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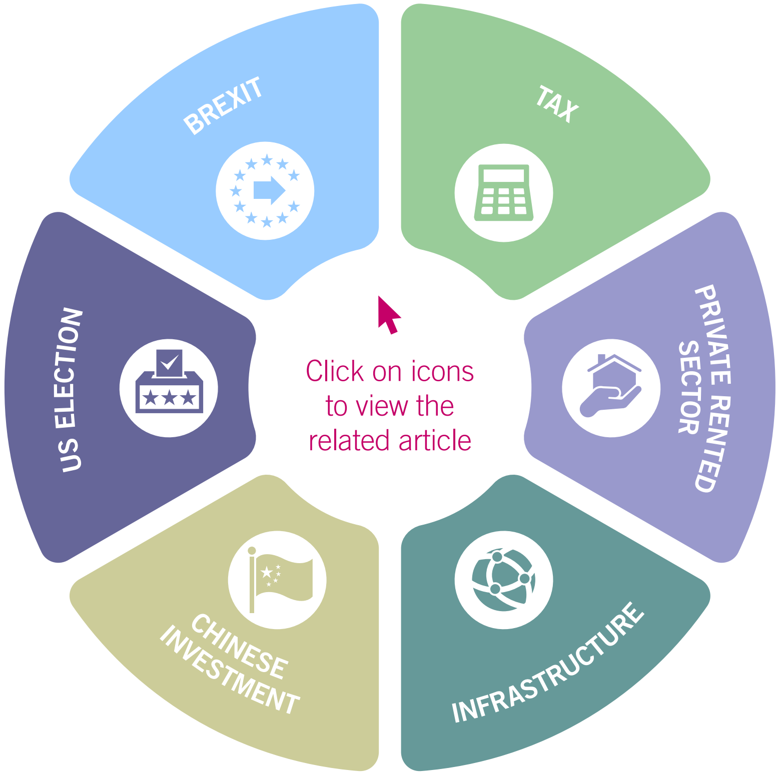
Looking back on 2016 reminds me of the oft-quoted (but sadly apocryphal) Chinese curse: "May you live in interesting times".

By any standard, the events of 2016 were very interesting indeed: Brexit, the fall in sterling, big increases in business rates (albeit focused on central London), Donald Trump's election and huge geo-political upheaval. But should we consider 2016 cursed?

I'd prefer instead to count our blessings. Whilst the UK real estate market isn't perfect, it does benefit from a sound underlying economy, transparent pricing, strong rule of law (a blessing, no matter what the Daily Mail headline writers may think), flexibility in deal structuring, an innovative workforce, a well-placed time zone and (in London) one of the two global financial centres. A remarkable combination.

It would be a brave man that predicts where 2017 will take us, but over the next few pages we have focused on six key areas that will shape the year ahead and we offer a view on how that might happen. I remain a firm believer that the strength of the players, both domestic and international, in the UK real estate market is not so much their ability to foresee the future, but their ability to adapt to it and to thrive in whatever "interesting" situation they find themselves.

Best wishes,
Andy Bruce – Partner, Head of UK Real Estate



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Brexit

> "Despite the fact that political upheaval continues … the road ahead will not be all bumps."

