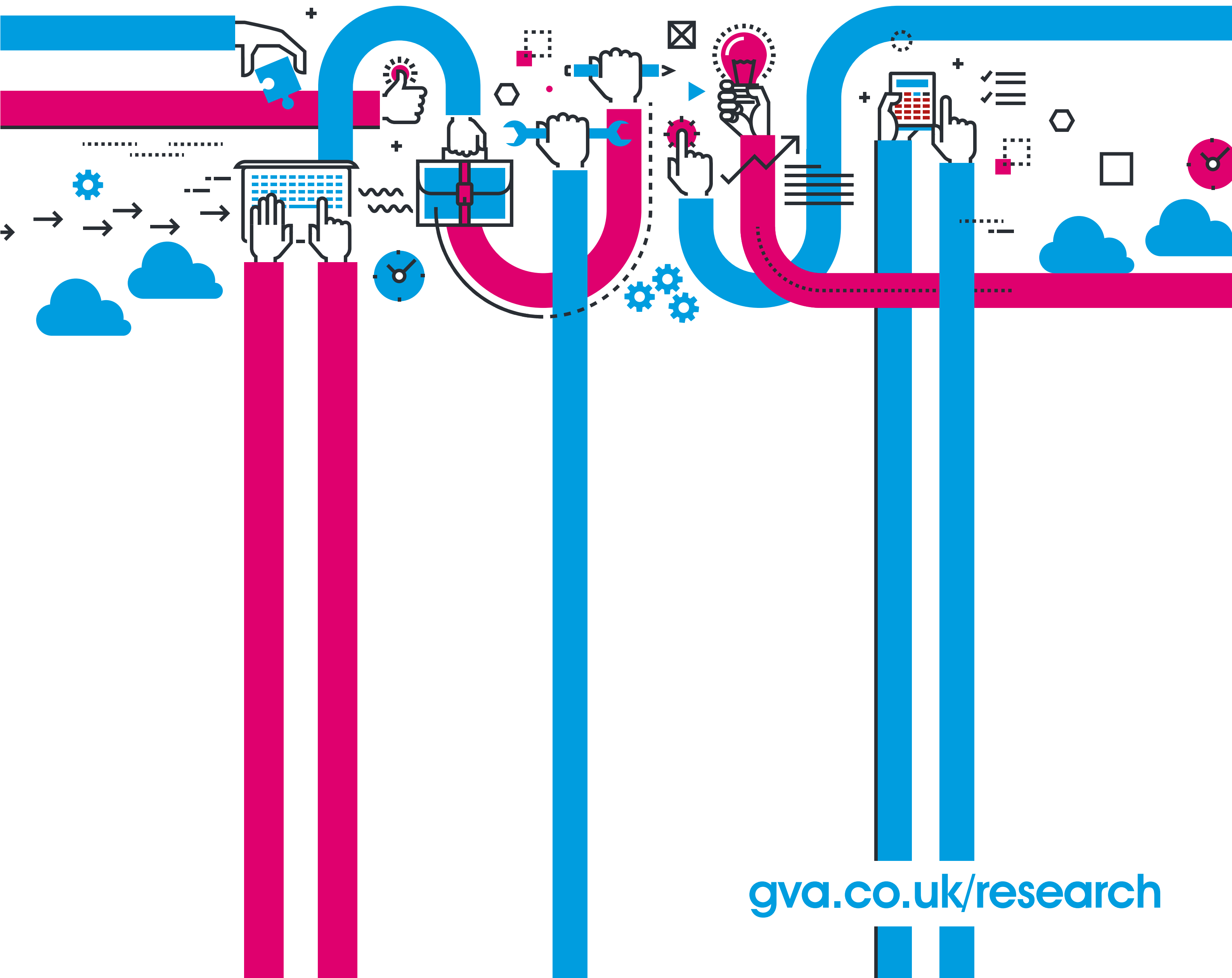
Research

EPMR UK

Post-referendum outlook

September 2016



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Economic outlook

Recent weeks have seen relative stability across the financial and property markets, helped by the quieter summer period. The rapid formation of a new government has helped to boost confidence, and an early general election appears to have been ruled out (although a second Scottish independence referendum is still theoretically possible).

