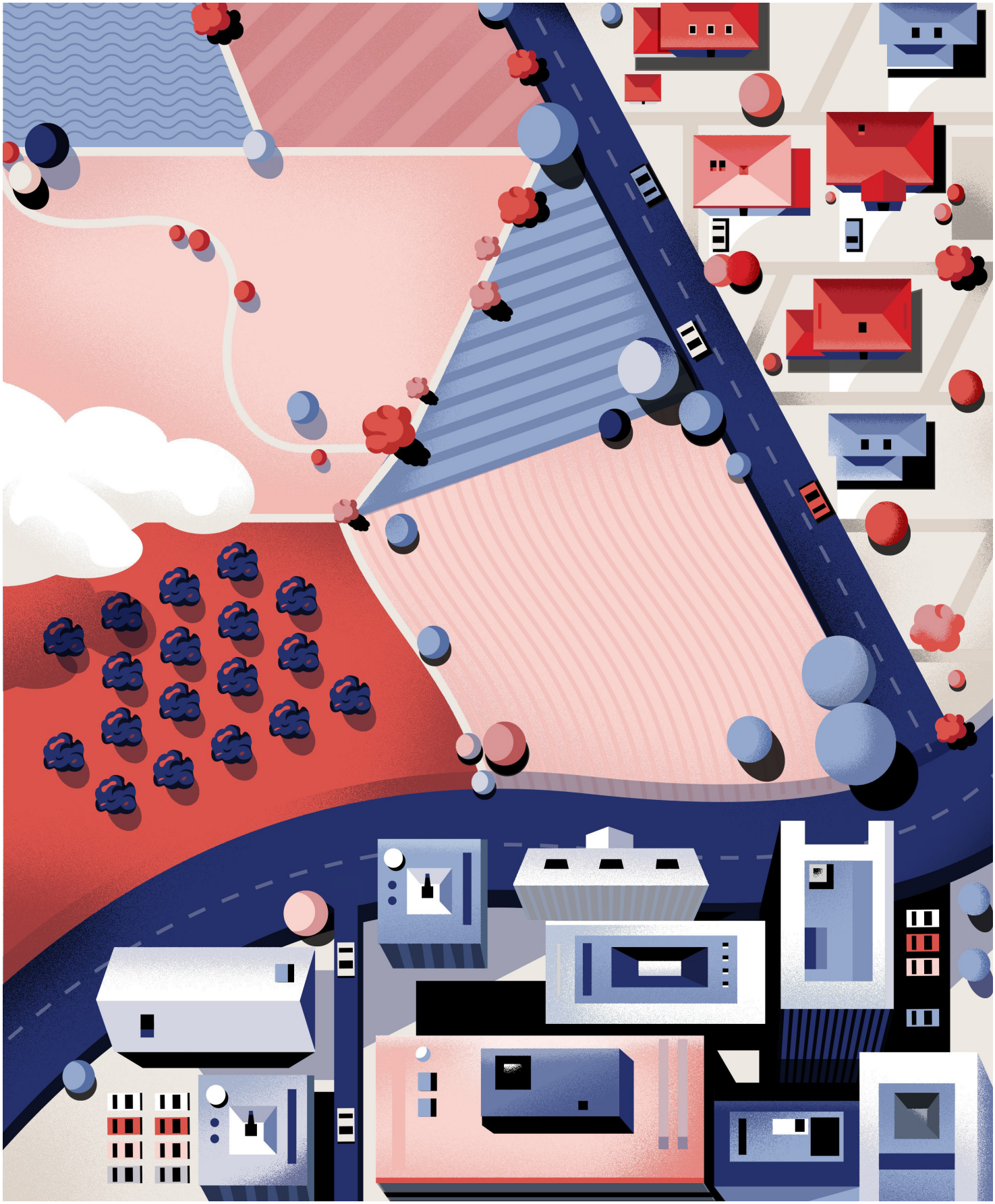
UK Commercial, Residential and Rural – 2021

SPOTLIGHT

Savills Research

UK Cross Sector Outlook

savills



Investment opportunities and trends for 2021 across the Commercial, Residential and Rural sectors

“For 2021, many people are asking: Is there a ‘new normal’ for real estate?”

At the start of 2020, we expected disruption, uncertainty and change to continue to influence the markets, much as they had done in 2019. What we didn’t know was that a pandemic would turn the world as we knew it on its head, leaving almost no sector unscathed. Looking ahead into 2021, many people are asking: Is there a ‘new normal’ for real estate?

We have certainly started to see some new trends. But it’s important to recognise the continuation and acceleration of existing trends too. Offices in central business districts, for example, will remain the sector of choice for commercial investors. The prime central London property market has secured a spot in our investment top picks for the second successive year, while biodiversity net gain, nutrient neutrality and carbon offsetting still feature as key revenue opportunities for rural land investors.

We referenced the importance of environmental, social and governance issues in our report last year, and despite the unforeseen challenges that 2020 presented, it’s an issue that’s continued to grow. With most aspects of the UK Government’s 10-point plan for a green industrial revolution impacting real estate to some degree, social impact will be at the heart of investment in 2021 and beyond.

What is clear is that in times of uncertainty, real estate is still an asset class that investors turn to. We hope you enjoy reading our latest UK Cross Sector Outlook.

James Sparrow
CEO, UK & Europe
020 7409 8873
jsparrow@savills.com

The green agenda

ESG will be a driving force in real estate investment

While 2020 presented unforeseen challenges, the importance of sustainability and environmental, social and governance (ESG) credentials have continued to grow – issues we referenced in last year's outlook. The drive for net zero and social trends are seen in all sectors of real estate and increasingly link property types.