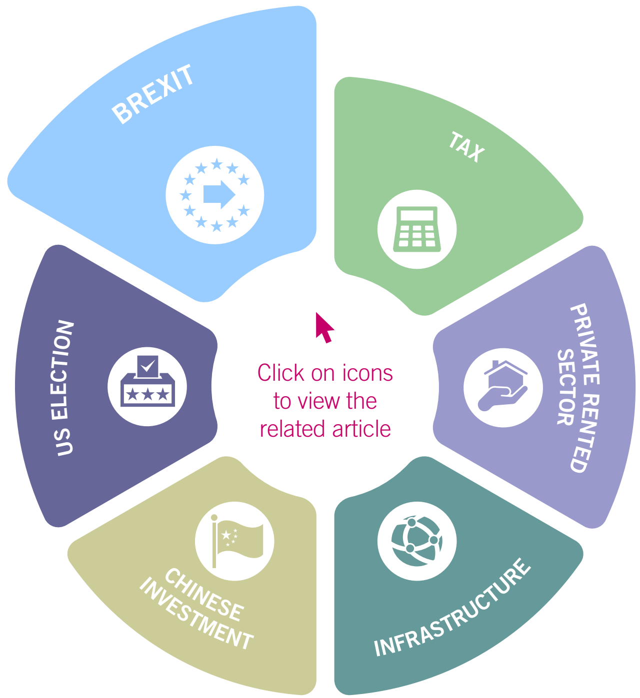
There was great unease on the morning of 24 June 2016 as investors and occupiers started to evaluate the implications of the Referendum result. What impact would there be on capital values or tenant demand? Would investors avoid UK transactions as they waited to see the impact on the UK economy?

Six months on, the market has proved to be much more resilient than many had feared. Values stabilised quickly and the closing of a number of UK funds did not result in fire sales. Overseas funds with long term investment horizons continued to see the UK as a solid market and a safe haven for pension funds and private wealth. Tenant demand has stayed steady, there have been some notable deals and transaction volumes increased in the last quarter of the year.

Much of that optimism will carry over into 2017, but there will be rocks in the road ahead. This year Brexit will start to take shape and more details of what this means for the UK will emerge. The debate on the service of an Article 50 notice and continued headlines about legal challenges will create uncertainty as to the timing of the withdrawal from the EU. The negotiators on behalf of the remaining 27 nations in the EU are expected to react unfavourably to any proposals that are put forward by the UK government, and key questions such as free movement of workers, passporting rights and whether there will be a transitional period following conclusion of exit terms will not be resolved quickly. A "hard" Brexit is more likely than ever.

Some investors and occupiers may hold off from new transactions while the dynamics of negotiations play out, so 2017 may be a difficult year for the real estate market. Office development is likely to be curtailed and speculative projects put on hold. 'Bad news stories' could emerge as some major occupiers announce their intention to relocate parts of their business to other EU countries.

Despite the fact that political upheaval continues and even increases in parts of Europe and the rest of the world, the road ahead will not be all bumps. Our view is that the UK will remain attractive to overseas investors for whom a quality building let to a good tenant provides a decent return compared to other markets. In a similar way, hotels, industrial, student accommodation and PRS can expect a less rough ride as these sectors are likely to be less impacted by some of the uncertainties.



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Tax

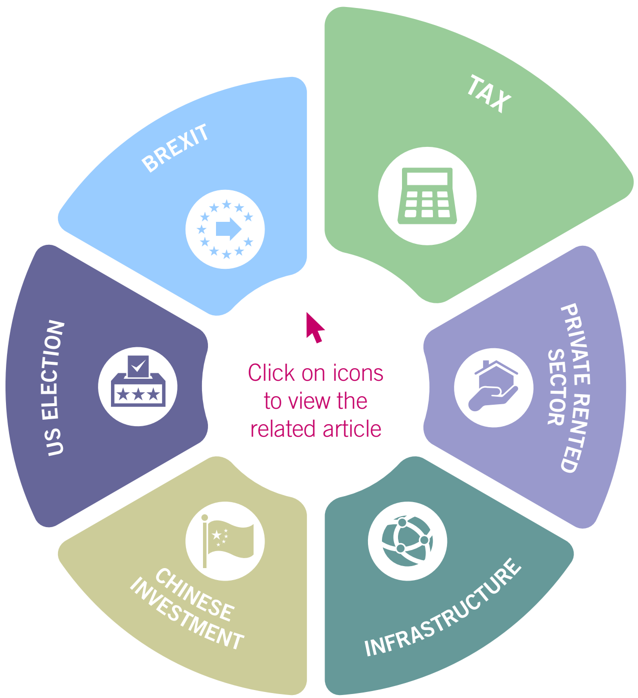
> "…taxpayers in the UK are facing a myriad of potentially complex new rules…"

As we start 2017, the international tax landscape remains in a state of flux, in large part due to the OECD's project to address tax avoidance in the form of "Base Erosion and Profit Shifting" ("**BEPS**"). Over a year after the final BEPS reports were published, UK domestic measures to implement a number of the reports' conclusions are now on the horizon for 2017. As we predicted this time last year, taxpayers in the UK are facing a myriad of potentially complex new rules of wide-ranging and uncertain application.

