UK Commercial Property 2017

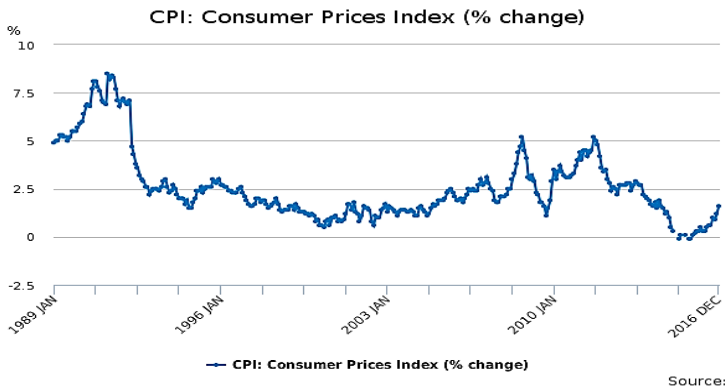
With the IPD Quarterly Property Index Results out this month, the annual total returns for 2016 stand at 3.5%. This time last year predictions for 2016 total returns were at 7.90% (IPF Forecast Survey Feb 2016), a 56% mismatch between expectations and reality. There were however some exceptional factors, the two main ones being, Brexit and the election of Trump, again both misread.

Brexit is still to be played out with the expected trigger for Article 50 to be served by the end of March 2017 and a projected departure by summer 2019. Realistically, agreement on the exit details is unlikely in this time frame and the process will be extended by a number of years. All this will create on going uncertainty which is disliked by the markets and creates caution.

The trends going forward for 2017 look mixed

- Inflation has been kept low in recent years but is under pressure with a number of factors likley to impact on 2017 being
    - The fall in value of Sterling hitting a 31 year low against the dollar following the Referendum vote in June. Before the vote the £ was at $1.48, currently in mid Febuary 2017 it is around $1.24. The cost of imports and raw materials will be considerably higher this year.
    - The cost of crude oil has risen over 75% in the last year to over $50 a barrel, which will have a significant impact on transport costs and pricing.
    - The National Living Wage is to rise by 4% in April 2017 to £7.50 an hour, putting further pressures on production and service costs.
    - The Rating Revaluation is due to be implemented from 1st April 2017 on all non domestic properties in England and Wales. Rates are the third biggest outgoing for many small businesses after rent and staffing. Costs are likely to be immediately higher in London and the South East but those areas benefitting from falls will have these phased over 5 years, continuing the pressure on pricing.

Inflation as measured by CPI currently stands at 1.8% (Feb 2017) but expect this to rise.



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- Inflation is likely to lead to a contractionary monetary policy, using interest rates and Gilt yields to control the economy. Gilt yields, as measured by UK Government 10 year bonds, reached an all time low of 0.58% in August 2016 but the trend has been upwards since then, currently hovering around 1.3%. A rise in rates will have a knock on effect on property pricing. The yield gap looks healthy at the moment but if rates rise, rental growth is needed to sustain the differential however this is expected to be subdued for the reasons outlined above.

Expectations for commercial property in 2017

Capital values fell after Brexit with a surprise rise in the later part of Q4 2016. With pressure on rates, limited rental growth and continued uncertainty, property pricing continues to look expensive and capital values are likely to fall further.

Real estate out performed equities and bonds on a 3 and 5 year basis at the end of 2016, but has fallen behind on a 1 and 10 year basis, the average total return for 10 years being 4.2% pa. With an income return of just under 5% and an expected fall in capital growth later in 2017, total returns for this year will be similar, expecting to average just over 5% pa for the next 5 years.

Regional distribution and London industrials continue to see increased demand and rental growth. With SDLT rises hampering residential transactions over £1m, owners are choosing to sit tight, refurbish and extend; creating tenant activity in the bulky good & DIY sector where relatively attractive yields are on offer. Regional offices are providing a glimpse of out performance from rental growth as supply lines diminish in selected key cities. The 'Alterative' sectors offer opportunities for income.

With this uncertainty transactional turnover will continue to be lower. In 2016 turnover was down at around £49bn from the recent record of £69bn in 2015. For 2017 expect further reduced activity. Investors will need to be more discerning on their stock selection with income becoming key – they will need the skill set of The Magician.

Tim Morgan Feb 2017