A key point is that victory for the 'Leave' campaign was a vote against membership of the EU, rather than for any specific course of action. The question of the UK's future relationship with the EU remains as open as it was on 24 June and Government policy remains little more than "Brexit means Brexit".

One certainty is that the process of exiting the EU will be long and complicated. Indeed, it does not officially begin until the UK Government triggers the now-infamous Article 50 of the Lisbon Treaty. It has indicated that this will not happen until 2017, and it may well be delayed until next autumn, after the general elections in France and Germany have taken place.

Businesses need certainty and the Government is under immense pressure to clarify its approach to Brexit. However, it also needs to take the time to get its strategy right across a vast range of complex issues. This dilemma will be a significant challenge.

Whatever approach the Government takes, the UK will remain a member of the EU for two years after Article 50 is triggered, and we will still be able to trade with the EU on the existing basis during this time (although discretionary EU funding will become much harder to obtain).

The financial markets have settled down, with Sterling trading at circa 10% below its pre-referendum level against the US Dollar and the Euro. **UK equities** have increased in value since the referendum (the FTSE 100 by circa 8% and the FTSE 250 by circa 4%). That said, the share price of housebuilders and property REITs remains below pre-Brexit levels, but property shares were always going to be vulnerable to a 'Leave' vote compared with more defensive sectors. Fears that the UK's **institutional "retail" funds** would be overwhelmed by the level of redemptions have not materialised, with only a small number of forced sales.

Confidence

Most hard economic data still largely relates to the pre-referendum period, but there has been some reassuring post-result survey data. **Consumer confidence** has started to rebound from the immediate referendum shock. The latest GfK survey plummeted from -1 in June to -12 in July, but rose to -7 in August. Consumer demand has been resilient so far, and retail sales volumes over the period June-August were 1.6% higher than over the previous three months, and 5.5% higher than over the same period last year.

Business confidence saw a significant increase in August, with a rebound in the respected Markit/CIPS Purchasing Managers' Index back into positive territory. This is illustrated in **chart 1** (which shows the average across the manufacturing, services and construction sectors).

Inflation and interest rates

CPI inflation was 0.6% in August, unchanged from July. The rate has risen from broadly zero a year ago and will rise faster over the next year due to Sterling's devaluation. The consensus view is for 2.5% in 2017 (although it is likely to peak higher than this), but any further volatility in the foreign exchange markets could alter this outlook.

The Bank of England deployed further stimulus in August to boost domestic demand. This included a reduction in the **Base Rate** to 0.25% and an injection of £70 billion into the economy through the purchase of government and corporate bonds (quantitative easing).

The Bank may well use further stimulus measures in the coming months, although there is only so much that monetary policy can achieve, particularly as interest rates are now so close to zero. Certainly, the Bank is not concerned at the prospect of inflation rising above its target range at this stage.

Government intervention

With interest rates close to zero, the bulk of any further stimulus measures will need to come from fiscal rather than monetary policy. With the previous target of eliminating the budget deficit (annual borrowing) by 2020 now jettisoned, there should be room for such stimulus.

This year's Conservative Party Conference in October and the **Autumn Statement** on 23 November will be keenly watched, as