For investors and developers in the UK real estate sector, the new UK restrictions on the tax deductibility of interest from 1 April 2017 (implementing the BEPS recommendations), and how these changes are going to impact returns in the sector, are one of the key concerns. The promise of an exclusion from the new rules for third-party loans to property owning companies renting to unrelated tenants, and a more general relaxation of the rules for groups with high third-party leverage, seem likely to alleviate some of the concerns, but the full details of these proposals have yet to be unveiled.

The proposed measures to bring non-UK resident companies investing in UK real estate within the scope of UK corporation tax in respect of their rental income (rather than being within the income tax regime, as they are now) would mean that the new restrictions on interest deductibility (and the UK corporation tax system generally) would apply equally to onshore and offshore investors in UK real estate. The forthcoming reduction in the rate of corporation tax to 17% (from 2020), compared with income tax at 20%, may make this proposal more welcome and will, arguably, level the playing field between overseas and domestic investors. Crucially, however, there is no suggestion at present that the UK Government intends to bring non-UK landlords within the scope of UK tax on capital gains on UK commercial property. This has always been one of the features of the UK tax system which makes UK real estate so attractive to overseas investors and it is to be hoped that the Government will be keen to avoid changes which would discourage such investment.

It is notoriously difficult to predict changes to Government policy on SDLT and the hoped for reduction in the higher rates of SDLT following the Brexit vote did not ultimately materialise. However, given the continuing political and economic uncertainty ahead and in light of the increasing focus on the private rented sector, it would be foolish to think discussion on this topic is closed. It would provide a welcome incentive for the sector as a whole.



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Private Rented Sector…At Last

> …investors are forecast to commit another £35bn by 2020…

After years in the wilderness, the UK private rented sector (“**PRS**”) is well and truly coming of age and interest from both UK and overseas institutional investors in this sector looks set to continue in 2017. According to figures produced by Knight Frank, investors are forecast to commit another £35bn by 2020 on top of the existing £15bn invested in the sector so far. As recently as 10 years ago, institutions shied away from anything to do with the private rented sector with its emphasis on tenant-friendly legislation and small-scale landlords.

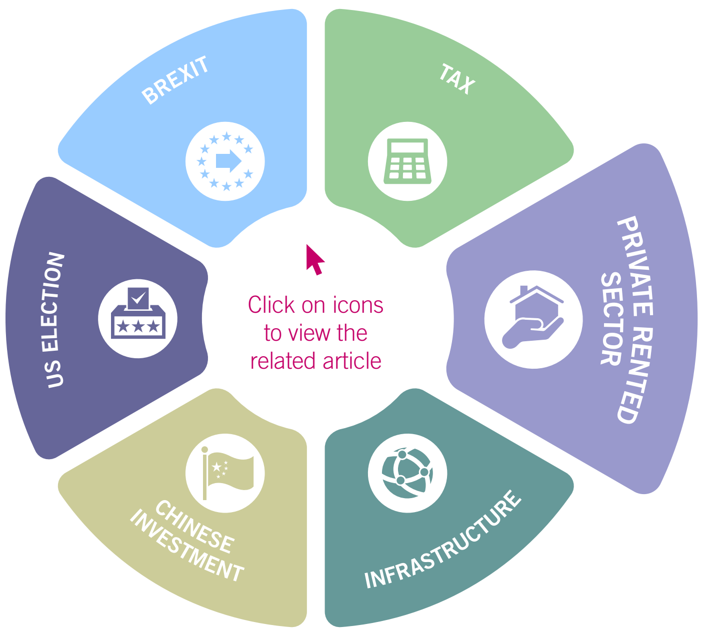
All this has changed as home-ownership has become prohibitively expensive (especially in London) and attitudes towards renting have shifted, following the German example, where PRS has been established for many years.

