Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

10/16

London Property Market Snapshot: October 2016

Keeping track of market movements is not easy in this post referendum period

With every political announcement comes another spike, another dip, talk of another bubble here, an opportunity there. Bond yields halve, then they double, the pound goes through the floor, the FTSE soars.

Private investors are telling us that since the referendum result, they have never made so much money in such a short space of time... and the world goes round again. Never a dull moment.

So where does commercial property fit in to the chaos? It seems that it fits in quite nicely indeed, and, if our investors are anything to go by, it's the shelter for all those profits made everywhere else.

It's an asset class that is not exposed to over leverage, and it's an asset that overall is not in a bubble.

It provides income in a world that offers next to none, and not just income, but income that is uncorrelated to other asset classes.

Will you double your money overnight? No. But, over the short, medium, and long term, it will provide steady, income-driven returns.

Where commercial property in London goes next is obviously a hot topic. This great city continues to evolve, and the announcement that Apple are moving to Battersea is really quite exciting for the whole of London.

As a house, our opinion remains that there is better value to be made outside of the capital, but as the data in this report suggests, the machine that is London keeps rolling for now.

Dominic Wright, Group Chief Executive

Global Macro overview

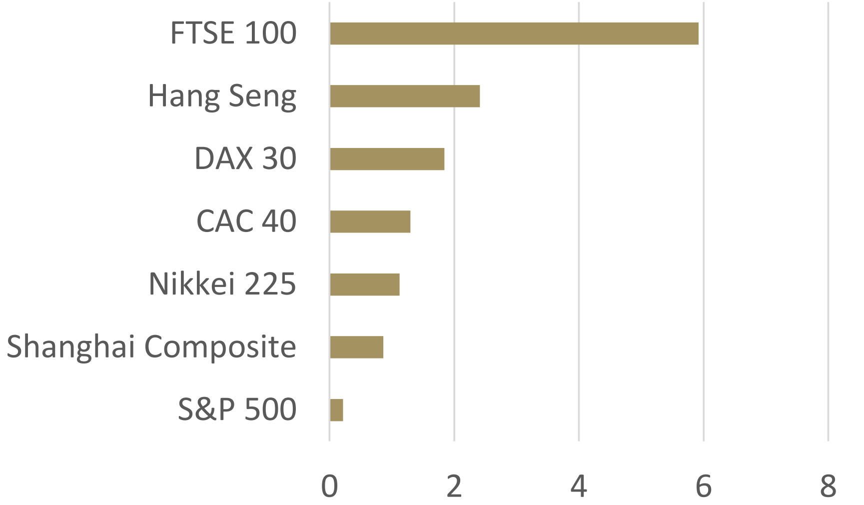
Recent data has given mixed signals about the short-term growth outlook in the US. For example, production-based business surveys like the ISM and PMI both pointed to a slowdown in GDP growth in the third quarter. By contrast, on the back of the rise in the price of oil, mining output has risen. Furthermore, non-farm payrolls saw a robust increase of almost 240,000 in September, the unemployment rate remains low at around 5%, and core inflation ticked up, suggesting that aggregate demand is healthy.

The picture was also mixed in the Euro-zone. For instance, the two main survey measures of activity, the composite PMI and the Economic Sentiment Indicator, pointed in opposite directions. And even though headline inflation has now begun to pick up, rising from 0.2% in August to 0.4% in September, there is still a considerable amount of slack in the economy. Indeed, at 10.1%, the Euro-zone rate of unemployment was unchanged for a fifth straight month in August.

As a result, central banks are likely to keep monetary policy very loose. For instance, the Bank of Japan announced it will be setting policy to deliver a target for 10-year bond yields of 0%. The ECB could well loosen policy further in response to weak data or continued political uncertainty. And while the Fed will probably tighten their target interest rate in December, any increases will be small and gradual. The Fed Funds rate is unlikely to rise by more than 100bps over the next 12 months.

