel concepts into UK markets."

In 2017, hotel investment will be significantly shaped by Brexit. But the construction pipeline suggests that a number of investors and operators will tackle the uncertainty by delivering fresh, innovative, trendy hotel concepts into UK markets. The results will be profoundly positive for the guest experience. Fortune will favour the bold.

HOTEL OPERATING PERFORMANCE WILL CONTINUE TO DIVERGE

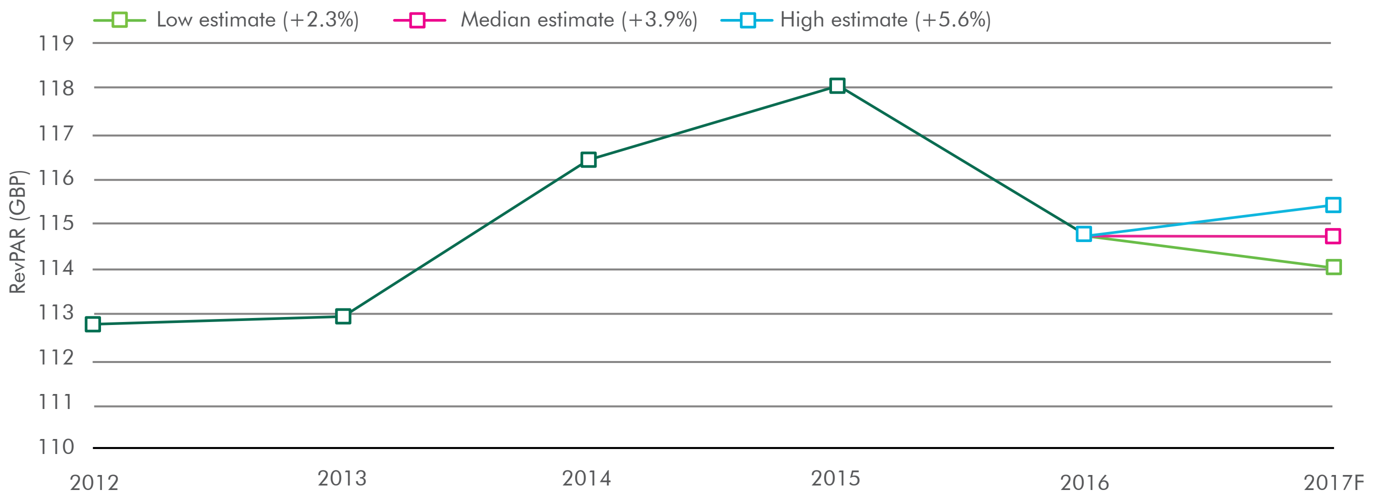
The international appeal of London's hotels guarantees that they will profit from the weak pound. Indeed this impact will be more evident in 2017 than in 2016, given the lag between booking and travelling. Operators will take the opportunity to increase room rates given the lower price-sensitivity of the inbound traveller. The provincial market, on the other hand, is anticipating a surge in domestic tourism as UK outbound foreign travel is hit by unfavourable exchange rates and security concerns. A degree of investment from the government's

Figure 9: Regional UK, 2017 Rooms Revenue per Available Room (RevPAR) Forecast – industry predictions



Source: CBRE Research, STR, PwC 2016. Estimates shown reflect typical industry views.

Figure 10: London, 2017 Rooms Revenue per Available Room (RevPAR) Forecast – industry predictions



Source: CBRE Research, STR, PwC 2016. Estimates shown reflect typical industry views.

Discover England Fund, aiming to support the growth of tourism, will also be realised in 2017. Grants will be awarded to projects which improve the tourist experience; ensuring that England remains competitive in the rapidly growing global tourism industry.

However, the weak pound will place upward pressure on UK inflation. This could reduce consumer spending and therefore hotel revenue, particularly in the provinces where demand for accommodation is predominantly domestic. However, operational expenses are likely to be rather more affected, as supplier cost increases cut hotel profitability.

SIGNIFICANT NEW HOTEL SUPPLY IN KEY CITIES

Whilst the outlook for guest demand in London is mostly positive, over 7,000 new rooms are confirmed for 2017. This is a 5% addition to existing supply which is almost double the long run average. Some parts of London will undoubtedly feel the heat of increasing competition and pressure on occupancy levels. Unloved assets will, as always, be the first to falter in an age of real-time customer reviews.