Increasingly used to the high-end student accommodation offered by many UK universities, today’s 20–30 year olds want high-quality residential accommodation with access to leisure, sport and other facilities all of which can be delivered by modern purpose-built private rented schemes. Added to this, Theresa May’s Government is moving away from the overwhelming focus on home-ownership of the Cameron era, towards a more balanced approach to housing, stressing the importance of the private rented sector.

The challenges for PRS highlighted by The Montague Review in 2012 largely remain, not least the historic lack of clear planning guidance. Certainly, PRS landlords being caught by the new 3 percentage point increase in the SDLT rates charged on “second homes” is contrary to the stimulus to the sector that commentators have been calling for. Creative solutions are needed to allow tenants of PRS schemes to enjoy longer leases than a typical assured shorthold tenancy whilst at the same time not affording them the sort of protection given to tenants in the 1970s.

The industry will no doubt welcome Sadiq Khan’s recent announcement that Build-to-Rent (purpose-built PRS) will be exempt from the 35% affordable housing threshold applied to build for sale developments (provided that local authorities instead insist that new Build-to-Rent developments stay in single ownership as rented blocks for at least 15 years with the developer allowed to offer discounted market rent as its affordable housing offer). However, there are still calls for Local Authorities to release more brownfield land for PRS schemes. So far, London has led the way, but schemes are springing up in Manchester and Birmingham and in other cities across the UK.

One thing is certain, 2017 promises to see even more activity in the private rented sector with banks now prepared to finance schemes which traditionally have been forward funded, encouraging more investors to take advantage of the long-term stable returns on offer.



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The Age of Infrastructure

“…the road laid out by the Government is being paved with good intentions, and no small amount of funding…”

The second half of 2016 saw the Government finally make decisions on a third runway at Heathrow, HS2 and a nuclear power station at Hinckley. But that was just the start. If the Chancellor’s Autumn Statement is anything to go by then not just 2017 but 2018 and every year to 2022 and beyond will indeed prove to be the age of infrastructure. Some of this was already anticipated, but there is relief in the real estate and construction sector that commitments have at last been made. Crossrail 2 and the Northern Powerhouse (now the ‘new Northern Powerhouse Strategy’) have also been long mooted and are finally moving forward.

The Autumn Statement, criticised in some quarters for lacking boldness, contained a host of measures intended to renew the UK’s infrastructure and boost the UK’s productivity ready for life after Brexit. These include:

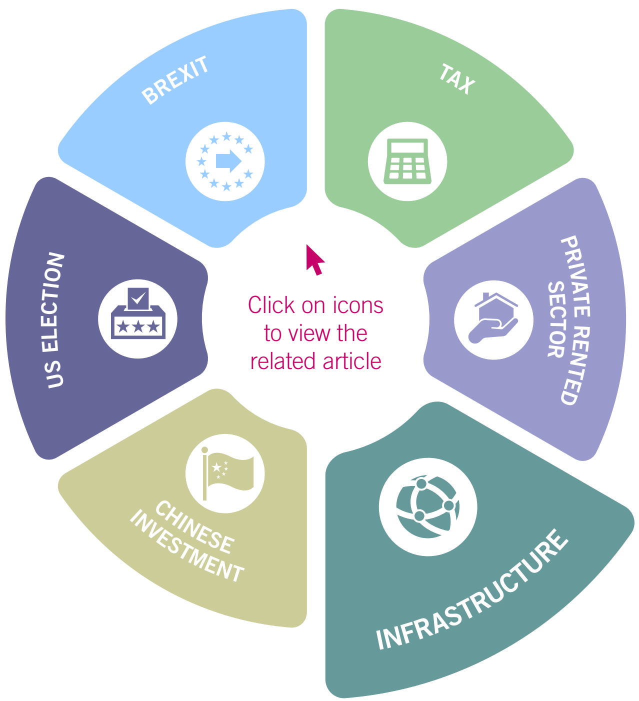
> **A new National Productivity Investment Fund** – this will provide £23 billion of additional funding towards areas deemed key to boosting productivity (transport, digital communications, research and development and housing). Success will of course depend on ensuring that projects are delivered across the country and not just flagship schemes in London and the South East. To their credit, policymakers appear to have got the message this time with specific projects already identified including £27 million to develop an expressway between Oxford and Cambridge and £110 million for East-West rail.

