UKIT

UK Investment Transactions Bulletin Q4 2014

Lambert Smith Hampton

www.lsh.co.uk

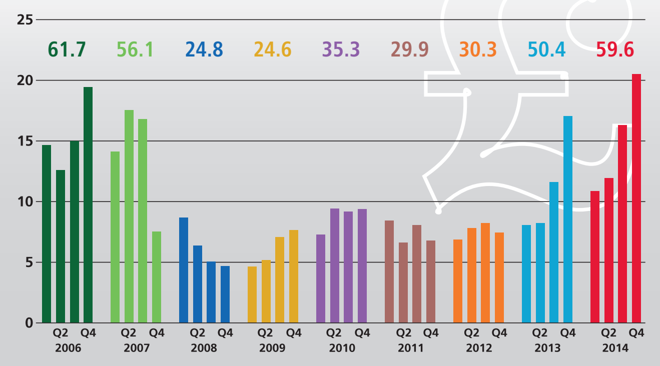
Record quarter for investment

- Investment volume of £20.5bn in Q4 2014 was a record for a single quarter
- Total volume for 2014 was £59.6bn, falling narrowly short of the 2006 high
- Investment in the regions reached £21.1bn in 2014, up 41% on 2013
- The All Property transaction yield stands at 6.11%, its lowest since Q2 2008
- All Property returns reach 19.3% in 2014, their highest since 2006

2014 was a stand-out year for the investment market. £20.5bn of commercial property assets changed hands in Q4 2014, the highest volume ever seen in a single quarter. This propelled investment for 2014 as whole to £59.6bn, the highest annual total after 2006.

The resurgence of institutional investors and improving economic sentiment beyond the capital saw investment into the regions reach £21.1bn for the year as a whole – up 41% on 2013. While Q4 2014 saw a substantial £9.3bn of inflows into London, 2014 investment into the capital fell 7% short of 2013's record annual total.

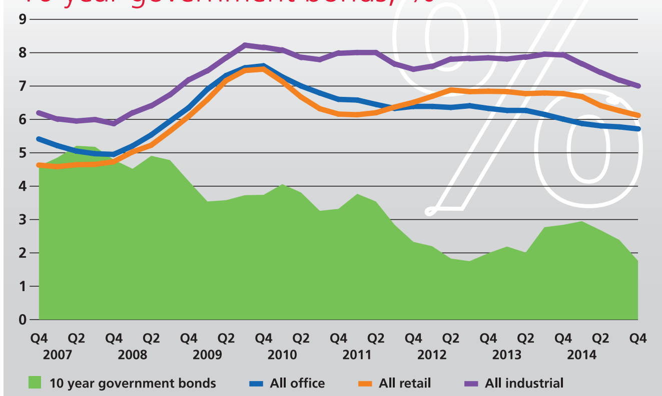
UK Investment market activity, £bn



Source: LSH Research, Property Archive, Property Data

The All Property transaction yield moved in by 2bps during Q4 to stand at 6.11%, its lowest level since Q2 2008. While the All Property transaction yield was broadly stable during the second half of 2014, it stands 43bps lower than 12 months ago. This underlines the continued strength of demand for UK commercial property, with All Property returns reaching 19.3% in 2014, its strongest annual outturn since 2006.

Rolling annual transactional yields & 10 year government bonds, %



Source: LSH Research, Oxford Economics

Outlook

2014 will be remembered as a stellar year for UK commercial property, with regard to both the volume of activity and the extent of yield-driven returns. The outlook is positive for 2015, although performance is expected to moderate to more sustainable levels, with the pace of capital growth easing down and income growth returning as the main driver of property performance.

The prospects for further yield compression are more limited over the year ahead – prime yields are either at or close to their historic lows, while a degree of election-related uncertainty is entering the market. Encouragingly, we expect 2015 to mark the return of meaningful, above-inflation rental growth beyond London and the South East. This is especially true of offices and industrial, where supply is becoming increasingly constrained.

