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THE PROPERTY INVESTMENT PEOPLE

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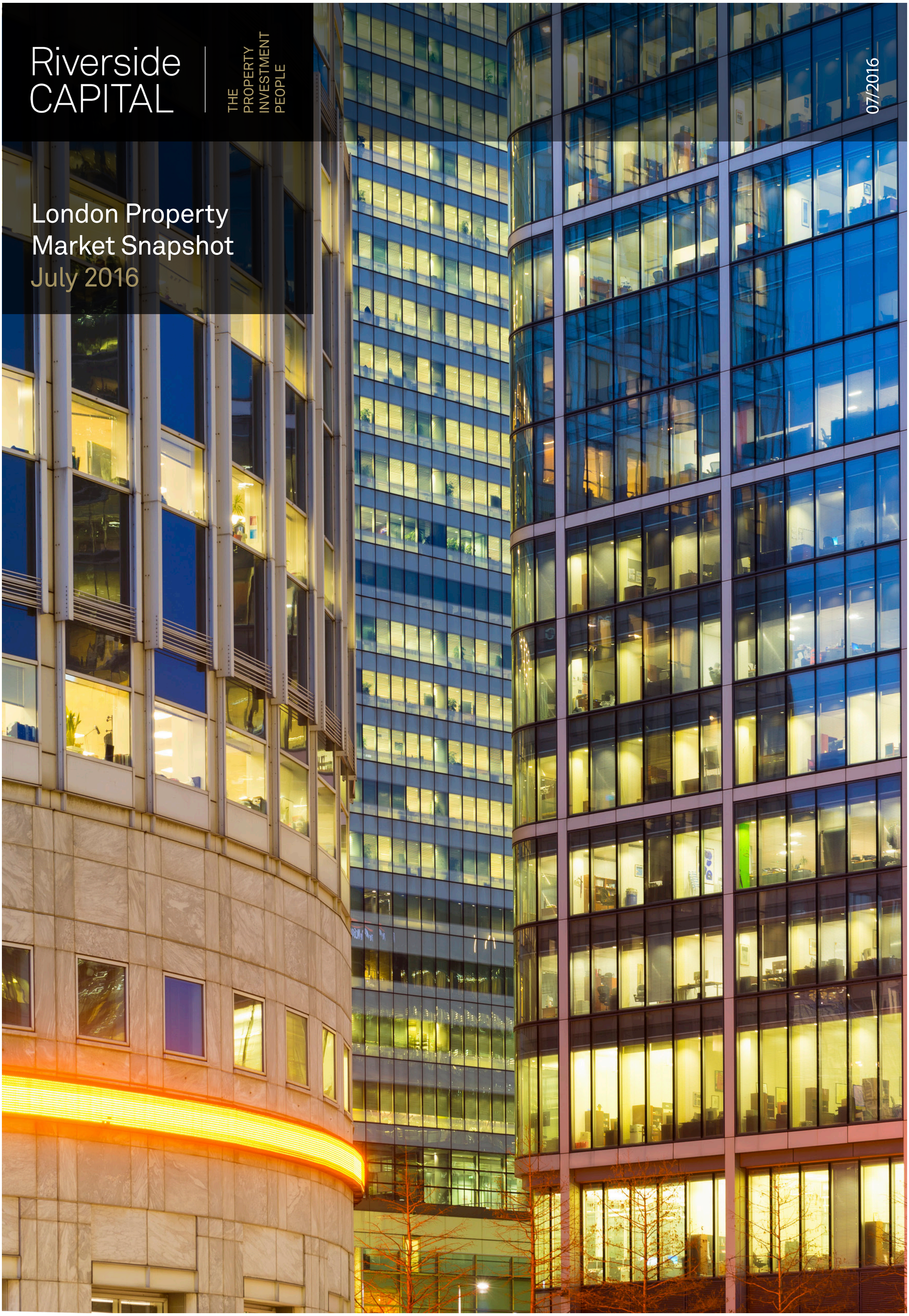
London Property Market Snapshot

July 2016



London offices may present a buying opportunity... But not yet

Lower interest rates, higher inflation, a devalued pound and an almost record spread between government bonds and commercial property yields suggest that commercial property located both in and out of London, and let on long leases to strong tenants, will perform well in the short to medium term. After all, what other investment gives investors a yield anywhere near that achieved in commercial property?