To encourage progress, the UK Government is using a carrot-and-stick approach with both investment and regulatory policies to reach its target of net zero carbon by 2050.

The 10-point plan for a green industrial revolution, announced in November 2020, pledged investment of £12 billion to create and support up to 250,000 green jobs. Most points on that plan will impact real estate to some degree, and we examine these on page 4.

From a regulatory view, there are two policies that investors should brush up on for 2021.

1. THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD)

Under plans announced in November 2020, the UK is set to become the first country to make the Task Force on Climate-related Financial Disclosures (TCFD) fully mandatory across the economy by 2025, in support of the UK's transition to net zero carbon. This will enable investors and businesses to:

- Better understand material financial impacts
- Manage and price climate-related risks more accurately
- Support the greening of the UK economy

Some requirements are expected to be in place from January 2021 and investors should start early in preparing for these disclosures.

2. MINIMUM ENERGY EFFICIENCY STANDARDS (MEES)

The Minimum Energy Efficiency Standards (MEES) requires residential property to have an EPC rating of band E or better to be let in England. In the commercial sector, landlords have until April 2023 before all privately rented property must be band E but any new leases or lease renewals must be at that level now.

However, band E is just the start. There are proposals that new residential tenancies will need to be at least band C by April 2025, and all will need to comply by April 2028. For commercial property, it's expected that at least a band C rating will be required by 2030, if not a band B.

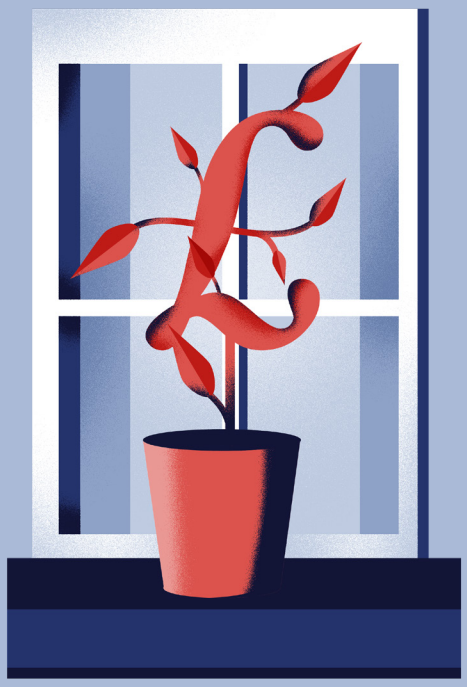
There is already evidence of property transactions with a band F or G rating being unable to proceed. Investors should futureproof their assets now so when new regulations are introduced, they're not left with stranded assets. This includes thinking about those that can be upgraded, changed in use or sold.

FUTURE CONSIDERATIONS

The drive to improve the energy efficiency of buildings isn't just down to regulation and investor demand. Many commercial occupiers have their own net zero targets and want the real estate to reflect these values. In the residential sector, although slower to take off, demand for green homes is increasing.

These are just a few of the ESG considerations for investors in real estate. To have a better understanding of the ESG performance of their investments, investors are increasingly using the Global Real Estate Sustainability Benchmark (GRESB). This enables them to compare results with peers each year and make improvements. Although GRESB is voluntary, investors will have to embrace this type of reporting, whatever the ESG credentials of the assets they hold.

This is just the beginning of the journey. The UK is not on track to hit its fifth and sixth Carbon Budgets (set to achieve an 80% reduction in emissions by 2050), let alone achieve net zero in 2050. More investment and regulation is expected, as the built environment, accounting for 40% of emissions, will continue to be a target. This will present challenges but also opportunities for real estate investors to make a significant difference.



Sophie Chick
Head of Department
World Research
020 7535 3336
sophie.chick@savills.com

Building a greener economy

What key aspects of the UK Government's 10-point plan will mean for real estate investment

PLAN AND AIM	WHAT THIS MEANS FOR REAL ESTATE INVESTORS
GREENER HOMES AND PUBLIC BUILDINGS Make our homes, schools and hospitals greener, warmer and more energy efficient with a target to install 600,000 heat pumps every year by 2028.	• For residential landlords and investors, the Green Homes Grant has been extended to March 2022. • Heat pumps will continue to increase in importance for residential developers as the Government consults to move forward its ban on gas boilers in new build properties.
OFFSHORE WIND AND HYDROGEN Produce enough offshore wind to power every home, quadrupling how much we produce to 40GW by 2030, and to generate 5GW of low carbon hydrogen production capacity by 2030 for industry, transport, power and homes.	• The source of energy for a building is an important consideration for investors in all sectors, particularly ensuring it can be de-carbonised. • Hydrogen is going to be trialled in homes for heating and cooking. The plan is to start with a Hydrogen Neighbourhood in 2023, moving to a Hydrogen Village by 2025, with an aim for a Hydrogen Town, equivalent to tens of thousands of homes, before the end of the decade, potentially creating investment opportunities.
ZERO EMISSION VEHICLES The UK will end the sale of new petrol and diesel cars and vans by 2030, and hybrid cars and vans by 2035.	• There is likely to be a big increase in demand for electric vehicles, but a key factor in the relatively slow uptake so far is a perceived lack of charging infrastructure. • Investors, developers and landowners need to establish charging points alongside hotels, offices, petrol stations, retail parks, supermarkets and new residential developments. They should ensure they have grid availability early on and the infrastructure to suffice or develop alternative solutions such as on-site generation.
PUBLIC TRANSPORT, CYCLING AND WALKING Make cycling and walking more attractive ways to travel and invest in zero-emission public transport.	• Office and residential buildings alike will need more investment in cycle storage. • Planning new developments in proximity to public transport will help encourage sustainable travel and cut down on car usage.
NATURAL ENVIRONMENT Protect and restore our natural environment, planting 30,000 hectares of trees every year, while creating and retaining thousands of jobs.	• Investors and developers can work with rural landowners to find suitable offsetting solutions. Read more on page 14.
INNOVATION AND GREEN FINANCE Develop the cutting-edge technologies needed to reach these new energy ambitions and make the City of London the global centre of green finance.	• Proposals to turn London into a green financial centre will help drive demand from occupiers for office space in the City.

