CBRE RESEARCH

2016

United Kingdom
REAL ESTATE MARKET OUTLOOK

CBRE

CONTENTS

Economic outlook 2

Investment outlook 5

Political outlook 9

Sectors

- Offices 12
- Industrial 16
- Retail 19
- Hotels 22
- Pubs, leisure and healthcare 25
- Student housing 27
- Residential 28

EXECUTIVE SUMMARY

Welcome to CBRE's UK Real Estate Market Outlook for 2016 and beyond. In this report we set out our prediction on the key trends likely to affect UK property markets over the next 12 months.

While emerging market economies across the world will weaken in 2016, OECD economies look well placed to grow. This is as true for the UK as anywhere else, with a benign combination of low inflation, low interest rates and jobs growth likely to conspire to create sure and steady growth at or around trend rates for the next two years.

Very strong growth in investment volumes in the last few years is now likely to flatten off, with 2016 seeing a similar volume to 2015. The mix of foreign investment will change, and while total returns will continue to be attractive in the next 2 years, especially relative to other asset classes, returns will look more marginal by 2020.

A referendum on membership of the EU could well overshadow real estate prospects in 2016, though the Scottish Parliament election in May looks unlikely in itself to add another independence referendum on top. London's Mayoral contest will deliver a Mayor opposed to Heathrow's expansion plans, while growth outside London looks likely to be spurred by the Chancellor's Northern Powerhouse initiative.

Strong employment growth will underpin **office markets** in 2016, with sustained investment, rental growth and take-up in both London and regional markets. Central London investment is somewhat exposed to current global risks, with yields at all-time lows implying caution over pricing from now on. We expect to see supply recovering, leading to lower rental growth by 2020. But this supply boost will be offset by planning reforms easing conversion of offices to homes.

The outlook for the **retail** sector looks positive for 2016, thanks to a strong UK economy. Retail sales have grown for 30 months in a row. Prime shopping centres, factory outlets and retail parks will perform strongly. Lower oil prices, wage growth, deflation and low interest rates have contributed to growth in 2015, but there are some threats on the horizon for retailers next year which could reduce profit margins.

Structural change in the retail industry, particularly online delivery, will also be a prominent influence on **industrial property** choices over the next few years. Industrial property could be temporarily affected by a slowdown in manufacturing growth, but overall investment prospects look relatively strong. We forecast that industrials, especially secondary sheds, will be an outperforming sector even given a sustained development response.

Wider economic strength will underpin **hotels** performance in 2016, though in London an increase in luxury hotel openings will act as a drag. Investment will remain strong, though an increase in 'buy to hold' strategies from Asian investors may mean 2016 repeats rather than exceeds 2015's record performance.

New investors have dominated activity in other non-traditional 'operational' real estate and this will continue in 2016. US REITs have driven the agenda investment **healthcare**, real estate investors are exploring **Pubs** opportunities, and patient international capital has been very busy in the **leisure** sector.

Student housing will experience continued strong demand from investors of all types but with significant supply side challenges in London and key student towns.

Growth in the wider **residential** market will moderate, and despite Government action, supply constraints seem likely to continue. Tax changes could discourage some investment, but there are clear opportunities in the private rented sector.

ECONOMIC OUTLOOK

AT-TREND GDP GROWTH IN 2016

While emerging market economies across the world will weaken in 2016, OECD economies look well placed to grow. This is as true for the UK as anywhere else, with a benign combination of low inflation, low interest rates and jobs growth likely to conspire to create sure and steady growth at or around trend rates for the next two years.

Global economic growth to polarise further in 2016

Global economic growth will further polarize in 2016. Emerging Markets Economies (EMEs) are suffering from the knock on effects of a slowdown in China and commodity price weakness, while the OECD economic recovery is strengthening.

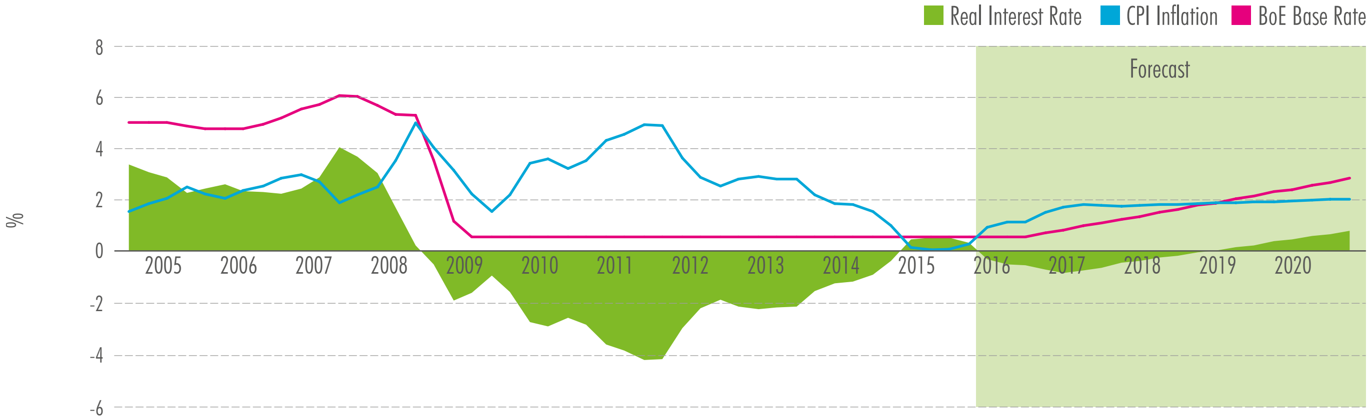
The commodity price boom which lasted through the recession and which contributed sizeably to its severity in OECD economies, is well and truly over. This is partly because of the slowdown in China; but it has also been driven by investment in new sources of supply when prices were high (not least in oil and gas). The commodity price collapse has given a much-needed boost to consumer demand in the west. Wages have stabilised and are even picking up in some countries. Meanwhile zero or negative inflation has boosted real incomes. Employment is also rising, and unemployment is falling in the US and across most of Europe.

On the other hand, commodity producers are suffering. Furthermore, some of them (and some non-commodity producing EMEs too) have borrowed heavily in US dollars and at US interest rates when QE made borrowing cheap. They now face a 'triple whammy' of falling export prices, a strong dollar and the prospect of rising US interest rates.

This has direct trade implications for European countries who are exposed to EMEs. But there is also an indirect financial risk. The default of one or more EMEs could cause problems for western financial institutions, with repercussions for property in western financial centres.

Such a risk looks superficially serious, but is probably transitory– rather like the Asian debt crisis and Russian default of the late 1990s. The mirror image of that threat is that western economies perform 'too well', stoking inflation. The commodity price collapse has obscured an increase in underlying inflation in some countries and has kept interest rates lower than they otherwise might have been. The danger is that monetary policy is too loose as economies recover and the increases in interest rates - when they come - are steeper than expected.

Figure 1: UK interest rates and inflation



Source: Oxford Economics

So we are at a fine balancing point. Investors are broadly happy with current rates of recovery. The prospect of a modest and gradual recovery in interest rates and the global economy does translate into rental growth in many European property markets. But a deviation in either direction – stronger growth and higher interest rates, or a renewed lapse, driven by an EME crisis, into recession would be considerably worse for investment performance than a steady economic recovery of the sort seen recently.

United Kingdom prospects look positive too

2015 has kicked off a period of moderate growth for the next two years, at around trend rates. The service sector experienced a brief weakness in summer 2015 but is now bouncing back. The volatile construction output posted a contraction that was counter to survey readings. The strong pound being cited as hampering manufacturing's export growth with output falling by 0.3%. The expectation is that outturn GDP for 2015 will be 2.4%, and 2.5% for 2016.

Business conditions remain favourable. The Bank of England Agents' Summary of Business Conditions and the forward Purchasing Managers' Index (PMI) both suggest near-trend growth will continue. And strong construction sector data, particularly in commercial property, suggests the official output data will be revised upwards. According to the PMI, commercial building activity grew at is sharpest pace for 8 months to November 2015. Furthermore, there is significant jobs growth in the sector as firms reduce reliance on sub-contractors.

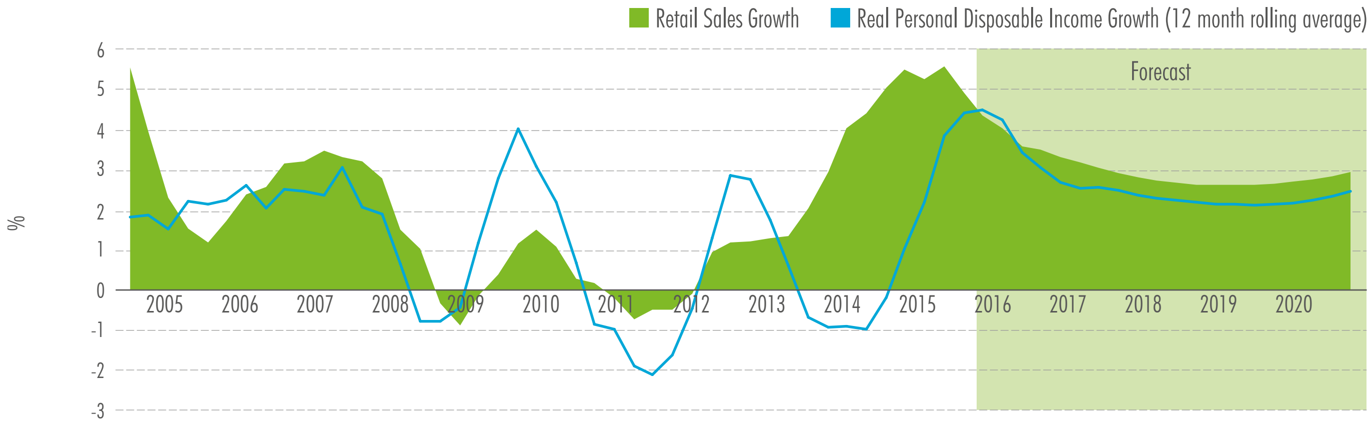
Low inflation, low interest rates and jobs growth imply a continued consumer rebound

Households are taking advantage of real earnings growth, low interest rates and low inflation to increase their spending. So real household spending will continue to expand, with recreation and culture purchases growing particularly strongly.