This month, we have seen Whitbread's flagship 'Hub by Premier Inn ' hotel, let for 25 years and located in Kings Cross, sell for sub 4%, confirming this view.

In complete contrast, forecasters are predicting capital value falls for London offices by as much as 10% between now and 2020. Whether such falls occur, and by how much, will obviously depend on how well occupational markets perform and how much supply developers provide.

In the short term, common sense says that occupational markets in London are going to struggle, as companies, and particularly banks, delay decision making on the back of the referendum. Anyone holding London office properties with leases of less than 5 years are now having to ask themselves some difficult questions, such as:

- Will my tenant renew on expiry?
- If they don't, how long will my building be empty for?
- In the face of inflation, what will my refurbishment cost be?
- What about the cost of owning an empty property?
- When I let the space, what rent will I receive, and will it be less than I'm receiving now?

Clearly, the answers to these questions will depend on whether developers reign in supply, and just how bad occupational data is over the next 6 to 12 months. Capital Economics' view is that occupancy rates of up to 8% would mean that rents at current levels can be sustained, and so it's not all doom and gloom.

However the point remains that right now, and in the short term, we can only speculate, and this is where opportunity may arise.

Owners will argue that they don't have to sell and at this point in time, that might be true. However, at some point, those owners that are accountable to investors (and not all owners are) will need to explain to their underlying investors, and maybe their banks, a case for holding.

With the full facts still unfolding it will be hard for those owners to say anything other than: "If we hold our nerve, then we might be okay", and if that's not good enough for the underlying investors or their debt providers, some riskier assets may be hitting the market.

If that happens, we could start to see some attractive looking London office prices soon.

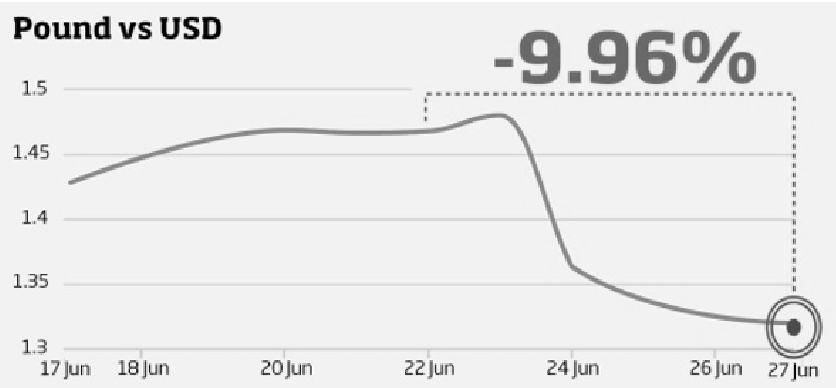
Dominic Wright, Chief Executive

Global Macro Overview

The 23 June 2016 will go down in history as the day UK voters decided to confound expectations and the warnings of many politicians and business leaders by choosing to leave the EU. Britain's vote to leave the European Union sent shockwaves across the world as sterling plunged in value and stock markets across the world crashed.

Confirmation that David Cameron would be stepping down as prime minister only served to heighten volatility and increase concerns about Britain's future going forward. Losing the referendum was a massive defeat for Mr Cameron who put his credibility on the line by leading the remain campaign.

As markets began to digest the news the pound fell substantially against both the dollar and euro. The trade-weighted currency plummeted close to 10% in the days following the referendum result.