Rebalance and reinvent

Need and social impact will be at the heart of investment

When we wrote this section of our cross sector overview last year, we opened with a quote from Lex Luthor to the effect that the need for land and property would prevail despite natural disasters and human conflict. That was approximately three weeks before the World Health Organisation first reported a cluster of pneumonia cases in the city of Wuhan. Little did we know how apt that reference would be in 2020, as the uncertainties of Brexit paled into insignificance compared with the disruption caused by Covid-19.

The extent to which the pandemic changes the way we use, appraise and value property long term remains open to debate. However, it seems certain to influence the strength of both occupational and investor demand for different asset classes in the short to medium term.

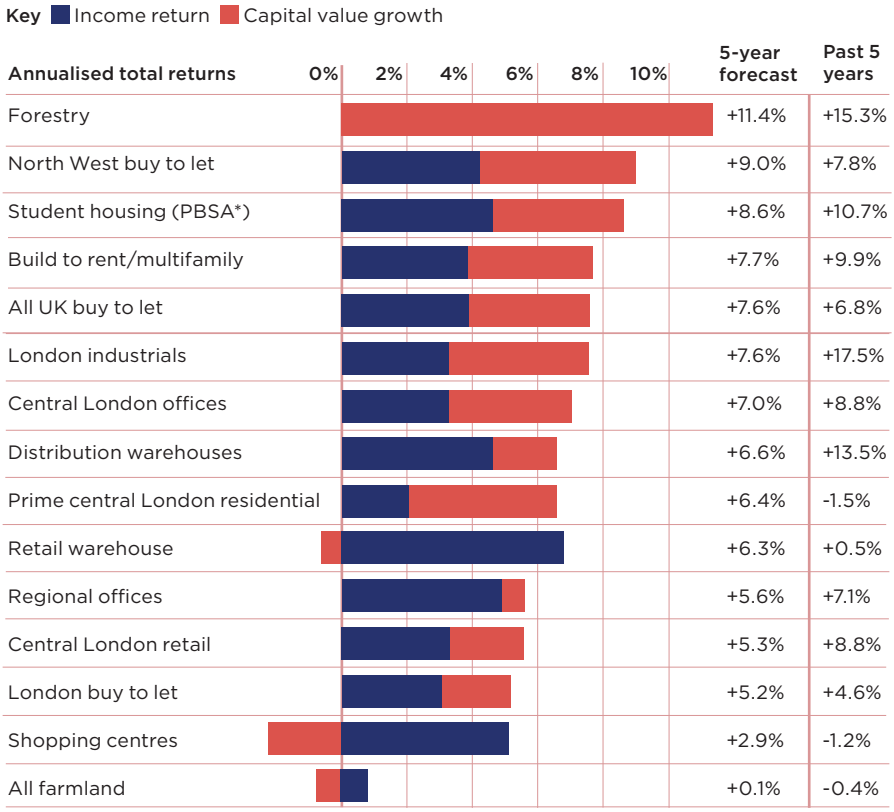
It has accelerated structural change in the retail sector, rebalanced the amount of time we expect to spend working at home versus the office and provided more time to reflect on the importance of the ESG credentials of our property assets. So, over the next five years we expect need and social impact to be at the heart of property investment.

The need for timber and environmental credentials of investment in forestry puts it at the top of our list of expected returns. However, the limited size of the market and the very long-term nature of the investment suggests that the prospect of money growing on trees will only be enjoyed by a select handful of investors.

From the need perspective, we expect beds and increasingly sophisticated sheds to deliver some of the strongest interest in this period, as yesterday's alternatives rapidly become tomorrow's mainstream. During this period of transition, development will remain key to buying in these sectors. Meanwhile, demand for this group of assets looks set to be underpinned by the security of their income streams and the potential for further yield compression, in a period when the cost of money is expected to remain low.

Other sectors are set for a period of reinvention, whether that be the retail and leisure offering on our high streets or the way we use our office stock. In both cases, demand will remain for those assets which are best in class and can adapt to our changing lifestyle priorities. That suggests a widening gap in the performance between prime, secondary and tertiary assets and an increase in redevelopment opportunities. It comes when the Government retains ambitious housebuilding targets and will welcome repurposing proposals that play to its levelling-up agenda.

Comparative returns Forecasts for the next five years compared with the past five years



Note *Purpose built student accommodation **Source** Savills Research

Note In a world of data, it is surprisingly difficult to arrive at comparative income returns for different asset classes. For residential buy to let investments, our model uses a combination of data from the valuation office, the Land Registry and Rightmove. We have then had to take into account that while commercial property income streams will often be underpinned by full repairing and insuring leases, in the residential markets these are the responsibility of the landlord. Agricultural tenancy obligations sit somewhere in the middle. For consistency, we provide figures net of all irrecoverable costs in line with IPD industry standards. No account has been taken of the restricted tax relief available to private buy to let investors using mortgage finance (which would reduce effective income returns for some investors).

