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THE PROPERTY INVESTMENT PEOPLE

12/15

# London Market Snapshot

## December 2015

## Global macro overview

November saw geopolitical concerns return to the fore, following terrorist attacks in Paris on 13th November where 130 people were killed. Headlines were dominated by the aftermath and there was a significant step-up in global security. The overall impact on equity markets, however, was limited.

Expectations for a rate hike by the Fed are now high. Since the summer of 2015, Fed officials continually stated that they might raise rates by the end of the year, but each month subsequently they have been kept on hold.

Minutes of the October meeting indicated that most of the Fed officials believed that the necessary conditions for a rate hike would be met by December. This was backed up by recent economic data and a particularly strong November nonfarm payrolls report.

Monetary policy action of the leading central banks was at the top of the agenda in November. The anticipated economic shift by the Fed is currently in stark contrast to moves by the the European Central Bank (ECB), who unveiled a package of measures to tackle the problem of low inflation, from a cut in the floor of interest rates to extending its bond-buying program by 6 months until at least March 2017.

Here in the UK, a rate rise has potentially become a more distant prospect following dovish comments from Bank of England governor, Mark Carney and inflation figures that remained in the "benign" territory.

The divergence in monetary policy by the central banks in advanced economies has already had an impact on FX markets as Carney's comments triggered a sell-off in Sterling, which fell more than two percent against the dollar.

Bond markets also reflected this expected divergence as the yield on two-year Treasury bonds rose 20 basis points in November, whilst the German government was able to sell two-year debt at a record-low yield of -0.4%.

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## UK economy

Towards the end of the year the economy had lost some of its momentum. Growth had started to slow faster than previously expected as austerity efforts were stepped up.

The second estimate of Gross Domestic Product (GDP) by the ONS indicated that the UK economy grew by 0.5% in the third quarter of 2015. This is a slight fall from the 0.7% growth in Q2 2015 and is lower than average quarterly growth over the past three years (0.6%).

Despite this slowdown, the overall economic backdrop in the UK remains positive. The labour market has continued to strengthen and the employment rate is currently at a record high.

November was another month where inflation was conspicuous by its absence. Inflation first fell to zero in February and has hovered at this level ever since. With the fall in energy prices and the current strength of the Pound, it is difficult to picture when inflation will return to the MPC's 2% target.

As with the Fed, there has been a considerable focus on the BOE and the likely timing of their first interest rate increase. Strong economic data had initially brought forward expectations of the hike. However, in their last meeting, the MPC voted by a margin of eight to one to leave the Bank Rate at 0.5%. The minutes of the meeting also showed growing concern about the deterioration in China and other emerging markets during the last month, which is likely to be a further drag on UK growth and inflation.

As we head into 2016, the slowdown in China and uncertainty over central bank policy will continue to play a significant role in investor thinking. In addition to this, the possibility of a British exit from the European Union (Brexit) will garner more attention over the coming year.

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## Residential market

The Autumn budget held more surprises for buy-to-let (BTL) investors. George Osborne, the chancellor, announced that he would levy a 3% stamp duty surcharge on all BTL and second property purchases from April 2016.

BTL landlords will also be hit by a change to Capital Gains Tax (CGT) rules.

From April 2019, they will have to pay any CGT due within 30 days of selling a property, rather than waiting until the end of the tax year, as at present.

This followed the surprise summer announcements that tax relief available to landlords on mortgage interest payments would be slashed from 2017, while additional tax relief for "wear and tear" would also be substantially reduced.

With this perceived "attack" on the BTL sector and measures bought in to help buyers on to the first rung of the ladder, it appears that housing has risen to the top of the governments agenda.

The programme for subsidised starter homes for purchase will be expanded and equity loans for Londoners will double under the Help to Buy programme. First time buyers in the capital will now be able to borrow up to 40% from the government, interest free for 5 years as long as they have a deposit of at least 5% of the purchase price.

## Total returns pick up in November

November was a strong month as total returns hit 1.1%, according to the latest CBRE Monthly index. The best performing sub-sector was central London offices, showing rental value growth of 1.1% and capital value growth of 1.3%, both more than three times that of offices in the rest of the UK segment.

Midtown outperformed significantly, delivering returns of 2.3% in November alone and 21.5% so far this year. The West End and City both recorded total returns of 1.6%.

The strength of London offices was a feature of 2015, with total returns reaching 16.8%, well ahead of the 12.8% seen across the UK's commercial property market.

The industrial sector has also performed particularly well, delivering returns of 16.4% in the first 11 months of 2015; 17.8% from industrial property in the South East.

2015 was another good year for UK commercial real estate with unleveraged total returns being close to 15%. Whilst this is a slowdown from the strong returns seen in 2014, it is still well ahead of the average since 2000.

