Welcome to Santander Corporate & Commercial’s first ever UK Real Estate Market Report. It provides a review of investment trends over the last twelve months as well as looking ahead to what we can expect in 2019.

For many in the sector, 2018 has been a challenging year, particularly for retailers and leisure operators. Combined with the economic uncertainty all businesses are experiencing as they assess the likely impact Brexit will have, the timing of this report is apt.

Looking across the market, our report shows that commercial property continues to be a strong asset class particularly for those clients who wish to acquire assets or grow their existing portfolio. The industrial sector has been attractive to existing and new investors whilst warehousing continues to grow as an important component of any portfolio given the increased use of this sub-sector by e-commerce enterprises.

Santander remains committed to investing in the UK commercial property market. Consistent with our cautious and disciplined approach, there are clear opportunities for existing and new clients and we stand ready to provide the expert support and financing investors expect. We look forward to continuing to strengthen our relationships with existing customers and focusing on new client growth.

I very much hope you find the expertise and market insight within this report useful.

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Real Estate Perspectives

Market Overview

Industrial, for the first time, is regarded as the preferred asset class by most of the respondents to CBRE’s Investor Intentions Survey.

Market uncertainty has reduced property investment flows from European investors to the UK, but London still receives the highest volume of investment property activity of any European city and remains the highest priority target from investors located outside Europe.

There is evidence of an influx of overseas investment into the UK market including considerable acquisitions from high wealth individuals from China and the broader Asian market.

Availability of investment property is a major problem not just in the UK but globally, with strong competition from other investors.

We believe that we are in an investors market with a lack of supply causing too many lenders to compete for the same project. This has caused a lot of current lending activity to be focused on refinancing.

Investor investment strategies have not so far increased risk in return for yield.

Main Investment Trends

Political and economic uncertainty means the current market continues to be topsy-turvy, with a slowdown in overseas investment being one of the main concerns. In fact, the real estate market at the end of May 2018, was down 2.1% in transactional activity according to CBRE, compared with the same period in 2017.

However, it’s not all doom and gloom, there’s now evidence of an influx of new overseas investment money, mainly arriving from China and the broader Asian market.

This industrial real estate growth and activity are mildly offsetting the general market negativity. There has however, been a shift towards retail distribution centres and warehouses over retail stores, which is causing extra turmoil in the retail sector.

Apart from the Industrial sector, investors are looking to alternative real estate, including student housing, healthcare, leisure, retirement living and single family residential for growth, especially as residential real estate continues to cool.
Market Outlook

Economic Background

The Bank of England has now followed the monetary policy normalisation set by the US Federal Reserve and increased interest rates, signalling a recovery from the 2008 financial crisis and global recession. Although higher interest rates make property mortgages and loans more expensive they are still very low in the UK.

While the European Central Bank has yet to raise rates, it's likely to start this process in 2019 as they are still at historically low levels, and it will likely take years before they rise to normal rates. Higher interest rates act as an extra expense on mortgage loans and will have many questioning if the risk of investing in property is worth it, as you can achieve just as good a yield from government bonds. Higher interest rates will also most likely lead to a rise in real estate yields to some extent.

The UK economy has lagged behind the European wide economic recovery. CBRE points to lower consumer confidence as measured by the market research institute GfK, with the balance falling to -10 in October 2017, and remaining at this sub-zero level in July 2018, this compared to an average of +1.8 for the year preceding the referendum.

Technology Trends

Proptech is a buzzword used for any technology that increases the efficiency with which buildings are built, bought, leased, used or managed. Many see the real estate sector as ripe for disruption, and Proptech innovation is likely to focus on the better and more efficient use of property market information. This, in turn, could assist in extracting more value from building stock. It could also increase liquidity in property market transactions by attracting more customers, but also increase volatility.

Proptech development in 2018 is set to include developments in virtual reality, showing how a real estate space could look when fully developed. Drone technology can assist with geographical analysis and aerial photography for site reviews and marketing. Proptech is likely to see developments in systems and processes that make leasing space far more efficient along the lines of Zoopla.
Key Investment Trends

Real estate transactions were down 2.1% by May 2018 compared with the previous year across various sectors, including office, retail and leisure.