But to condemn new hotel supply would be wrong. New design concepts set for delivery in 2017 will further cement London as one of the most innovative global hotel markets – a world-class accommodation offering for a truly global city. Notable 2017 entries include Moxy by Marriott and Hotel Indigo by IHG. Both owned by traditional hotel companies, these trendy brands put authenticity at the heart of the guest experience. After several years of nonthreatening supply risk, the UK regions also face the prospect of a big increase in stock in 2017. Around 19,000 new rooms are expected, with budget brands accounting for the lion's share. Hotspots will include Edinburgh, Manchester and Belfast. A sharp surge in the pipeline results from improved operating performance; however, securing finance for development will remain a challenge.

HOTEL INVESTMENT WILL INCREASE IN 2017

Transaction volumes in 2016 were down – but compared with a stellar 2015 which boasted numerous large portfolio deals. However, the actual value of sales in 2016 remained considerably higher than the long-run average, notwithstanding Brexit jitters. The pattern of current ownership and the UK's position in the performance cycle point to an increase in activity in 2017 compared with 2016.

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Fixed-income investment will remain in favour, with core investors seeking real estate alternatives to the commercial mainstream. Long-dated, index-linked lease terms are particularly attractive to liability-matching funds. To date, a limited number of operators in the UK have offered leases; however, Motel One and Staycity are two players fuelling their expansion through such agreements. Both will open more than 500 rooms in the UK through 2017, providing greater opportunity and diversity for investors seeking secure income.

Whilst at record lows, yields for leased hotel investments will remain stable through the first half of 2017 at least. Increases in gilt yields will reduce the risk premium; however, higher inflation (see pages 6-7) implies greater rental growth. Yields for hotels with operational exposure (vacant possession, management agreement) will also remain stable in prime UK markets. Future operating performance in prime markets will be supported by the delivery of strategic roads, railways and airports investment. However, secondary locations may see yields increase as portfolio owners consolidate their holdings, flooding the market by selling assets that contribute least to realising their strategy.

So will fortune favour the bold? We think it will. Slower growth in operating performance combined with relatively stable yields will make it more challenging to increase asset value. But the shrewd asset manager will find opportunities to squeeze out good returns, and the long-term conservative investor will be presented with chances to acquire high quality, finished assets. Opportunistic funds seeking high yielding stock may struggle to realise their aspirations unless they are prepared to develop.

“The shrewd asset manager will find opportunities to squeeze out good returns, and the long-term conservative investor will be presented with chances to acquire high quality, finished assets.”

One final way to add investment value is to reposition and rebrand: utilising a hip new brand to inject some fizz into an uninspiring, underperforming asset is certain to be a hit in 2017.

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PUBS: A SPECIALIST CLASS ATTRACTING MORE GENERAL INTEREST

Turning to pubs, the British boozer continues to be core to our national identity, with a visit to a traditional pub reportedly third on the wish list of overseas visitors and seven out of ten visitors achieving that during their time in the UK. However it is not just tourists taking a look at these iconic buildings and businesses. Increasingly non-emotional investors are seeing the attractions in pub real estate alongside more mainstream investment classes.

However, attractiveness is in the eye of the beholder: not all investors will find pubs suitable. Many will simply not have the resource, skill or appetite to price in or manage out the operational risk that is perceived to attach to such businesses. In some cases the seller helps the process by offering contracts which allow tenants to replace poorly performing assets with better ones. This reduces the risk of onerous leases, but still it is not an asset class for everyone.

In other cases, the nature of the investor – long-term actuarial based funds with an exquisite appreciation of uncertainty, or consumer-focused real estate investors with an eye on alternative use (either on default or intentionally) – can struggle to get to grips with the sector and offer attractive pricing for vendors used to valuing business on multiples of beer and food sales.

REAL ESTATE POTENTIAL OF PUBS INCREASINGLY BEING REALISED

Looking into 2017 there are two key indicators that will, in our view, further crystallise this trend towards a more real estate focus on pub estates.

