UK Real Estate Market **Predictions 2020**

Time to act

Contents

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On 21 January 2020, Dentons held its annual Real Estate Predictions Event in London at which industry experts gathered to share their views on the market. In contrast to 2019, the focus was more global and the mood more upbeat. Combining those views with our own transactional experience, the key trends emerging for 2020 are:

- cautious optimism,
- taking responsibility, and
- understanding and adapting to change.

Cautious optimism

The general feeling as we enter 2020 is one of cautious optimism. The greater political certainty brought about by the 2019 General Election result has released, at least for the time being, the Brexit brake that was holding back the market at the back-end of last year. There is renewed vigour and a real appetite to get more deals done – a 'Boris Bounce' perhaps.

Overseas investors may not benefit from such an attractive currency play as they have had over the last few years, but that is not likely to dampen enthusiasm too much. For example, on the build to rent side investors see plenty of opportunities because of the unsated demand in the UK for more high quality residential rental product. Other overseas players will want to seize the initiative whilst UK pricing remains relatively good value compared to other major investment locations. What is clear is that there are many sophisticated and nimble overseas investors who understand the markets well and who are now actively seeking out UK opportunities, particularly in London.

"There is renewed vigour and a real appetite to get more deals done."

It is also predicted that we will see more activity from domestic institutional investors who may have been in a Brexit holding pattern. Again, there are plenty of opportunities as sectors such as the central London office market continue to show remarkable resilience and to deliver attractive returns. Meanwhile, alternatives such as student accommodation, build to rent and assisted living are shrugging off their tags to become far more mainstream.

The expected increase in deal flow will be good news for funders who have been willing to lend but have struggled to find transactions due to lower volumes in 2019. It is not just the variety and availability of funding that is encouraging – those who experienced the 2007 property crash will be reassured by the discipline being shown by lenders who are currently showing no desire to return to riskier lending criteria.

Overall, there is a lot of pent-up capital waiting to be deployed in a market that is getting its confidence back.

However, there are a few notes of caution. Firstly, Brexit is not done. As we enter into the transitional period, the UK still has to work out the fine detail of its future relationship with the European Union and any hiccups along the way could dent confidence, particularly as we edge towards the end of the year. Secondly, even within the strongest sectors, such as logistics, it is still possible to make sub-optimal investment decisions (for example, investing in outdated product or in areas of over-supply). Finally, as Brexit worries recede, attention will inevitably be drawn to other pressing matters.

Taking responsibility

Globally there is no more pressing matter than climate change. It is climbing up the political agenda both at home and abroad. The property industry recognises that it is a major contributor to the carbon footprint and that if the government's commitment to becoming carbon neutral by 2050 is to be taken seriously, real estate needs to act and act fast.

However, it is not just climate change that is preoccupying the market. In our view one of the key themes for 2020, and in fact this whole decade, is going to be ESG – Environment, Social and Governance. It is a term that encompasses many things from sustainability to anti-slavery to place-making. At its heart is the central notion that the property industry has responsibilities. While such matters have been on the real estate radar for some time, the industry is now signalling a desire to move away from approaching ESG as just a tick box exercise.

In part, this shift is being driven by the growing realisation that there is a link between ESG credentials and value. On the lender side, we are seeing the emergence of more green lending products – where borrowers can secure more favourable lending terms if they are able to meet certain green criteria. Meanwhile, investors are asking more questions about the ESG credentials of the properties and people they are investing in and increasingly shying away from anything that could have a negative impact on reputation. At our Predictions Event, one commentator even went so far as to say that good ESG credentials are now "essential for institutional capital" investment. At home, children are asking their parents what they are doing at work to tackle ESG issues.

However, the value in good ESG policies is not always obvious. Feedback at our Predictions Event highlighted that sometimes there is little apparent benefit to the industry in doing the right thing (for example, recycling). Often policies make it more desirable to knock down buildings and start from scratch. There is also an array of different accreditations out there and it is not always clear which is the gold standard that parties should try to achieve.

These are all issues the industry is going to need to work through over the next decade as part of another theme – understanding and adapting to change.

Understanding and adapting to change

There is no doubt the industry is changing. Construction techniques have moved on – modular construction, with its potential to shorten development timeframes, insulate projects against adverse weather risks and increase the safety of the workforce, is on the rise. The way in which buildings are used and managed has evolved, with a greater emphasis today on the human experience and landlords adopting a more operational business model to reflect the service industry in which they now find themselves. Even the demand for property is changing, with retail perhaps being on the decline but with lifestyle centres and logistics taking its place.