Top picks

Key investment opportunities across each sector for 2021

Commercial

CBD OFFICE DEVELOPMENT

Despite the debate about how and where we work, offices in CBDs will remain the sector of choice for most occupiers and investors. Typical post-recessionary trends will mean these will become increasingly scarce. High quality, well-located buildings that tick both ESG and wellness boxes will out-perform.

REPURPOSING

Recessions have always left the market with an oversupply of some type of space. The winners in post-recessionary periods are those who buy those assets cheap with an eye on what they could become. This time around, we expect to see traditional retail, office and industrial assets being repurposed for residential, life science, data centre and medical-related uses.

Residential

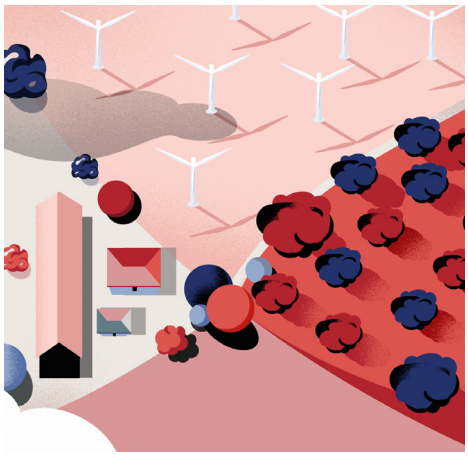
PRIME CENTRAL LONDON

Yes, it was on our list of top picks last year and it remains so this year. A short-lived Boris bounce at the beginning of 2020 hinted at a recovery that has been held back by international travel restrictions. With prices still 20% below their 2014 peak, it continues to look good value in both a historical and international context. And while a 2% non-resident buyers stamp duty surcharge is due in March, total buy, hold and sell costs will remain competitive compared with other world cities.

SINGLE FAMILY BUILD TO RENT

Some 63% of all privately rented homes are houses as opposed to flats, yet houses only account for 12% of build to rent stock. That presents an untapped opportunity for institutional investors to capitalise on the nascent suburban or 'single-family' model, which is geared towards the fastest growing segment of the rental market – families and those over the age of 40. With less need for communal areas, lower running costs and less tenant turnover, it offers an attractive proposition for those looking for secure long-term income streams.

Rural



FORESTRY

The stellar returns in forestry hint at a market nearing capacity, but a winner-takes-all attitude and the soft power of timber within an investment portfolio means that demand dynamics continue to drive capital appreciation. The long-term play is that valuations reflect growing carbon agendas, repaying investors with super-long term horizons.

GRADE 1 FARMLAND

The market for prime Grade 1 peat arable areas of the East has struggled in places, as commercial farmers question market returns and limit expansion plans. However, the carbon potential of these peatland soils arguably makes them the target for future policy intervention and market innovation. Regenerative practices and alternative uses could bring outsize value returns for prime soil investors.

Sense of familiarity

Many market trends were already in motion before Covid-19

Mat Oakley
Head of Commercial Research
020 7409 8781
moakley@savills.com

The uniqueness of the Covid-19 period in 2020 has led many commentators to suggest that things will be markedly different going forward. However, the performance of most commercial occupational and investment markets this year has been typical of past recessions, and this leads us to conclude that 2021 and beyond will be very recognisable to anyone who has worked through previous recovery phases of the UK property market.

This does not mean that changes will not be taking place, but that many of these changes will be a continuation or acceleration of trends that were already present in the market before Covid-19. For example, as our chart on page 8 shows, 2020 has seen an acceleration of the divergence between logistics and retail yields that has been happening for much of the past decade. The record high levels of leasing activity in the logistics market in 2020 will drive even more investor interest in an already crowded sector, and thus put further downward pressure on yields.

"In 2021, there will be an end to (or at least a diminution of) Brexit-related uncertainty in the investment market"

RETURN TO THE OFFICE

The office sector is seen by some as being most likely to be hit by new behaviour post-Covid-19. However, virtually every survey that has been done of office workers suggests that most will continue to spend the majority of their working week in traditional CBD offices. While this return to normality is unlikely until a vaccination programme has been widely rolled out, it will support investor demand for what is still the largest commercial property asset class.

