PRIME PROPERTY OUTLOOK 2019

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WELCOME TO PRIME PROPERTY OUTLOOK, OUR VIEW ON WHAT WILL DRIVE THE COMMERCIAL, RESIDENTIAL AND RURAL PROPERTY MARKETS IN 2019, AND THE OUTLOOK FOR PROPERTY PERFORMANCE.

We are writing at a time of almost unprecedented uncertainty, with politics affecting the real economy as almost never before. But away from Brexit, technology continues to drive immense structural change, and new policy initiatives will alter the way in which markets operate. It will be a fascinating year!

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KEY DRIVERS

ECONOMIC & DEMOGRAPHIC DRIVERS

- Consensus forecasts suggest **economic growth** of 1.5% in 2019, up from a projected 1.3% in 2018. This is well below the long-term average, and growth will remain subdued over the medium term. A "no deal" Brexit would reduce projected economic growth in 2019, whilst an increase in certainty may create a modest "Brexit bounce".

- Having peaked at 3.1% in November 2017, CPI **inflation** fluctuated within a range of 2.3-2.7% for most of 2018. It is forecast to moderate a little further to circa 2% by the end of 2019.

- Following the EU referendum, **Sterling** fell by more than 10% against the US dollar. Another devaluation would further encourage overseas investment into UK real estate, but would increase inflation. Currency movements would also affect the rural sector in terms of commodity prices and therefore farm profitability, but a devaluation could benefit those high streets that rely on overseas tourists.

- The UK has seen an extraordinary run of **employment growth** in recent years, with nearly two million additional employees added to the UK's workforce over the last five years. 2018 is likely to have seen around 400,000 additional workers, close to the five-year average, but we expect this figure to slow dramatically to under 70,000 in 2019, as skill shortages increase.

- With the pool of skilled labour shrinking further in 2019, **wage pressures** will mount. We expect average wages to rise by circa 3% in 2019. With wage growth likely to be above inflation, consumer spending should rise a little compared with 2018, but will remain historically weak, offering little respite for the high street.

- Global interest rates are rising and **bond yields** are likely to increase further. However, these will still be historically low, and maintain a significant gap with property yields.

- UK short-term interest rates are also likely to rise, although this would be less certain in the event of a "no deal" Brexit. This should be limited and gradual, but a key risk is that the **base rate** rises faster than currently expected. This would impact adversely on consumer expenditure, business confidence, the residential market, and the profitability and debt serviceability of the farming sector. Indeed, the banks are increasingly aware of this and are already factoring it into their lending decisions.

- **Population growth** will continue at a rate of circa 400,000 pa, focused on the key urban centres, and this is unlikely to be slowed by Brexit. There are implications across the property spectrum, with increased demand for housing, food production and waste disposal facilities.

- **Transport infrastructure** will be a major driver of growth, with progress being made on projects such as HS2, the Oxford to Cambridge link and Northern Powerhouse Rail. This will continue to generate opportunities for the property sector.

- The UK's **broadband capability** is not keeping pace with the global competition. 5G (the next generation of mobile communications technology) will require more sites for infrastructure.

KEY DRIVERS

BREXIT

- **Article 50** expires on 29 March, at which point the UK will leave the EU (barring a major political intervention). If the Withdrawal Agreement can be ratified, the UK will then enter a transition period until the end of 2020. This Agreement will outline the broad nature of the future relationship between the UK and the EU, but the detail would be negotiated during the transition period (and probably beyond). The multitude of issues around trade relations and other matters will take many years to resolve. Failure to reach agreement would clearly mean significant political and economic uncertainty in the short term.

- **Uncertainty** over Brexit is undoubtedly holding back investment and decision-making across the household and business sectors, as well as occupier demand across the commercial property spectrum. However, businesses adapt quickly to changed circumstances, and business investment could rebound sharply if a clear direction of travel emerges. More political 'fudge' could have the reverse effect.

- Trade agreements will continue to be a major risk for UK **agriculture**, as will access to the EU's labour force, and until such issues are resolved rural businesses will have to prepare for the worst case scenario – the closing of EU borders and reverting to World Trade Organisation tariffs.

