RICS UK Commercial Property Market Focus - August 2016

Sentiment hit in the immediate aftermath of Brexit vote

The results of the recently issued RICS UK Commercial Property Market Survey highlight a heightened sense of caution across the sector in the days following the Brexit vote. Indicators for investment and occupier demand dropped, pushing near term expectations for capital value and rental growth into negative territory. Although sentiment has deteriorated noticeably in all parts of the UK, the downward shift is most visible in London. As the survey sample was collected in the immediate aftermath of the referendum result, it remains to be seen whether some of negativity will unwind in the coming quarters or if this is the start of a more sustained downturn.

Occupier Market - rent expectations balance turns negative

During Q2, occupier demand failed to increase for the first time since 2012, with the headline indicator slipping from +21% (net balance) to zero. The sector breakdown shows tenant demand fell across the office and retail areas of the market but increased modestly in the industrial sector. In keeping with this, availability remains particularly tight in the industrial sector, with the supply indicator remaining negative in Q2 - the sixteenth consecutive quarter in which the supply of leasable industrial space has fallen.

The more subdued demand backdrop in the uncertain economic climate has led surveyors to sharply downgrade their near term rental expectations. Indeed, the all-property rental expectations net balance dropped to -7% from +26% previously. Chart 1 plots the RICS rent expectations series against the rental value index produced by CBRE. Pushing the expectations series forward by three quarters demonstrates its accuracy in providing a strong guide to future changes in rents. As such, the sharp drop in the latest results now points to rents being marginally down on a year on year basis by Q1 2017 (currently up 3.4% on an annual comparison).

This chimes with RICS members' twelve month projections which signal rental declines of a little under 1% over the coming year. When disaggregated, secondary retail and office sectors are expected to see the most significant declines of 2.5% and 2% respectively. At the other end of the spectrum, respondents envisage prime industrial rents continuing to rise, albeit only modestly.

The central London office leasing market has seen a particularly sharp deterioration in near term rent expectations. Chart 2 maps these expectations against the CoStar rental data. Currently, central London office rents are up 9.1% on an annual basis, albeit the rate of growth has already slowed markedly compared to a peak of 19.3% last year. Nevertheless, the steep decline in the latest RICS reading is consistent with rents falling as much as 5% (year on year) through to the early part of 2017.

Chart 1: RICS 3-Month Rent Expectations and CBRE All-Property Rental Value Index

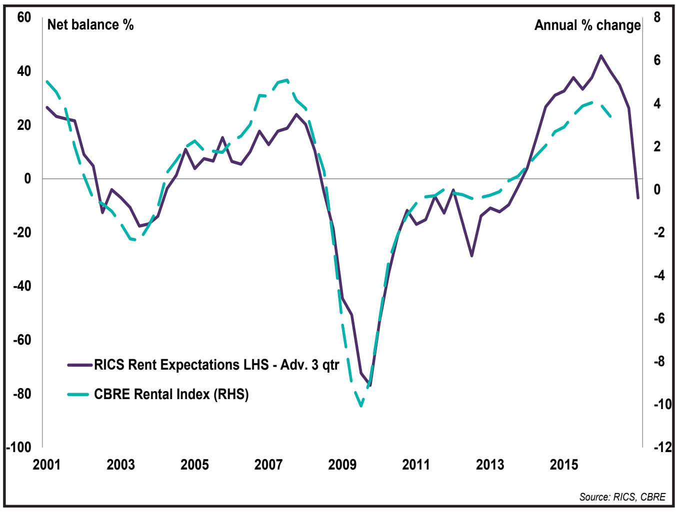
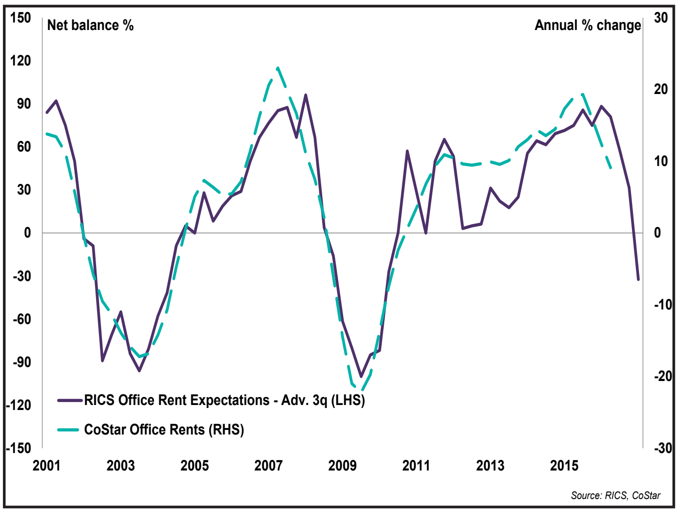