The economic outlook for 2015

The UK economy performed impressively in 2014, with the latest official estimate of 0.5% growth in Q4 taking annualised growth to 2.6%, the best performing of the G7 Nations. While the outlook for 2015 brings greater uncertainty, both economically and politically, the consensus points to continuing robust growth over the coming year.

Productivity improving as real wages rise

The UK's record on employment has been remarkable over the past few years, with the working population at an all-time high and unemployment at 5.8%, its lowest since Q3 2008. Moreover, for the first time since 2009, wage growth has moved ahead of inflation which indicates that productivity is also improving. Rising real wages should underpin consumer demand and support ongoing growth in the UK economy.

Low inflation will help rather hinder the UK outlook

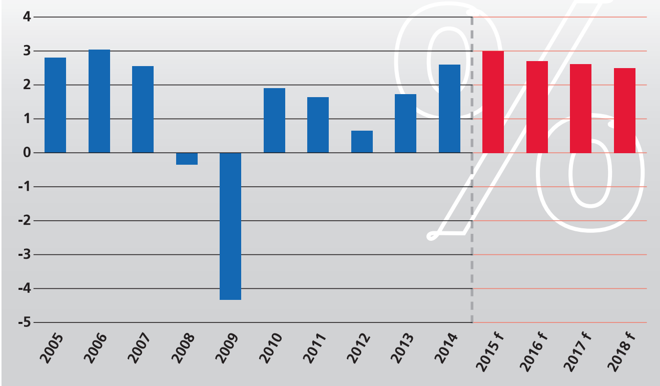
The prospect of continued real wage increases has been given an additional boost by a sharp fall in CPI inflation which, at 0.5% over the year to December 2014, is equal to the lowest rate in its 25 year history. While low and falling inflation can prompt concerns over demand, the recent trend is attributed to a halving in oil prices over the past six months, brought about by softening global demand and high output in the Middle East.

While low oil prices will have implications for the North Sea oil industry, it is likely to be a boon for UK consumers. Lower costs are feeding through to lower petrol, utilities and food prices which will free up more disposable household income and boost growth. Reflecting these changing circumstances, the EY item club recently revised up its forecast for UK economic growth in 2015 to 2.9%, a 0.5% improvement on its previous forecast.

Interest rate rise as late as 2016?

Given the very real prospect of inflation averaging less than 1% throughout 2015, consensus is increasingly leaning to a first interest rate rise as late as Spring 2016. When the rise does take place, the Bank of England has been mindful to make clear that any increases towards 'normalised' rates will be gradual, and this should support the improvement in the lending appetite to consumers and businesses alike.

GDP growth, % pa



Source: ONS, Oxford Economics

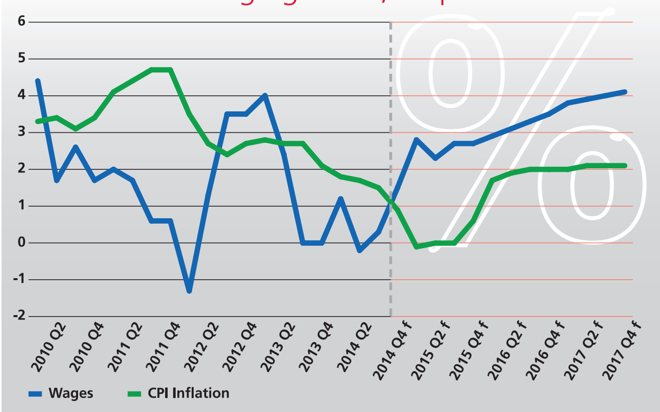
Election uncertainty

Domestically, there is uncertainty around the outcome of May's general election, and the prospect of a hung parliament is a strong possibility. The two main parties also have diverging stances over taxation, public spending and the pace of austerity, which may delay decision making. However, arguably greater risk surrounds a possible referendum over the UK's membership of the EU in 2017, which may change the perception of international investors towards the UK.

Eurozone weakness is the main downside risk

Stagnating growth in the Eurozone arguably presents the main risk to the outlook, and the UK will be reliant on strengthening domestic demand to offset weaker prospects from our largest single trade partner. However, it is hoped that the ECB's recent announcement of a 1.1 trillion Euro package of quantitative easing will reignite Eurozone growth in the near future.