- In the **residential** sector, Brexit uncertainty is deterring vendors from marketing their properties, meaning that the supply of properties for sale has been unusually tight this year. Conversely, uncertainty has been positive for the lettings market as potential buyers look to rent while the market is in flux.

- Brexit will continue to 'crowd out' a myriad of other issues and consume a large amount of political capital – issues such as **elderly care, housing, infrastructure, pensions**, and raising the UK's productivity. A lack of parliamentary time for non-Brexit matters will also slow the passage of important bills relating to major infrastructure projects.

- A rise in **certainty** (whatever the outcome of the negotiations) should mean occupiers, landlords, developers, and investors feel more able to take decisions in the latter part of the year, assuming the overall economic outlook remains benign (which we expect).

- Related to Brexit uncertainty is the risk of a **general election**. A change to a Labour Government under Jeremy Corbyn would see a major shift across a raft of policies, which could include banning zero hours contracts, raising the national living wage, nationalising several utilities and accelerating public sector housebuilding.

LEGISLATIVE & POLICY DRIVERS

- The Government is proposing to introduce additional **Stamp Duty Land Tax** (SDLT) of 1% on overseas buyers of residential property. While it is a relief that it has watered this down from 3%, we suspect it could result in falling activity across parts of the market in 2019, notably in central London and potentially in university towns where many overseas students purchase flats while studying.

- **Mortgage tax relief on buy-to-let (BTL) properties** will see yet further tapering in 2019 (to 75%). We have already seen an impact and this, plus the proposed SDLT overseas levy will mean fewer BTL investors coming into the market. Data from UK Finance shows that BTL mortgages are already down by an average of 36% since April 2016 while there has been an increase in first time buyer mortgages over the same period of around 18%.

- We are expecting a **ban on some fees charged by letting agents and landlords** to their tenants (such as charging for an accompanied viewing, receiving an inventory, signing a contract, or renewing a tenancy) to come into force in 2019. However, landlords are likely to have to pay for referencing, tenancy paperwork and inventory check-out reports and will probably bear the brunt of the ban in the immediate term as their agents will not be able to pass much of this cost on to tenants.

- The **Agriculture Bill** will fundamentally reform the sector and is undoubtedly the most significant change in UK farming policy in 70 years. Direct payments to farmers will be reduced from 2021 and completely phased out by 2028. However, despite the knowledge of this change, there is currently insufficient clarity and too long a transition period for any certainty over the impact.

- Official projections for new household formation have been revised sharply downwards, reducing the calculated **housing need** in many local authority districts. The government has stated that is will revise the standard method for calculating housing need to bolster its target of 300,000 homes pa. If this doesn't happen then local authorities may use it as an excuse to decrease the number of new homes set out in local plans.

- The issue of **land value capture** will feature strongly in 2019. Increasingly, Homes England and local authorities will look to get increased infrastructure funding (both hard infrastructure and social infrastructure) from land value, so the burden of CIL and Section 106 agreements is likely to rise. This will become an increasingly important part of planning proposals, most notably where placemaking is an important aspect.

- **Affordable homes delivery** will be a key issue. With relaxed borrowing criteria through the lifting of the HRA cap, we will see more councils looking to provide housing. This will require more joint ventures with the private sector, as local authorities no longer have the capacity to undertake major housebuilding programmes.

- New **CIPFA guidelines** are likely to be released, which will provide further limitations on the extent to which local authorities can borrow to invest in commercial property.

SECTOR OUTLOOK

RESIDENTIAL

- In some areas, for example parts of the Midlands, the North and Yorkshire, the market appears to have reached a natural equilibrium with pricing in line with earnings, and transactions held up well in 2018. In contrast, across the South, East and London where prices are very out of step with average incomes, transaction levels have cooled markedly. The current low level of sales is likely to persist until earnings growth begins to improve the house price to earnings ratio.