Chart 2: RICS 3-Month Central London Office Rent Expectations and CoStar Average Achieved Rents



Investment Market - enquiries fall significantly

Although weaker sentiment was visible across most indicators in the latest results, the investment side of the market perhaps displayed a more significant decline. Indeed, the RICS investment enquiries gauge fell from +25% to -16%, representing the sharpest quarter-on-quarter decline in this measure since its introduction in 2006. Even so, with 16% more respondents reporting a fall in enquiries (as opposed to a rise) the indicator is still well above levels seen during the global financial crisis. Foreign investor demand reportedly fell at a sharper rate than the overall figure, however, with the net balance sliding to -27%.

Chart 3 plots the RICS Investment Enquiries data alongside the CoStar national investment volumes figures. The RICS series has been advanced three quarters to provide a steer on the likely path for investment volumes over the remainder of the year. From a peak of £75bn in Q2 2015 the annual total has already eased to £57bn. The drop in the investment enquiries gauge, on the basis of past form, suggests the rolling annual sum of investment will continue to decline as the year progresses. What's more, the rate of decline is likely to gather pace.

The RICS Investment Sentiment Index (a composite measure encompassing variables on demand, supply and price expectations) fell into negative territory during Q2. Mapping the ISI, advanced by two quarters, against the capital value index produced by CBRE now points to a fall in headline capital values through the remainder of 2016. In year on year terms, prices could be down by rougly 5% come Q4 2016. At the end of the second quarter, capital values were up 4.7% on an annual comparison, down from a high of 13% at the end of 2014. As such, growth was decelerating noticeably even before the Brexit vote, although the current uncertainty appears to have exacerbated the trend quite substantially.

Property Cycle Perceptions

Across all parts of the UK, there was an uptick in the share of respondents sensing their local market has now entered the early stages of a downturn. At the UK wide level, the proportion taking this view stands at 36%. Despite opinions being mixed, this category returned the highest proportion of responses relative to all others (chart 5). As recently as Q1, the largest share of respondents nationally were of the opinion conditions in their local market were consistent with the middle stages of an upturn. The aftermath of the referendum result has therefore induced a sharp turnaround in views on the property cycle. The latest data also shows perceptions on valuations were revised slightly, although not to the same degree. Indeed, the proportion of respondents sensing commercial real estate to be overpriced to some extent edged up from 15% to 22%.

In London, the majority of respondents (54%) feel the market is turning down, up from 21% in Q1. Meanwhile, 60% believe valuations are stretched relative to fundamentals. During Q2, near term capital value expectations dropped sharply into negative territory, with the net balance coming in at -38% (the weakest reading since RICS started collecting regional data on this variable in 2010). At the twelve month horizon, prices are expected to fall across each sub sectors in the capital, although projections are most negative across the retail market (both prime and secondary areas). Moreover, further weakness is also expected over the medium term. Last quarter, respondents were pencilling in headline capital value growth to average 4% in each of the next three years in London. Following the Brexit vote, contributors foresee prices declining by 2% per annum over the coming three years.