Change is inevitable, immediate understanding is not. For example, when presenting modular construction projects to funders for the first time there are new issues to be grappled with – what happens if the modular manufacturer goes bust? Where is the security for the loan? How would a lender enforce? These are not insurmountable, especially given the promise of healthy returns for those with the enthusiasm to adapt. Equally, an understanding of how technology is evolving will be key to evaluating investment opportunities in existing stock. A well-located warehouse unit may look like a great investment but, if it cannot accommodate the fit-out demanded by modern occupiers, then it may not be the bargain it first appeared.

"Understanding change is going to be one way of keeping ahead of the game."

Of course, it is not just about understanding the building, it is also about understanding the occupier. One modern phenomenon that we are likely to see grow in importance is the rise of online platforms giving immediate feedback on properties and companies. This is something the build to rent industry is taking seriously – it recognises the value of reputation and brand, and the need to monitor and quickly respond to its customers' feedback. Feedback on other types of stock, such as offices and retail, is also likely to grow and owners of the same will no doubt follow the lead from the residential sector.

Understanding change is also going to be one way of keeping ahead of the game and that is going to be key, given that 2020 looks like it is going to be a year of increasing competition.

Competition

With the increased optimism for UK property comes increased competition making now the time to act. Domestic and overseas players are looking afresh at the market with a wall of capital looking to invest and not wishing to incur the opportunity cost of waiting. This is something our clients are already reporting as they manoeuvre themselves to secure the best deals. Getting the edge in an increasingly competitive market will come down to many things. Place-making, the theme from our 2019 Predictions Report, is certainly one of them. However, the savvy will realise that a competitive advantage can also come from embracing responsibilities and adapting to change.

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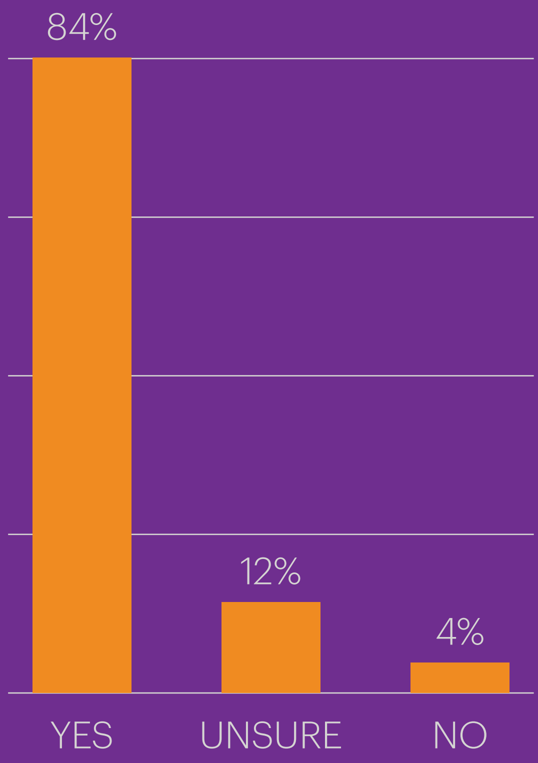
During our January 2020 Predictions event in London we asked our audience whether, post the December 2019 General Election, they felt the prospects for real estate in 2020 were more positive. The results were: 84% said yes, 12% were unsure and 4% said no.



Later into the evening we asked the audience for one word to describe the outlook for the real estate market in 2020 and whilst the most popular choice was positive, it was was closely followed by unpredictable, uncertain and bumpy.

Scottish Real Estate Market Predictions 2020

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On 30 January 2020 Dentons held its Scottish Real Estate Predictions event in Glasgow at which a panel of industry experts gave their views on what is likely to happen in the Scottish real estate market in 2020. There were a variety of different perspectives on what is in store for different sectors, but general agreement that the key influencing forces would be:

- political uncertainty,
- our changing demographics, and
- global responsibility.

Political uncertainty

2020 is off to a positive start for the Scottish real estate market. The Conservative Party's general election victory at the end of last year and the UK leaving the EU on 31 January have provided some political stability, which the market has been craving. It looks hopeful that this buoyancy will continue for the first half of the year.

However, might it be a year of two halves? 31 January was only the beginning of the end of Brexit. We now face a year of tough negotiations, uncertainty and cliff hangers. Some resultant market volatility seems inevitable as the year goes on. In Scotland, there is heightened uncertainty in the form of a potential IndyRef2. If Brexit negotiations don't go well, this will lend more credence to the pro-independence movement. As long as another referendum is on the agenda, many investors (particularly UK funds) may remain cautious.

Having said that, Scotland continues to see a large amount of foreign investment, particularly from Asian and Pan-European investors. Scotland remains a strong place to invest, offering good value and solid property fundamentals. Scottish retail warehousing in particular is one to watch in 2020.

Within Scotland, the city of Glasgow is in a particularly strong position in 2020. The supply and demand dynamics in Glasgow are currently at their optimum, and the city is providing both good yields and net effective rental growth.