Strong spending has contributed to retail sales, with headline retail sales growing for the past two and half years. But, as we argue in our retail sector outlook (see page 20), retailer margins are suffering from higher input costs. For example, food stores had only modest sales growth given falling prices. That said, there is some good news. Food prices on international markets in October 2015 were 16% lower than in 2014, and factory gate costs faced by retailers are falling at a faster rate than consumer prices. This will help retailers to rebuild their margins.

Online sales continue to expand. Around 12% of sales are now fulfilled this way (compared to less than 4% in 2007).

Figure 2: Real incomes expectations drive retail sales



Source: Oxford Economics

ECONOMIC OUTLOOK CONTINUED

Internet sales in the clothing and footwear sector have grown particularly strongly recently. We predict that the total proportion of sales fulfilled over the internet will continue to increase, to around 15% by 2020.

Inflation will remain low for some time. Near-zero inflation caused mainly by big falls in oil prices in late 2014 will begin to unwind during 2016. Low oil prices have largely been a boost for the economy, freeing up cash to be diverted to other uses, by households and (energy intensive) businesses. But the drivers of inflation are divergent: services inflation (domestically generated) is strong, while goods inflation (to some extent externally generated) is weak. We expect core inflation to remain around 1% until mid to late 2016.

At 5.3%, the UK unemployment rate is now significantly below the 7% level which the Bank of England's originally indicated would prompt a rise in interest rates. Nearly half a million people are now in work compared to late 2014, with over half in full-time work. Average earnings have accelerated since mid-2014, stabilising at around 3.0%. With zero inflation this earnings growth is all 'real' and with food, energy and transport costs down (approximately 30% of the CPI basket) these real wage increases will be apparent to households.

From a regional perspective, the South looks likely to outperform the North. That said, Manchester is predicted to perform well over the next five years, although London will see stronger growth. We expect 7.6% growth in office-based jobs in the main commercial districts of Manchester by 2020, equating to 27,000 jobs, compared to 167,000 jobs, and growth of 9.1%, for the inner London area.

When the Bank of England introduced forward guidance it indicated it would leave interest rates unchanged at 0.5% provided there weren't risks to inflation or financial stability. Given uncertainties over global growth rates and the forthcoming referendum on UK membership of the EU (see page 10) the Bank is likely to delay rate rises until they are sure that growth is fully embedded and unlikely to be knocked off course by market uncertainties. They will be mindful of the actions of the US Federal Open Market Committee, which is expected to raise rates as we go to press.

We envisage the first increase in UK rates late in the first half, or in the second half, of 2016, although further deferral may still occur if disinflationary conditions persist. We still expect slow and steady rises when they do occur.

FIVE BIG QUESTIONS AFFECTING UK REAL ESTATE IN 2016

1 **What will happen in the EU referendum?** We think the Prime Minister will aim to get the question settled in 2016, but it's already causing nerves.

2 **What will be the pace of UK interest rate rises?** Markets are confused about the Bank of England's position. We predict one 25 basis point increase in the second half of the year, following a US increase.

3 **Will zero inflation persist in the UK?** We foresee modest inflation as oil prices stay stable; food prices may surprise on the up side

4 **Will weakness in emerging market economies precipitate a financial crisis affecting the UK?** UK real estate is much less indebted than in 2007, but the skill of Chinese policy makers in calming markets will be crucial.

5 **Will George Osborne's fiscal squeeze hit UK economic growth?** His 2015 Autumn Statement hasn't caused us to change our view, but if tax receipts disappoint there could be fresh cuts in spending.

INVESTMENT OUTLOOK

TOTAL RETURNS TO PROPERTY OF 10.1% IN 2016

Very strong growth in investment volumes in the last few years is now likely to flatten off, with 2016 seeing a similar volume to 2015. The mix of foreign investment will change, and while total returns will continue to be attractive in the next 2 years, especially relative to other asset classes, returns will look more marginal by 2020.

2015 likely to be a peak in investment volumes, with stability for the next two years

Since 2012 real estate investment activity has grown enormously in the UK. Total turnover in 2015 so far has been nearly double that seen over the same period in 2012. But activity in Q3 2015 was relatively weak, below both the Q2 2015 and the Q3 2014 levels. This was probably driven more by the lack of product than a fall in investor demand.

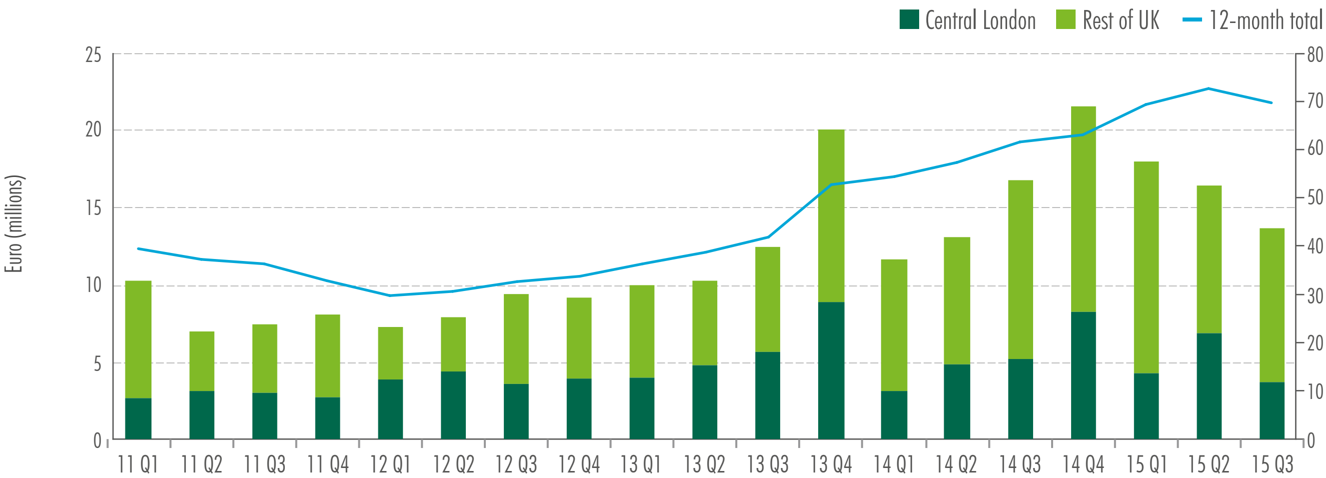
This is particularly true of Central London where there was only £2.4 bn of property being marketed at the start of Q3. This makes the outcome in Q4 of particular interest. Much more property was on the market at the start of the quarter and the extent to which this is successfully sold will be a good indicator of the strength of the market. We are probably at the peak of the market in investment volume in the current cycle, a little above the last cyclical peak of around £62 billion in 2006. Our forecast for 2016 and 2017 is that investment volumes will be similar to, rather than greater than, those in 2015.

International investment will change in origin

Foreign investment has long been one of the main drivers of the Central London market; this rose further in 2012-13, but seems to have reached a plateau at around 70% in 2014-15. In contrast, foreign investment has not historically been a significant part of the UK market outside Central London, making up only around 20% of acquisitions. However, in recent years foreign investment outside London has increased. In 2015 so far, 32% of transactions (by value) outside London have attracted foreign buyers from 31 different countries – a noticeable increase in the diversity of investors.

Indeed, the pattern of foreign investment looks likely to change further. Slower growth in China has already discouraged some investors from Asia. Persistently low oil prices have changed the balance of Middle Eastern investment. However, these impacts are not as clear cut as one might expect. For example, while sovereign capital from the Middle East has fallen, it has been more than replaced by

Figure 3: Investment into UK commercial real estate



Source: CBRE, 2015

private wealth diversifying away from the region. So Middle Eastern investment continues to grow. Similarly, despite the withdrawal of some Malaysian and Chinese investors from the UK market, there are also new entrants from the region. Flows from Singapore, Hong Kong and Taiwan appear to be rising and increasing investment from Japan is also expected.

The outlook for capital values, and thus total returns, is dependent to a great extent on continued inflows of foreign capital, but there are other relevant factors. With yields already at low levels by historic standards, investors will need rental value growth to generate capital value growth. The economic outlook (and therefore the outlook for occupier demand) appears sound, so the strength of the development pipeline is crucial in to determining the realism of these rental growth prospects.

Property comparatively attractive, but total returns will decline by 2020

Pricing in other asset classes is going to be an important driver of real estate yields. Prime property looks attractively priced relative to government bonds and the yield gap between the two remains high. The spread between the average prime property yield and the dividend yield from the FTSE 100 is quite stable over time, averaging 2.4 percentage points over the last decade. It is below that at the moment as a result of the 10% fall in the FTSE since its peak in the spring. However, it is still within its normal range indicating that real estate pricing is in line with that of equities.

