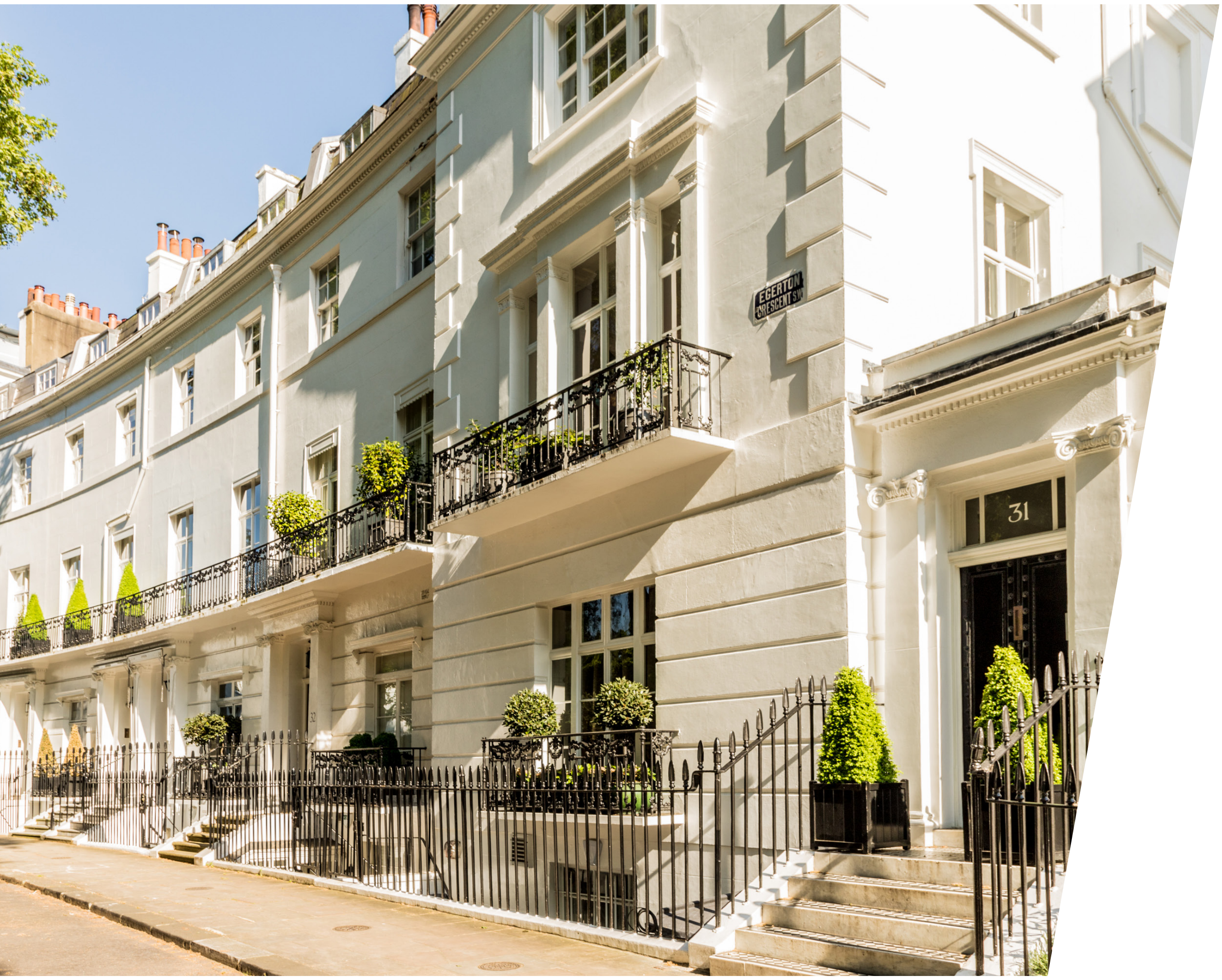
Guide to Property Investment in England and Wales

brought to you by

Investec Private Banking

Contents



Introduction

The property market in England and Wales has attracted global investors for many years – and with good reason. While the uncertainty of the UK's 2016 vote to leave the European Union continues to play out, in England and Wales the long-term case for buying a home, investing in an office property, or buying a warehouse is supported by unparalleled access to global markets, strong investor protections and the potential to earn attractive returns.