> **Research & Development** – £390 million is going towards future transport technology, renewable fuels and energy efficient transport – driverless cars, electric and hydrogen busses and zero emission taxis.

> **Digital infrastructure** – £1 billion will be used to support the private sector to roll out more full-fibre broadband by 2020/21 and to support trials of 5G mobile communications.

A year ago in our Horizons Scanning 2016 publication we took the pulse of the real estate technology sector and suggested that the industry needed to “adapt fast or become irrelevant”. Given future investment in 5G, this seems to have been borne out.

So the road laid out by the Government is being paved with good intentions, and no small amount of funding, but where the rubber hits the road is implementation. How much of the ‘age of infrastructure’ will have started work on the ground by this time next year?



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Chinese Investment...What Next?

> "...the Chinese central government will continue to support genuine, strategic outbound investment into real estate."

In November, an official statement was published by the Xinhua news agency and posted on the China central government's website. It said that although there would be no change to the regulatory framework for outbound investment, the government would "check and verify outbound investment projects by some companies according to relevant laws and regulations".

The South China Morning Post then reported that China's central government was embarking on a 'massive policy shift designed to stem capital outflows by curbing mainland China's outbound investment'. The Post reported that weakening of the yuan against the US dollar and shrinking of foreign exchange reserves, meant authorities were expected to become increasingly hostile to overseas deals and to impose more regulatory scrutiny and foreign exchange checks on mainland investors.

It is well known that Chinese investors have been active investors in the London real estate market recently, investing billions of dollars. So any major policy shift which impacts that, is something to which we should pay close attention.

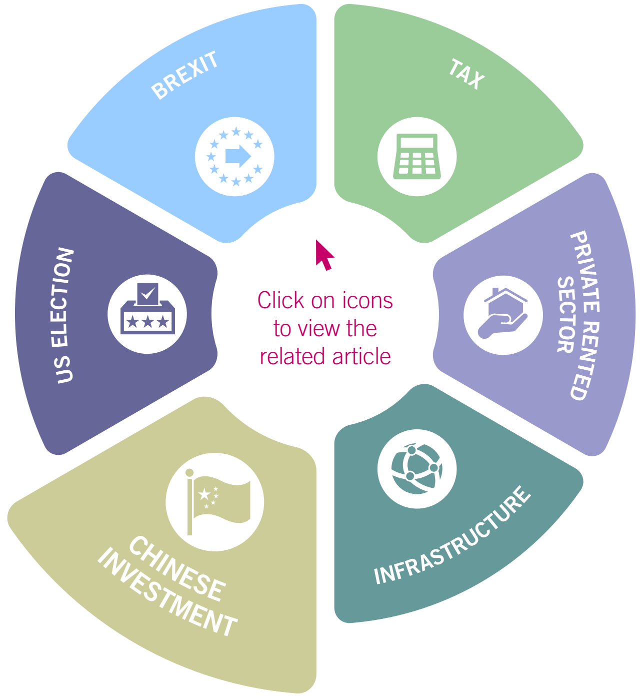
What do we know so far?

> First, no rules have been published, as they are currently being formulated, but they are expected to expire in October 2017 (although that remains to be seen).

> Second, whilst the rules are expected to impact on outbound investment in various ways, the key proposals block state owned enterprises from overseas real estate investments in excess of USD 1 billion and non-state owned enterprise from overseas real estate investment if the investors are not real estate companies.