Source: www.propertyweek.com

Banks and other financial stocks were among the hardest hit, with the industry entering a bear market. European financial companies were down nearly 30% for the year before rebounding slightly. This comes as no surprise, as many European financial institutions house their trading operations in London and concerns going forward will revolve around their passporting rights.

Given the results of the Brexit Vote, we would anticipate that the Federal Reserve will hold off on raising rates until we start to see a clearer global economic picture. Several Fed policymakers have said that the uncertainty warrants caution, including New York Fed President William Dudley who said on Tuesday the Fed needed to be patient on rate increases and that it was too soon to know the fallout from the British decision.

The Brexit vote, which shocked the investment community, and political community alike, has raised anxiety in financial markets around the world, in part because it could take years before Britain and the EU agree to new rules on finance, trade and immigration. Of immediate importance to the markets is how economic treaty negotiations play out in the short term and whether or not EU-based banks are able to continue their operations effectively and efficiently in a country no longer associated with the European Union.

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UK Economy

Economists are forecasting that the uncertainty and sterling weakness caused by the referendum vote will lead to a dip in growth. This is due to a mixture of delayed UK corporate investment and recruitment, lower consumer spending, diminished foreign investment, and a rise in inflation.

Prior to Brexit, the UK was predicted to be the second fastest growing global economy, with consensus growth for 2017 at 2.1%. Going forward however, forecasts for UK growth have taken a significant knockback. Capital Economics have downgraded its forecast for UK GDP growth in 2016 from just above 2% to 1.5%. IHS Global Insight have also said it is 'substantially cutting' its GDP growth forecasts to 1.5% from 2% for 2016 and to 0.2% from 2.4% for 2017.

Whilst the fall in Sterling will provide a significant boon to exporters, it has also rapidly devalued UK wages and boosted the cost of imports. Considering that the UK's imports far outweigh its exports, and most Britons spend most of what they earn, the effect on consumer spending could be significant, and we could also see a substantial rise in inflation. Analysts have pointed to another potential source of inflation (other than the fall in Sterling): the possible imposition of import tariffs if Britain fails to reach a free-trade agreement to replace EU membership.

The loss of the UK's AAA credit rating and the prospect of looser monetary policy by the Bank of England sent 10-year gilts to their lowest yield ever: 0.87%. They have fallen lower after month-end. Short-dated gilts briefly strayed into negative territory for the first time.

In the short term Brexit has raised a number of political and economic problems that will take some time to unravel. Over the long term, however, we remain optimistic about the ability of the UK to adapt to the changes that are now inevitable. The Bank of England has ensured that banks are in good shape and are likely to cut interest rates on any signs of further weakness. The new government seems set to give the economy a fiscal boost later this year, perhaps through an increase in infrastructure spending and the new Chancellor, Phillip Hammond, has also indicated that there is scope for fiscal policy to be "reset" at the Autumn Statement.

The road ahead looks extremely bumpy and it would be wrong to pretend that the economic environment is not difficult. There is however, scope to not be too pessimistic. According to a report by PWC the UK should avoid severe recession or house price crash despite growth downgrades following the Brexit vote. Any economic downturn is also not expected to be anything like as severe as that following the global financial crisis of 2008-9 or indeed the deep recession of the early 1980s.

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UK Property Funds

The pressure on property fund (open ended) investors mounted after a number of managers took drastic action shortly after the UK voted to leave the European Union (EU). Asset managers Aberdeen, Aviva, Canada Life, Columbia Threadneedle, Henderson, M&G and Standard Life Investments all suspended trading on their UK property funds after investors rushed towards the exit door.

Whilst this did cause panic amongst investors, it must be remembered that these decisions were taken during a period of exceptional market circumstances and the mechanism was put in place to protect investors by preventing funds from becoming forced sellers of their assets.

The spate of suspensions, the first since the 2008 financial crisis, has revived a debate over the validity of holding illiquid property assets in 'open-ended' funds. Property should be seen as a long term investment strategy and this can only be achieved through closed end funds.