But when your wealth is on the line, you probably want some deeper analysis, and comfort that your lender understands how that shapes your own appetite for investment. That's why we've developed this guide to help you understand the state of the market, the options available for property investment and the key trends shaping the future.

To do this, we're going to look at a number of investment options, including Build to Rent, commercial, industrial and residential property. We'll also examine some of the key themes affecting these segments and what they mean for investors looking to move into property or expand their personal portfolio.

Our specific areas of focus in this report are:

- The state of the market, focusing on residential property with a summary of markets for office, industrial and retail markets.
- Investment opportunities outside London; which assets show the greatest promise and what to look for as new markets develop.
- Meeting the challenge of a chronic housing shortage, recent reforms and the impact of changing economic conditions and interest rate policy.
- New opportunities to invest in property in response to changing demographics, workplace requirements, and ecommerce.

Our observations are not a recommendation on making specific investments, and nor should this guide be considered legal advice. Note that our data and analysis is correct as of September 2018.

The state of the market

The headlines seem relentless: investing in property is currently a huge risk, they warn. While it would be foolish to ignore everything in the media – or indeed, the very real risks associated with any investing – the truth is property in the UK is still one of the world's most secure investments.

The phrase 'safe as houses' has some justification after all. Property values, particularly in urban areas, have shown tremendous resilience to economic hardship, fluctuating markets and changing tax policy.

Today, the UK's well-established legal system, stable currency, growing population and limited land supply continue to provide a favourable backdrop for investors, whether they seek financial returns or just need a place to settle their families.

But behind the broad aphorism, there's a nuanced picture. "It's very much specific to individual markets, whether that is in prime London, wider London, or the wider UK," says Peter Izard, mortgage broker business development manager for Investec Private Bank. "You can't sweep it with a broad brush."

Prime residential property in London, for example, has struggled over the past four years, falling nearly 18% since the market peak in 2014, according to research by Savills.[1] But during the same period, property prices in areas outside central London have been among the best performing across Britain.

The Brexit effect… or something else?

Many people blame Brexit for London's high-end property stall, as financial services businesses shift high-paid jobs to the European mainland. But Izard believes the decline in central London residential property prices is more likely related to recent tax changes, particularly stamp duty and the surcharge on second homes. These changes, phased in from 2017, "did take the market by surprise, and affected prime London dramatically greater than anywhere else."

Izard also believes an absence of forced sellers has reduced the amount of stock available for purchase at prices that buyers are willing to pay.

Although sales in prime London locations have fallen, Izard notes that there has been a concurrent pickup in rental demand. This benefits Buy to Let (BTL) investors by boosting yields on their rental properties. Even so, Izard notes that here and elsewhere across England and Wales, the BTL market faces significant headwinds from recent tax changes.

1 Savills Plc, Market in Minutes: Prime London residential, 25 July 2018

A changing tax landscape

As housing affordability issues have moved up the list of government priorities, the government has taken steps to reduce the tax benefits provided to BTL property owners. Where individual investors were previously able to offset their mortgage interest costs for buying a property against the rental income received, there are now restrictions on how much tax relief they can get.

"Today, the UK's well established legal system, stable currency, growing population and limited land supply continue to provide a favourable backdrop for investors"

The state of the market

The phasing-in of these restrictions began in April 2017. From April 2020, tax relief will be restricted to 20% on the full interest cost. The consequence of this is to increase the tax burden on private landlords by £20 tax per £100 of interest cost for higher tax rate payers.

There is also a new 3% Stamp Duty Land Tax (SDLT) levy applied to UK BTL properties and UK second homes purchases by both overseas as well as domestic investors, unless they can show they do not own another home anywhere in the world. The new surcharge is in addition to the general SDLT, the exact amount of which depends on the price of the home they buy.

This can be 8% for properties valued at over £250,000 and as much as 15% for properties valued at over £1.5 million.