Inflation and wage growth, % pa



Source: ONS, Oxford Economics

Sector focus

While Central London offices was key to Q4's record turnover, each of the three main sectors saw higher volumes in 2014 compared with 2013. 2014 was also a record year for activity in the alternative sectors, with student accommodation, healthcare and automotive combined seeing £7.4bn of deals.

Landmark deals boost office volumes in Q4

Offices accounted for the lion's share of Q4's record investment, with £9.8bn of offices changing hands, or 48% of total volume. The average transaction yield for all UK offices now stands at 5.5%, its lowest level since Q4 2007.

Q4 saw a substantial £7.8bn of investment in Central London offices. This was underpinned by several headline deals, including Qatar Investment Authority's £1.18bn purchase of 8 Canada Square (4.75% NIY) and the Safra Group's £724m purchase of 30 St Mary Axe (The Gherkin) reflecting 3.80% NIY.

However, investment in Central London offices over 2014 fell 10% short of 2013's record. This arguably reflects a shortage of stock, as London's status as a magnet for global capital flows remains undiminished. In contrast, investment in offices outside the capital increased by 40% on 2013's level to reach £8.2bn in 2014. This underlines the resurgence of institutional demand and improving prospects for rental growth outside the capital.

Major shopping centre deals fuel retail volumes

£3.5bn of retail assets traded in Q4, taking the total for 2014 to £12.8bn – an increase of 13% on 2013. Shopping centres were key to this increase, however, with £5.3bn of assets changing hands, the highest volume since 2006. The largest shopping centre deal of the year was Land Securities' purchase of a 30% stake in Bluewater for £656m (4.10% NIY) in Q2 2014.

The proliferation of major retail lot-size deals reflects the polarisation in the retail sector, with locally dominant retail centres attracting strong demand. Despite a halving in volumes from Q3, retail warehouse investment reached a six-year high of £2.85bn in 2014. The sector's appeal for Click & Collect has reinvigorated investor demand, with the transaction yield moving in by 78bps over the last 12 months – the strongest shift among the retail sub-sectors.

Record year for industrial investment

Industrial enjoyed a stellar year, with investors attracted to positive fundamentals of acute Grade A supply shortages and rising demand through the growth of ecommerce. Industrial transaction yields have moved in sharply over the past 18 months, while total returns of 24.4% on the IPD index were the highest of the three main asset classes in 2014.

Industrial volume reached an annual record of £6.66bn in 2014. South East Industrial saw a substantial £500m of activity in Q4, up 90% from Q3. This was driven by two portfolio deals, Dunedin and Brockton Capital's £225.5m purchase of the Partridge Portfolio (6.80% NIY) and Orchard Street's £113.8m purchase of the Orbital Portfolio (6.10% NIY).

Transaction yields and volumes

Sector	Volume (£bn) Q4 2013	Volume (£bn) 2014	Volume (£bn) 2013	Yield Q4 2014	Yield Q3 2014	Yield Q4 2013	3 month movement (b.p.)	12 month movement (b.p.)
Shops	£1.76	£4.67	£4.63	5.00%	4.89%	4.98%	11	2
Shopping Centres	£1.05	£5.26	£4.22	6.94%	7.05%	7.57%	-12	-63
Retail Warehouse	£0.67	£2.85	£2.47	6.20%	5.81%	6.98%	39	-78
All Retail	**£3.48**	**£12.78**	**£11.33**	**6.15%**	**6.02%**	**6.71%**	**13**	**-56**
Central London Offices	£7.79	£17.08	£18.97	4.58%	4.71%	4.39%	-12	19
Rest of South East Offices	£0.58	£2.27	£1.92	6.44%	7.54%	7.69%	-110	-125
Rest of UK Offices	£0.99	£3.27	£2.05	8.29%	6.46%	7.96%	183	33
Office Parks	£0.42	£2.62	£2.01	7.05%	7.53%	8.54%	-48	-149
All Office	**£9.78**	**£25.25**	**£24.95**	**5.52%**	**5.63%**	**5.73%**	**-11**	**-21**
South East Industrial	£0.50	£1.15	£0.73	6.67%	5.88%	7.06%	79	-39
Rest of UK Industrial	£0.64	£1.93	£1.47	6.98%	8.77%	8.13%	-179	-115
Distribution Warehouse	£1.12	£3.58	£2.63	6.60%	6.56%	7.04%	4	-44
All Industrial	**£2.26**	**£6.66**	**£4.83**	**6.73%**	**6.73%**	**7.41%**	**-0**	**-68**
Hotels	**£1.05**	**£3.83**	**£2.00**	**5.90%**	**7.21%**	**5.61%**	**-131**	**29**
Other (incl. Leisure and Portfolios)	**£3.92**	**£11.07**	**£7.33**	**6.87%**	**7.39%**	**7.35%**	**-52**	**-48**
All Property	**£20.50**	**£59.60**	**£50.43**	**6.11%**	**6.13%**	**6.54%**	**-2**	**-43**

