Socio-economics

The potential for real estate investment in the UK outside London is large and diverse, the population of the UK is almost 65 million, and with 8.3 million people in London, that means over 85% of the UK population resides outside of the capital city, with almost 9 million people residing in the South East region and 5.5 million in the South West. In terms of the real estate market, the UK regions exist very much in the shadow of the capital however outside of London there are a wide range of businesses supporting a highly diverse employment base.

The unemployment rate in the UK currently sits at 5.1% (ONS) and varies from 3.7% in the South East region to 7.9% in the North East, and whilst many who reside in the South East work in Central London, there is a large proportion who work in areas such as the Thames Valley. During November and December 2015 all regions except Central London saw a fall in their unemployment rates of between 0.1 and 0.7%.

Investible Market

UK commercial property, with its attractive yield profile, provides investors with consistent levels of income, through rent, and good risk adjusted returns. With the UK economy strengthening, particularly compared to our European neighbours, property is now offering investors the potential benefits of rental and capital growth. Whilst Central London is often the first stop on every investors wish list, the regional UK real estate market provides investors with a huge swathe of opportunities, both by value and number of properties.

According to the IPD dataset, there is almost the same amount of office stock (by value) in the UK outside of London, at c. £23bn, with over twice the amount of investible assets. Whilst London typically offers larger lot sizes, there is a wide range of lot sizes available in the UK regions. The average lot size in the Regions in 2015 ranged from £23.2m in the South East to £11m in the Rest of the UK, and additionally, portfolio transactions can help provide scale if required.

For benchmarked investors it is critical to maintain a close alignment between fund weights and as such a diversified strategy will be relevant for most balanced investors.
For investors willing to move up the risk curve, taking on asset management opportunities, development sites and/or vacancy then discounts can still be found. Areas of London which are benefiting from new transport infrastructure, such as Crossrail, and other regeneration as well as regional office and logistics assets all offer good upside opportunities.

4. RISKS AND RETURN

There is no generic real estate cycle in the UK as the market offers a highly diverse range of real estate products, from offices, retail and industrials to alternatives including student housing, healthcare and leisure and they all exhibit a range of cycles within their sectors and regions.

Therefore, risk and return profiles vary across segments of the UK market, providing investors with the ability to construct portfolios that provide optimum long term risk adjusted performance.
In terms of risks and returns it is the Central London markets that are characterised as being more volatile than regional UK markets and react more quickly to changes in the economic environment, both positively and negatively.

The competition between investors for UK real estate has resulted in the IPD ‘All Property’ initial yield falling to 4.98% at the end of February 2016, its lowest level since November 2007.

On one hand, this looks reasonable in the context of 10 year UK government bond yields that are currently priced at 1.44% and given the prospects for steady rental growth over the next few years. Therefore, the yield spread could narrow to c.1.5% to 2% without exerting any real upwards pressure on All Property yields.

On the other hand, we can’t ignore the risks that currently exist, with equity market turbulence, global growth slowdowns and a EU Referendum all potentially impacting on property values. But these risks also provide opportunity for buyers should values be impacted by these macro economic factors.

In any case, we see these risks as limited. The UK remains the entry point to real estate investment in Europe and transacted more than both France and Germany combined in 2015.

**FIG 4. REGIONAL OFFICE VACANCY LEVELS**

Source: BNPPRE/PMA

5. OPPORTUNITIES

There continues to be a wealth of opportunities in UK real estate and particularly in the UK’s regions. We are firmly of the opinion that regional offices and industrials will outperform the ‘All Property’ Total Returns benchmark over 2016 and provide the best opportunities to maximise returns over the medium term.

Whilst we expect London to deliver solid returns over the next 5 years and do not support the view that the Capital is either overpriced or over supplied, opportunities for yield compression and rental growth without undertaking

**FIG 5. TOTAL RETURNS FORECAST (2016-20)**

Source: BNPPRE

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Agent’s Outlook

Hugh White, Head of National Investment, provides his opinions on what he expects to see in 2016

The UK’s regional market has changed character over the last 12 months. The money flowing into the retail funds stabilised somewhat by the end of 2015, which has allowed a pause for breath at the prime end of the market.

Instead, it has been debt-led, opportunistic investors that have been driving the out-of-town and business park market. However, with yields having come in over H2 2015, investors are pricing in rental growth as the way to meet returns, rather than yield compression. Further demand is also being driven by overseas investors attracted to the cash on cash play available through well-let, single tenant, out-of-town offices.

We at BNP Paribas Real Estate consider prospects for rental growth to be good, with 2.3% forecast on average per annum to 2020. In areas which have seen a significant reduction in office stock, due to conversion to residential through Permitted Development, we expect to see above average growth.

As far as future opportunities go, the main story of 2016 will be the narrowing of the spread between prime and secondary with prime pricing remaining broadly level but secondary compressing.

Finally, the persistently low returns across all asset classes means that further sources of capital, both new and old are turning their attention to real estate. Coupled with the prospects of rental growth we believe the prospects for strong returns in the regional office market in 2016 look promising.

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**Estimated total return 2016-20, %pa**

Source: BNPPRE
intensive asset management certainly lie outside of the Central London retail and office markets.

The dwindling supply (see Fig 4) in offices particularly, and the comparative lack of development, coupled with the sustained occupier demand in both sectors, support the view that rental value growth will continue to uphold capital growth in the regional markets.

Some regional cities have seen an upswing in levels of development recently but this does not translate into increased levels of stock.

The onset of Permitted Development has eroded the office stock in many locations and enabled developers to change the planning use on many office buildings to other uses, notably residential. For example Bristol has lost over 1million sq ft of office stock.

Whilst the fundamental change in retailing, with more online shopping than ever before has been to the absolute benefit of the industrial and logistics sector and we firmly believe that this demand will hold up.

The regional markets are fairly priced in our view and if our economic forecasts prove to be correct and the UK economy continues to perform at its current level, then there could be an opportunity for yields on regional offices, multi-let industrials and single let logistics warehouses, to move in further.

FIG 6. ‘ALL PROPERTY’ CAPITAL VALUES VS PEAK OF LAST CYCLE

<table>
<thead>
<tr>
<th>CITY</th>
<th>CAPITAL VALUES (JUNE 07 VS DEC 15)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manchester</td>
<td>29.95%</td>
</tr>
<tr>
<td>Birmingham</td>
<td>9.71%</td>
</tr>
<tr>
<td>Bristol</td>
<td>8.53%</td>
</tr>
<tr>
<td>Glasgow</td>
<td>-3.42%</td>
</tr>
<tr>
<td>Edinburgh</td>
<td>-10.96%</td>
</tr>
<tr>
<td>Sheffield</td>
<td>-14.76%</td>
</tr>
<tr>
<td>Leeds</td>
<td>-17.66%</td>
</tr>
</tbody>
</table>

Source: MSCI

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