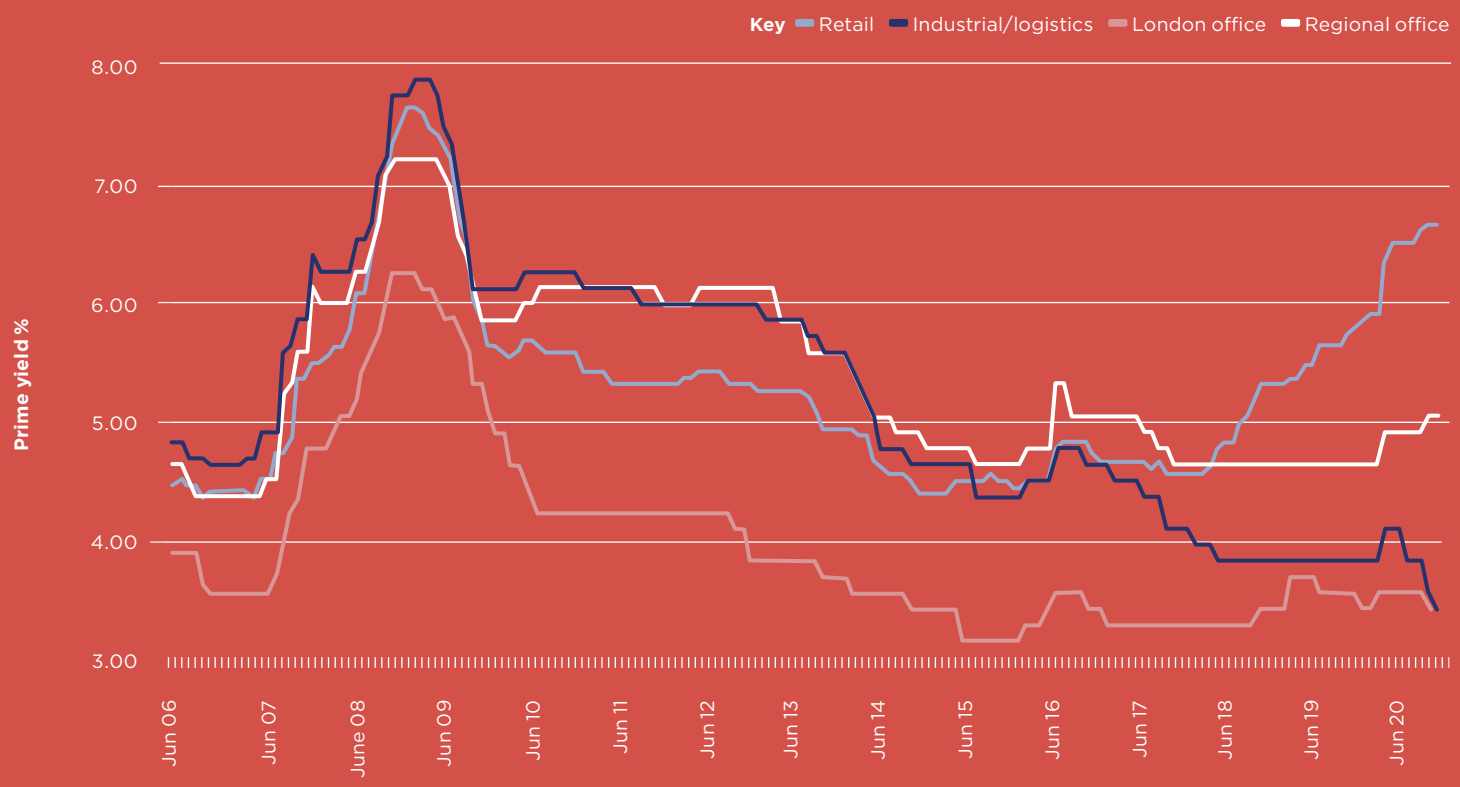
In 2021, there will also be an end to (or at least a diminution of) Brexit-related uncertainty in the investment market. The non-domestic investors who have stayed away from the UK because of this uncertainty will definitely look favourably on the UK once this happens, as many sectors are now looking comparatively attractive in terms of both pricing and income security.

THE RISE OF ALTERNATIVES

The final trend that was present pre-Covid-19 that will see an acceleration in 2021 is the rise of alternative asset classes. We expect to see more attention being paid to data centres, any asset with a health or science badge, and multifamily housing in the UK. While most of these segments are still pretty small in the UK, they may offer the change of use opportunity that retail landlords will be looking for next year and beyond.

Commercial property prime yields

Covid-19 has accelerated structural changes that were already happening



Source: Savills Research

Commercial sector outlook 2021

Our at-a-glance summary of how we see commercial assets behaving in the coming year

CHANGE AHEAD	MORE OF THE SAME
HIGH STREET RETAIL A short-term bounce in suburban trade will dissipate post-Covid-19. Repurposing to residential and other uses will have to rise.	**CBD OFFICES** This will remain the core of many investors' portfolios. Typical post-recessionary divergence between prime and secondary performance ahead. Great offices will be green, accessible and safe.
RETAIL WAREHOUSE PARKS The best will prove to be resilient to both Covid-19 and internet retailing. The rest could be repurposed for logistics, residential or life sciences.	**LOGISTICS** Will remain many investors' sector of choice in 2021. Pricing will be driven both by weight of investor demand and occupational fundamentals.
BUSINESS PARKS Accessibility and less dependence on public transport will interest investors and occupiers. There is also potential for densification.	**ALTERNATIVES** Income-producing alternative asset classes will remain popular and become the second-largest asset class after offices. Concerns around senior and student housing will raise interest in the private rented sector, data centres and primary health.

Future living

2021 will be a year of three parts for the residential sector

Lucian Cook
Head of Residential Research
020 7016 3837
lcook@savills.com

The year 2020 was remarkable for the UK housing market. Despite the deepest recession in living memory, house prices rose by 6.5% in the year to the end of November. With the behavioural response to Covid-19 outweighing the expected economic impact on the market, transaction levels surged in the wake of the first lockdown.

Had someone suggested in May that we would see £20 billion of monthly mortgage approvals by October, they would have been dismissed as mad. Yet there was a record amount of mortgage debt approved in that month, as those with the financial security to move reassessed their housing needs given both their immediate experience of lockdown and an expectation that it would have a lasting impact on their lifestyle.