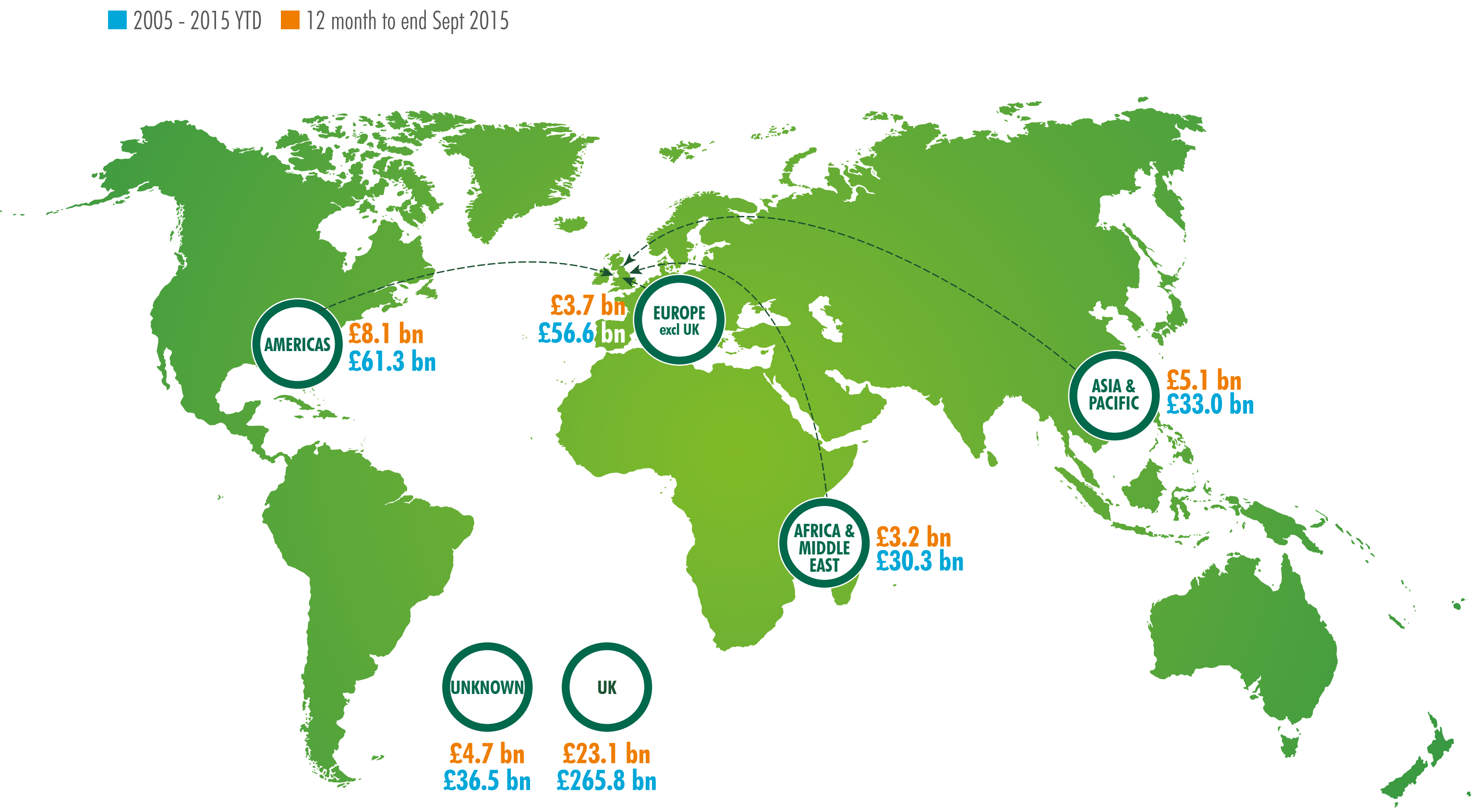
In some markets, real estate yields in the UK may continue to fall slightly in 2016-17, driven by rental value growth and the continuing gap between real estate yields and bond yields. But by 2019-20 we predict that rising bond yields, and rental value growth curtailed by more development, will cause property yields to rise – particularly in the office sector. So capital value growth should remain positive for the next few years, but with the rate slowing each year and turning negative in the office sector in 2019-20.

We predict that total returns will show the same pattern, declining each year from their peak in 2014, at around **10.1%** in 2016; but remaining positive through to 2020. As capital value growth slows, income starts to be the most important driver of returns and the higher initial yield from industrial means that as a result, our forecasts suggest that sector will outperform with total return of 9.5% pa over the next five years. Lower income returns from retail and offices suggest total returns of 7.0% pa and 7.4% pa respectively.

> **“Prime property looks attractively priced relative to government bonds and the yield gap between the two remains high”**

REAL ESTATE CAPITAL FLOWS INTO THE UK

LAST 10 YEARS AND LAST 12 MONTHS, £BN



£20.3bn

Foreign investment into UK, 12 monthsto September 2015

£183.5bn

Foreign investment into UK, 12 months2005 - 2015 YTD

Source: CBRE, 2015

POLITICAL OUTLOOK

POLITICAL OUTLOOK

EU REFERENDUM TO GENERATE UNCERTAINTY

A referendum on membership of the EU could well overshadow real estate prospects in 2016, though the Scottish Parliament election in May looks unlikely in itself to add another independence referendum on top. London's Mayoral contest will deliver a Mayor opposed to Heathrow's expansion plans, while growth outside London looks likely to be spurred by the Chancellor's Northern Powerhouse initiative.

Investors unsettled by EU referendum uncertainty

The forthcoming referendum on the UK's membership of the European Union could have a profound effect on the British economy. Although current polling implies that the electorate would vote to stay in, experience from the 2014 Scottish referendum shows that this cannot be taken for granted. Political betting data also implies that a vote to leave is significantly less likely than a vote to stay.

However, neither the nature of the settlement which the Prime Minister will put to the electorate nor the timing of the vote are yet known. Press reports suggest that the Prime Minister will aim for an early vote in June 2016, even though he is not required to hold it until December 2017. This enables him to deal with the issue as quickly as possible; though it also means he has less time to secure his objectives with his EU counterparts.

If the UK decides to stay in, the real estate outlook will reflect the status quo. Two of the PM's objectives for reform will be helpful for property markets (preventing Eurozone members discriminating against non-Eurozone members within the single market, and the requirement for a package of competitiveness measures, including a Capital Markets Union). The other two (limiting welfare payments to immigrants and an opt-out from the founding principle of 'ever closer union') will not have any noticeable effect.

So the implications for property markets rest rather more on the overall decision, and in particular what it means to leave the EU. It remains very unclear what being 'out' of the EU will mean, and the PM is unlikely to attempt a definition: fear of the unknown is a more powerful tool for him. When polled, most CBRE investor clients take the view that investment in real estate would suffer if the UK were to leave the EU. We

HOW THE BOOKIES SEE IT: POLITICAL BETTING, BEST ODDS

EU REFERENDUM RESULT	SCOTTISH PARLIAMENT LARGEST PARTY	LONDON MAYOR
 **Remain** 8/15 (65% chance)	 **SNP** 1/66 (98% chance)	 **Goldsmith** 6/5 (45% chance)
 **Leave** 7/4 (36% chance)	 **Labour** 16/1 (6% chance)	 **Khan** 10/11 (52% chance)

Source: Oddschecker.com, 1 Dec 2015

1 For example http://www.telegraph.co.uk/news/newstopics/eureferendum/11617702/poll.html

“Most CBRE investor clients take the view that investment in real estate would suffer if the UK were to leave the EU”

think this view is based mostly on uncertainty about what leaving means, rather than opposition to what it means – and it may not get any clearer during the campaign.

So the uncertainty created by the very existence of the referendum could also have noticeable short term effects; this effect is certainly observable in the 2014 Scottish property investment statistics. However, evidence from Scotland also suggests that the effect was only temporary. After the Scotland referendum, deferred investment did take place, to such an extent that the referendum had no observable impact on the full-year figures for real estate investment in Scotland in 2014. We expect a similar temporary ‘chilling’ effect for the EU referendum. Transaction statistics suggest that this is already happening. But – assuming the electorate votes to stay – this effect may be barely noticeable in retrospect.

Heathrow - the big issue for London’s Mayor

London elects a new Mayor, and Scotland a new Scottish Parliament, on 5 May 2016. For property markets the choice between Sadiq Khan and Zac Goldsmith doesn’t hold any obvious contrasts. The most important issues facing London property markets – housing and infrastructure – are being addressed with vigour by both candidates. Importantly, they both agree that a third runway of Heathrow, which the Airports Commission said would add 35,000 new jobs to the economy, should not proceed. Although it is not the Mayor’s decision, this opposition could act as a drag on the decision-making timetable for the new runway if the Government decides to go ahead.

SNP on a roll, but no immediate second referendum in Scotland

Meanwhile, in Scotland, a key question affecting property markets is whether there could be a second independence referendum. The forthcoming Scottish Parliament elections are thought likely to produce another strong result for the SNP. This in itself is not likely to prompt a second referendum, partly due to a lack of new, positive economic arguments – and indeed, a collapse in the oil price has adversely affected North Sea tax revenues. The most likely trigger for a second referendum would be a vote to leave the EU in the referendum above, which (according to Scottish National Party leader Nicola Sturgeon) is not likely to be in line with the mood of most Scots.

In the meantime, therefore, the key preoccupation of property markets in Scotland is the detail of the SNP’s forthcoming manifesto. Land and tenancy reforms, and land taxation, will be in focus. The election might also see the SNP emboldened to vary the new Scottish Rate of Income Tax (SRIT) and the non-residential rate of Land and Buildings Transaction Tax. Whilst these may be seen as unhelpful rather than significant in their own right, taken together they may cause some investors to pause and reflect on the emerging differences between Scotland and the UK.