Chart 1

Purchasing Managers' Index

Source: Markit/CIPS

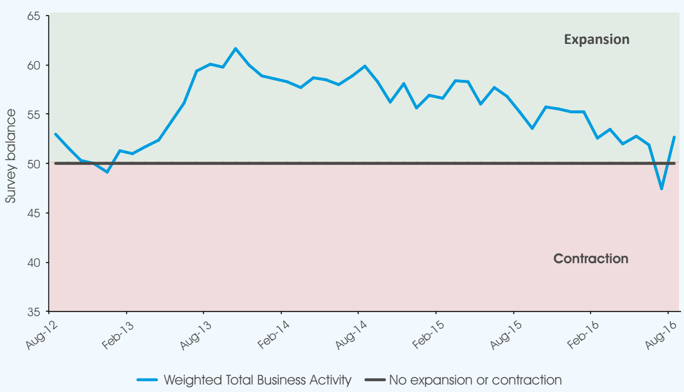
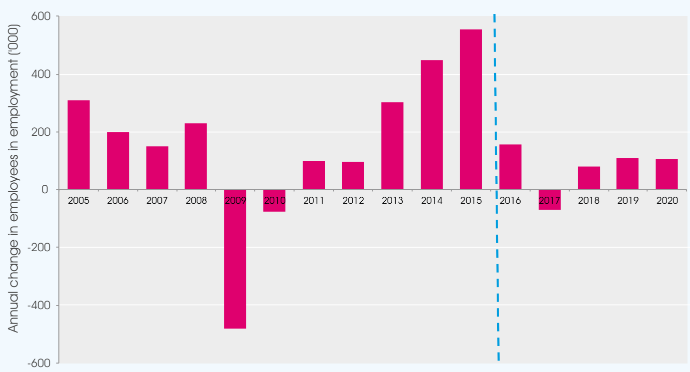


Chart 2

Annual change in total employees

Source: Experian, Bilfinger GVA



they will set out the Government's fiscal agenda. It is already clear that the new administration will signal some significant changes across a range of policy areas.

Infrastructure investment may well feature heavily. There is a strong argument in favour of this, given the low cost at which the government can borrow and the need to make significant improvements across a wide variety of infrastructure types. Without this, the more uncertain environment, lower economic growth and increased cost of imported materials are likely to mean a fall in investment.

Another key test will be the willingness of the new Government to take key decisions in this area, most notably on additional runway capacity in the South East. The Government's commitment to the important devolution agenda will also come under close scrutiny.

Employment trends

In total more than a million jobs were added to the UK labour force during 2014 and 2015. This growth was unsustainable and was already slowing prior to the EU referendum. However, the latest data suggests that the labour market has remained robust. During May-July (so partly covering the post-referendum period) employment rose by 174,000 compared with the previous three months. The unemployment rate has fallen to 4.9%, the lowest since Q3 2005.

The picture is likely to weaken as some businesses put hiring decisions on hold, and we expect a modest fall in employment next year, before growth resumes in 2018 (see chart 2).

Earnings are currently rising at a little over 2% pa. As the employment outlook weakens and inflation rises, earnings could be falling in real terms by the end of next year (see chart 3). This erosion of consumer spending power is likely to negatively impact retail spending.

Outlook for growth

The UK economy was growing at a healthy rate in the run-up to the EU referendum, rising by 0.6% in Q2 (in line with the long-term trend), up from 0.4% in Q1. We expect a marked slowdown in growth during the second half of this year although given post-referendum survey evidence, a major recession seems unlikely. However a technical recession (two quarters of declining output) remains possible, which would adversely affect confidence.

The overall effect on the 2016 growth figure will be modest (a mark-down from 1.8% to 1.6% for 2016). However, growth of just 0.7% is now forecast for 2017, compared with the 2.1% previously expected (well below the long-term average of circa 2.6% pa).

Looking further ahead growth is expected to accelerate, but should remain well below trend. The revised forecasts suggest that the economy will be 4% smaller by 2020 than would have been the case using pre-referendum forecasts.

Chart 4 illustrates the forecast revisions. The EU remains our most important trading partner, and will also feel the impact of Brexit. Although only Ireland is heavily exposed to the UK in terms of exports, there is likely to be a negative impact on consumer and investor sentiment. Eurozone growth is already weak and is now likely to be even more subdued.

The European Central Bank will probably come under pressure to provide more monetary stimulus.

The longer-term impact of Brexit remains highly uncertain, and much will depend on the type of trade deal that can be negotiated. A number of economic studies on the long-term impact have been undertaken. Most suggest a marked negative effect, but the wide range of possible impacts underlines the uncertainty.