Changing demographics and requirements

Changes in the size and age structure of the population are having implications for the real estate market. Scotland's population is continuing to age, with our working age population projected to fall, particularly if EU migration is reduced.

What people require from their living spaces is also changing. Increasingly, people want to be able to work, play, learn, shop and exercise from in or near their homes. There is a growing demand for mixed-use developments in Scotland, whether build to rent

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– which is becoming more established north of the border – or private renting. Particularly popular are developments with integrated social aspects. A city centre is of course by its very nature mixed use, and there is an increasing demand for residential offerings in city centres. The demand is coming not just from millennials but from older people looking to downsize. An increase in 'downtown' living could help stimulate the leisure and retail economy of city centres outside of working hours.

In a similar vein, office requirements continue to evolve. The co-working model, where companies deliver flexible office space as a service remains important to our economy. It is well established that people work better with other people around them and in an environment where they have all the modern commodities and services that a more established business would have. Co-working spaces and serviced offices with real flexibility of tenure remain in high demand. Developers and landlords are now having to respond by offering more facilities and services.

There is also a continuing and increasing demand by occupiers for flexibility in lease durations. Businesses, particularly small and/or start-up companies, need core spaces with flex options. Downsizing is no longer necessarily a negative thing, as agile working increases and technology provides more efficient business solutions. Of course while businesses are fluid, properties are fixed, so developers and landlords are left with a challenge. Sometimes the provision of serviced elements can be a solution. For investors, a key challenge is how to value office blocks filled with tenants who on paper are short term, albeit they often end up staying longer than expected. Traditional methods of valuation will need to evolve.

Environmental, Social and Governance (ESG)

The prominence of ESG continues to grow within the industry. The climate crisis is, and has for some time been, the biggest trend currently affecting the real estate market. Everyone is talking about the importance of sustainability in buildings. But do we still need a little less conversation, a little more action? Some funds and investors are taking action, but others seem to be waiting, perhaps to take action only once mandatory regulations are imposed, or once occupiers make stronger demands. As occupiers increasingly require this, it will become more of a priority for investors, and therefore for developers. The pressure will be cumulative. Achieving sustainability in buildings should result in less depreciation of assets and protect against reputational risk. The increasing availability of advanced building technologies will also drive the ESG requirement.

A core challenge for real estate is how to refurbish old buildings to make them sustainable, whilst also fit for purpose and for modern working/living. This is not helped by rising construction costs, and a shortage of trade skills and construction professionals in Scotland. Another challenge arises from the pressure which local authority planning and building control departments are under. Public officers working in these areas need to be properly resourced, remunerated and trained.

In November 2020, Glasgow will be hosting Conference of the Parties 26 (COP26), a major United Nations climate change summit, with up to 30,000 delegates expected to attend. Not only will this shine a spotlight on Glasgow, but it will bring sustainability even more into the collective consciousness of Scotland in 2020.

A key social aspect of real estate is creating communities. We observed earlier the growing demand for mixed-use developments, with integrated social aspects. At the heart of this is place-making, and encouraging community engagement. These are two principles which are at the forefront of Scottish Government policy. In 2019 the Scottish Government adopted a Place Principle, committing to take a collaborative, place-based approach and to encourage community involvement and local flexibility. A report produced by the Infrastructure Commission for Scotland in January 2020 highlights the importance of putting "place" at the heart of infrastructure prioritisation and planning, in order to achieve an inclusive net zero carbon economy.

Glasgow has recognised the fundamental importance of place for social, economic and inclusive growth. A Place Commission for Glasgow was launched in September 2019 and will be looking this year at how the city can design its places to put people first and make the city a better place for all to live in.

Balancing short term gain against long term responsibilities

These three forces of political uncertainty, changing demographics and global responsibility are longer-term pressures that will persist beyond 2020 and beyond our immediate shores.

However, investors, occupiers and developers will still have to navigate more immediate pressures on their businesses such as fluctuations in currency, rising construction costs, and changing consumer demand for goods and services to ensure that they are well positioned to navigate these global forces.

Businesses will therefore need to balance their need for short term gains against longer term sustainability and social responsibility goals. The best advised will realise that with consumers' increasing demand for products, services and buildings from businesses that have ESG high on their agenda, governmental regulation will also increase. The Scottish Government already has ambitious climate change targets and it seems likely that they will also incentivise businesses to develop innovative solutions to the social and environmental problems that we currently face.

One thing we can be sure of is that the balance is shifting. Sustainability and responsibility should therefore no longer be seen as a box ticking exercise, and one that is detrimental to profits or returns. There is now a real opportunity for the most flexible and innovative businesses to capitalise on this change in demand and turn that into competitive advantage in 2020 and beyond.

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"People want to be able to work, play, learn, shop and exercise from in or near their homes."

"The concept of co-working remains valid – people work better with other people around them."

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