Overseas investors have also been impacted by tax changes over the past few years, such that they are now liable to UK capital gains tax on disposals of residential BTL properties. Another recent tax change is the introduction of the Annual Tax on Enveloped Dwellings (ATED), which is payable where UK residential property valued at £500,000 or more is held in structures.

However, exemptions are available for rental and property development businesses but filing may be required to claim the exemption.

It's all in the structure

In response to these tax changes, it is important that as a private investor, you think through how you hold BTL properties. The use of structures such as a UK company may prove beneficial due to the lower rate of corporation tax being applied to rental income earned as opposed to a 45% income tax rate.

There is also the potential to take full tax relief for interest costs in a company, as opposed to the restrictions placed on individual investors. However, these benefits must be weighed against the initial set up and on-going compliance costs of employing a structure. Distribution of profits from a company will first be subject to UK corporation tax before being taxed a second time in the hands of the investor. The use of a structure may not be appropriate for everyone and their use will depend on each investor's personal circumstances and long-term intentions.

If you do decide a structure is the most appropriate for you, the next challenge is finding a lender that is able to lend. Although Investec Private Bank is very flexible here, most other lenders will typically only lend to individuals in their personal name.

Office

Occupancy demand across the UK has been rising as the economy outpaces an inadequate supply of space in most regions outside of London. But prime rental yields within London have dipped over the past year as concerns about Brexit's impact on the City have started to translate into the real movement of jobs to other European financial centres. In secondary cities across England and Wales, rental yields have been boosted by a demand from local business clusters and an exodus of back office jobs from London. This has caught the attention of overseas investors, who are keen to take advantage of the weak pound and to diversify into assets with yield.

Industrial

Demand for urban and near-urban warehouse space is high as logistics operators need to provide last-mile delivery services for online retailers. The UK remains what Savills describes as an "under-warehoused country".[2] In addition to the expanding needs of ecommerce, demand for redeveloped urban industrial space from which to sell to consumers is increasingly coming from SMEs. These multiple demands, together with a chronic undersupply of urban residential dwellings, are also contributing to the growth of mixed use property redevelopments.

Retail

The flip side of the dramatic rise of online shopping has been structural changes in retail property requirements, including significant downsizing and an increased need for flexible spaces.

These changes represent a serious on-going challenge to this segment, not least because the UK is now the largest online retail market in Europe.[3] A direct downside of ecommerce success has been large-scale business bankruptcies and dramatic downsizing across the country, both on the high street, where space is costly and inflexible, and in shopping malls.

---

2 Savills Plc, Savills Programme and Cost Sentiment Survey, 8 May 2018

3 Royal Institution of Chartered Surveyors, Online shopping causing growing divide between struggling retail and booming industrial, 26 April 2018

Why there's value to be found outside London

The recent performance of regional property has been a study in contrasts. Non-London residential prices have been steadily rising since April 2012.[4] This trend has been most prevalent in the East and West Midlands, and prices in Birmingham have risen particularly strongly. But growth is also evident in the South West and North West of England and in Wales, according to the Royal Institution of Chartered Surveyors (RICS).

The most recent UK House Price Index from the Office of National Statistics[5] shows that house prices across the UK have risen 3% on average in the year to May 2018, from an average 3.5% in the year to April, with the slowdown primarily attributed to a downturn in the South and East of the country.

Alternative residential

The BTL sector, which accounts for more than 10% of property ownership in the UK, has seen an exodus of smaller individual investors and a shift towards a more professional approach. This may weigh on your decision to pursue a BTL investment.

While changes in the UK tax regime are quickly shrinking this market,[6] individual landlords and some institutional investors are finding alternative investments in Private Rental Sector (PRS) property developments, as well as the related Build to Rent (BTR) market. Both these sectors enjoy the support of government policies designed to address the nationwide housing shortage.

The BTR segment, in particular, while still relatively small is attracting investment interest from sovereign wealth funds, pension funds and insurance companies[7] focused on alternative investments that are both scalable and offer attractive yield characteristics. Those same attributes might be attractive to investors looking at their private portfolio.

Strong rental yields have also buoyed interest in prime office space, particularly in the secondary cities of England and Wales, according to Cushman & Wakefield.[8] Manchester and Birmingham averaged a 5% yield over the past year, with 5.75% in Cardiff and Newcastle. Over the same period, rents slipped in the City and in West End, and current yield is only 3.25%.