With EU trade negotiations not starting until next year, markets are now likely to focus their attention on November's US Presidential election. We may also see further market volatility as more substantive policy announcements are made on the Government' approach to Brexit and more meaningful post-referendum economic data becomes available.

Ultimately, it is the reaction of the UK's consumers and corporates that will determine the health of the economy during and after the Brexit process.

Table 1

Latest consensus forecasts, August 2016

Source: HM Treasury (compilation of forecasts), Bilfinger GVA

	2016	2017	25 year trend
Economic growth (GDP)	1.6%	0.7%	2.6% pa
Private consumption	2.4%	1.0%	–
Employment growth	1.0%	0%	0.7% pa
Bank base rate (Q4)	0.1%	0.2%	–
CPI – Inflation (Q4)	1.3%	2.5%	–
RPI – Inflation (Q4)	2.0%	2.9%	–

Chart 3

Inflation and wage growth

Source: Experian, HM Treasury Consensus

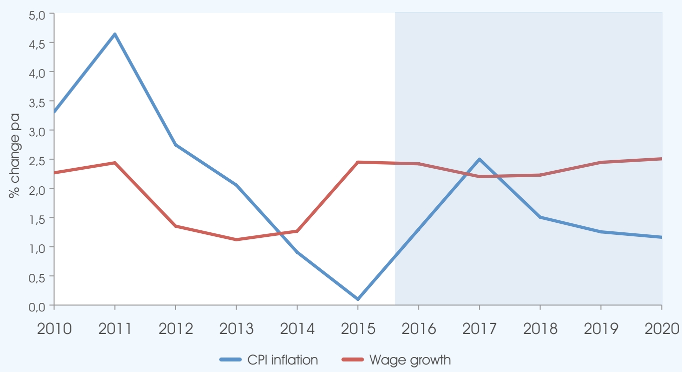
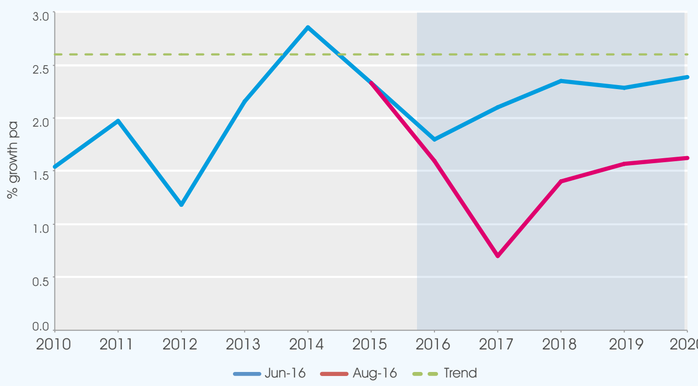


Chart 4

GDP growth forecasts

Source: HM Treasury Consensus, Experian, Bilfinger GVA



Commercial occupier market

Occupier demand

Occupiers now face considerable uncertainty across a range of fundamental issues including their ability to trade with the EU and to employ labour from the EU, as well as a more uncertain economic outlook.

There have been few concrete announcements by corporates on their strategies to deal with Brexit. This is unsurprising. Not only do strategies take months or years to evolve and implement, but corporates also lack hard information on the implications of Brexit upon which they can base any decisions.

A 'soft' Brexit which retained many of the current benefits of EU membership, including the UK's important 'passporting' rights, could mean a relatively limited impact. A 'hard' Brexit would have wider-reaching implications.

Survey evidence suggests that more than half of corporates did not undertake any contingency planning for a 'Leave' vote. They will now be undertaking this process in earnest, and the longer the uncertainty continues the more these contingency plans will have to be put into action.

Supply

The recent development cycle has been relatively subdued, meaning that few prime commercial occupier markets are in an oversupply situation and many are experiencing a shortage of stock. Chart 5 illustrates the low level of commercial construction in the current cycle (using new construction orders as a proxy). Although activity has recovered sharply, it has remained well below levels seen before the financial crisis.