Despite the prospects of more accommodative monetary policy, equity markets gains have been modest. Indeed, ranging between 0.2% and 2.4% major stock markets have all posted only marginal gains over the last 20 trading days, with the Hang Seng index recording the strongest rate of growth

Chart 1: Selected Equity Market Indices (% change last 20 trading days, latest = Sep 12 2016)



Source: Thomson Datastream

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UK Economy

The survey data released since June's referendum has generally been encouraging. The composite PMI has recovered July's losses to sit at 53.7 in September. Similarly, the CBI output trends survey also has shown an improvement since the referendum.

Chart 2: CIPS/Markit Composite PMI

Source: CIPS/Markit

And while slightly less timely, the official figures have highlighted that the drivers of household spending have also been resilient. In fact, at 173,000 in the three months July, job creation was healthy, keeping the unemployment rate unchanged, at 4.9%. And despite nominal pay growth slowing slightly, low CPI inflation has helped support real incomes. As a result, retail sales grew by 6.2%y/y in August.

However, despite the better-than-expected string of data, UK financial markets had a slightly bumpier ride. Withtalk of a hard Brexit on the rise, cable sank to just over $1.20. In turn, given that the FTSE 100 contains several multinational companies with revenue streams denominated in other currencies, the falling exchange rate helped the FTSE 100 be one of the top performing major stock markets over the last 20 trading days. Meanwhile, the fall in sterling appears to have boosted inflation expectations among market participants. This, combined with the diminished risk of recession suggested by survey data, has caused 10-year gilt yields to rise, but at less than 1% they are low in a historical context.

It is possible that with the fall in sterling and interest rates helping to support sentiment and activity, but longer-term issues like the erosion of real income growth through higher inflation yet to bite, the economy is in something of a sweet –spot.

However, with monetary policy set to be loose for the foreseeable future, and fiscal policy set to be less restrictive, there is no obvious reason to expect the economy to weaken more markedly next year.

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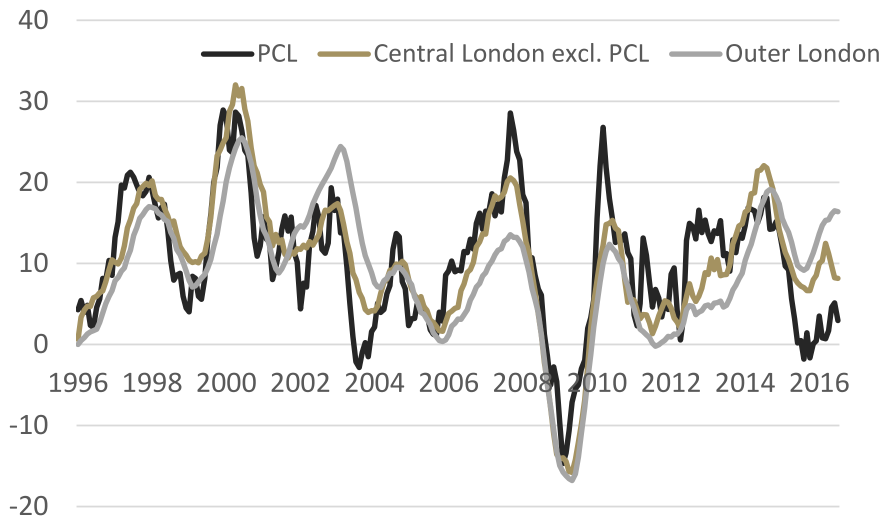
London Residential

The RICS housing market survey for September highlighted that, even in the capital, the Brexit-shock has largely dissipated. Since the referendum, London has seen an improvement in both the buyer enquiries and new sales instructions balances. Indeed, new buyers enquires in London rose from -50% in June to -12% at the latest reading. Meanwhile, the new sales instructions balance rose from -61% to -16% over the same period. This means that the fall in supply should provide some support for prices going forward.

That said, mortgage advances in London have been weakening. Data from the CML showed that 17,000 loans for home purchase were advanced in the second quarter, reflecting a 9%y/y fall. However, mortgage approvals were already softening even before the referendum, in part, due to the stamp duty surcharge for investors and second home buyers introduced in April.

On the whole, the data on house prices suggest that they have proven resilient. Yet, with prices already very high in London, it is unsurprising that the slowdown in the pace of house price inflation has been most notable in the capital. **Within London's sub-markets, and due to the combination of tax changes and the high prices, prime central London house prices are rising at a much slower pace than in the outer boroughs.**

Chart 3: House Price Growth (% y/y)



Source: Land Registry

With transaction activity limited and prices still high, we think that house price growth in London is likely to slow substantially over the coming months.