Source: LSH Research, Property Data, Property Archive

Regional focus

Substantial levels of investment activity returned to the UK regions in 2014. While strong competition for London assets remains unabated, and largely driven by overseas demand, the capital's share of UK total volumes slipped to 43% in 2014, its lowest since 2006.

Sharp rise in regional investment

Investment into single asset regional property reached £5.4bn in Q4, taking the total for 2014 to £21bn, 41% above 2013 and the second highest figure on record. The emphatic resurgence of UK institutional investors has been key – buoyed by improving economic sentiment beyond the capital and a search for higher returns, capital inflows from this investor-type increased by 48% in 2014.

All of the UK regions saw stronger investment activity in 2014 than in 2013. While the South East continues to be the most heavily invested region outside London, the North West has seen a substantial 67% increase in activity year on year. Manchester has had an unforgettable year, with the city seen to offer sound prospects for growth while providing an attractive alternative to London among institutional investors.

Investment in Scotland rebounds in Q4

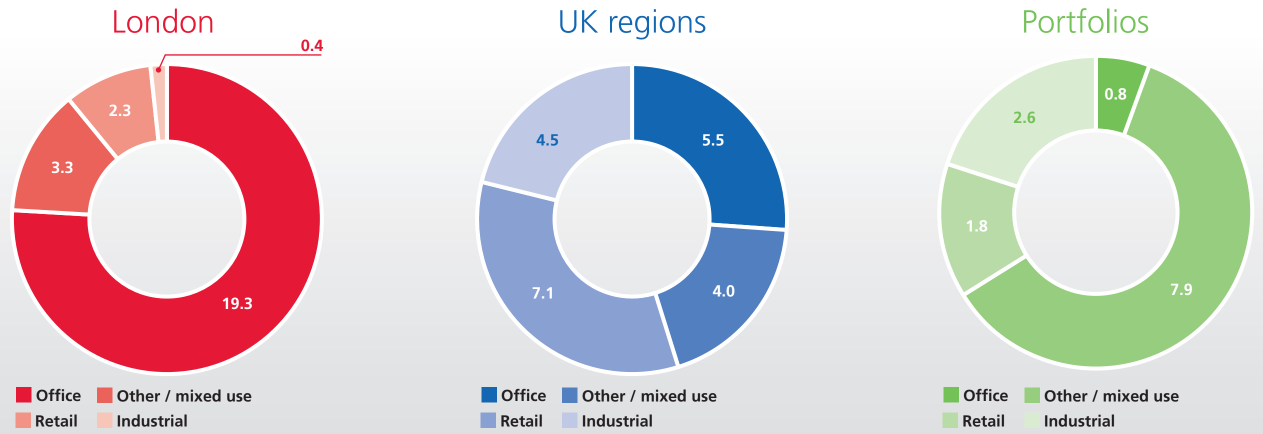
Scotland has seen a post-referendum rebound in activity, with Q4 investment increasing to £1.0bn, its highest quarterly total since Q2 2007. A number of large retail deals boosted volumes – HSBC Alternative Investments' purchased The Almondvale Retail Park, Livingston for £224m; and Land Securities bought the remaining 50% stake of Buchanan Galleries, Glasgow for £138m.