This lag in the development of new office space outside of London in relation to the economic cycle coincides with a shift in industry-driven investment away from the capital. The resulting lack of liquidity in the office market in many other major UK cities will mean it continues to be a buyer's market over the next six to 12 months.

4 iNews, What's really going on with UK house prices, explained in three charts, Martin Armstrong, 19 April 2018

5 ONS, UK House Price Index, May 2018

6 The Times, Buy to Let market shrinks after stamp duty and tax changes, Philip Aldrick, 16 May 2018

7 Financial Times, Investors professionalise private rental sector, Andrew Bounds, 11 July 2016

8 Cushman & Wakefield, United Kingdom Office Market Snapshot, Second Quarter 2018

Other segments in commercial property

There are several other segments of the commercial property market outside London that are attracting attention. Investments in commercial property such as warehouses, retail or mixed-use rental properties benefit from performance characteristics that are relatively uncorrelated with equities and bonds. They also provide a steady income that is indexed to inflation.

Many of these commercial property investments are exclusively offered to institutions. However, individuals who want to increase their exposure can invest in funds that hold the physical assets in their portfolio. These buy into either a specific type of property, or a mix of properties directly and can be structured either as open- or closed-ended investment trusts. Either way, they have similar characteristics to a direct investment. However, because the assets they hold aren't regularly bought and sold, these are not typically very liquid.

Property Securities Funds, which buy listed property companies, or Real Estate Investment Trusts (REITs), which are portfolios of properties, offer much greater liquidity for the individual investor with less volatility. But these may not offer the level of exposure to a desired segment of the property market or trend that a direct investment in a property would.

Supplying an undersupplied student market

Private purpose-built student accommodation (PBSA) is a great example of a hot property investment segment. "The student accommodation market has continued to gain mainstream acceptance among investors," says Jonathan Long, who works in the Structured Property Finance team at Investec Private Bank. "Investment volumes seem to increase year on year, and in 2016 alone we saw £3.5 billion of purpose-built student accommodation being traded."

Growth in PBSA is the result of several factors,[9] including rising numbers of students from abroad and a significant growth in the number of British school-leavers choosing full-time university courses. There has also been a drive towards the private sector for the delivery of better-quality accommodation in what has historically been an undersupplied market.

Long says another attraction for private investors in student accommodation is that "people view student accommodation as a countercyclical asset class. If there was to be another financial crisis, individuals would be drawn back into higher education." This is particularly true if the employment market is weak.

> Individuals who want to increase their exposure can invest in funds that hold the physical assets in their portfolio. These buy into either a specific type of property, or a mix of properties directly, and can be structured either as open- or closed-ended investment trusts

9 Cushman & Wakefield, UK Student Accommodation Report, David Feeney, 7 December 2017

Meeting the challenge of residential property investment

It is the residential property market that holds the most interest for many investors, buoyed as it is by long-term supply and demand fundamentals that structurally support rising prices. "We're an island with a growing population," says Peter Izard. "Brexit won't stop that. We have an influx of immigration rather than emigration, and we don't build enough houses to meet that demand.

"There's not enough infrastructure. There's not enough land granted to build it. And even if we had the land and the materials, there aren't enough tradespeople to physically build enough for supply to outstrip demand either."

In the shadow of the crisis

Property developers in England and Wales still operate in the shadow of the global financial crisis. When the downturn hit, banks sharply curtailed lending to each other and to home mortgage borrowers. When mortgage approvals collapsed in 2008, homebuilders soon halted construction activity, leaving an estimated 250,000 craftsmen without work. Many left the construction industry altogether.

Now that mortgage lending has resumed and demand is up, these same homebuilders are discovering a severe shortage of skilled bricklayers, carpenters and joiners. Domestically, there are not enough qualified tradespeople coming through the vocational training system to meet demand. And where there is labour available, some 62% of those who enter the construction industry have not completed their training.[10] Meanwhile, the prospect of Brexit-induced restrictions on labour-related immigration from Europe could further worsen labour shortages within the construction industry.