Even though the commercial sector, and funds in particular, has looked weak since Brexit, it's important to remember that this is not indicative of the property market as a whole.

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London Outlook

The outlook for London's office market is undeniably weaker than it was prior to June 23rd. Last month's referendum outcome has undoubtedly clouded the outlook for the UK's economy, as well as the occupational market. The uncertainty stemming from the timing of an exit or the shape of the UK's future arrangements means firms are less likely to make long-term commitments. That will hold back business investment and demand for space.

The response of the major European countries will be important to the prospects for the UK. If our EU counterparts decide to play hardball, then concerns regarding our economic outlook will dim further. However, the fact that the UK will become the single largest export market for the EU should work in our favour.

The Occupational Market

The Banking sector will likely be the hardest hit over the next two years. Questions around passporting rights will drive the decision of most banks as to whether they must reduce their London operations. The outcome of this will predominately influence occupational decisions in the City.

Historically, banking has driven a large part of office take up in the city. However, it is important to note that the sector has only accounted for 5.5% of central London take-up since the start of 2010.

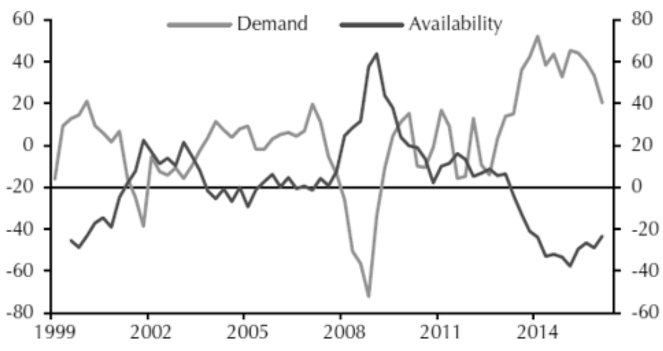
In the days following the vote there were major concerns that a number of banks would move operations and jobs out of the UK. However, Goldman Sachs (GS), Morgan Stanley, JP Morgan and Bank of America (BAC) have all since put their names to a statement promising to work with the U.K. to help London "retain its position as the leading international financial centre".

The biggest risk to the London office outlook may be that it talks itself into a deeper correction.

The lack of clarity over what the future holds is driving the abrupt shift in sentiment. But it also offers a reason not to over-react. The loss of passporting rights is not yet set in stone. And given that relocations are expensive and time consuming, that could mean that firms defer any final decisions until the UK's post-Brexit arrangements are clearer. After all, if the UK ends up with a "Norway plus" type deal, which seems plausible, the case for leaving London would be greatly weakened.

As we look further out, there are reasons to be more sanguine about the prospects for occupier markets. At present, the market can be characterised by a lack of supply which could lessen the impact of any shortfall in demand.

Net Balance of RICS Surveyor Reporting Rising Availability or Demand (%)



Source: Capital Economics

In London, where the demand and supply risks are arguably larger, we think that the outlook for rental value growth is far from disastrous. According to Capital economics, even in the event of a net loss of 70,000 jobs, developers' response to weaker demand should ensure that the vacancy rate would rise to about 8%, a level still consistent with stable rents.

We suspect that London will see some loss of jobs over the next few years, regardless of where the EU negotiations end up. Accordingly, Capital economics forecasts envisage that capital values in the City office market will drop by 10% between now and 2020, with the West End falling by 3% to 4%. But if we are right in that the economy is not heading for a recession, and financial markets will not freeze, the biggest risk to the London office outlook may be that it talks itself into a deeper correction.

Encouragingly, monetary policy should lend some support to valuations. Cuts in the Bank Rates are back on the cards in August, whilst the BOE may once again deploy quantitative easing. The asset-purchase programme could be worth £100-£150 billion, on top of the £375 billion-worth of QE that the bank has conducted in the past. The drop in interest rate expectations has been more than compensated for by rises in the property risk premia, with gilt yields now likely to stay lower for longer.