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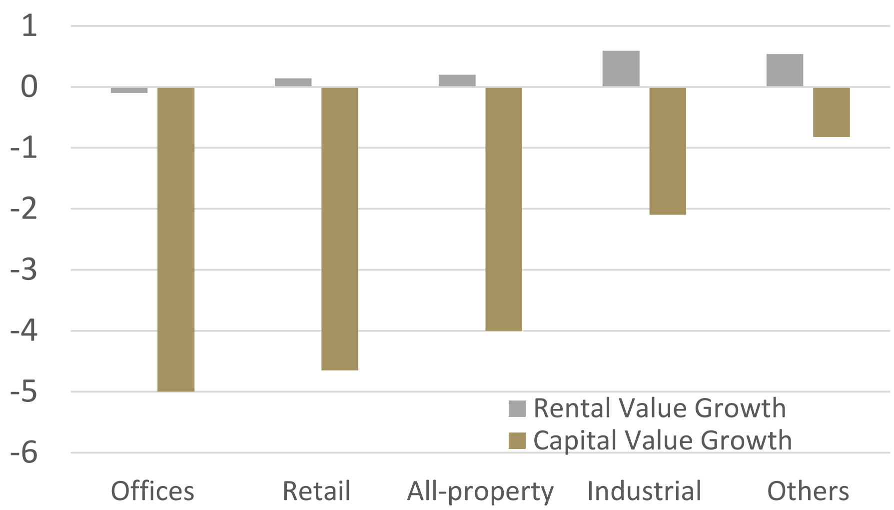
London Commercial

Despite the glum macroeconomic predictions of the consequences of a vote to leave the EU, occupier market conditions nationally have held up relatively well. In fact, over the three months to September, all-property rental values in the prime end of the market actually rose, albeit by a muted by 0.2%. **That said, London's fortunes have been more mixed.** While central London retail rents have risen, office market rents in the City and West End are broadly unchanged since the referendum.

Chart 4: Q3 2016 Prime Rental and Capital Value Growth (% q/q)



Source: CBRE

The fact that rental values have held up well stems from limited availability and healthy levels of occupier demand. For instance, retailer demand has been buoyed by the impact of a lower exchange rate on tourist-spend, as well as the very limited availability of prime space. Data from Colliers suggest that occupier demand conditions have also fared well in London's office market. At 2.3m sq.ft. in the third quarter, office take-up in Central London rose by 48%q/q, although this partially reflects the weakness of the second quarter. Despite the delivery of a few new schemes, healthy take-up helped the amount of available office stock to fall by 5%q/q to 6.8m st.ft, and the vacancy rate to sit at 3.4%.

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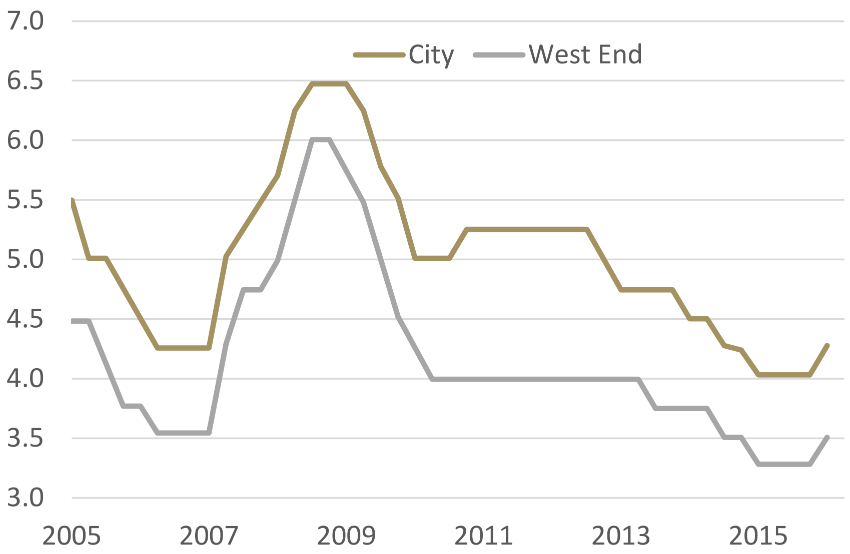
In line to the strength of occupier market conditions, the capital value correction in London has been slightly smaller than the national average. Indeed, since June, capital values have fallen by some 5% in London's office markets, roughly 100bps less than the national office aggregate. Meanwhile, held up by rising rental values, retail shop capital values in London have marked time, compared with a 4.7% fall nationally.