The CBRE Cross-border Capital Flows Chart for UK property investment flows show a falloff in 2016, followed by a strong recovery in 2017 to post the second highest year of investment on record.

CBRE says that industrial real estate growth and activity is to some extent offsetting the market negativity in the retail sector. There remains considerable demand for long term secure income investments, with the alternatives sector making up in excess of 75% by number of the assets in the CBRE Long Income Index.

There is also a trend towards retail distribution centres and warehouses from the growth in e-commerce and a decline in retail stores. It’s also clear that retail and food are having a very difficult time, with the exception of some low cost supermarkets who are bucking this trend.
Although the percentage of overseas investors in UK real estate is down compared to previous years, they are still a dominant and significant group and account for 33% of investors. The CBRE UK Investment Volumes for Overseas Investors Chart shows that investor volume from China and Hong Kong grew dramatically in importance in 2017. It’s also worth noting the volume from the USA has shrunk, with impacts of currency change, low yields and possible Brexit concerns being reasons behind this, which will raise alarm bells for some as they have long been a strong and lasting component of UK foreign property investment.

There are lots of reasons foreign investors prefer the UK real estate market. The currency, legal language, universal structure, and ability to buy to name just a few. It goes some way to explain the trend for considerable private investment from China into UK real estate over the past few years. High net worth Chinese individuals are keen to move some of their wealth to a safer market, and have done this despite the challenges they face from Chinese regulations.

Another factor is that the trend for long income leases has now changed. While once it was 20 years plus, it’s now significantly below this level, with ongoing pressure for it to fall further. As flexible working extends in the market, businesses can reduce their office space to accommodate this, with 92% of landlords agreeing to flexible office space leases. Furthermore, co-working spaces like WeWork are very fast growing and successful at raising money, as they are able to offer tenancies on shorter leases.
Geographic Key Trends

London as the UK capital and business centre is the most popular geographic area for real estate investment, even attracting new investors who are reassured by the fact they are investing in a well-known global city. Development in Central London is however slower in 2018, though there is growth in residential builds and growth in mixed use developments. Prices of prime residential property in London have also fallen, putting a question mark on whether this trend will continue, or if there will be a strong bounce back post Brexit. The global trend is mixed with cities such as Shanghai and Sydney having a price decline in their house-price index, but house prices in New York and Paris are still inflating strongly.
The CBRE UK Investment Volume Chart shows that the London office space makes up a significant proportion of UK investment volume and its share has increased sharply in quarter two of 2018.

For overseas buyers, the favourite location remains London with Asian buyers prepared to consider small units/apartments across London, Manchester and Birmingham. Outside London they are attracted by the prospect of buying three to four properties in Birmingham, rather than just one in London, as it reduces their stamp duty costs. These logistics require specific location characteristics that are found ‘outside of the city’ and is a sector growing strongly across the EMEA.

As mentioned earlier, alternative real estate, including student housing in prime university towns is the biggest area of alternative investment.

**Sector Key Trends**

The CBRE UK Investment Volume chart shows that investment into the industrial sector has grown significantly, while retail has shrunk.

CBRE Commercial Real Estate in the Capital Value Index Chart shows all sectors increasing, with the exception of retail which has started to decrease in H1 2018. This reflects what people have been saying on the ground for some time now.

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![UK Investment Volumes Chart](chart1)

![UK CRE Capital Value Index Chart](chart2)
### Office

With the slowing UK economy, the outlook for UK office markets in 2018 can only be described as testing. Rental growth is expected to be stable, or have a small increase in the large regional markets, but with small declines in parts of Central London. Low levels of availability and relatively strong demand for the best Grade A space will moderate any rental falls.

Brexit concerns are having an adverse effect on real estate in Canary Wharf. There is the question of a tenant base of European law firms and banks remaining in a post-Brexit UK.

Office development activity across the UK is set to slow down in 2018. Around 5.4 million sq ft of Central London office development is expected to be completed in 2018, a fall of 16% on 2017 and just under 50% is already pre-let. This situation could lead to future shortages, especially in Grade A.