What, then, does that experience mean for 2021? Assuming the stamp duty holiday has a limited shelf life and the behavioural impact of lockdown dissipates as a vaccination programme is rolled out, it increasingly looks as though it will be a year of three parts.

EARLY 2021: RUSH OF ACTIVITY DESPITE CONTINUED SOCIAL DISTANCING

In the early part of the year, we expect transactions and prices to continue to be supported by a combination of exuberant attempts to beat the end of the stamp duty holiday, the final days of the current incarnation of Help to Buy and the continued desire for people to find a home that better meets their immediate requirements.

MID-2021: POTENTIAL LULL IN ACTIVITY

The experience of 2016 tells us that nothing distorts the housing market like a pre-announced change in taxation. And with the stamp duty holiday due to come to an end around the time unemployment is expected to peak, we can be pretty certain of a pronounced lull in activity during the middle months of the year.

With that comes the very real prospect that some of the price gains made during the preceding 'mini housing market boom' will unwind. However, the extent of any house price falls are likely to be tempered by the boost to consumer confidence of an effective vaccination programme.

This period is also likely to mark the beginning of the end of the great work from home experiment as people return to their office environment on a more frequent basis. That is likely to result in less urgency to upsize or relocate to the heart of the commuter zone or its fringes.

LATE 2021: DEMAND RESTORED BUT TEMPERED

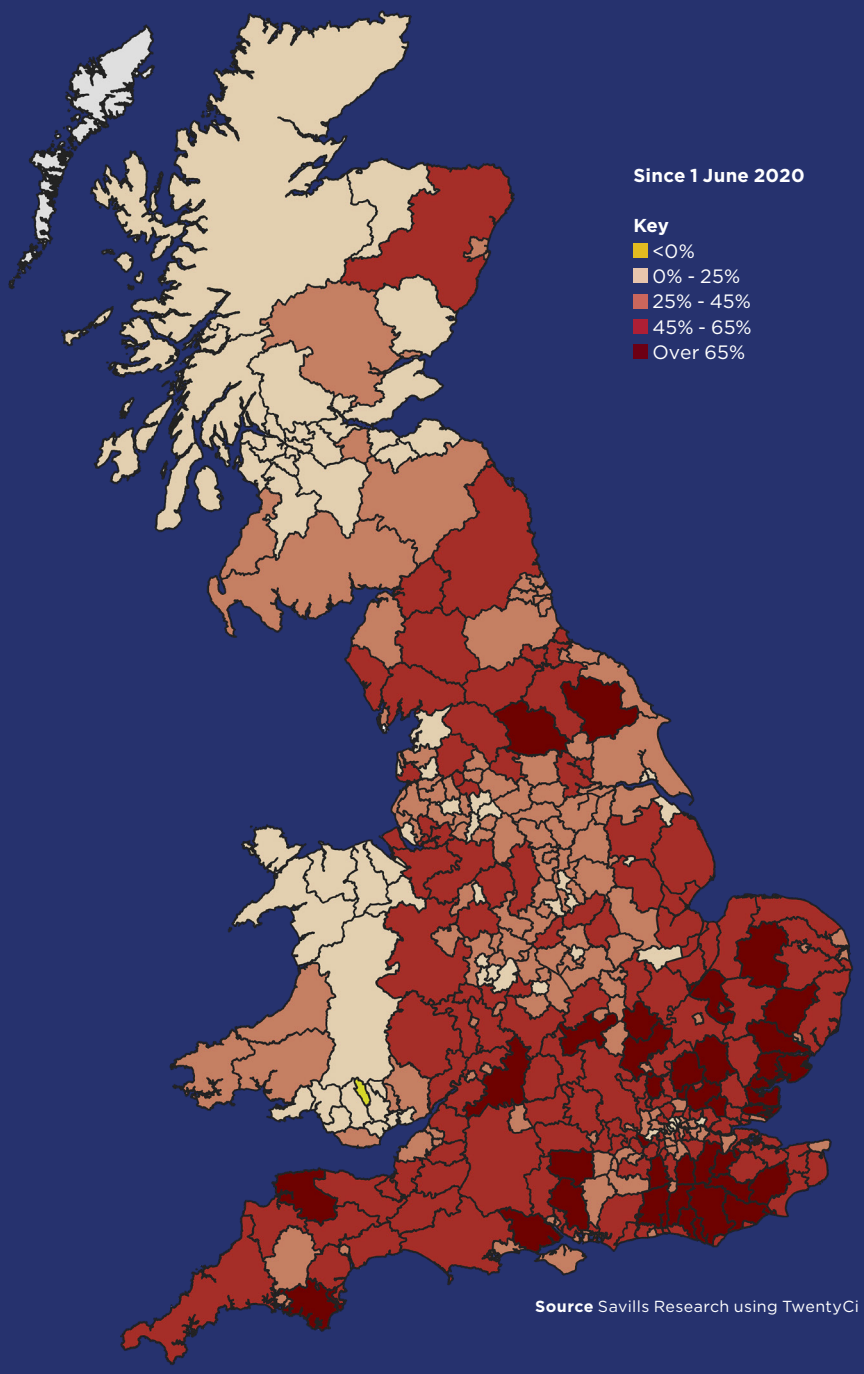
Only in the latter part of the year do we expect the economic fundamentals to come back to the fore. Falling unemployment and low interest rates are expected to restore housing market demand. However, the financial clout of potential buyers is likely to be tempered by the prospect of tax rises as attention turns to balancing the government's books.