The subdued development cycle has meant less new stock coming on stream. But other factors are also working to reduce the level of existing stock. These include the changes to permitted development rights legislation, which have accelerated the conversion of offices to other uses; and the minimum energy efficiency standards (MEES), which will prevent the granting of a new lease (or lease renewal) on a building with an EPC rating below 'E' from 1 April 2018.

Coupled with this, strong long-term underlying demand will underpin many key property sectors, including logistics, healthcare, student accommodation, and the private rented sector. The huge potential of PRS could be further increased if Brexit uncertainty means fewer first-time-buyers are willing to enter the housing market.

Clearly, there is only limited data on construction post-referendum. The latest ONS figures report that total UK construction output was flat in July, with new construction work rising by 0.5%. This suggests that the sector was resilient during the initial post-referendum period, but these figures can be quite volatile from month to month, so should be treated with caution.

There is now less certainly over future occupier demand, so it is likely that development activity will fall as schemes are put on hold. This will vary across sectors, reflecting the outlook for demand. The distribution sector, for example, may well be more insulated.

Sector impacts

In the lead up to the EU referendum, occupier activity across the Central London office market was muted with many businesses waiting to see the outcome before committing to office space. This resulted in just 4 million sq ft of take-up for the first half of the year, the lowest since 2012 and 18% down on the corresponding period in 2015. However, for many occupiers Brexit changes very little. Whilst there has been a tail off in new demand, continued low levels of availability are underpinning rental levels for the time being.

Demand across the 'Big Nine' regional office centres held up well in Q2, just 3% below the five-year average, in spite of the referendum uncertainty. Over the summer there has been a reasonable level of viewing activity and enquiry levels, although there has been a slowdown in the quantity of transactions.

Brexit uncertainty is certainly causing some occupiers to review their strategies. However the affects across most markets will be somewhat insulated by the shortage of quality stock and constrained development pipeline, with the prominence of more cautious pre-let development activity witnessed over the past two years.

A number of factors will help to cushion any impact on demand. For example, a significant number of civil service jobs will move from central London over the next five years, with the creation of 16 new super-hubs in outer London and many of the UK's regional cities. The UK's growing 'knowledge' sectors will also continue to fuel demand, and the Government's commitment to safeguard funding for research and innovation projects is reassuring.

Against a background of limited supply in many key locations, the industrial and logistics sector looks to be in a relatively strong position. The recent strong rate of average rental growth continues, with rental values rising by 4% over the 12 months to August.

Chart 5

New Construction Orders (Development activity) Retail, office and industrial

Source: ONS, Bilfinger GVA

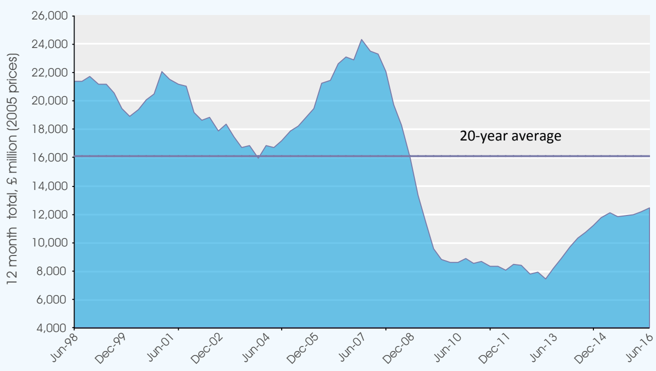
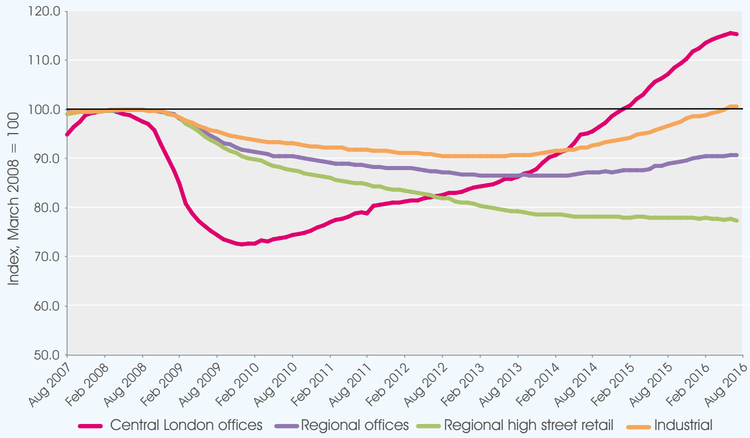