Chronic undersupply

Against this backdrop, government estimates put the need for additional housing in England alone at 232,000 to 300,000 new units per year, a level of output that has not been achieved since the late 1970s. This is also two to three times current supply.

The challenge is not just about there being more people – it's also how they're living. The number of new households, including individuals living on their own, divorcing couples, and couples with growing families, has exceeded new supply every year since 2008.

The National Housing Federation estimates that there is now a shortfall of more than half a million dwellings across the country, despite years of government efforts to accelerate development and curb speculative buying.

10 Institute for Employment Studies, The Labour Market Story: The State Of UK Skills, July 2014

Predictably, prices have risen out of all proportion to people's ability to afford home ownership. Between 1997 and 2016, the median price paid[11] for residential property in England and Wales increased by 259%, while median individual annual earnings rose by only 68%.

Planning bottlenecks

The UK's chronic housing shortage has been exacerbated by long-standing developmental planning practices and by property taxation policies. This has led to large-scale property speculation and incentivised generations of BTL investors.

Until the recently implemented reforms, the National Planning Policy Framework allowed local planning authorities enormous leeway for determining what and where property may be developed. This had a tendency to slow or halt the delivery of residential developments, often at great cost to the developer. Reforms introduced this year, however, could start to unblock the system.[12] The newly relaunched Home England initiative will provide the government with land buying powers and funding to help deliver an average of 300,000 homes a year by 2020.

11 Office for National Statistics, Housing Affordability in England and Wales: 2016

12 Strutt and Parker, How the changes to the NPPF could boost housing delivery, Q1 2018

A Housing Delivery Test will also be applied to help calculate housing needs in a particular area using standard methodology and then measure each local authority's housing delivery performance. Logjams are also being removed from the planning system – particularly conditions that must be met before development can begin. These will be accompanied by penalties for developers that fail to begin work on land where planning permission has been granted.

A more controversial measure requires that at least 10% of homes on major sites be made available for affordable home ownership. Property developers complain that the requirement could threaten the viability of some large housing developments, particularly in London.

Less contentious measures include those designed to accelerate the delivery of residential developments on urban brownfield sites, such as under-utilised retail or industrial spaces, or extending existing blocks of flats and houses by building upwards.

Economic challenges

A vibrant economy driven by a strong services sector has put England and Wales among Europe's best performers since the financial crisis. But Victoria Clarke, economist at Investec, says that since the Brexit referendum the outlook for the property market in England and Wales has become clouded. Clarke says the primary driver of this more clouded outlook has been the sharp drop in sterling after the referendum. That has lifted inflation and applied a squeeze on household incomes. Even so, "households have got past the peak of inflation in November last year – and at the same time wage growth has picked up a bit." This has improved housing affordability, and together with strong employment gains should boost mortgage approvals and sales for the next 12 months.

The Consumer Prices Index (CPI) 12-month inflation rate was 2.4% in June 2018,[13] unchanged from May, while wage growth slipped to 2.7% in the three months to May 2018.[14] Clarke believes we are headed to a transition period, where "we come out of the EU, but we stay operating under the rules and ways and means of the EU so we can come to a detailed agreement on the longer-term trade arrangements."

Rate rise impact

Clarke feels that Brexit's impact on the property market and on the economy is unknowable because nothing like it has ever happened before. What is more certain is the turn in the interest rate cycle and its impact on households.