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## London market

### Occupier market recovery continues to gether pace

- Strong employment numbers have helped to provide a significant boost to occupational demand for the London office market year-to-date. The outlook over the next few years remains positive, according to Oxford Economics, who expect employment growth to grow by 6% over the next 5 years (2015-19).
- Take-up in Central London for November 2015 was 904,300sq.ft, 26% lower than the previous month and 15% below the 10-year average according to the latest CBRE Monthly Index. This was mainly due to limited availability rather than a decline in occupier demand.
- The vacancy rate in the West End fell to 3.4%, which is the lowest level since 1989. Availability in Central London as a whole, however, rose for the third consecutive month, according to CBRE.
- Despite these increases, availability remains significantly below the 10 year average of 14.9m sq ft.

### Further yield compression to come but rental growth set to drive returns

- Year-on-year, yields across London have continued to fall and are now at record lows.Current yields are supported by robust levels of rental growth and high levels of investment into the capital.
- The investment market continues to be fuelled by overseas investors, who account for 64% of all purchases. Whilst prices maybe deemed to be high, Central London will continue to attract investment for a variety of reasons.

| Prime Yields | Nov 14 | Nov 15 | Sentiment |
|---|---|---|---|
| City Offices | 4.25% | 4.00% | Positive |
| West End (Offices) | 3.50% | 3 - 3.25% | Positive |
| Bond Street (retail) | 2.50% | 2.25% | Positive |
| Oxford St (retail) | 3.00% | 2.50% | Positive |

- As the UK occupier recovery continues to broaden, rental growth is set to replace yield compression as a key driver of returns.
- Strong post-recession economic growth in London has resulted in high rental levels with rents at £67.50 psqf in the City and £125 in the West End.
- Rental values in Central London rocketed 10.3 per cent in the year to October, CBRE said, the first double-digit growth since April 2008.

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## 2016 London Market Outlook

- London is still one of the most attractive commercial property markets in the world, and it's likely to remain strong in 2016.
- Demand is set to remain high as the low vacancy environment persists into 2016. Over 70% of London's sub-markets are experiencing insufficient supply to satisfy even average levels of demand for new Grade A product, according to Colliers. Available space and choice will continue to be an issue.
- At the end of 2014 there was a considerable voice of opinion that yields in London were as low as they could possibly get. However, 2015 saw further yield contraction and returns continue to be driven by a 'tsunami' of money.
- As we move into 2016 we believe there will further yield compression as London remains highly attractive to overseas investors.
- Capital growth will ease from the high levels experienced over the last 2 years but this will be offset by the rental recovery which is now firmly entrenched. Rising rental growth will become increasingly more important in an environment of low inflation and low interest rates, especially where investors are broadening their search for income.
- Office rents have reached all-time highs across the West End, Midtown and the City.
- The UK economy continues to grow, with the CBI forecasting growth of 2.4% for 2015 and 2.6% in 2016.
- Whilst the UK faces more years of fiscal consolidation there remain some bright lights on the economic horizon as shown by the UK, US and Eurozone continuing to grow at a moderate pace.
- London is expected to continue to outperform the UK economy with the latest GLA Economics forecast for London's economy, which was published in November, forecasting output growth of 3.4% in 2015, 3.2% in 2016 and 2.7% in 2017.
- The biggest concern for London's economy is the prospect of "Brexit".The government has promised the electorate that they will get a chance in 2017 to decide whether they should finally break away from the EU entirely.
- Supporters of the EU argue that an exit could create economic unsuitability and could cost the UK thousands if not millions of jobs. Whereas EU skeptics argue that a contraction would be only temporary and that the elimination of strict regulations in the financial sector will outweigh the transitory contraction of the UK economy.
- Whatever the outcome there is certain to be a level of uncertainty in the run up to the vote.
- A rise in interest rates will also be on the agenda over the next 12 months. The date at which the first rise occurs is less important then the eventual path and magnitude the rises take.

The New Year will present further yield compression as London remains highly attractive to overseas investors.

We remain extremely positive on the outlook for commercial property over the next 12 months. Given the continued high levels of inward investment chasing a limited supply of property, we do forsee further downward shifts in yields in the short term. As the year progresses the prospect of higher rents will continue to tempt investors.

Prospects of higher UK interest rates will undoubtedly create more volatility than we have seen in recent years. Therefore, as investors we will have to be more selective in our investment choices. As long as interest rate rises remain gradual,in the prescence of rising rents, any impact on property pricing is likely to be muted.

In a low yield world, high quality commercial property continues to yield in excess of other comparable assets available to investors.With fundamentals beginning to reassert themselves, 2016 is set to be another good year for the sector.

## Key deals in November

| Address | Sector | Area (Sqft) | Price (£m) | Yield (%) | Purchaser |
|---|---|---|---|---|---|
| Broadgate London, EC2 | Office | 457,000 | 415 | 4.95 | Hines/HSBC Alternative Invs |
| Old Broad St London, EC2 | Office | 191,465 | 250 | 3.57 | Evans Randall |
| Old St London, EC2 | Retail & Office | 150,682 | 248 | - | Helical Bar/Crosstree |
| Bishopsgate London, EC2 | Office | 194,000 | 189 | 4.5 | The Capital (London) Fund |
| Atrium, Uxbridge | Industrial | 353,000 | 158 | - | AB InBev |
| 7 Bishopsgate, London, EC2 | Office | 122,402 | 135 | 4.1 | Massachusetts Mutual Life |

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