Record period for portfolio deals

The increased emphasis on regional investment is more significant when portfolio deals are factored in to the equation. Portfolio deals amounted to a quarterly record of £5.5bn in Q4 2014, taking the total for 2014 to a record annual high of £13.0bn. In search of large lot-sizes, portfolios have also been a key source of overseas investment outside the capital.

US private equity buyers dominated the portfolio market in Q4, accounting for 66% of volume and each of the six largest deals. Key examples included Lone Star's £1bn purchase of Moorfield Real Estate Funds I and II; and Northwood Investors' £635m purchase of The Highcross Portfolio.

2014 London and regional breakdown, £bn



Total investment

Source: LSH Research, Property Archive, Property Data

Buyers and sellers

Overseas investment in UK property was a record £27.6bn in 2014, up 14% on 2013, while 16 of Q4's largest 20 deals involved overseas buyers. Overseas buyers have provided a major source of demand for UK property in recent years, accounting for 46% of total UK volume in 2014.

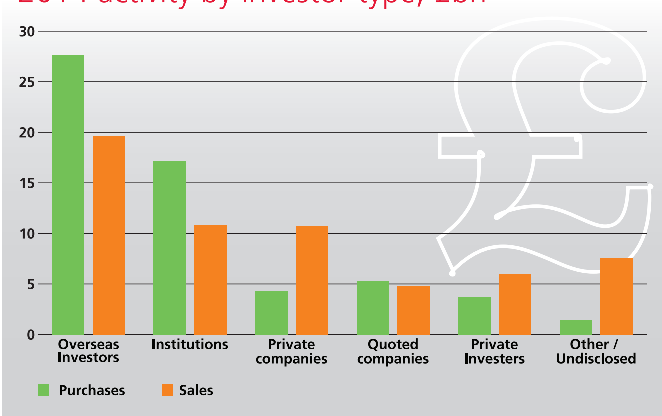
However, it is interesting to note that overseas investment into London in 2014 actually reduced slightly on 2013. This indicates that overseas appetite is increasing for assets outside the capital, where competition for stock is intense.

US investment in UK property doubles in 2014

Overseas buyers were net investors in UK property to the tune of £7.9bn in 2014. This was due in large part to strong activity from US banks and private equity funds, who view the UK as an attractive location for investment in large lot-sizes. The substantial influx of US money to UK property has been partly offset by lower investment from other parts of the world in 2014, namely the Middle East, Europe and Far East.

Europe's reduced investment in UK property is likely to reflect increasing weakness in the Eurozone and the relative strengthening of Sterling. Far Eastern investment is expected to feature prominently again in 2015, with the Japanese Government Pension Fund set to invest up to £43bn in global real estate and choosing London as the base for its operations.