The yield premium on commercial property against gilts is now back at the levels last seen during the Global Financial Crisis. In a low sovereign yield environment, property is likely to look more attractive than many of the other asset classes, which will boost demand of commercial property - at least once it becomes clear that the fears of a recession are being overplayed.

10 Year Gilt Yield vs Commercial Property Yields

Source: Bloomberg and www.investing.com

Investment

At this stage it is still too early to make a call on what will happen to investment levels. While some deals that were under offer (pre Brexit) have gone through with price adjustments, other buyers and even sellers have withdrawn from the market entirely. We will start to see a clearer picture once market volatility, caused by retail fund suspensions, starts to quieten down and we get a better idea of where the UK economy is heading.

At end of 2015, it was widely predicted that the London office market would see a drop off in volumes over the next 5 years due to a fall in overall returns. The referendum result will now reinforce this and central London office investment volumes will undoubtedly be lower than expected in 2016 and 2017.

According to Savills, larger deals are more likely to be deferred and delayed, and this will affect the City of London more negatively than the West End. The first half of 2016 saw investment volumes into the UK of £21.8bn. This was a decrease on the same period in 2015 as investors remained cautious ahead of the referendum result.

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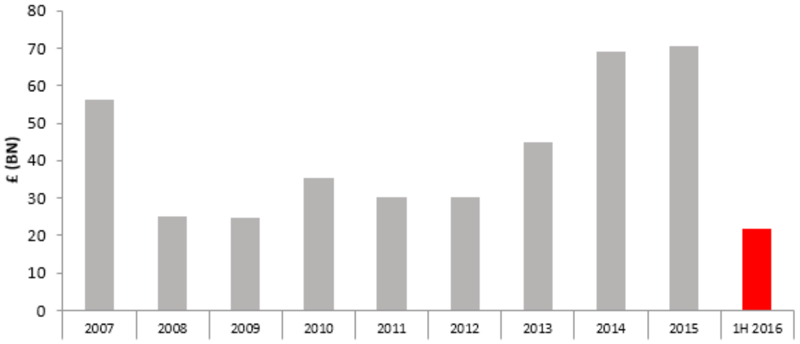
UK Investment Market Activity



Source: Property Archive

Encouragingly, foreign investors are still net buyers of UK commercial property. Both UK institutions and overseas investors continued to dominate on the purchase side with overseas investors at 47% (£10.3bn) and UK institutions at 21% (£4.5bn). The Far East were the largest overseas investor at £4.0bn (39% of overseas total) followed by both the Germans (£1.3bn) and the Middle East at 13% (£1.3bn).

Whilst certain investors are increasingly cautious of the London market. Many overseas investors will view London as a buying opportunity due to the expected price falls and an extremely favourable move in currencies.

Following the vote to leave, investment managers have reported an increase in enquiries from overseas money wanting to buy sterling-linked assets, particularly commercial property, with the current exchange rate meaning they will get a better deal.

Conclusion

Clearly, the uncertainty caused by the referendum's result has had an adverse impact on sentiment. However, if we are right in thinking that occupier and investment markets are well placed to weather the uncertainty, we suspect that fears of a repeat of 2009 are overdone.

The UK property market has historically been deemed to be a safe haven by overseas investors, in both economic down-turns and times of prosperity, and we do not have any evidence to suggest the contrary. Whilst short-term rental growth prospects have weakened slightly, assets offering relatively high and stable income will undoubtedly remain in high demand.

In order to succeed outside Europe, Britain will need to treat Brexit as an opportunity to become a more competitive, efficient and dynamic economy. London will be at the forefront of this opportunity given its dominance as a global, rather than just European, financial centre.

For further information please contact:

Sarah White
Head of Marketing
+44 (0)20 7297 4480
+44 (0)78 2480 5164
sw@rivercap.co.uk

Jaspal Phull
Head of Research
+44 (0)20 7297 4480
+44 (0)75 4014 2458
jp@rivercap.co.uk

www.rivercap.co.uk