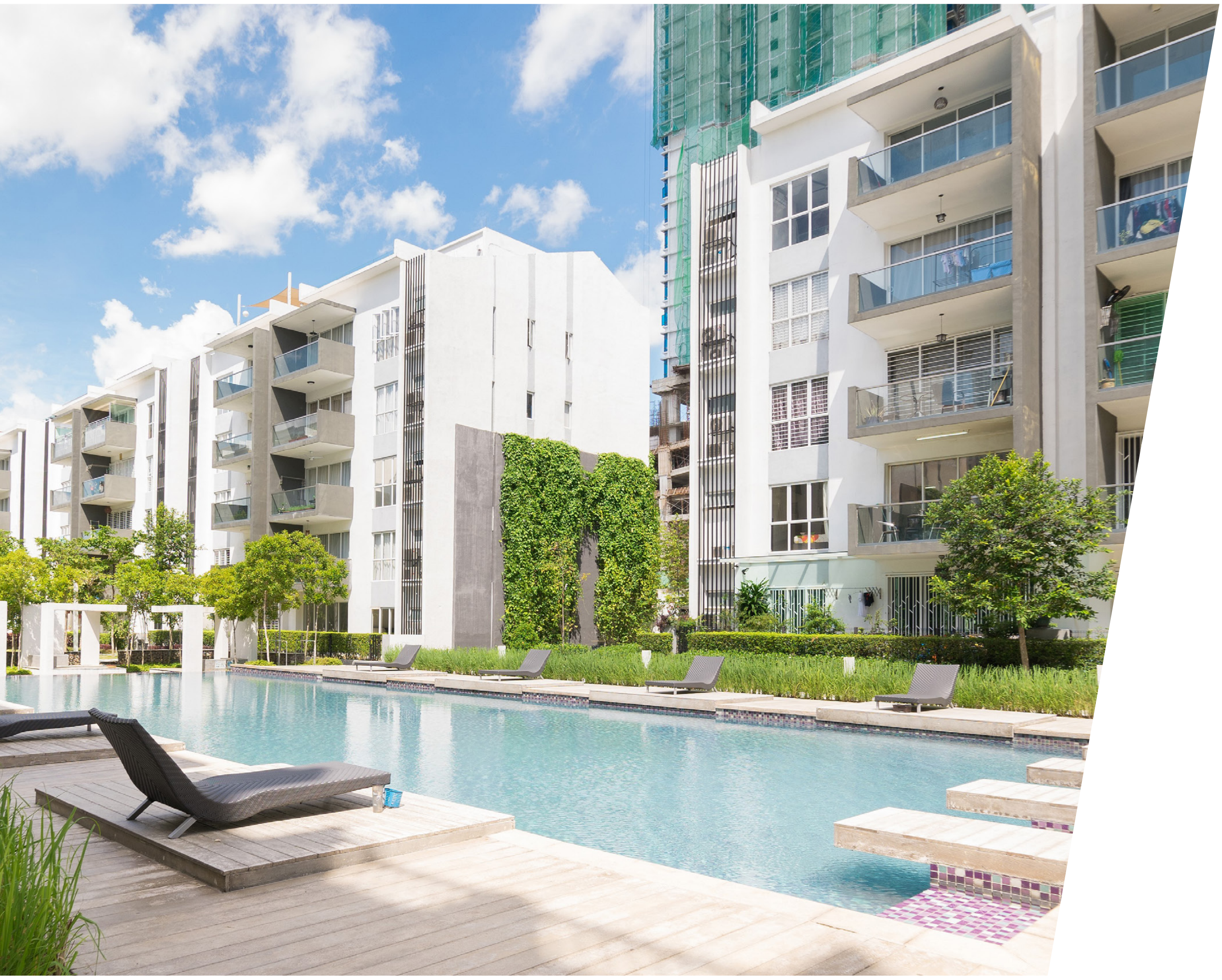
"Because rates have been so low at these record levels for such a long time, there is an added question about how households will react to that," Clarke says. She believes that next year will potentially bring two more quarter of a percentage point interest rate hikes, bringing the Bank of England's key rate to 1.25%.

13 Office for National Statistics, Consumer price inflation, UK: June 2018

14 Office for National Statistics, UK labour market: July 2018

While this is still very low by historical standards, Clarke notes there was a significant dip in mortgage approvals after the first rate hike last December. So it would be wrong to underestimate the potential impact of further rate rises on the housing market, particularly at the margin, where people struggle to afford a mortgage.

Another impact from normalising interest rates in the UK is a likely rebound in the value of the pound against other currencies. Clarke predicts this will happen if a Brexit arrangement is agreed with the pound rising through any 'transition' phase. If this pushes down on inflation, this could take the pressure off household finances.



Opportunities to invest are increasing

The commercial property markets in England and Wales are as diverse and developed as anywhere in the world. This, together with an expanding range of opportunities in residential property, brings a plethora of property assets to consider when choosing investments.