Firstly, the pub companies (‘pubcos’) themselves are looking at their assets as real estate as well as brewery taps. They are increasingly letting units out on commercial leases and to non-industry tenants. For example, Enterprise Inns aims to have at least 20% of its pubs in its commercial property division. However, in some cases these companies see this as a solution for failing pubs rather than as a core competence or focus.

Secondly, the risk-adjusted yield is significantly higher than many other property sectors. For example, NewRiver Retail recently purchased two portfolios of pubs at 12%+ net initial yields. As the major pubcos look to trim their estates, investors are ready to step in.

However, the financing structures of many pubcos prevent this happening quickly. With high levels of securitised debt with first call on the freehold, new investors need to be both bold and imaginative to release the real estate opportunity.

More immediately and outside of those securitisations, we estimate that around 50 new pubs will be built in 2017 by the major groups. At a value of up to £4m each, these present a long-income opportunity for the newest, brightest and most investor friendly real estate.

TENANTS OPTING FOR MARKET RENTS WILL CREATE A NEW OPPORTUNITY

Furthermore, the Market Rent Option will take hold. This allows tenants to free themselves from the ‘beer tie’ in return for an open-market rent. As a result, many of the leased and tenanted pub companies will (reluctantly) begin to build more conventional portfolios of rented pubs – again providing an exciting opportunity for specialist investors who understand the sector.

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DIVERSITY, INTEGRATION AND CONSOLIDATION IN HEALTHCARE REAL ESTATE

The healthcare real estate sector continues to attract significant interest and funding, and the promise of greater integration between social care and healthcare throws up new opportunities. Retirement Living will continue to be an area of focus.

A DIVERSE SECTOR ATTRACTING SPECIALIST INVESTMENT

Healthcare real estate supports one of the most diverse sectors of the UK economy, taking in everything from the most complex Intensive Care Unit through to assisted living residential communities. Investor appetite has focused on a few small segments of the market covering self-pay elderly care homes, consolidation of the Primary Care / GP surgery sector, development financing for the owner occupied retirement living market or selective targeting of 'close-to-investment grade' tenant credits across the market.

A combination of perceived reputational hazard, opaque outlook for public funding and procurement coupled with memories of some high profile distress, has until the last couple of years, kept all but the pioneering investor away. In spite of this, investors committed another £1bn to the market over 2016 and a cumulative £10.5bn since 2012. Momentum has increased but 2017 will see real market movement.

INTEGRATION AND CONSOLIDATION SPELLS PROMISE FOR HEALTHCARE INVESTORS

More integrated approaches to public sector funding and procurement will open up opportunities for responsible capital: Government has arguably been the silent party in the health and social care market for the last ten years. There are signs that this is changing. Barriers are starting to come down. The gulf between healthcare (the NHS) and social care (care and nursing homes) appears to be closing, creating efficient local healthcare economies requiring new, integrated facilities.

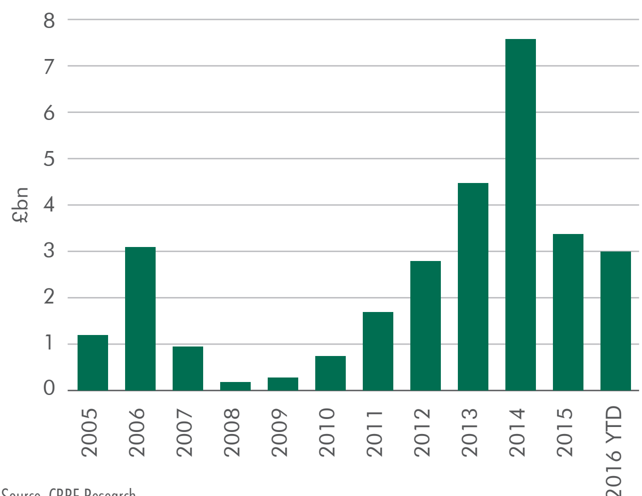
Likewise the real estate function has been dispersed, with everyone from single doctors, private sector providers and individual hospital trusts through to NHS Estates and Community Health Partnerships owning real estate. We expect to see a more integrated approach to funding, commissioning and ownership of public assets and services.