THE LASTING IMPACT

All of this begs the question: what lasting impact will Covid-19 have on the housing market? There is little doubt it has caused households to reassess their work-life balance, their housing needs and where they want to put down their roots. The permanence of these changes is very closely linked to the future role of the office, the extent to which the dream of part-time home working becomes a reality and the practical experience of commuting, even if on a part-time basis.

A nod to the future?

Increase in agreed house sales in the period 1 June 2020 to 29 November 2020 compared with same period in 2019



Source Savills Research using TwentyCi

Residential sector outlook 2021

Mapping the road ahead for residential development and residential investment

RESIDENTIAL DEVELOPMENT

A strong housebuilding agenda remains underpinned by:

- planning reform and fixed local housebuilding targets that seek to strike a balance between increasing delivery in areas of most need and where it can be accommodated.
- facilitating home ownership (creating ESG-friendly investment opportunities in shared ownership).

...but is subject to disruption from:

- increased tensions between local and national development agendas.
- renewed trade-offs between housing need and viability given the proposed end to Help to Buy in 2023, the Government's aspirations for First Homes and a revised approach to land value capture via proposals for a new Infrastructure Levy.

RESIDENTIAL INVESTMENT

Low interest rates will provide some breathing space for those private investors not scarred by voids and arrears.

The clamour for needs-based residential will continue but with increased focus on rental growth prospects in different parts of the market and features that increase the security of the income stream.

Medium-term rental growth will be determined by the outlook for income growth, though the short-term distortion between supply and demand due to lockdown should fall away as and when social distancing is relaxed.

Management reputation and branding will play an increasing role in a flight to quality among more affluent tenants where rental growth prospects are greatest.

Strong values

Despite political upheaval, rural land assets remain solid

Emily Norton
Head of Rural Research
020 7016 3786
emily.norton@savills.com

Commentators look at the correlation between policy change in agriculture and land values, and lament that Brexit is going to spoil the fortunes of farmland as an asset class. They are wrong.

The evidence for the direct payments made to farmers being capitalised into land values is weak at best. Total budgets have been consistent both before and after the change to area-based payments in 2003. What changed in 2004 was the perception that land was cheap compared with other asset classes. What will change post-Brexit is not land value, but the perception that returns from farmland are more valuable than returns from other asset classes.

In England, the shift to policy reflecting the long-term sustainability of land use means payments are received for 'public goods' delivered over and above the regulatory baseline. In Scotland, income-style support payments will be retained in the medium term at least.

Our research shows that average earnings from farmland have stayed pretty consistent and

"Fortune will favour the bold – there are new, bigger and existential problems to tackle"

pegged at about 1%, and we are conservatively predicting that this will stay the same over the next five years. The smart owners should be able to do much better, but disruption during the post-CAP transition phase is inevitable and this will weigh on sentiment in the short term.

Scotland may be cushioned by consistency but struggling farmers will struggle further wherever they are. Systems that have scraped through propped up by benefits and chasing ever diminishing efficiencies will buckle. Ultimately though, fortune will favour the bold, because the policy zeitgeist in both nations is similar: there are new, bigger and existential problems to tackle.

The macro-level drama playing out around trade, climate change and food policy casts land as hero, villain and victim. Accountability shifts for owners and investors on climate risk and impact means that some are already looking at the long-term value of sustainable land management practices over and above conventional returns from land.

Some are already deciding to take land back in hand or working with tenants so that natural capital opportunities in forestry or land use change can be captured and reported. To make sense of this changing policy and investment paradigm, land investors need to keep their eyes on the prize and adopt a clear strategy to ensure that land assets can successfully and sensibly play their part. The two golden rules to remember will be:

1. OVERALL ASSET MANAGEMENT STRATEGY NEEDS TO REFLECT THE TRUE COST OF CARBON

At present, a low market price and relative affordability of land for carbon offsetting (on marginal hill land) or carbon offsets (overseas) drives offsetting at the cost of actual carbon reduction plans, which are now getting expensive as the low-hanging fruit are taken. The regulatory baseline on asset performance will keep getting higher, which means that an aggressive internal carbon price is needed to ensure organisations make rational short-term investment choices for long-term security.

2. RURAL LAND IS, AND ALWAYS HAS BEEN, A MULTIFUNCTIONAL ASSET

Farmland values have always reflected returns from non-farming incomes, but stripping investment accountability back to a carbon value alone will risk appropriating an entire asset class to those able to afford carbon offsets, risking long-term food security and environmental wellbeing, and undermining efforts to protect corporate reputation and licence to operate.

Carbon is not the only metric of interest. But this is about income as well as capital value: developing a blended approach to land use that reflects the wide range of beneficiaries and co-dependencies in landscape management is more important than ever for leveraging returns from land investments. Occupation models need to reflect these new value drivers and earning opportunities, bringing diversity and resilience to land investments.

If we can get this right, rural land presents by far the most attractive long-term play of any asset class. It meets all of our core needs, offers security and non-correlated returns, and it now offers new and valuable income streams as markets for nature-based solutions to the vulnerabilities of human existence are expedited.