A significant consideration in any investment is to understand that changing economic, market, regulatory or tax policy conditions can negatively affect the performance of one type of investment, while supporting the outlook for another.

Many of the newer property assets may prove more attractive over time, particularly in the context of possible changes in taxation. In the meantime, the commercial properties that have attracted the most attention from investors in recent years include office, industrial, and retail, while student accommodation has also gained in popularity.

Buy to Let and Build to Rent

In residential, the Private Rental Sector (PRS) could be attractive to individual investors in response to tax changes that have caused the Buy to Let (BTL) sector to lose many of its advantages. But Crispin Gandy, Head of Investec Property UK, says that PRS, particularly in high-density urban areas, “has been hard to push through”. He points out that a challenge emerges for developers when they are asked to set aside rental units to increase the availability of affordable housing: “When you try to stack up a building project with a 35% affordable element it makes many sites unviable.”

The small, but growing Build to Rent (BTR) sector is, by contrast, attracting substantial institutional investment in the UK and abroad. These are developments that typically involve at least 100 occupancy units and are designed and built expressly to provide fully integrated rental services.

The expanded use of this model across the UK could make BTR an opportunity for any yield-focused investors, since the properties themselves will not be sold. One drawback is that this market is still in its infancy, so suitable portfolio investments are still difficult to find.

A more liquid niche of particular interest to investors seeking to diversify their portfolios is in private purpose-built student accommodation (PBSA). Like BTR, PBSA allows investors to capitalise on demographic trends that are driving more students in the UK (and those from abroad) towards higher education. There is an additional countercyclical factor in PBSA from the tendency of people to return to higher education when an economic downturn causes the job market to weaken.

Office property options

The story surrounding office property investment in recent years has been one of an asset class that has gone from strength to strength, says Gandy: "The office sector within the UK has actually had a very good run."

Although the latest data paints a mixed picture of the London office market - with prime office rents down 1.5% in the City and down 6.4% in the West End from last year - property specialists Cushman & Wakefield are optimistic:[15] "With space under offer now at their highest level for more than 10 years, prospects for H2 are positive."

Across England and Wales, occupancy demand for quality space is also driving institutional investment. "We are seeing increased demand for reasonable office assets," says Investec's Jonathan Long.

This has caught the market off-guard, because there's been far too little new development in the regions since the financial crisis, even as growing tech companies have started moving their back office functions out of London to obtain cheaper rents.

Long explains that "there has been a real supply and demand imbalance and we're seeing such low vacancy rates in these regional towns, so rents have been increasing quite dramatically, even on Grade B." For example, he recently closed a deal on an office block in Cardiff at a 7% yield.

> Clarke notes there was a significant dip in mortgage approvals after the first rate hike last December. So it would be wrong to underestimate the potential impact of further rate rises on the housing market

15 Cushman & Wakefield, United Kingdom Office Market Snapshot, Second Quarter 2018

Impact of ecommerce

Two segments of the commercial property market that have become inextricably linked by the evolution of online ecommerce are the retail sector and the industrial warehouse sector.

The consumer shift away from high street stores or shopping malls towards the convenience of online shopping has dramatically affected retail businesses across the country. Izard expects the trend of large retailers going bust to continue. However, he sees elements of the commercial sector that should experience continued growth – notably in industrial warehousing and last-mile logistics. According to Cushman & Wakefield, last-mile delivery costs are expected to grow between 7% and 10%[16] over the next five years, even in mature markets such as the UK and Western Europe.

This, together with a continuing demographic shift towards urban centres, will pressure logistics providers to acquire or build warehouses in the vicinity to enable deliveries to inner city delivery points. Considering the shortage of land in near-urban locations across England and Wales, one solution involves acquiring brownfield industrial spaces that can be reconfigured to host modern warehousing and logistics services.

Investec Private Bank's Peter Izard says that, historically, these properties have provided very low asset appreciation, but strong rental yields. "What we're seeing now is that they've got good, strong rental yields, good long-term rental returns, but with a growing asset base as well in the sense of asset price rises on the actual infrastructure itself."

