ECONOMIC OUTLOOK

THE UK ECONOMY IS BACK IN BUSINESS
Economic success is mostly a confidence game, as the French say, la confiance appelle la confiance. One of the biggest takeaways of 2014 was the UK’s performance in the context of a weak Europe. But, despite the good news of 2014, underlying confidence about the future seems somewhat frail. A stubbornly high public deficit and record low interest rates cast a shadow over the UK’s recent economic success. Recoveries from financial crises take time, and the recovery which began in 2013, became entrenched in 2014, looks set to continue in 2015. Which, in the context of the current global outlook is very good news indeed!

2014 RECAP... UK ECONOMY BACK ON TRACK
- GDP grew by 2.6%, the fastest rate since the financial crisis, driven by growth in consumer spending and business investment. The main drag on growth was UK exports.
- Unemployment fell below 6% for the first time since 2008 and the economy added more than half a million jobs.
- The rate of inflation was 1.5%, with prices slowing considerably towards the end of the year; due to weak global inflationary pressure and a sharp drop in oil prices. Overall, the impact of falling inflation was positive; boosting real wages and reducing business costs.

2015... ANOTHER YEAR OF PROGRESS
- Growth to continue at above trend pace, 2.5% or above seems like the most likely outcome.
- Last year, employment growth beat expectations; in 2015 this trend is set to persist on the back of a strong investment outlook.
- We anticipate that unemployment will fall below 5.5% in 2015, which should support a recovery in productivity and, in turn, growth in real wages.
- Inflation is expected to remain subdued in H1, with the potential for deflation in spring. Thereafter, a gradual pick up in prices is likely, as the output gap closes and slack in the labour market is eliminated.
- Markets are pricing the first rate hike in H1 2016. But, if temporary factors such as the lower oil price have a persistent impact on inflation, it could push the first rate rise back further.

EUROZONE... DRAGHI TO THE RESCUE
- With the inflation and growth outlook worsening towards the end of 2014, it became clear that the ECB would undertake QE in an effort to kick-start a recovery in the currency bloc.
- Indeed, by Q4 the anticipation of QE had begun to ease financial conditions in the Eurozone. Sovereign bonds fell at an unprecedented rate and 10-year yields in core countries hit a historic low of sub 0.5%.
- Despite initial fears that the ECB would come up short, on balance markets have reacted positively to the announcement of open-ended monthly purchases of €60 billion to return inflation to the 2% target.
- The key risk to the Eurozone in 2015 will be the fate of Greece and its position in the EU.

GLOBAL ECONOMY... A TURBULANT OUTLOOK
- Despite headwinds, the global economy is expected to continue recovering in 2015, with growth above 3%. Key risks to the outlook in the short-term are geopolitical tensions and financial market volatility, and over the medium-term, lowflation in developed economies and a decline in EM (emerging markets) growth.
- Expansionary monetary policy in the Eurozone and Japan will support a recovery in these markets, but at the expense of their trading partners, to whom they will export some deflation.
- To act against disinflation, central banks in EM’s are expected to continue to cut rates as 2015 progresses.
- For the BRIC’s, Chinese growth looks set to slow, Brazil is in stagflation and Russia is set to continue to struggle under Western sanctions. On a positive note, India looks as if it might have turned a corner.
- The global economy will benefit from increased demand as the US recovers. But, the prospect of Fed rate hikes could generate capital flight and a sell-off in equity markets.
- Lower oil prices and mini-stimulus packages by smaller industrialised and emerging economies should support global demand.
THE CURRENT STATE OF PLAY

- 2014 saw the highest UK investment volume on record at £61 billion. London accounted for 38% of total UK investment and 72% of UK office investment.
- Foreign investors continue to drive London investment volumes with overseas capital accounting for 67% of the overall Central London investment volume and 73% of office investment.
- Overseas investors are increasingly looking beyond Central London as the availability of large trophy assets in the capital begins to fall. At £11 billion, overseas investment into the regional markets is at its highest level on record (previously £10 billion in 2006), up by 67% on 2013.
- Rapid improvements in occupational markets throughout the UK are providing a significant boost to investor confidence, placing further pressure on yields which have already sharpened across most major markets.

THE SHOW GOES ON

- Although prime and average rents have seen strong performance across certain markets (most notably within the London office market and both the Greater London and Golden Triangle logistics markets) there is still some way to go before we begin to see slowdown.
- Last year saw some major investment transactions and further pricing movements in Central London, including Safra’s purchase of the Gherkin for £726 million equating to a 3.75% initial yield, Norges’ £583 million investment at the BoAML Financial Centre at a 5.25% yield, and the £265 million purchase of 6 St James’s Square by Ponte Gadea, representing a 3.89% initial yield.
- Outside of London saw even more dramatic surges in both volume and pricing of assets across sectors. Land Securities purchased a stake in the Bluewater shopping centre for £656 million, representing a 4.1% yield. The Crown Estate and a Chinese investor paid £345 million at a 5% yield for Fosse Park in Leicester. In June M&G Real Estate showed their confidence in the Manchester office market with a £318 million purchase of the Spinningfields office complex, at a 4.8% yield.
- We predict that 2015 should see the highest rental growth recorded since the peak of the last cycle, with the Central London office market leading the charge.
- Undoubtedly, yields within central London markets have begun to close in on their peaks. But, the sheer demand for assets will drive further yield compression during 2015.
- Outside of the capital, we have witnessed particularly strong movements in the prime logistics markets of Greater London and the Midlands.
- As we move into the next phase of the cycle, there is potential for further yield compression for well-positioned secondary assets, with some investors looking to move up the risk curve in search of yield. This is also likely to extend to the development or forward funding of prime assets and intensive asset management opportunities on non-prime buildings.