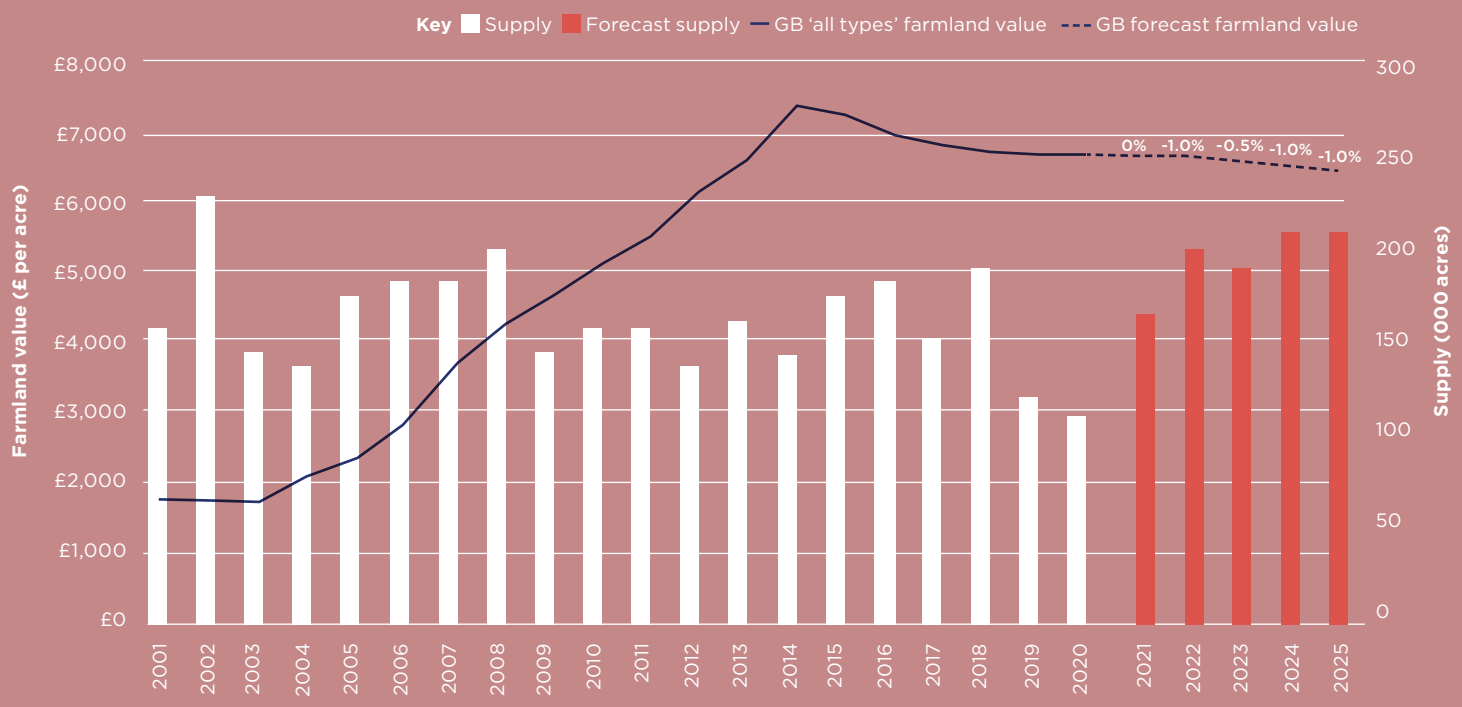
This is before all of the traditional benefits of land ownership in amenity and sporting value are considered. Developing the right strategy to rural asset management to meet these wide-ranging opportunities and expectations will be key as we move beyond the constraints of the Common Agriculture Policy (CAP) into a more liberal and entrepreneurial agri-economy.

Rural sector outlook 2021

Post-Covid-19, three emerging themes will drive investment opportunities in rural land

ENVIRONMENT	LIFESTYLE/WORKSTYLE	THE MARKET
The principles of natural capital are driving new value streams from rural land for the benefit of residential and commercial development. Biodiversity net gain, nutrient neutrality and carbon offsetting remain key revenue opportunities for rural land investors.	Digital work accelerated by Covid-19 has created the ability to live and work anywhere, and confinement has led to a renewed appeal of rural spaces. Spikes in domestic tourism may be temporary, but the increased demand for rural logistics is likely to be sustained.	A generational change in land ownership and occupation is imminent, as the policy supporting farm businesses is reshaped to meet new outcomes. But new entrants to the industry are legion, from suburban dwellers looking for space, to institutional funds looking for positive ESG returns. Short-term disruption will be inevitable but provided land values are affordable, competition for land will remain high.

GB farmland forecast 2021-2025



Source Savills Research

Savills Research
We're a dedicated team with an unrivalled reputation for producing well-informed and accurate analysis, research and commentary across all sectors of the UK property market.

Sophie Chick
Head of Department
World Research
020 7535 3336
sophie.chick@savills.com

Lucian Cook
Head of
Residential Research
020 7016 3837
lcook@savills.com

Mat Oakley
Head of
Commercial Research
020 7409 8781
moakley@savills.com

Emily Norton
Head of
Rural Research
020 7016 3786
emily.norton@savills.com

James Sparrow
CEO,
UK & Europe
020 7409 8873
jsparrow@savills.com

Richard Rees
Managing Director (UK),
Development Services
020 7499 8644
rrees@savills.com

Andrew Harle
Head of UK Rural
01904 756 312
aharle@savills.com

Justin Marking
Head of
Global Residential
020 7499 8644
jmarking@savills.com

Jeremy Bates
Executive Director
Office Agency
020 7409 8813
jbates@savills.com

James Gulliford
Joint Head of
UK Investment
020 7409 8711
jgulliford@savills.com

Richard Merryweather
Joint Head of
UK Investment
020 7409 8838
rmerryweather@savills.com

Peter Allen
Head of Operational
Capital Markets
020 7499 8644
pallen@savills.com