A mixed bag of other issues

2016 will also see the evolution of the Chancellor’s Northern Powerhouse initiative, focusing on improving civic governance, infrastructure and skills in England’s northern cities. With the Liverpool and Birmingham conurbations now agreeing to follow Manchester’s example in agreeing to a London-style ‘metro Mayor’, the stage is set for a resurgence of investor interest in these cities. New measures are likely to be added to the Government’s Housing and Planning as it proceeds through Parliament, with hot topics including the PM’s Starter Homes initiative, housing association finance, and further planning deregulations in England (especially for brownfield sites).

OFFICE OUTLOOK

OFFICE OUTLOOK

STRONG JOBS GROWTH TO UNDERPIN OFFICE RENTS

Strong employment growth will underpin office markets in 2016, with sustained investment, rental growth and take-up in both London and regional markets. Central London investment is somewhat exposed to current global risks, with yields at all-time lows implying caution over pricing from now on. We expect to see supply recovering, leading to lower rental growth by 2020. But this supply boost will be offset by planning reforms easing conversion of offices to homes.

Central London well positioned, but more exposed to global risks

From an economic perspective the outlook for the London office market is still positive. While UK economic growth is slowing a little (but will be close to trend for 2015) growth in the London economy will outpace the national economy.

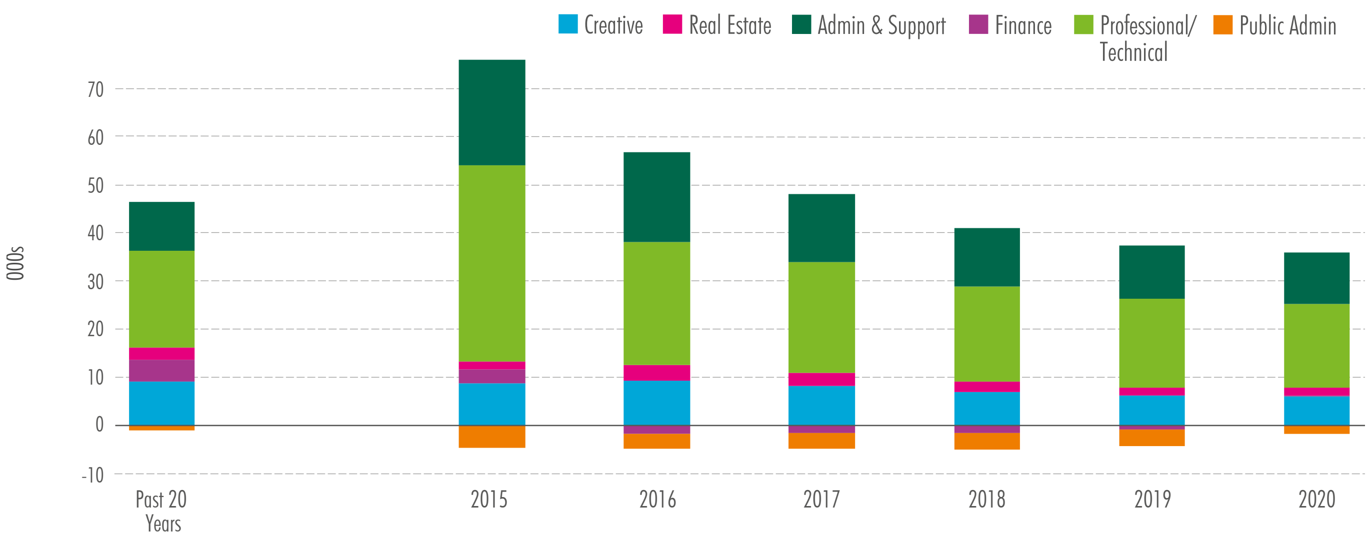
Two major differences are apparent in London from a year ago. First, London's economic growth is forecast to ease. Growth will slow from its current rate to below the 20-year average from 2017 onwards. This will moderate the growth in office-based employment, a key driver of office demand.

Second, and as we note elsewhere in this report, the risk of a 'hard landing' in emerging economies around the world has increased. London's internationally-facing economy is more exposed to a global slowdown than any UK region. This slowdown could also have an impact on the London investment market given how active Asian investors have been in the London real estate market since 2013, though recent data suggests that it is holding up. The final major risk facing the London market, given its exposure to financial services, is the pending referendum on the UK's position in the EU (see page 10).

Strong short-term rental growth in London

Notwithstanding these risks, we predict that the Central London office market will experience robust rental growth in 2016, supported by strong office based employment and tight supply as well as another year of double-digit capital value growth. An easing of employment growth and an expected increase in the development pipeline will moderate rental growth from 2017 onwards. By 2018, the imbalance

Figure 4: Office-based employment growth by sector in inner London, 2015-2020 and past 20 years



Source: Oxford Economics

OFFICE OUTLOOK CONTINUED

"Regional office prices remain very attractive relative to markets in the South East and London"

between demand and supply will shift with rents forecast to fall in some Central London markets. The strength of the development response will depend, among other things, on there being an increased availability of debt finance for speculative development.

We expect the amount of global capital targeting the London office market to remain high in 2016 supported by a strong rental outlook, particularly relative to other European office markets, and the broader attraction of real estate and London in general. Investment into London is expected to be in the range of £18-20bn in 2016. City prime yields are currently at 4.0% which is 25 basis points below the 2007 low. West End prime yields are at 3.5% – matching the 2007 low. Very little movement in prime yields is expected in 2016, with West End yields forecast to fall, and City yields forecast to rise, by 10 basis points by the end of the year.

Although equity has been targeting London, the future source of investment is a potential cause for concern. Asian money had been crucial in setting London's premium prices. Will these investors continue to buy at or above the levels seen recently? And if London sees a drop in Asian investment, what effect will this have on prices? We think Asian investors will retain their focus on London but this expectation may shift if Asian domestic economies weaken to a greater extent than is currently forecast.

Regional markets also now in recovery

At-trend UK GDP growth will maintain the strong economic conditions that have allowed the South East and regional office markets to stage a robust recovery during the past two years. Unusually the South East occupational market has been a little slower to respond to the positive economic signals, but the second half of 2015 appears to have pushed the region more firmly forward, and we expect this momentum to continue into 2016.

However, as we went to press, some leading indicators, particularly the Purchasing Managers Indices, imply growth at a slower pace for some regions in 2016. This may be a short term period of softer growth, or the start of a more sustained period of weaker activity, so is a potential risk as we move into 2016. Nevertheless, employment growth is forecast to remain strong over the next two years and as such it is likely that occupier demand will stay strong. Whilst some of the annual and quarterly take-up records set in recent years in Bristol, Leeds, Aberdeen and Manchester are unlikely to be repeated, the traditional market churn, boosted by larger floorplate deals, will continue to characterise the market.

At the prime end of the market, we expect further pre-letting activity in the big city markets in 2016. Development space continues to emerge in cities such as Birmingham, Manchester, Leeds and Edinburgh, as well as in areas of high demand in the Thames Valley and West London. Indeed, given the improvement in office quality that these new schemes represent, leasing deals in these buildings are likely to set new record levels for prime rents in their local markets.
There will also be more development starts, particularly in those cities, such as Bristol, which began speculatively building much earlier in the cycle. Speculative development activity so far has been steady rather than spectacular, and we

expect the delivery of new supply to be broadly in line with expected demand: oversupply of office space is not on the cards.

For investors, the availability of appropriate stock will be a critical factor for the year ahead and will influence the type of buyers most active in regional markets. In 2015 there was an increase in overseas interest in regional offices, coupled with continued spending from UK institutions. Indeed the overseas interest is coming from the most diverse source of nations ever seen in some of the UK regional centres, particularly Asian money.

Regional office prices remain very attractive relative to markets in the South East and London. Indeed there is now significant variation across the big UK cities, with prime yields at 4.75% in Manchester, 5.5% in Glasgow and Leeds, rising to 6.5% in markets such as Southampton. For some markets there remains scope for further yield falls, including for secondary offices, in contrast to London where yields look unlikely to fall further. There also still remains a healthy cushion between regional office pricing and other asset classes, should interest rates rise in 2016.

Planning reform could remove significant volumes of older stock

A significant amount of office stock has been lost to other uses in the last two years. A recent CBRE report for the British Council of Offices shows that permitted development rights (PDRs) allowing conversion from office to homes have had their greatest impacts in London, selected parts of South East England, and some other southern urban centres including Reading, Bristol, Southampton and Brighton.

The deadline for completion of conversions had been May 2016. But following a Government decision to make these PDRs a permanent feature of the planning system in England, we expect to see a surge in office stock being converted, and not just in the areas affected to date. This should have a positive impact by removing effectively obsolete office space from the market.

> "The Central London office market will experience robust rental growth in 2016, supported by strong office based employment"

INDUSTRIAL OUTLOOK

INDUSTRIAL OUTLOOK

INDUSTRIAL PROPERTY LIKELY TO OUTPERFORM

Structural change in the retail industry, particularly online delivery, will be a prominent influence on industrial property choices over the next few years. Industrial property could be temporarily affected by a slowdown in manufacturing growth, but overall investment prospects look relatively strong. We forecast that industrial, especially secondary sheds, will be an outperforming sector even given a sustained development response.

Change in retail will be a big influence on industrial and logistics property

The challenges of delivering goods the 'final mile' will remain a focus for the industrial and logistics sector during 2016, particularly as it examines the fallout from the busy Black Friday and Christmas delivery period. During the last year, the logistics market has shifted its focus from the impact of online retailing on large distribution centres, to the means by which the final leg of the delivery marathon can be improved and made more customer-friendly. Thus leading online retailers are taking direct control over the final mile, leasing smaller warehouses on the edge of large urban areas. We predict more of this type of activity in 2016, from both retailers and the major parcel carriers.