Chart 6

Average rental levels

Source: IPD Monthly Index, Bilfinger GVA



We remain positive about the prospects for the industrial and logistics sectors. Manufacturers won't escape the economic impacts, but the positive effect of weaker Sterling will help to offset this. The huge shifts in the retail market will continue despite Brexit, and retailers will still need to respond to changing logistics requirements. Along with third-party logistics providers, retailers continued to provide the majority of demand during the first half of the year.

The early signs of a bounce-back in consumer confidence are certainly welcome news for the retail sector. Clearly, Brexit does not change the fundamental challenges faced by physical stores of the relentless move online. However, it could serve to accelerate the demise of retailers who were already in long-term difficulties.

The latest figures from the Local Data Company suggest that the overall vacancy rate for shops increased marginally from 12.3% in June to 12.4% in July, reversing the trend of gradually falling rates seen since mid-2012. However, shopping centres saw a further fall in vacancy, and there has been very little new development over the latest cycle. This will help to maintain rental levels in the prime centres.

The leisure sector has been growing strongly, and should benefit from the depreciation of Sterling across a range of subsectors including restaurants, hotels and leisure parks. A rise in 'staycations' and more overseas tourists in the UK will help significantly. However, the leisure sector is particularly vulnerable to a change in immigration policy as it employs a significant number of EU nationals. This will come on top of the additional cost burden associated with the new National Living Wage.

Outlook for rental growth

There are plenty of reasons to think that the property market will continue to be resilient in the face of the challenges ahead. For occupiers, the current market represents a good time to renegotiate their lease terms. Indeed, with increased levels of uncertainty, we expect to see more occupiers re-gear existing leases rather than move.

Average rental levels remain below their previous 2008 peak across most UK commercial property sectors, with the main exception of the central London markets (see chart 6). Coupled with this, the lack of quality supply will help to underpin rental values, and so the likelihood of significant falls looks remote.

Even in central London, recent development activity has mainly replaced existing stock rather than provide additional space. Given the inherent advantages for many occupiers of locating in the capital (which include skills, English language, cultural benefits, access to world-class educational and technological institutions, plus our strategic time zone) we think occupier demand will prove resilient.

The loss of 'passporting' rights has the potential to have a significant impact on London's office market, but this is by no means certain, and will be a key part of trade negotiations. The Government has already sought to allay concerns over the ability of key overseas staff to work in the UK. On the retail and leisure side, central London will benefit disproportionately from the devaluation of Sterling.

There is a direct link between economic and rental performance. Lower forecasts for economic output and employment growth following the EU referendum inevitably mean we have lowered our expectations for rental growth over the next five years.

All property rental growth has been decelerating over the course of this year. Average rental values increased by 1.3% during the first six months, and have been virtually flat during July and August (IPD Monthly Index, see chart 7).

We expect rental values to be broadly flat in 2017. Thereafter, rental values should begin to rise again, although this is likely to be a gradual acceleration. Given the shortage of stock in many markets, prime rents should outperform. However, the nature of Brexit and its impact on occupier demand is clearly hard to predict at this stage, and so there is a higher than usual level of uncertainty over this outlook.