In our view, this is unlikely to represent a fundamental policy shift and most commentators agree the Chinese central government will continue to support genuine, strategic outbound investment into real estate. In the short term, there may be some practical difficulties (such as delays whilst permission to remit funds overseas is obtained) and some uncertainty. In the long run, we expect London will continue to attract Chinese investors and the Chinese central government is likely to continue to support appropriate investment.

The Chinese premier, Zhou Enlai, when asked in 1972 whether the French Revolution of 1789 was a good idea, famously answered that it was "too soon to tell". In much the same way, whilst there may be a short term hiccup until the new rules bed down, we have no doubt that Chinese investors will be a long-term feature of the UK real estate market.



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US Election

"Uncertainties in world markets encourage investors to seek out safe assets in safe havens for their cash."

At noon on 20 January 2017 Donald J Trump will be sworn in as the 45th President of the United States. Inauguration Day, traditionally, is the opportunity for a new (or re-elected) President to speak, not just to the citizens of the United States, but to the citizens of the world.

In his inauguration speech on 20 January 1961, President John F Kennedy made his now famous appeal:

"*My fellow citizens of the world: ask not what America will do for you, but what together we can do for the freedom of man.*"

Those who have observed the 2016 Presidential election with interest (and possibly alarm!) are unlikely to expect oratory which will be remembered and admired over half a century later.

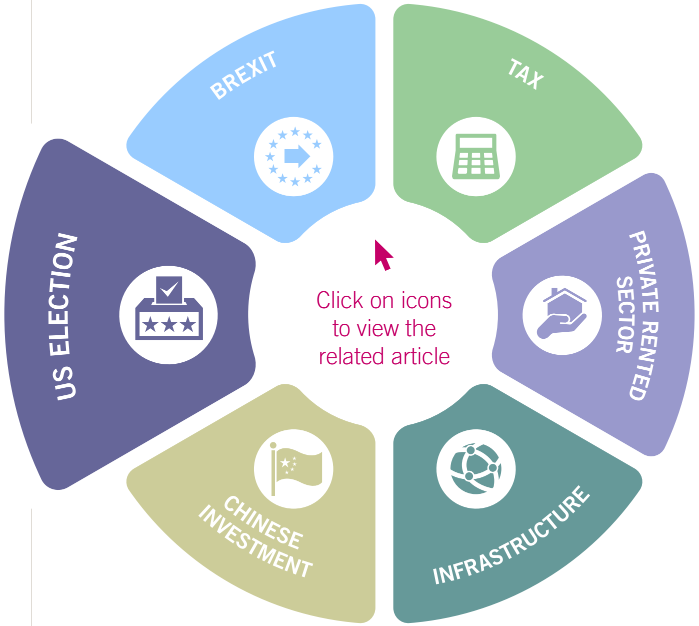
What is certain, however, is that the consequences of Trump's victory are resonating and will continue to resonate across the globe as today's "citizens of the world" attempt to assimilate "what the hell is going on" (to use his words) following his election.

Here in the UK, despite obvious challenges ahead, Trump's election victory means that we are no longer alone on the naughty step following our decision to leave the EU in June. Instead of being "at the back of the queue", there is every expectation that the UK's quest for new trade deals outside Europe will be greeted with more rather than less enthusiasm in the United States and among other major global economies.

Uncertainties in world markets encourage investors to seek out safe assets in safe havens for their cash. With its long (and continuing) tradition for transparency, lease contracts with bond-like characteristics and a relatively benign tax system, the omens are certainly looking favourable for the UK real estate market, particularly for those investing from overseas with the added advantage of an effective 17% price reduction to reflect the devaluation of sterling post June.

We are seeing evidence of this favourable climate from instructions from around the globe for direct and indirect investment into the UK real estate market, principally in Central London but, increasingly, chasing better yields in well-tenanted quality stock elsewhere in the UK.

The real estate market never ceases to re-invent itself after a fall: President-elect Trump would doubtless know all about that!



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