New speculative office space development has continued strongly in the South East and its supply of Grade A was 33% above its five-year average at the end of Q3, 2017. However, new development completions in the core regional cities are forecast to fall 77% in 2018. Shortage of Grade A space will be a feature of the property market in Bristol, Edinburgh and Glasgow where development has not kept pace with demand.

The flexible office space operators expanded rapidly in 2017 and this trend is expected to continue in 2018. Occupiers with smaller requirements (under 5,000 sq ft) are increasingly turning away from conventional office space and using flexible office space instead. This trend has caused a drop in the volume of transactions in Central London since 2016 in the under 5,000 sq ft category. The flexible office space operators significantly expanded their presence beyond London into the southeast and regional cities such as Birmingham and Manchester during 2017. The thriving creative industry sector and the large numbers of new start-up businesses are known to prefer flexible office space.

### Retail

A slowdown in consumer spending will make 2018 a tough year for retailers and leisure operators. The UK has seen stronger e-commerce growth than in other parts of the EMEA and it now commands 20% of total retail sales compared to just 5% in parts of Europe.

These factors are putting pressure on retail profitability, but when you factor in the weaker pound it provides some comfort for internationally-oriented retailers.

Rents are unlikely to grow, but significant amounts of new, high-quality shopping centre space will open and merger activity will continue.

Even when you take into account that investment volume in UK retail property fell sharply in 2017 and is expected to continue to fall this year, prime retail yields have been stable for a few years and have started to edge upwards in the last quarter.

### Industrial

Industrial space includes warehousing, transport, utilities, storage, as well as industrial usage. Warehousing is a growing and important component as e-commerce uses this subsector and is taking market share away from retail.

The structural reasons for the industry sectors growth have overwhelmed any negative uncertainties from Brexit. Industry witnessed only a marginal fall in values following the Brexit referendum in 2016, a loss that was reversed within months. However, it is possible that some transport and logistical parts of industry could be adversely affected by the vote to leave.

There are new building models such as multi-storey logistic designs and developments, but there is no sign that these will make up the shortfall any time soon.

New technologies such as truck platooning that use smart technology to drive the trucks, could have logistical property implications as warehouses may no longer have to be located at a distance that takes into account the strict rules governing driver hours. The transformational effect of the internet on retail and distribution is by no means complete, and the increasing volume of online orders is expected to drive further demand for warehouse space, particularly for smaller units in urban settings.

From a banking point of view, there are strong cash levels in the industrial sector. Although there is lots of risk, it is easy to underwrite. Banks like this sector as it offers good yields, has a high recovery rate, healthy risk cover and is heavily sought after. Yields however, are historically low in this sector, at just 4% for London.
We are following the CBRE’s Beds sector definition which includes owner-occupied housing, built-to-rent housing (which includes retirement and single family residential), student accommodation, but also contains hotels and healthcare. Residential is the second most important sector. However, we see residential real estate as cooling with sales volume a concern in contrast to other areas.

According to Nationwide, the annual rate of house price inflation is expected to slow to 2.6% in 2018, down from 4.1% at the start of 2017, and from a peak of 11.6% in 2015. The slowdown was largely driven by London. Affordability constraints will limit first time buyer ambitions and the trend to rent will continue. In contrast, annual house price inflation picked up in some regions, with East Midlands posting the strongest price increase of 5.1% in Q3 of 2017. CBRE expects house price inflation of 17% across the UK over the next five years.

The composition of transactions has changed with a marked increase in first-time buyers with this group accounting for 48% of all mortgages. This increase in first-time buyers partly reflects the government’s ‘Help to Buy’ initiative and the trend is most marked in London.

Households with dependent children now account for a third of renters, according to the English Housing report. Some developers are responding to this demographic group with a more bespoke family-friendly offer. Sigma for example, launched its PRS REIT in 2017, with a mandate to provide family homes for rent.