- We expect that the lower end of the affordability spectrum will continue to fare well in 2019. Property pricing that attracts lower stamp duty (SDLT), and transactions where first time buyers are SDLT exempt will be very popular, as they have been in 2018. Properties where affordability more closely aligns with earnings will be the most attractive. Furthermore, those properties at a lower price point will also attract potential cash buyers who would not be effected by the negative financial implications of the changes in mortgage tax relief on BTL properties.

- In all of the above scenarios it is London that will be negatively impacted as housing at a lower price point is simply not achievable here. However, high quality, well located prime property will continue to be in high demand.

- Prior to the EU referendum in June 2016 the market was robust, transactions were at healthy levels and there was an overall air of positivity. Demand remains robust, although many buyers feel they have the upper hand given the uncertainty and are demanding reductions which for many are unreasonable. A Brexit “deal” in March could unleash some pent up enthusiasm, with an increase in listings and potential buyers, although this is likely to feed through gradually.

- More landlords are now exiting (particularly ‘accidental’ landlords), despite the lacklustre sales market. The tapering of mortgage tax relief to 75% in 2019 and the expected ban on some fees charged by letting agents and landlords could result in this trend accelerating. Occupier demand in the lettings market should remain strong, but with more landlords exiting supply will reduce, creating upward pressure on rents.

RURAL

- The UK's agricultural **land market** has held up relatively well over the last 12 months with only a modest correction in pricing noted, despite the uncertainties surrounding Brexit. However, the sector will remain in a state of limbo until there is more clarity on issues such as trade and changes to subsidy. Except in the case of distressed or tax-related sales, in terms of Inheritance Tax and Capital Gains Rollover, landowners will be unlikely to put assets to market, thus supply is likely to remain limited during the first half of 2019 at least.

- We expect **demand** to be stable in 2019, similar to 2018, although in the event of an extended negotiation period on Brexit, whereby uncertainty is prolonged, there will continue to be limited activity for much of the year. There may be opportunities to purchase land at a realistic price where Brexit has already been factored in. Investors who do buy will generally do so for reasons not reliant on income producing assets or where there is long-term potential to diversify, at least in the short-to-medium-term.

- Overall, **pricing** will continue to come under pressure, with values expected to stabilise in some areas and experience some downward movement in other parts of the country. However, with Brexit already priced in we do not anticipate a significant fall in **land values** whatever the outcome.

- Macroeconomic factors will not impact evenly across the agricultural sectors. For example, the **livestock sector** is likely to suffer from changes in trade tariffs, as UK trade levels are currently in deficit with the EU, while the **dairy sector**, which imports more than it exports, may benefit post-Brexit under a change in tariff levels.

- **Lifestyle farms** should maintain resilience over commercial farmland. Estates with residential property and/or diversification opportunities are in a strong position to withstand Brexit, but only if they are income generating or have long-term change of use potential.

SECTOR OUTLOOK

COMMERCIAL

- An acute **shortage of quality supply** will drive rental growth in a number of key markets across the office, industrial and distribution sectors. This can be seen in city centre office markets such as Bristol, Cambridge, Leeds and Oxford, where **limited speculative development** in recent years and strong occupier demand means grade A supply will remain constrained over the next 12-24 months.
- **Office occupiers** are increasingly focusing on quality over cost, and elements such as natural light and other wellness factors are becoming increasingly important. This is helping to forge a widening divergence between the prime and secondary markets.
- We see no let-up in demand for **large industrial units** in 2019. However it will continue to be hugely challenging for developers to satisfy the needs of industrial occupiers. As land becomes more scarce and expensive, particularly in the South East, developers are becoming increasingly creative. The **multi-storey concept**, and in particular the convergence of urban logistics with residential, could gain more traction in 2019.
- Vehicle movements are being taken away from city centres, making the servicing of retail and residential more difficult. The distribution market will need to adjust to the introduction of **electric & hybrid vehicles and low emission zones**, which will be a major trend over the next few years.
- There is a severe shortage of units for **last mile delivery** and also waste recycling. **Open storage sites** will remain in strong demand in 2019, for a wide variety of storage and parking uses. This sector is often overlooked but is evolving into an asset class in its own right, and can attract strong rents, particularly in the South East. However, as sites continue to be taken for higher-value residential use, land and rental values will see further increases.
- The relentless shift towards online retailing continues. Internet sales accounted for a record 21.5% of total retail sales in November, compared with only 6% a decade ago. On the high street, this has meant a shift towards **independent retailers**, which do not sell generic goods easily bought online. More major retailers could go into administration or become online-only in 2019, spurring additional demand for distribution warehousing solutions.
- The **food & beverage sector** has seen some over-expansion in recent years and is going through a period of consolidation. This market is notoriously fickle, and its reliance on discretionary spend makes it vulnerable to an economic downturn or further fall in consumer confidence.
- There is a huge opportunity in repurposing unwanted retail property and underperforming shopping centres, and in **reinventing town centres**. However, local authorities need to be pragmatic, as well as ensuring responsible development. Overall, we think 2019 will be a fascinating year for the high street.