The cost challenges of the final mile will prompt yet more innovation in the types of delivery options available to customers and the technologies used to implement them. Whilst commentators speculate endlessly about the arrival of delivery drones, the reality may be somewhat different. Regulatory hurdles and practical difficulties will delay or even prevent the arrival of these innovations.

Strong growth in the so-called 'sharing economy' within the logistics industry looks more likely. Services such as uShip, Nimber and Shiply use technology to bring together underutilised space in delivery vans with those requiring items to be delivered. This 'Uber-isation' could have a significant impact on urban delivery networks. Leading parcel delivery firms will respond by placing even greater emphasis on customer service.

Slower manufacturing growth presents a demand-side risk

Manufacturing sector growth weakened in the autumn of 2015. Should growth remain below expectations in 2016, this may have a dampening effect on demand for industrials, particularly those parts of the market less reliant on the opportunities that come from retail distribution.

Indeed, global concerns may also play a part within the UK supply chain, should weakening demand in emerging nations lead to reduced exports and weaker global trade flows. Nevertheless, we continue to see further investment into the automotive sector in particular, which in turn will lead to further requirements from the wider supply chain, particularly across the Midlands.

Development will be sustained in 2016

A wave of speculative development has been underway in the UK industrial market for around two years. This will continue in 2016. Units are quickly being taken by occupiers when schemes reach practical completion. So availability levels have not moved significantly.

We expect a greater volume of schemes in 2016, so ready-to-occupy supply is likely to increase in some parts of the country. Developers are also likely to venture into locations where speculative development has yet to emerge at any scale, for instance across the South West.

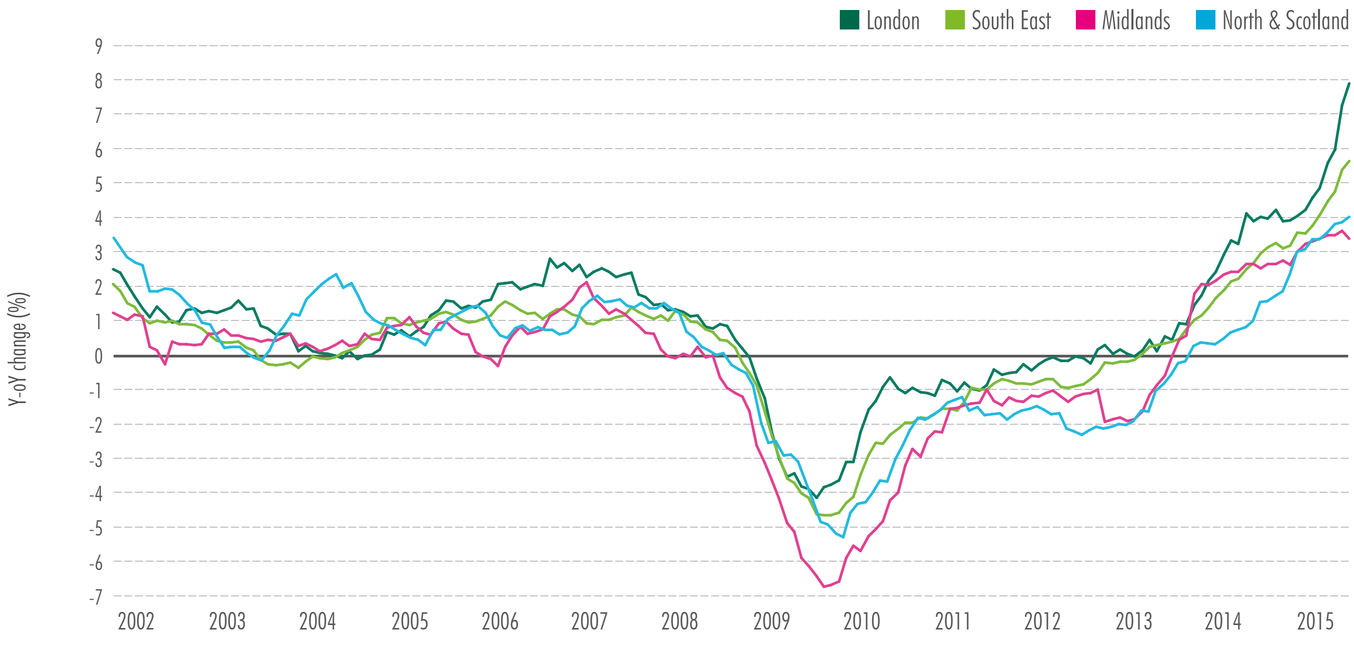
Investment outperformance underpinned by rental growth

As noted on page 7, we forecast that total returns on industrial property will outperform most other sectors in the next few years. Investment performance, having been driven almost exclusively by yield falls in recent years, will increasingly be influenced by rental growth during the year ahead. Those falls decelerated during the second half of 2015, particularly for prime industrial units. Whilst there is some scope for further falls in yields, this is more likely for secondary assets, further closing the gap between prime and secondary industrial property that opened up eight years ago.

The shift to rental growth will inevitably lead to significant national variation in capital growth – with the London and South East markets achieving superior performance. Already in 2015, rents in London accelerated rapidly, returning the sector back to growth rates last seen in the mid to late 1990s. In the twelve months to the end of October 2015, London industrial rents grew 8.1% and we forecast that they will rise higher still. Other regions have also benefited from this acceleration, albeit not to the heady heights observed in the capital. Although growth will surely moderate from this level, the current balance between demand and supply (particularly for those types of property being demanded by the fast-changing retail logistics sub-sector) is such that robust rental growth will continue to be a feature of the market across the UK.

> "We forecast that total returns on industrial property will outperform most other sectors in the next few years"

Figure 5: Rolling twelve month industrial rental value growth, by region, to October 2015



Source: IPD Monthly Index

RETAIL OUTLOOK

RETAIL OUTLOOK

REAL INCOME GROWTH RAISES HOPE

The outlook for the retail sector looks positive for 2016, thanks to a strong UK economy. National statistics show that retail sales have grown for 30 months in a row. Prime shopping centres, factory outlets and retail parks will perform strongly. Lower oil prices, wage growth, deflation and low interest rates contributed to growth in 2015, but there are some specific threats on the horizon for retailers next year which could reduce profit margins.

Central London rents will remain high and we expect higher rental growth regionally

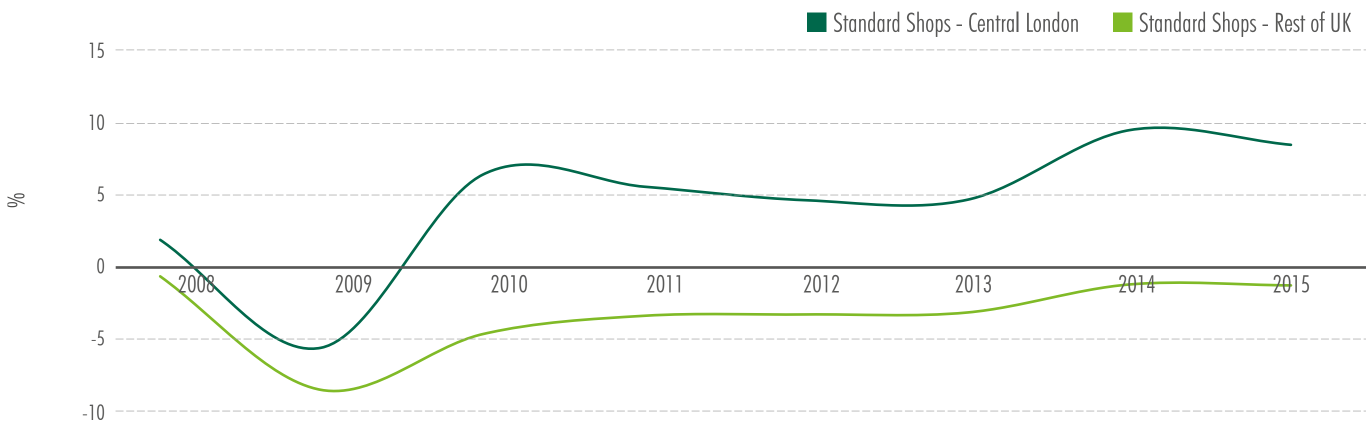
Shop rents in prime Central London streets should continue to grow, although not at the levels seen recently. Demand for prime units will continue to outstrip supply. Retailer confidence and a growing population is encouraging large scale mixed use developments such as the extension to Westfield London (White City), Battersea Power Station/Nine Elms and Earls Court. Emerging regenerated areas such as Shoreditch, Spitalfields and Kings Cross, will also benefit from higher footfall as retailers target these markets. Outside London and the South East we expect higher and more widespread rental growth until 2018 though growth rates are unlikely to match prime Central London locations.

Mass market brands will further grow their UK estate

Global brands will further expand their UK estates in 2016. Owners of brands such as H&M, Sports Direct and Zara are branching out with new format stores to increase their appeal to different consumers and to expand their market share.

In grocery, Aldi and Lidl will, once again, outnumber supermarket openings from the big supermarket chains combined. Value operators B&M and Poundland have also announced ambitious store opening plans for 2016. And the boom of food and beverage openings show no sign of slowing down as operators expand their estates up to grab a slice of this growing market.

Figure 6: % Shop Rental growth in Central London compared with rest of the UK (2015: CBRE Forecast)



Source: IPD, CBRE

Rate revaluation, increasing rents and the national living wage could reduce profits for retailers

Sales volumes are increasing but profits are under pressure. The grocery price war will continue as the big supermarket chains defend their market share from the ongoing threat of Aldi and Lidl. Meanwhile, retailers have serious concerns about the impact of both the national living wage on wage bills and the introduction of the Apprenticeship Levy.