2014 activity by investor type, £bn



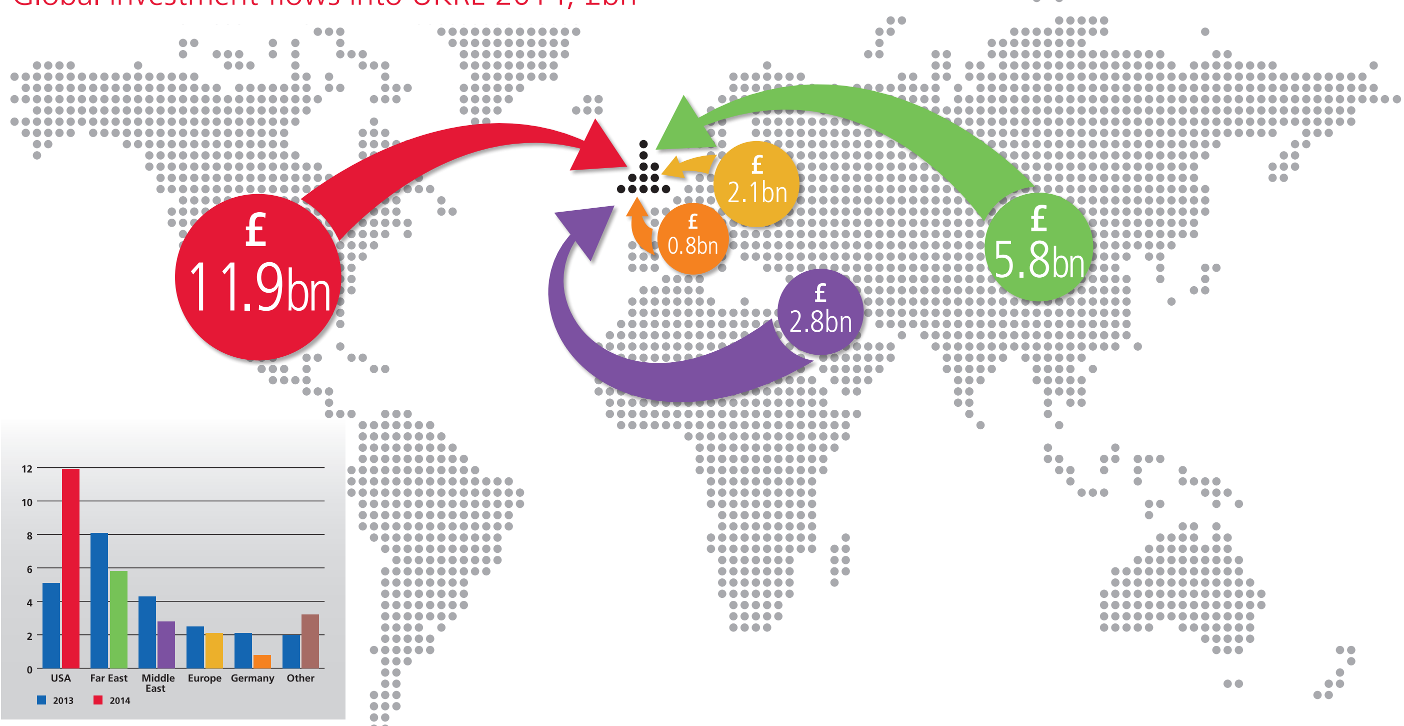
Source: LSH Research, Property Archive, Property Data

M&G retains position as most active institution

The UK institutions are also a major source of demand for commercial property. A strong weight of money saw the institutions invest a record £17.2bn in 2014, 20% above the previous high of 2006. Moving forward, we expect the institutions to capitalise on strong overseas competition by selectively selling out of London assets to invest in higher yielding opportunities elsewhere in the UK.

As was the case in 2013, M&G proved to be the most active institutional buyer of UK property in 2014, purchasing £2.2bn of commercial stock. Their largest acquisitions comprised Spinningfields Square in Manchester for £320m and, in Q4, a portfolio of six hospitals from The Priory Group for £233m.

Global investment flows into UKRE 2014, £bn



Source: LSH research, Property Archive, Property Data

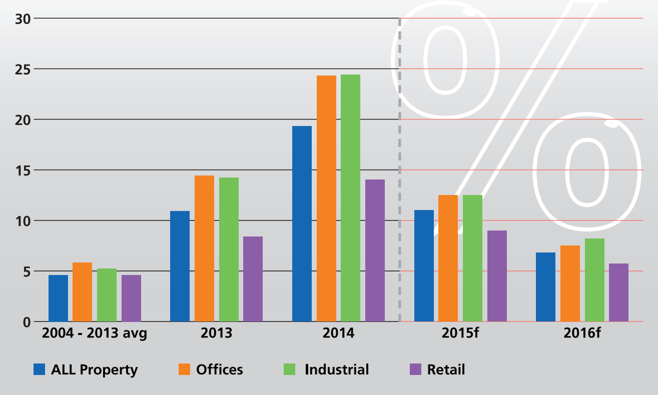
The outlook for 2015

2014 was an exceptional year for the investment market, while growing confidence in the economic recovery has seen occupier sentiment improve around the country. However, with increased economic and political uncertainty ahead, can the positive momentum be sustained in 2015? Below is our assessment of the main risks, together with our key predictions for the year ahead.