THE OUTLOOK FOR CENTRAL LONDON

KEY DRIVERS

- Although delayed, the opening of the **Elizabeth line** will revolutionise east-west transport across London and relieve pressure on the existing underground network. We expect this to generate further office rental growth in the areas is connects.

- Greater London is forecast to see output growth of 2% in 2019, well above the UK average of 1.5%. The capital's population is projected to grow by more than 100,000 during the year, in line with recent trends. However, **employment growth** will reduce, reflecting the national trend, although more than 40,000 net additional workforce jobs are nevertheless projected to be created across the capital.

- Concerns have decreased over the outlook for London's **financial services** sector post-Brexit, and the vibrant technology sector will be important in maintaining economic growth. Fintech is likely to become an increasingly important driver of jobs and demand for office space. However the tech sector relies heavily on attracting the right global talent, which Brexit has the potential to disrupt if immigration controls become more restrictive.

CENTRAL LONDON OFFICE

- **Occupiers are becoming increasingly footloose** and the Elizabeth Line will serve to accelerate this trend as movement across London becomes easier and quicker. Occupier diversification is being actively encouraged by landlords and the economic development agencies in some locations. For example, Canary Wharf Group is promoting Canary and Wood Wharfs to the fintech sector, and the City of London Corporation is actively courting occupiers from the creative, media and technology sectors.

- The take-up of **co-working space** will continue at a robust rate, and demand is likely to move up the size curve. We will also see smaller-suite landlords offering shorter and more flexible leases in order to compete with the flexi-office leasing model. This is being done increasingly overtly, rather than landlords being forced to do so through negotiation. Some landlords are also offering space on a fully-fitted basis, although they are not offering the full suite of services that operators such as WeWork provide.

- In 2019 we expect rents to plateau in the **West End, Midtown and South Bank**, underpinned by low vacancy, except in the **Mayfair and St James's** prime market where rents are likely to decline modestly as occupiers continue to seek better value space in neighbouring districts. We also expect the **City, City Fringe, Docklands and West London** sub-markets to witness a modest decline in rents, reflecting Brexit uncertainty and relatively higher vacancy rates. However, most central London sub-markets should see the restoration of rental growth during 2020 as business confidence returns.

CENTRAL LONDON RESIDENTIAL

- **Activity levels** have dropped noticeably this year (transactions are 32% down on a monthly basis since the extra stamp duty and the EU referendum). Overall we expect the market to be broadly stable over the next 12 months; with house prices in many parts of the city so out of line with earnings and affordability constraints so strong, there is unlikely to be any change in transaction levels until wage growth begins in earnest.

- The proposed 1% additional **Stamp Duty Land Tax on overseas buyers** would impact particularly on the prime central London market, and if imposed, there may be a small fall in activity. However, London will always be a highly attractive place to invest and the UK tax regime is still more favourable than many other global cities. Unexplained Wealth Orders could also have an impact.