The impending rate revaluation (April 2017) will cut profit margins even further for some retailers. This will undoubtedly lead to further store closures in marginal locations. And although online sales are contributing to sales growth, order costs could also eat into profits - especially for those offering same day delivery. These factors could moderate (but are unlikely to prevent) landlords' attempts to increase shop rents.

Shopping Centre developments to continue into 2016

Significant new shopping centre schemes will open in 2016, including in Chelmsford, Leeds, Rushden and Stafford. These schemes aim to boost the local economy by transforming these centres into stronger retail destinations. Existing shopping centres, for example Intu Lakeside and Meadowhall will also see investment, particularly aimed at improving the food and beverage offer. A recent CBRE survey revealed that increasing numbers of people now visit shopping centres simply to eat or drink, highlighting the importance of focussing on this aspect of the changing retail experience.

Shopping centre owners will also aim to introduce other innovative concepts that they can introduce to their centres to improve that experience. For example, we predict an increase in the number of activities targeted at families, foreshadowed by Kidzania at Westfield London; and growth in similar leisure concepts, such as trampoline parks.

"Increasing numbers of people now visit shopping centres simply to eat or drink"

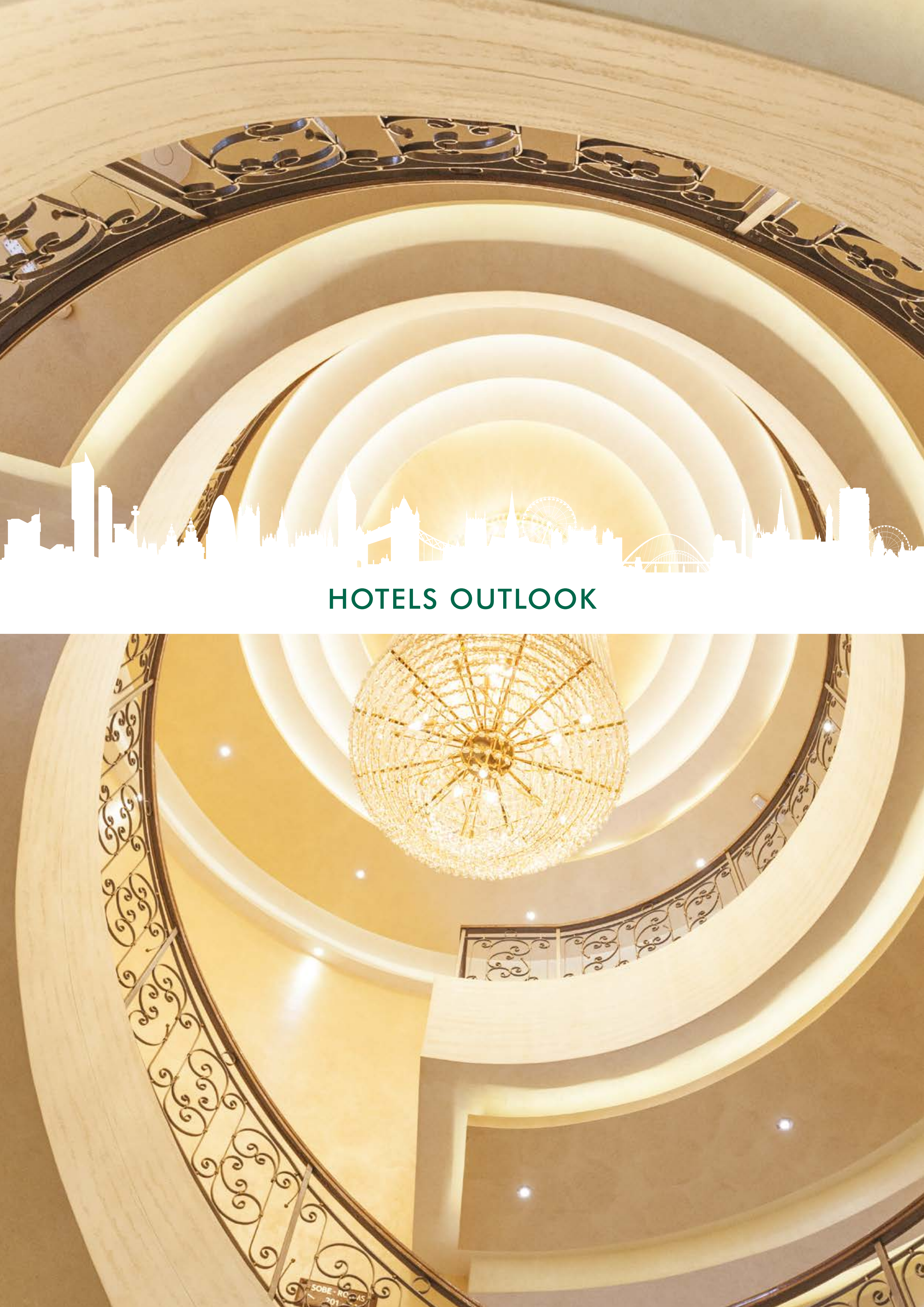
Retail Parks will continue to attract shoppers at the expense of High Street retail locations

The resurgence of retail parks will continue into 2016 at the expense of High Street locations. Many parks offer a great mix of retail, leisure and food and beverage and are proving a great attraction for consumers. With free parking they are increasingly attractive to customers who pay for products online to collect in store. The lack of new retail parks has resulted in low vacancy rates, a trend which will extend into next year and which could underpin rent increases. Subject to planning restrictions, developers will continue to invest in existing retail parks to accommodate retailers looking to grow their estates.

Innovation and technology will play a key part in the future of retail

Technological innovation will continue to disrupt retailer business models as retailers try and utilise the huge sets of customer data they collect to understand their needs. According to a poll conducted by Conlumino, smartphone ownership in the UK has soared from 14% in 2009 to 61% in 2014 and UK shoppers are forecast to spend £53.6bn a year on mobile technology in 2024 compared to £9.7bn in 2014.

Not since the invention of the telephone has technology been so important in creating new sales channels. For example, sales via social media are becoming increasingly important as more people shop on the move. Retailers will need to understand their customers' shopping behaviour more than ever and be ready to react to any sudden changes in technology.



HOTELS OUTLOOK

HOTELS OUTLOOK

ECONOMY TO UNDERPIN HOTELS PERFORMANCE

Wider economic strength will underpin hotels performance in 2016, though in London an increase in luxury hotel openings will act as a drag. Investment will remain strong, though an increase in 'buy to hold' strategies from Asian investors may mean 2016 repeats rather than exceeds 2015's record performance.

Wider economic strength will underpin hotels performance

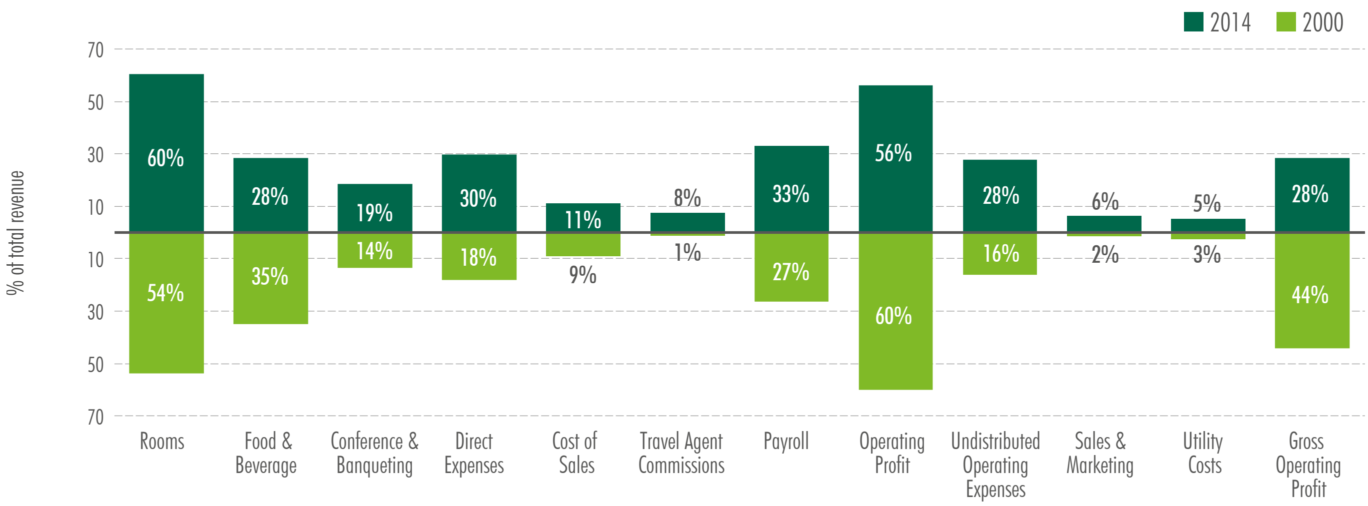
The performance of hotels exhibits a strong correlation with the performance of the UK economy. So it's unsurprising that UK hotels have flourished in recent times. In August 2014, the key measure, rooms revenue per available room ('RevPAR') surpassed the peak of the former cycle in July 2008 by 8%; and market-wide hotel profitability is up 7.1% in the year to October 2015, as operators drive rate against the backdrop of high occupancy levels and a moderate net supply increase.