Uncertainty around the outcome of May's general election is not expected to derail the positive momentum in the markets. The most likely scenario is a temporary softening of transaction activity, as some investors sit on their hands and await the outcome, or possible shape of a coalition government.

The impact of Eurozone weaknesses should be offset by strengthening domestic demand. As our single largest trade partner, the UK's growth prospects depend partly on improving fortunes in the Eurozone. However, falling oil and commodity prices should stimulate domestic demand. This bodes well for the ongoing recovery in the occupier markets, which stand to benefit from rising consumer confidence and business investment.

Total return forecasts, % pa



Source: LSH Research, IPD

The market has little to fear from rising interest rates. With inflation expected to average less than 1% across 2015, the first rate rise could come as late as Spring 2016. If and when rates do move up, it will have a negligible impact on pricing provided the transition to 'normalised' rates is slow and gradual. Despite pronounced yield compression during 2014, the yield differential between property and UK bonds will remain substantial enough to retain property's appeal to investors.

The outlook is more uncertain but we are optimistic that another good year is in store for commercial property. Below we set out our key expectations for the year ahead.

1) Another year of double-digit returns

We expect 2015 to be another good year for property investment performance, with forecast All Property returns of circa 12%. Reflecting more limited prospects for prime yield compression, the pace of capital value growth is expected to ease down, with total returns moderating towards trend in subsequent years and driven by income growth.

Improving prospects for rental growth will attract more investors up the risk curve, both sectorally and geographically. By nature, secondary properties benefit from higher income returns over prime, but we expect this to be augmented by rising rental levels in the tightly supplied office and industrial markets.

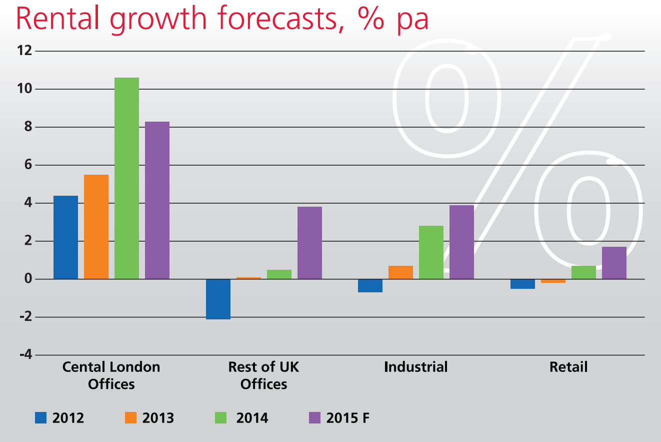
Harder to predict is the quantum of investment market activity. Despite the rise in available stock in latter 2014, sales volumes are unlikely to match last year's extraordinary levels. Nevertheless, we expect volumes to comfortably exceed the ten-year annual average of circa £40bn.

2) International investment will diversify and spread into the regions

Despite election uncertainty, ongoing geopolitical and global economic upheaval will maintain strong overseas appetite for UK property. Far Eastern investors are expected to be particularly acquisitive in 2015 and, with London looking increasingly expensive, top tier regional markets should increasingly benefit from rising overseas interest, following in the footsteps of the US Funds.

3) Industrial to see strong rental growth

Severe shortages of good quality supply will exert strong upward pressure on industrial rents during 2015, with rents in prime South East and West Midlands markets set to grow at their fastest rate in a generation. Speculative development is expected to gather pace in 2015 as investors seek to take advantage of supply shortages. However, development will not be sufficient to keep up with demand, and rents for second-hand space will come close to prime levels in the tightest markets.



Source: LSH Research, IPD

4) Speculative development returns to regional office markets

Positive occupier sentiment returned across the UK's office markets in 2014, and many regional markets recorded their best year of take-up since the last recession. Strong investor appetite for regional office stock will continue into 2015, particularly for value-add opportunities, as dwindling supply puts upward pressure on rental levels.

Speculative development will increase in 2015 and spread into each of the major regional cities. With pent-up demand growing for new space and a raft of major lease expiries in the pipeline, the delivery of new-build schemes is likely to set new headline rents in a number of markets, with examples including Bristol, Birmingham, Leeds and Cardiff.