- The changes to **mortgage tax relief** for landlords could disproportionately affect the London lettings market, given the number of accidental landlords. We will doubtless see fewer lettings, and perhaps more landlords selling before the relief is due to end in 2020.

- The post-referendum fall in **Sterling** assisted the market, and its path in 2019 could yet again impact on overseas demand. However, London will remain an attractive to place to invest, irrespective of Brexit.

PROPERTY OUTLOOK

COMMERCIAL PROPERTY INVESTMENT

- **£62 billion** of commercial property was purchased in the 12 months to Q3 2018, an almost identical figure to the previous 12 months. Although this is some way below the all-time peak of more than £75 billion in 2015, it underlines the strength of the market. However, volumes are being held back by a severe lack of quality stock coming to the market.
- **Investors** are currently in "wait and see" mode, and yields have been broadly stable in recent months. However, there is variation according to sector, quality and location.
- We do not expect a significant **yield shift** in 2019, although with the weight of money looking to invest in the industrial sector we believe there remains scope for some further downward yield movement here. Any modest dampening of local authority interest is unlikely to impact the overall market, and quality long-income commercial property will remain highly sought after.
- Even in a "no deal" Brexit scenario, **values should be resilient**. After all, values across the commercial sector only fell by circa 4% following the 2016 referendum (MSCI All-property Monthly Index). There would be few forced sellers, especially as the retail funds now have larger cash reserves, and opportunistic buyers will be ready to take advantage if any pricing correction were to occur.
- The UK will remain important to **overseas buyers** as a store of value, and any further Brexit-related devaluation of Sterling would create increased overseas interest. So any post-Brexit upward shift in yields would probably be modest and short-lived, although a short-term slowdown in transaction activity would be likely.

OUTLOOK FOR DEVELOPMENT

- The focus for development will remain on the **residential sector**, given the significant housing need and political priority of reaching 300,000 units pa in England. With completions currently running at only 161,000 (in the 12 months to Q2 2018), the scale of the challenge is clear. The **build to rent** sector will be highly active.
- The major **housebuilders** have strong balance sheets, and will continue to buy land (both strategic and with planning permission). With prices relatively static in 2019, and buyer confidence being influenced by Brexit and rising interest rates (albeit modest), the key question is whether new sales volumes can be maintained, and potentially accelerate post-Brexit. We believe the current momentum across the housebuilding sector will be maintained and output will continue to rise in 2019.
- **Commercial development** will remain challenging and is being held back by future market uncertainty, rising building costs and land release rather than a lack of occupier demand in today's market. Activity will continue to be well below historical averages, despite the need for significant development of office, industrial and R&D space across many key markets.
- The issue of **land value capture** will be increasingly important. The Housing, Communities and Local Government Select Committee has concluded that funding for infrastructure and affordable housing could be raised by significant reform in this area. There is virtually no project where infrastructure does not play a significant part, and we believe a streamlining of the system is urgently needed.

PROPERTY PERFORMANCE FORECASTS

- With yields broadly stable and only modest rental growth, we forecast a **prime all-property total return of 4.4% for 2019**, a decrease from 7% in 2018 (see Figure 1).

- Prime industrial yields have moved sharply downwards over the last five years, reflecting a repricing of the sector as it has taken centre stage in the retail revolution. As a result, the sector has seen an exceptional prime total return of circa 18% pa over the last five years. Downward yield movement still has a little further to run, and industrial property will continue to outperform the prime all-property average, with a forecast **prime industrial return of 9.7% in 2019** (see Figure 2).

- We forecast a return from the **prime office sector of 5.1%**, with retail at just over 4%. We expect to see a sharp deceleration in **returns in the prime residential sector from 10.1% in 2018 to 2.8% in 2019**, in line with limited house price growth.

- Clearly, there is an unusually high degree of uncertainty around our forecasts. However, the overall picture is one of **resilient underlying occupier demand and limited supply across all sectors, which will underpin values**.