Whilst the introduction of the National Living Wage and increasing travel agent commissions threaten to erode profits, the favourable economic and consumer outlook which we set out on pages 2-4 should stimulate demand further in 2016. These positive prospects are further supported by critical infrastructure projects in many UK cities, which is allowing investors to underwrite longer-term performance growth and developers to confidently embark on new hotels construction. The hotel market continues to evolve, with particularly significant experimentation in hotel dining concepts. But, while local authority planning departments are showing a preference for full-service upmarket hotels , many developers are opting instead to construct limited-service or budget hotels such as Holiday Inn Express and Hampton by Hilton and replacing restaurants with bedrooms to improve revenues and profits-around 70% of new rooms in 2016 outside London will be in the limited-service or budget categories.

London: strong supply response to demand is affecting performance

London total hotel revenue (TrevPAR) is up 16% compared with the peak of the last cycle in 2008 and gross operating profit has risen at a rate of 15% per year in the 5 years to 2015. Mounting demand for rooms in the capital reflects the health of the London economy. Business confidence has reduced business customers' sensitivity to hotel prices. Meanwhile a burgeoning events calendar, in addition to the city's strong global reputation for history, culture and retail will stimulate demand from leisure customers.

Figure 7: Profitability comparison - UK full-service hotels, fixed sample 2000 and 2014, GBP, nominal



Source: HotStats 2015

Encouraging demand trends, however, are translating to sluggish performance 2015 as a result of considerable growth in new supply. RevPAR in the year to October 2015 is up just 0.2% for all London hotels and down 1.6% for London luxury hotels – casualties of big increases in supply and thus declining occupancy.

Although London hotel profitability is holding steady for now, it remains sensitive to a decrease in operational efficiency should occupancy rates fall further. We expect an increase in rooms of 6% in 2016, implying even greater pressure on operating performance in the coming year. Between 15 and 25% of stock coming forward in 2015 and 2016 is 5-star, thinning the demand for top-tier hotels, dragging on performance and reducing the growth potential of the tiers below. Given the seemingly unshakeable RevPAR growth recorded by London budget hotels (up 7% in the year to October 2015, year on year), the outcome is an increasingly squeezed mid-market.

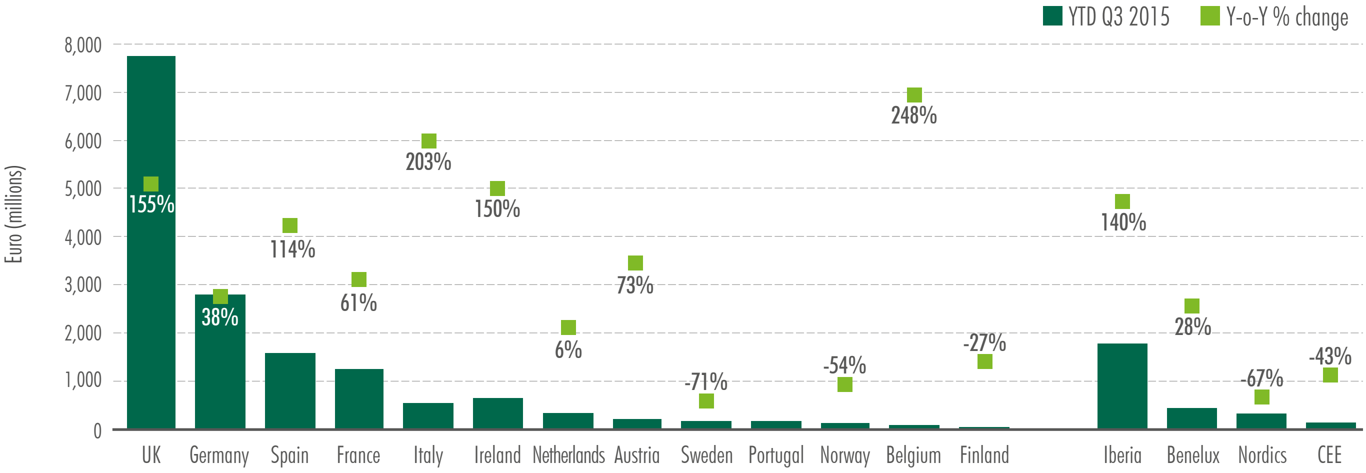
2015 will set a hotels investment record, driven by portfolio sales

By the time we went to press, trade in UK hotels had already eclipsed 2006 and 2007 levels and we predict it will exceed £7bn by the end of 2015: a record-breaking year. This growth (figure 8) has been driven largely by portfolio sales and the divestment of US private equity funds that assembled portfolios earlier in the cycle. These were bought largely by Asian investors looking for a substantial foothold in established European hotel markets.

Investor interest is set to remain high in 2016. However, we expect that volumes will be a little lower because Asian investors have longer-term holding strategies. Those strategies have contributed to their aggressive bidding and therefore their success in competitive acquisition processes.

In London, yields for unencumbered assets, or those under a management agreement, appear to have flattened off due to a lull in performance growth. But a high level of investor interest remains, particularly from through-the-cycle investors who want to benefit from the long-term security and consistently high relative performance offered by the London hotel market.

Figure 8: Country hotel deal volumes - year to Sept 2015 actual, Y-o-Y % change, EUR excluding debt trades



Source: CBRE, 2015

PUBS, LEISURE AND HEALTHCARE OUTLOOK

INVESTMENT IN NON-TRADITIONAL PROPERTY WILL EVOLVE

New investors have dominated activity in non-traditional 'operational' real estate and this will continue in 2016. US REITs have driven the agenda in healthcare, real estate investors are exploring pubs opportunities, and patient international capital has been busy in leisure.

Alternative sectors will continue to look attractive, but for different reasons

Momentum in non-traditional sectors has grown since 2012 when pioneering investors took advantage of clear pricing opportunities, driven by the combined impacts of wider malaise and operational leverage in Healthcare, rapidly accelerating closures in Pubs and evaporation of discretionary spend in Leisure. But after three years of enhanced income returns the spread between core and non-traditional yields has closed. So, has the attractive pricing come to an end? We think not. "Other" is far from finished, but it is changing. Investment will be less about those who pick stock well and time trades perfectly, and more about engagement with the underlying businesses (see box).

Legislative change provides opportunity in Pubs investment

New legislation will allow all pub tenants to break the 'beer tie' (the mechanism by which they are obliged to purchase beer and other supplies from their landlord) over the next five years. The tie has discouraged most property investors. Its removal allows existing owners and potential new entrants to review their approach to pub real estate, by more clearly separating the operational drivers of performance (delivering a better pub to more markets) from the real estate drivers (considering optimum uses for community and semi-rural real estate).

As PubCo owners and investors become more focused on real estate we predict a fundamental shift in income and pricing. Specialist real estate investors such as Healthcare and Student REITs trade at 20%+ premiums to their Net Asset Value (NAV). A PubCo with the right balance sheet and equal focus on real estate and operating business might perform similarly.

Understanding of consumers will drive investment in leisure

In Leisure, demography is taking hold. In the gym market, in hotels, and in nightclubs, the market appears to separating into luxury and budget offerings, with not much in between.

DRIVERS OF FUTURE RETURNS IN OPERATIONAL REAL ESTATE INVESTMENT

Operational Influence – The property investor that can influence the underlying operating business will reap the advantage of trading upside and be equipped to deal with trading turbulence

Strategic Change – Many of the operational real estate classes are undergoing huge regulatory and market change. The investors who can grip these changes will find value in them.

Capital Flows – Global capital is pooling around wealth-preserving long income and opportunity situations. As they enter new markets, so pricing follows as we have seen in Student Housing. Leisure, healthcare and pubs are now on the radar.

Demography – A clear polarisation in both age and affluence implies the middle ground will become a more difficult place to be in Health, Leisure or Pubs. The affluent live longer and are more active, while the less affluent have more chronic conditions and less disposable income. The usual home for the cautious property investor in non-traditional sectors of the "safe" mid market may not be the haven it first appeared.

PUBS, LEISURE AND HEALTHCARE OUTLOOK CONTINUED

Nightclubs are struggling as the youth market no longer needs to gather in dark barns to interact, while live music offerings proliferate. Leisure and retail are merging fast and global capital is already moving in. Center Parcs and Premier Marinas both sold in 2015 to patient international capital willing to embrace operational exposure in sectors with high barriers to entry and good demographics, which combine to create long income inflation-tracking investments – priced accordingly.

Healthcare will thrive on demographic support and structural reform

Healthcare presents an increasingly clear demographic story, and structural change is throwing up billion-pound opportunities for specialists with deep understanding of the sector.

Debates about NHS and Social Care funding, particularly for the elderly, are evolving fast. Whilst income deficits are problematic, the bigger crisis relates to capital requirements. 23% of the public healthcare estate is classified as unfit for purpose and will not meet future needs. According to Laing and Buisson, 79% of care homes were first registered before 2000, indicating a dominance of older stock which predates the minimum standards for new care homes set out in the Care Standards Act 2000.