The next generation of Public-Private Partnerships will emerge and with an integrated approach the public sector could well end up with a robust long term model to enable 'patient' capital to partner with public-sector care providers. This journey will take time but 2017 will see foundations laid and investors will need to quickly understand the opportunity and position themselves to take advantage.

RETIREMENT LIVING IS STILL AN AREA OF INTEREST

Elsewhere, the Retirement Living revolution which we wrote about in our 2016 Outlook report is continuing. Until now, for most investors the Retirement Living sector has meant a development market for a premium sales model or a lower quality product based on affordable rents. In reality the customer has been demanding a quality product offering a rental model focused on care and security rather than just lifestyle. Investors are starting to wake up to this and a 'build to rent' elderly PRS market will emerge, becoming an interesting new option for long income buyers.

Figure 11: Investment in UK healthcare real estate, 2005-November 2016



Source: CBRE Research

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LONDON WILL CONTINUE TO DOMINATE THE EUROPEAN DATA CENTRE MARKET

The UK's data centre market (which really means London) will continue to grow in line with recent trends. Brexit is not a major issue but data protection issues will be of concern. The continued growth of cloud services will drive demand, with more firms willing to outsource to cloud service providers. There is a strong UK supply pipeline – which will help to maintain market equilibrium given strong recent take-up.

Representing around 80% of the total UK data centre capacity, London is the key data centre market in the UK. This dominance looks unlikely to change. London has 384MW of total data centre supply (at Q3 2016), which represents 44% of the total across the major European markets, which also includes Frankfurt, Amsterdam and Paris.

London is the largest 'colocation' data centre market in Europe by total supply, and always has been. Colocation data centres are those in which occupiers can lease IT rack space and associated power. During 2017, the market will grow by a further 8% to 10%, in line with recent trends.

"London has 384MW of total data centre supply, which represents 44% of the total across the major European markets."

DATA PROTECTION ISSUES AND CLOUD SERVICE PROVIDERS WILL SHAPE 2017

Two major trends will influence London's continued success in 2017 and beyond.

- **The continued growth of the major cloud service providers.** The sector has never been so reliant on such a small number of companies providing so much of the take-up of IT power. If these companies continue to be active in the UK, then the London market will continue to be successful.
- **Data protection regulation.** After Brexit, matching the EU framework will be important to ensure the free flow of data across borders. The UK risks losing data centre occupiers if hosting in the UK means being non-compliant with EU regulations.

However, the UK data centre industry will probably not be negatively affected directly by Brexit; we expect the industry to adapt to any concerns given the UK's global position as a major marketplace.

SUPPLY PIPELINE IS STRONG SO DEMAND FOR CAPACITY CAN BE MET

There is a strong and good quality supply pipeline which will ensure that new requirements can be satisfied in London. The UK is still a key marketplace for data centre occupiers because of rapidly increasing usage of applications powered by cloud service providers. Further ahead, there will be a resurgence in demand for data centre space from more traditional corporate sectors. This will strengthen London's digital ecosystem, maintaining its dominance as a European data centre destination.

Given the dominance of the cloud service providers in the European data centre market, there's a risk of oversupply if demand from that source reduces.

CORPORATES ARE INCREASINGLY WILLING TO RELY ON CLOUD SERVICES

Many large corporates are developing cloud strategies, and providers are increasingly developing solutions to the issues of governance, customer service and data protection which have prevented many potential adopters, to assist them in doing so. We expect cloud demand to grow strongly for the foreseeable future as more corporates integrate cloud solutions into their overall IT architecture. This will in turn drive growth in the data centre sector.

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CBRE RESEARCH

This report was prepared by CBRE's UK Research Team, which forms part of CBRE Research—a network of pre-eminent researchers who collaborate to provide real estate market research and econometric forecasting to real estate investors and occupiers around the globe.

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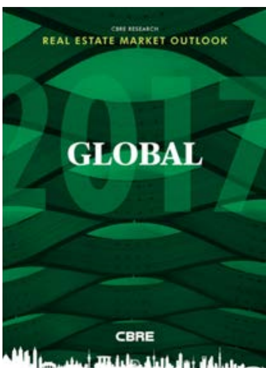

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