Our revised forecasts for all property rental value growth are shown in chart 8 and table 2

Table 2

All property rental growth forecasts

Source: IPF, REFL, Bilfinger GVA

IPF Quarterly Consensus (August 2016)	2016	2017	2018
Maximum	3.2%	2.0%	2.1%
Minimum	-1.5%	-5.0%	-1.3%
Average	1.3%	-0.7%	0%
Bilfinger GVA (September 2016)	**1.4%**	**-0.3%**	**0%**

Chart 7

All property average rental growth

Source: IPD Monthly Index

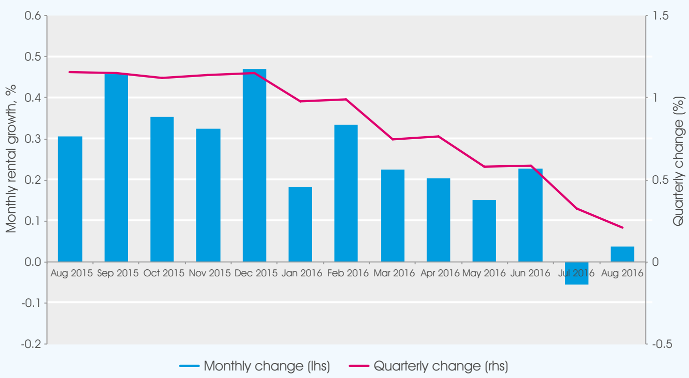
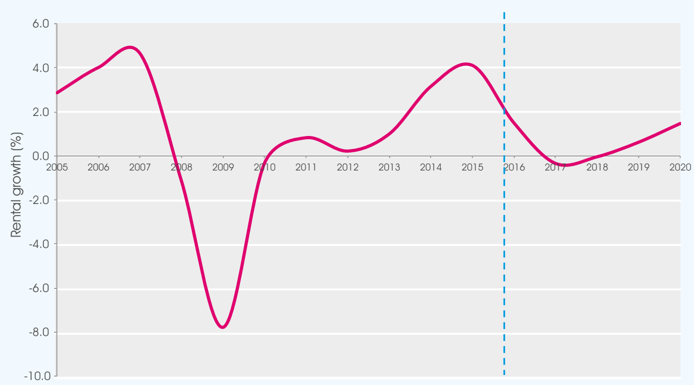


Chart 8

All property average rental growth forecasts

Source: MSCI, REFL, Bilfinger GVA



Commercial investment market

Initial concerns about a severe adverse reaction to the 'Leave' vote have proved unfounded although there has inevitably been a fall in investment transaction volumes, as many investors have opted for a 'wait-and-see' approach.

A slowdown in activity was already happening in the run-up to the EU referendum, with £12.3 billion transacted in Q2, the lowest since Q1 2014, and a sharp contrast from the £20 billion transacted in Q2 2015 (Property Data). The summer is always a quiet period, so the overall impact is hard to gauge, but a total of only £3.1 billion was transacted during July and August - a monthly average of just £1.5 billion. More than £8 billion was transacted over the same period last year.

Sterling's depreciation is already making the UK a more attractive place for **overseas buyers**, and this will benefit the investment markets in London and the key regional cities. Almost half of the value of purchases so far in Q3 has been from overseas buyers, up from 42% during the first half of the year.

However, **UK property companies** are also seeing purchasing opportunities in the current market. There have been relatively few forced transactions from the **'retail' funds,** which are gradually returning to business as usual.

The overall level of debt in the real estate market is not concerning, in sharp contrast to the situation after the financial crisis, with outstanding lending to real estate 40% lower than at its peak, according to Bank of England figures. The modest fall in capital values is unlikely to trigger a rise in real estate enforcement and while some lenders may reduce their level of new lending or become more selective, most are still firmly in the market.

A fall in **commercial property values** was inevitable following the referendum result, but it has certainly not been the sharp correction that could have occurred; the IPD Monthly Index recorded a drop of 2.8% in July plus a further fall of just 0.7% in August (see **chart 9**). Added to the modest drop seen prior to the vote in June, all property values have fallen by 3.7% over the last three months on the IPD measure.