Student numbers fell slightly in 2017, but investment volumes for 2017 exceeded 2016’s total of £3.5bn by £1.1bn to £4.6bn. An analysis of CBRE’s regular valuation data of 60,000 bed spaces showed total returns of 9.6% in the 12 months to September 2017, and student accommodation showed 2.98% net rental growth nationally. Yields are stable in the regional towns. In London, yields for operational stock are falling as planning constraints create scarcity, which is translating into rental growth for existing assets. Limited student finances remain a concern for investors and operators, who are responding with more budget options.

Hotels performed well in 2017 and this is expected to continue for 2018. Available rooms will grow at double the long-term average rate in 2018. Investment levels will remain robust, though there will be a shortage of stock available in London. The weaker pound for the 12-month period after the Brexit vote allowed UK’s more international markets, chiefly London, to increase the volume of tourists and prices through 2017 but continuing this in 2018 will be much more difficult for hoteliers. In the UK provinces, hotel turnover increased for the seventh consecutive year, mostly driven by growth in room rates. Hotels are facing problems such as inflation increasing costs for hotels and at the same time reducing effective demand. The hotel sector’s high proportion of foreign-born workers are being hit by a weakening currency and Brexit concerns on their future right to work in the UK. This could translate into recruitment and staffing difficulties for UK hotels.

Investment in UK healthcare real estate has grown strongly. Prime elderly care and private acute hospitals remain the focus for investors, with the integration of health and social care starting to create new areas of investment. By the end of October 2017, healthcare real estate investment in 2017 was already almost double at £1.4bn the investment levels in the whole of 2016. The elderly care home property experienced record prices in 2017 and breakthroughs in retirement living in 2017 suggest growth in this sector will be an opportunity for 2018. Yields for good quality care home investments let at close to investment grade covenants fell below 5%. Retirement/senior living is an immature market that has yet to fully work out how the model of repayment works.
Real Estate Future Predictions

There is a general shortage of housing in London and the limited number of such developments are occurring in a quieter period. This is causing a gap to open for additional investors to enter.

There are questions as to whether the market will become saturated in London and then expand to the regions.

Forward market projections for the real estate market are ever changing, but there is a strong trend for more efficient building, buying and renting.

It is expected that retail and office real estate space will have changed in just five years’ time as the needs of businesses change. An example trend along these lines is the increase in build-to-sell, over build-to-rent developments.

A possible future trend for commercial property owners is to let out 5 of 7 floors for longer term tenancies, and then 2 of the 7 for shorter-term tenancies, which is not too dissimilar to the WeWork model and creates more opportunites to cash in on a variety of business leasing models. The other benefits of this concept and the WeWork model is it’s able to subliminally drive networking opportunities between businesses and future growth.

In flexible office space, buyers and lenders find the higher margins appealing and are willing to accept the flexibility they need to offer. CBRE says as the flexible office market matures and there is more data available the task of valuing such offices will also become clearer. Tenants in these instances like the fact that they can use a property manager or developer to rent them out, which is especially attractive if it includes maintenance and facilities management.

Using existing technology that makes leasing commercial space far more efficient, along the lines of the internet technology used by Zoopla, could be a game changer for the retail market.
Conclusion

For the first time, industrial assets, are regarded as the preferred class according to CBRE’s Investor Intentions Survey.

What has also become clear, is the UK market uncertainty has reduced property investment flows from European investors, with London being the only exception which continues to receive the highest volume of investment property activity of any European city. This has helped it remain the number one priority target from investors located outside Europe.

Evidence also points to an influx of overseas investment into the UK market, with wealthy individuals from China and the broader Asian market making considerable acquisitions. This, in turn, has contributed to the fact that investment property availability is becoming more and more of a major problem. That’s not just here in the UK either, strong investment competition is turning the problem into a global one.

It’s why we believe we’re currently in an investors market. This lack of supply is causing too many lenders to compete for the same project, forcing lenders to initially focus more on refinancing rather than taking an increased risk in return for yield.

Proptech is potentially best placed to benefit from all of this, with investors taking a more cautious approach, their ability to use virtual reality to show how a real estate space could look when fully developed could be key.

Bibliography


For further information, visit santandercb.co.uk/realestate

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