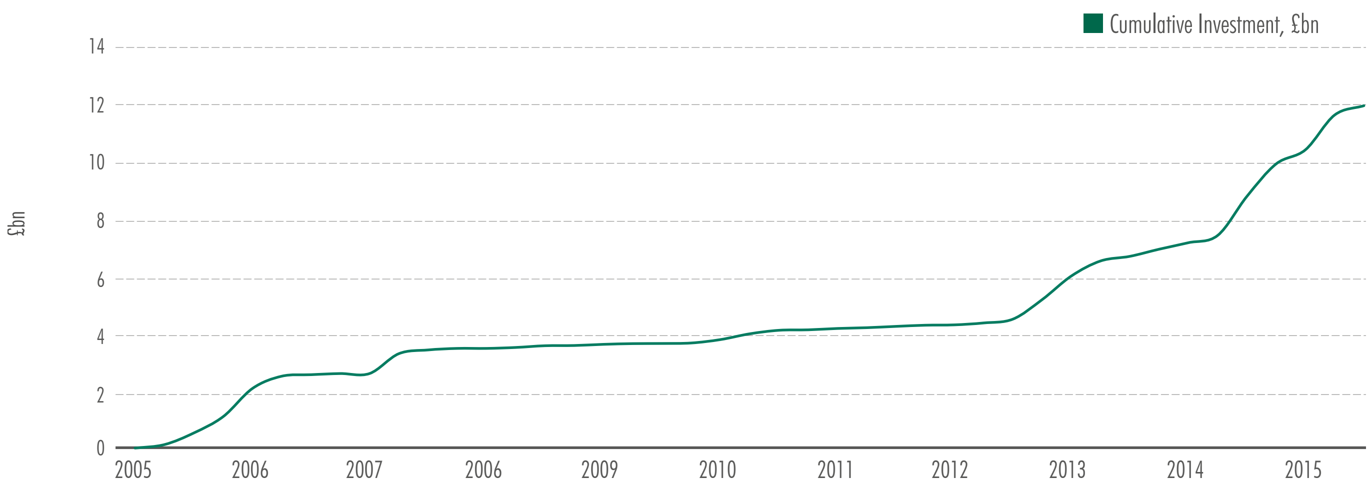
Investors will play a role in facilitating an urgent retooling. Real Estate capital is a responsible, long term cost effective partner. Those players (on both sides of the debate) who can devise effective Strategic Partnerships will go a long way to meeting urgent healthcare needs.

To date, US REITs have dominated investment in the elderly care market. But their dominance in healthcare is no longer as clear cut. Share prices are under pressure, leading to a dip in their activity in the UK.

US interest rate increases will maintain this pressure into 2016. Rather than withdrawing, we predict that US REITs will team up with more patient capital and meet return requirements by assuming the role of manager/investor.

Healthcare investment interest is usually underpinned by the clear demographic case, particularly for elderly care. But many investment strategies don't follow this logic through into capital deployment decisions. The demography is changing even in old age, with the biggest growth being in people living healthier for longer and living longer with degenerative disease. Retirement Living should be as significant in the UK as it is in other OECD economies; and specialist care should not be a step too far for investors. Investors who can evolve strategy beyond mid-market residential care will be well placed.

Figure 9: Cumulative investment in UK healthcare, £bn, 2005-2015



Source: CBRE, 2015

STUDENT HOUSING OUTLOOK

A NEW 'SINGLE ASSET' MARKET WILL EMERGE

Student housing will experience continued strong demand from investors of all types but with significant supply side challenges in London and key student towns.

Student housing will move into a 'single asset' market

After a year which saw over £4.7bn traded, total returns shown by CBRE valuations of nearly 30,000 bedspaces nationally were 18.4% in the 12 months to September 2015, which has outperformed IPD. Yields are now at their previous 2007 low point and values at their previous peak, with positive sentiment fuelled by some very significant portfolio deals. But with only a small number of major portfolios left to be sold a 'single asset' market is now likely to develop, which will provide greater clarity on the yields and values of individual properties. There will be healthy competition for good quality single assets, with institutions and new portfolio operators all looking to grow further.

Active running cost management will come to the fore

With values at their current high levels, there is no suggestion that investor demand is abating, but there will be greater emphasis on rental performance next year. Headline rental growth has been slightly subdued. This is partly due to increased supply in some towns, partly the low inflation climate and partly due to the rising cost of a degree. Savings in running costs will be a driver of net rental growth. Energy efficiency and longevity of fit out, thereby reducing lifecycle costs, will be key to keeping running costs under control. Investment in broadband and social spaces will be key to 'future proofing' schemes and securing ongoing rental growth. Greater consolidation and scaling up of operators in order to drive cost savings looks probable. The Scottish Parliament has also pledged to legislate on rent controls by mid-2016; this could affect the operation of purpose-built student schemes in Scotland, although the details are as yet unclear.

Planning constraints will act as a drag on supply

On the supply side, it is getting harder to secure planning permission for new developments. More stringent planning policy, competing political priorities, Community Infrastructure Levy, affordable housing contributions, and 'nimbyism' are all factors. Alongside rising build costs, these factors contribute to mounting difficulties in securing sites when student developers compete with residential ones, especially given recent Government action to support housing development. In future investment and development decisions, the performance of the local universities and their ability to continue to attract students is likely to come under greater scrutiny in the world of increased tuition fees since 2012.

Overall, the outlook for 2016 remains positive, with a greater emphasis on safeguarding value and the performance of individual assets.

"With only a small number of major portfolios left to be sold a 'single asset' market is now likely to develop"

RESIDENTIAL OUTLOOK

LACK OF SUPPLY WILL SUPPORT PRICE GROWTH

Growth in the residential market will moderate, and despite Government action, supply constraints seem likely to continue. Tax changes could discourage some investment, but there are clear opportunities in the private rented sector.

A lower transaction, lower growth environment

Residential sales in 2015 will broadly match those in 2014, at around 1.2 million. But this is significantly below the pre-crisis average of 1.5 million. This lower level of transactions reflects a new operating environment, for which there are a number of reasons including affordability and mortgage constraints, an increased number of buy-to-let borrowers and an ageing population. So we expect transactions in 2016 to also be near this level.

We predict that UK house prices will grow by 3% in 2016. This reflects declining affordability, mortgage regulation and potential interest rate increases. Over the next five years house prices are expected to grow by 22% across the UK. London will continue to perform most strongly with 5% inflation next year and total growth of 28% by 2020. However, in contrast to previous years, in the near term, prices in outer London will rise faster than central locations. Smaller cities with strong economies such as Oxford, Cambridge and Bristol will also outperform.

Supply remains a fundamental problem

Supply shortages remain a fundamental issue. Although housing completions edged up in the last financial year to 152,450 (DCLG), they are still well below the long term average of 220,000 and below the Government's target level. And over the last decade we have built around 1.2 million new homes in England, yet our population has increased by 4.2 million. This has caused prices to rise, with areas facing the most acute supply restrictions seeing strongest growth.

Figure 10: House price growth forecasts, by region, %, 2016-2020

	2016	2017	2018	2019	2020
London	5	3	5	6	6
Prime Central London	3	4	6	6	6
South East	5	4	4	5	5
South West	4	4	5	6	6
East Anglia	3	3	4	4	4
East Midlands	4	3	4	4	4
West Midlands	4	3	4	4	4
Wales	4	3	3	4	4
North East	3	3	4	4	4
North West	2	3	4	4	4
Yorkshire and Humberside	2	2	3	4	4
Scotland	2	3	3	4	4
UK	3	3	4	5	5

Source: CBRE, 2015

Supply shortages are compounded by poor availability of second hand stock. The average number of properties per agent is at a historic low of 45, according to the NAEA, against a long term average of 64. In contrast the number of house hunters per agent, typically averaging around 300, is currently at 364.

So in London, this has led to the highest absorption rate of new build homes in recent years; almost 70% of units under construction are already sold off plan. Anecdotally, stock shortages reflect homeowners' inability to 'trade up' because of the gap between earnings and current prices, even if they were able to buy earlier in their lives. This situation looks unlikely to change in the short term, pushing up prices significantly in some areas.

Government policy change could incentivise new supply

Presently, housebuilders are typically required to deliver affordable homes for rent on their schemes, or make a payment in lieu of that provision. However, the definition of affordable homes will change to include Starter Homes (subsidised first time buyer homes offered at a 20% discount to market price). So developers can now deliver schemes that are 100% for private sale, without an affordable rental element. This will reduce costs and should act as an incentive to develop more homes – though not all sites will be suitable or viable even with this change.

Tax changes may impact buy-to let-investment

The buy-to-let market makes up around a sixth of UK housing sales. However, landlords will be hit by HM Treasury's recent tax reforms. Landlords will soon have to pay tax on rental income, with any relief restricted to the basic rate (20%) of income tax. For example, with rental income of £20,000pa and mortgage interest costs £12,000pa, a landlord would currently incur tax of £3,200. However, once the new rules are introduced, the tax charge will rise to £5,600; an increase of 75%. As a result, a landlord's profit will decline by 50% in the period. The change is being phased in from April 2017 with the full restriction in force by 2020.

In addition, from April 2016 buy-to-let and second home buyers will face an additional 3% Stamp Duty Land Tax liability, which will add around £7,500 to the transaction cost of a £250,000 property. This could lead to a surge of activity in the first half of the year. Taken together, these changes could discourage investment – as much for the signal they send about potential future increases as for their actual effect.

Strong potential in the build-to-rent market

Affordability constraints have led to big increases in the number of households in the private rental sector (PRS); from just over 2 million in 2001, to 5.4 million now. The sector makes up 20% of all households. Most of the stock is held by private individual investors, with only 2-3% held by institutions and professionally managed companies.

The rental sector is expected to grow further, to 7.2 million by 2025. Tenure switching within the current housing stock will accommodate some of this increase, but it also implies a significant new housing requirement. While some of this will come from buy-to-let demand, there is a huge opportunity for the embryonic build-to-rent sector.

Around £25-30 billion of capital is earmarked for the UK PRS market. Most funds, particularly US, mainland European, Middle Eastern and UK investors, want to be part of this growing sector, attracted to low levels of supply against high demand across the country.

Initially investment was largely focused on London. In London, there are currently 99 developments earmarked as private rental schemes, delivering 2,380 units. However, other regions are now being very heavily targeted. Although there is substantial development, it is relatively minor compared with the overall potential offered by build-to-rent stock with the regions making up the bigger share. CBRE alone have been instructed to fund the development of 20,000 PRS units, 60% of which are outside London. We predict significant growth in the sector by 2020.

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