Gilt yields, already historically low before the referendum, have tumbled further, standing at circa 0.8% for 10-year gilts. This has further widened the gap with commercial property yields, as **chart 10** illustrates, making property relatively more attractive.

There is now greater certainty over **property values** than in the initial post-referendum period and this should help to boost confidence and activity going forward. However, for very large central London office developments, land and buildings, retail parks and shopping centres, valuers are still exercising a greater degree of judgement in view of the lack of transactional evidence.

The economic outlook has undeniably deteriorated, although it is increasingly difficult to view Brexit in isolation; the vote to leave has arguably been a catalyst for an immediate correction to the economy and property markets which would have taken place in any event over a longer time period.

For many parts of the investment market, such as **healthcare, student accommodation and PRS**, a compelling long-term demand story coupled with long-dated secure income means that Brexit will hardly be an issue at all, although clearly the opportunities are not uniform across all UK locations.

We are also upbeat about the **distribution/ logistics sector**, where immense opportunities exist. The demand created by major shifts to retail distribution networks will not abate and, if anything, Brexit will serve to accelerate the rate of change as the pressure on retailers to achieve efficiencies becomes more acute.

Clearly **total returns performance** will be impacted by the 'Leave' vote, and slowing rental growth plus a modest upward shift in all property yields will mean much lower returns for this year and next than we have seen recently. As with rental growth, there is a higher than usual level of uncertainty over the outlook and an unfavourable outcome to the forthcoming Brexit negotiations (from the UK's point of view) could negatively impact occupational strategies.

Restricted supply will boost rental growth performance for quality stock and the significant weight of global capital looking to invest will maintain values.

Brexit has not altered the fundamental benefits of investing in UK commercial property, which include high market transparency, liquidity, market size and quality, and its 'safe haven' status. Ultimately, commercial property is a long-term investment and we believe investors will continue to take a long-term view.

Chart 9

Monthly change in capital values

Source: IPD Monthly Index

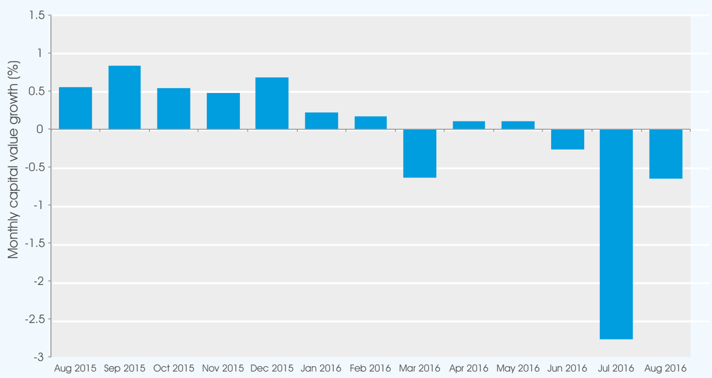
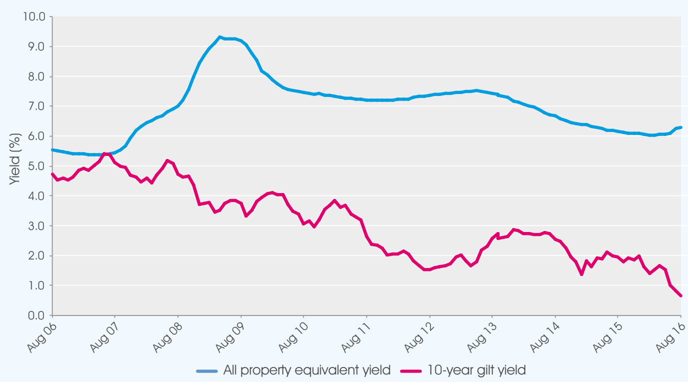


Chart 10

Property and gilt yields

Source: IPD, FT, Bilfinger GVA



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For further information please contact:

Daniel Francis
Head of Research

daniel.francis@gva.co.uk
020 7911 2363

gva.co.uk/research 08449 02 03 04

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