With rental values broadly unchanged over the quarter, changes in capital values have been determined by movements in yields. For example, data from Cater Jonas shows that City and West End office yields have risen by some 25bps, from near-record low levels. **And, with prime yields of 3.5% and 4.25% respectively, capital values in London's West End and City office markets are particularly vulnerable to even modest increases in investors' required yields.**

That said, the degree of uncertainty about the UK's future arrangement with the EU, and particularly the fall-out for London's financial service firms, mean that property yields may well drift higher. Yet, with occupier markets seemingly holding up, and the pound and interest rates both falling, the bulk of the capital value adjustment may now already be behind us.

Chart 5: Prime Office Yields (%)



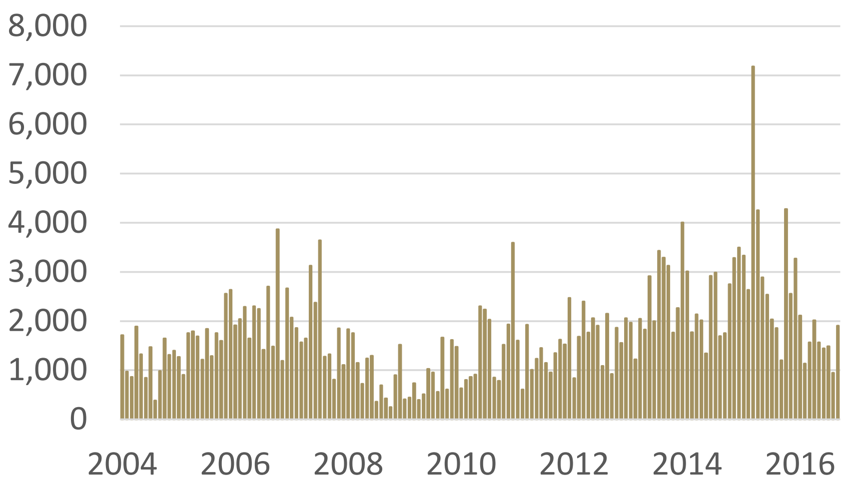
Source: Carter Jonas

The bulk of capital value adjustment may now already be behind us.

Investment

With a combined value of £4bn, the total value of deals signed in September rose by 114% compared to August's weak figure. **Within that total, the regional breakdown of the figures highlighted that investors still view London favourably. At £1.9bn, the value of investment in London reached its highest level since April.** Moreover, in the three months since June, properties with a combined value of £4.3bn have changed hands in London. This represented 52.4% of the national total, a figure comparable to the long-term average. The largest deal reported in the capital was Ramsbury's purchase of Debenham's flagship store for £400m.

Chart 6: Value of Commercial Property Deals in London (£m)



Source: Property Archive

Encouragingly, overseas investors seem to be taking advantage of a weaker exchange rate. Over recent months, large deals in London involving foreign buyers have included Mitsui's purchase of a 50% stake in 245 Hammersmith for a reported £137m, and the £120m purchase of 23 King Street by Wheelock Properties.

That said, the latest improvement is unlikely to signal a swift and consistent recovery in transaction activity. September's improvement was heavily reliant on a handful of large deals which won't necessarily be repeated month after month, and activity has been skewed away from the traditional office, retail and industrial sectors. **As a result, the market may take some time to normalise.**

Nevertheless, despite the uncertainty surrounding London's prospects, the fact that occupier markets are starting off from a strong position is encouraging. Furthermore, we think that the adjustment in values that has already been observed, along with the fall in the pound, and the attractiveness of property yields when compared to alternative assets should provide support for both activity and capital values over the near-term.

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