Figure 1 Prime all property total returns
Source: Carter Jonas

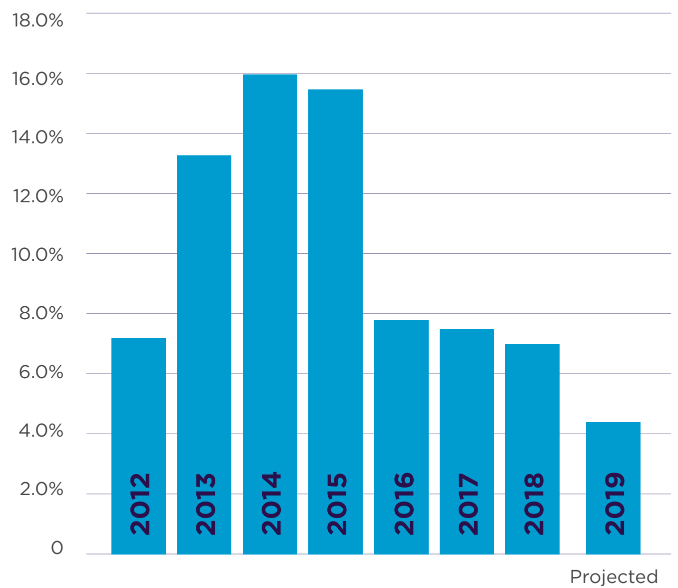
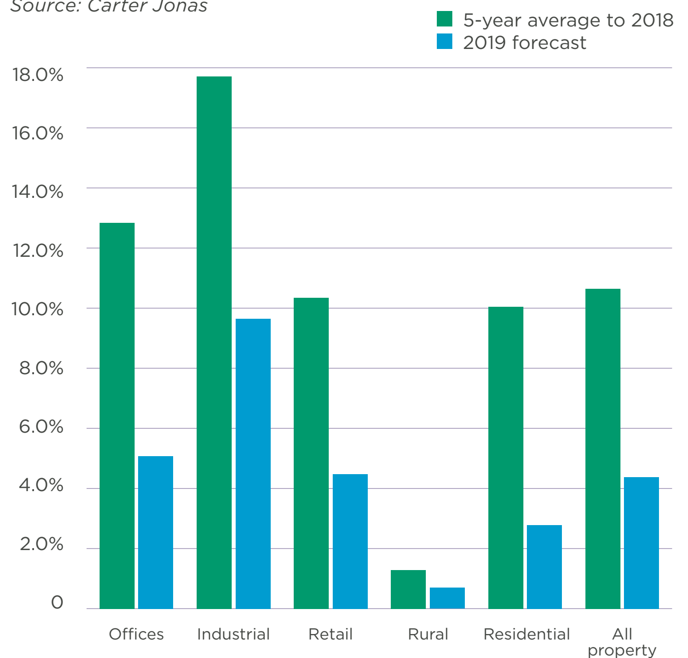


Figure 2 Prime total returns by sector
Source: Carter Jonas



33 OFFICES ACROSS THE COUNTRY, INCLUDING 9 IN CENTRAL LONDON

Bangor	Marlborough
Bath	Marlborough Rural
Bath Commercial	Newbury
Birmingham	Northampton
Cambridge Central	Oxford
Cambridge North	Peterborough
Cambridge South	Shrewsbury
Cardiff	St Albans
Harrogate	Taunton
Kendal	Truro
Leeds	Winchester
Long Melford	York

National HQ One Chapel Place	Knightsbridge & Chelsea
Barnes	Marylebone & Regent's Park
Fulham Bishops Park	Mayfair & St James's
Fulham Parsons Green	Wandsworth
Holland Park & Notting Hill	

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THE TAILORED SERVICE AND SIMPLY BETTER ADVICE WE OFFER OUR CLIENTS BUILDS LASTING, INTELLIGENT AND TRUSTING PARTNERSHIPS.

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Sources used in this report

Estimates and forecasts for GDP, inflation, labour market: Experian / HM Treasury comparison of independent forecasts

Commercial investment volumes: Property Data

Commercial and rural performance data: Carter Jonas

Residential data: HM Land Registry, UK Finance, Experian, Valuation Office