These trends make urban warehousing attractive for investors looking to diversify out of BTL and into reliable revenue streams that are less exposed to tax policy risks.

Growth of mixed-use

Gandy says that a further trend to watch for is in mixed-use property. This is emerging as an option for investors due to the shortage of available urban land as well as the changing dynamics of commercial and residential property use.

A typical mixed-use property will allow a large and reasonably flexible brownfield or new-build space to be shared among a range of occupants, including logistics service providers, but also SMEs with limited space requirements, back offices and even residential occupants.

16 Cushman & Wakefield, Urban Logistics, The Ultimate Real Estate Challenge, 24 October 2017

Conclusion: You can profit if you plan

Property opportunities in England and Wales are evolving dynamically and they're creating new opportunities for savvy individual investors. Asset appreciation assumptions, changes in the tax code, demographics and technology have shifted appetite for residential Buy to Let, while retail upheaval and geopolitical factors are shaping commercial property decisions.

We believe that short-term uncertainty due to Brexit will be overcome. Long-term economic factors and changes in the marketplace will prove more durable. So despite headwinds at the moment, we expect yields in most property asset classes to remain supported. If you're looking at your personal portfolio and considering new investment opportunities, we see real reassurance that the UK's settled legal system, currency and location remain strong positive factors underpinning the property market.

Ally that to a lender with strong on-the-ground expertise, an agile approach to securing financing for property investment, and the ability to tailor its approach to your unique income profile – and we think there is a huge opportunity for investors to make smart, long-term investments.

If you're ready to explore your opportunities in property investment further, these are just some of the factors you'll need to consider:

We believe that short-term uncertainty due to Brexit will be overcome. Long-term economic factors and changes in the marketplace will prove more durable

Opportunities for property investment	Market conditions to keep in mind
• Residential property values are rising in most parts of England and Wales. • The market should be bolstered by limited land availability amid growing populations; undersupply of housing shows no signs of improving. • Large-scale Build to Rent developments are a growing new area of the residential property market, promising reliable rental yields while meeting growing urban demand for rental accommodation. • Prime office occupancy levels are high in urban areas across England and Wales and could push rental yields higher. • Demand for office space outside London continues to support new development and conversions of industrial property. • Demand for warehousing and mixed-use space from SMEs, and last-mile delivery service providers, will support continued demand for high street and near-urban commercial property. • Rising student populations are underpinning continued growth in the provision of private purpose-built student accommodation in university towns in England and Wales, providing countercyclical property investment opportunities.	• There's significant local variation between different parts of the UK. • Accelerating economic activity will cause interest rates to rise further, making it more expensive to borrow for property investment. • Residential properties are now subject to a progressive Stamp Duty that could make the investment less attractive. • Buy to Let property tax benefits are being phased out for individual investors. Longer-term, government policy points to further disincentives for individuals to invest in such properties. • Affordability issues will continue to drive local governments to accelerate planning applications and require provisioning for affordable housing in new Private Rental Sector residential developments. • Retail property provides a mixed picture of downsizing retailers, inflexible spaces and the growing impact of ecommerce on walk-in business.

What are the next steps?

If you're ready to take the next steps into the property sector, or to expand your existing portfolio, it's important to work with a lender who can offer you a service that's bespoke to your needs. At Investec Private Bank, we work closely with property investors to make sure we're delivering lending solutions that take into account their unique earning position and asset base.

INVESTEC PRIVATE BANK

About Investec Private Bank

We're a private bank built to service a small number of individuals with an entrepreneurial spark and an active desire to create wealth.

For these clients, who typically earn over £300,000 a year and have £3 million in assets, we offer extraordinary banking, lending services, and access to investments and financial planning through Investec Wealth and Investment. Our team of dedicated Private Bankers build long-term relationships, understand our clients' potential and tailor solutions to meet their specific financial needs.

Disclaimer

This article is for general information purposes only and should not be used or relied upon as professional advice.

No liability can be accepted for any errors or omissions, nor for any loss or damage arising from reliance upon any information herein. It is advisable to contact a professional advisor if you need further advice or assistance as the implications of buying an investment property can vary depending on an individual's personal circumstances and may be subject to change in the future.

CGZ0265.1118