Chart 3: RICS UK Investment Enquiries and CoStar UK Investment Volumes

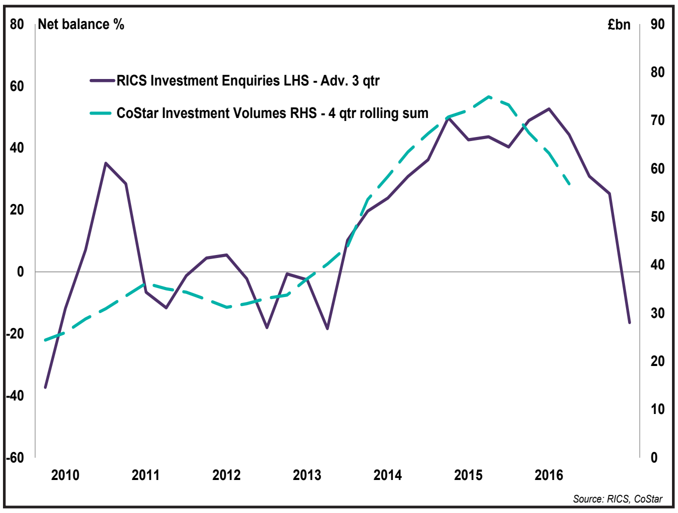


Chart 4: RICS Investment Sentiment Index and CBRE Capital Values

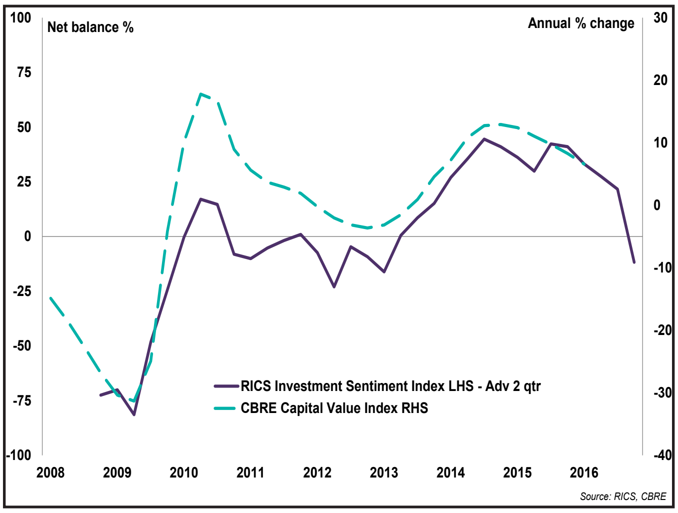
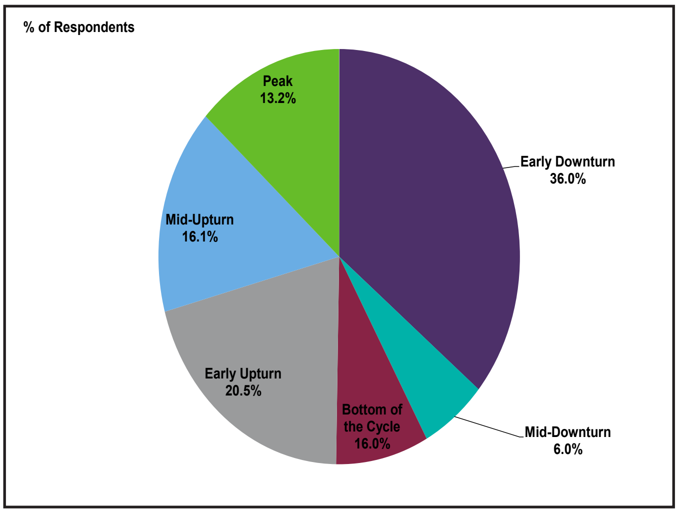


Chart 5: RICS Respondents' Perceptions of current valuation levels



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