INVESTMENT VS YIELDS

[Graph showing investment vs yields from 2004 to 2014]

Source: BNP Paribas Real Estate

- Central London office take-up for 2014 (16.03 million sq ft) is at its highest level since the height of the dot-com boom in 2000. Office take-up in the major regional markets is up 11% on 2013 and up 60% on the low of 2011.
- Logistics take-up is at its strongest since the downturn which is all the more impressive considering it was a period characterised by a chronic lack of availability.
- So what about the retail shaped elephant in the room? Investors are more wary about putting their money into retail assets, where fundamentals have lagged and returns have underperformed.
- However, the recent stellar performance of the logistics sector has been largely driven by retail occupiers. Online currently accounts for 14% of total UK retail sales, and by 2018 deliveries are set to increase by 40% to 1.35 billion.
- But, what about the bricks and mortar? 2014 retail sales were up 3.8% on 2013. Retail vacancy is down across the UK and investment volumes have seen steady increases but still remain below 2010 levels.
- With a much lower level of perceived risk, prime shopping centres and dominant retail parks have attracted the most interest from investors. However, limited availability has seen investors explore riskier secondary opportunities which could start to feed through into investment volumes during 2015.
RECAP ON 2014

- 2014 was an exceptional year for UK real estate, outperforming the all-property returns of 2006 and producing the best performance since 2005. An 18% all-property total returns confirmed last year’s expectations that 2014 would be a good year for UK property. With all sectors showing double digit total returns, the improvement on 2013 was driven by a sharp pick-up in capital growth, spread across all regions and sectors.
- With a total return for the year of 23% the industrial sector outperformed both office and retail, which returned 22% and 14% respectively. Performance across all sectors has been driven by capital value movements, contributing between 60% and 75% of overall total returns.
- Capital growth has largely remained yield driven, since June 2013 IPD figures show that equivalent yields have moved in by 12%, 15% and 19% for the retail, office and industrial sectors, respectively.
- On a geographic basis, London is once again undoubtedly the star performer. Heightened investor demand has resulted in a sharper contraction of yields across office, retail and industrial assets within Greater London.
- Even the retail sector has experienced strong performance in the capital, with West End retail returns ending the year at an incredible 28%, making it the best performing sub-segment during 2014.
- Demand has been further boosted by strong underlying property fundamentals. Take-up was impressive within the major office and industrial markets and the chronic lack of development across sectors has resulted in falling vacancy rates. This has led to a return to rental growth in almost all sectors. The only sub-sector yet to record a return to growth is standard retail units outside of the South East.

FORECASTS FOR 2015

- In 2015, UK property is set for another year of impressive growth. The broadening of growth across UK property markets which began in 2014 is set to continue, narrowing the spread between returns in regional markets and the high performing markets in the South-East.
- Underpinning this transition to a more balanced property market is a reduction in the risk associated with regional property investment, stemming from a broadening of economic growth from the South-East to the rest of the UK.
- Total returns for all UK property are forecast at 12% in 2015, with the strongest return in offices at 16%, followed by industrial at 11% and retail at 10%.
- In 2015, the ongoing turbulence stemming from currency wars, geo-political risk, and a general slowdown in global demand will underpin strong investor appetite for low risk investments. In the near-term, central London office and retail markets will continue to benefit from this trend and outperform regional markets.

FURTHER AHEAD

- Over the next five years, we expect annualised total returns of 6.5% for all UK property. Industrial is set to be the highest performing sector, with total returns of 8%, followed by retail and offices at 7% and 5%, respectively.
- The key take-away from this round of forecasts, is the diverging performance of offices against retail and industrial. In the near-term, offices has the strongest growth prospects, driven primarily by strong investor demand for safe assets in the capital. However, the amount of headroom in the central London office market looks limited beyond 2016, which should suppress returns thereafter.
- Due to structural issues with the UK retail market, the higher yield for some secondary stock may not be sufficient to compensate the risk involved in acquiring these assets and, as a result, investors are more likely to stick to prime stock. Therefore, whilst a stable outlook is expected for both the industrial and retail sectors over the five-year horizon, industrial returns are expected to be stronger.
RECENT DEALS

MOORGATE EXCHANGE

CLIENT: QUADRANT/CITY OF LONDON/ORION/CARVAL
PRICE: £211m

THE HOUNDSDITCH ESTATE

CLIENT: MADISON INTERNATIONAL
PRICE: £100m (50% stake)

ANGEL SQUARE, N1

CLIENT: DERWENT LONDON
PRICE: £75m

GILEAD HQ STOCKLEY PARK

CLIENT: EUROPA CAPITAL
PRICE: £46.25m

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