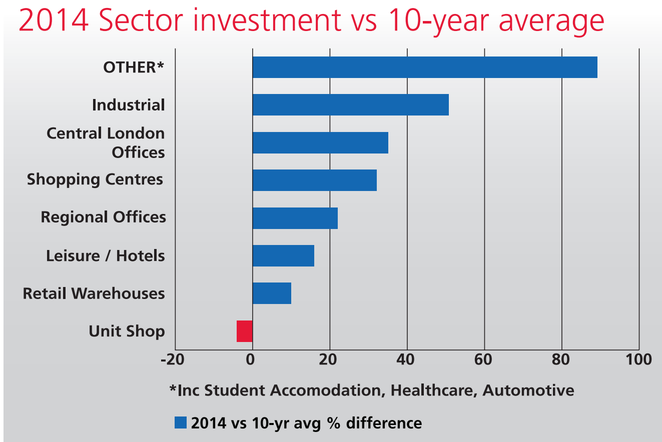
5) Continuing polarisation in the retail sector

While the outlook for UK retail is the least sanguine of the main sectors, structural change does present opportunities. Large retail centres which offer a combination of leisure and retail will perform well, with vacancy rates set to reduce to six-year lows. The rise of ecommerce and changing shopping patterns also brings opportunities, and we expect Click & Collect units to continue their rapid expansion at transport hubs and within suburban areas.

2014 was a tumultuous year for the major supermarket operators, with the value chains eating into market share. This may provide an opportunity for the investment market, with the major chains embarking on sale and leaseback packages of their successful stores in order to prop up their balance sheets.

6) Another record year for alternative investment

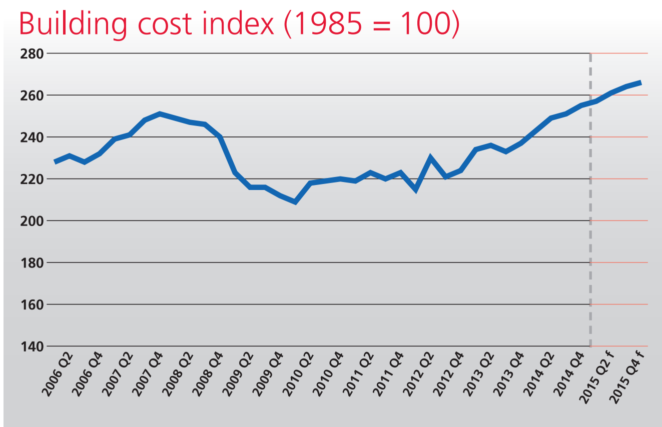
With continuing weight of money in the market, we anticipate investment into 'alternative' asset classes to hit another record level in 2015. A number of the major institutional investors have significant allocations for sectors including Private Rented Sector (PRS), healthcare and student accommodation. In time, these relatively immature sectors will be considered mainstream asset classes.



Source: LSH Research, Property Data, Oxford Economics

7) Rising build costs to be partly offset by falling input prices

The sharp rise of labour costs in the construction sector should be partially offset by falling prices of raw materials. Still, BCIS forecast tender prices to increase by an average of 4.3% in 2015, as demand for building work outstrips supply, particularly in London. Building firms are struggling for good quality employees, many of whom left the industry during the last downturn. Contractors are being more selective over tender opportunities, putting upward pressure on prices.



Source: BCIS

About us

At Lambert Smith Hampton, our clients mean a lot to us. Our success and reputation depends on how we contribute to their success and reputation. So why do our clients choose us? There are many reasons, but chief amongst them is that we're unashamedly and single-mindedly focused on the UK and Ireland. This means that we're on the ground, in the thick of it, at the heart of things. We're not here, there and everywhere. We're just here.

We want to understand all our clients' issues, from the huge right down to the tiny. This is – and always will be – the Lambert Smith Hampton approach. No stone is left unturned. No angle goes unconsidered. Every job is important.

It sounds like hard work. It is. But that's how success happens.

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