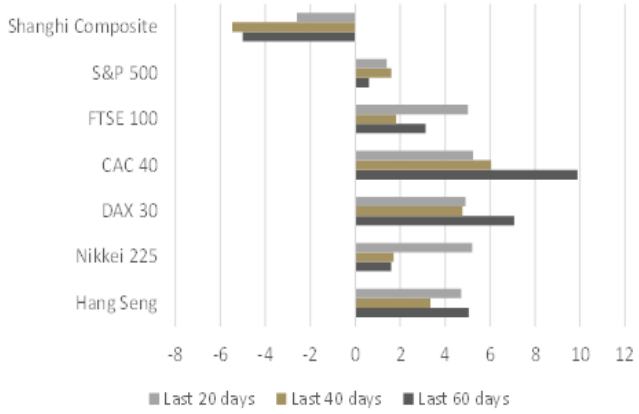
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

# May Update

## Global Factors

**Major equity markets have seen healthy gains over recent months. Indeed, both the FTSE 100 and S&P 500 were near record highs by mid-May.** More generally, with the exception of the Shanghai Composite Index, most major equity markets have risen over the last 20, 40 and 60-trading day periods (Chart 1).

### 1.0 Key Global Equities (% change)




Source: Thomson Datastream

The strongest gains were recorded in Germany and France, reflecting the health of the economic data. Indeed, Euro-zone GDP expanded by 0.5%q/q in Q1. Meanwhile, survey data from Germany – the Euro-zone's largest economy – currently suggests that activity has strengthened a little further in the second quarter.

**Political developments continue to dominate news flow.** May saw the second round of the French presidential election which resulted in a resounding victory for pro-EU candidate Emmanuel Macron.

## An Overview

The outlook for the world economy has improved. The recovery in the euro-zone has gained momentum and the US economy should perform well.

Despite an ongoing level of Brexit-related uncertainty, the UK is still seen as a relative safe haven. Further, with underlying fundamentals solid, investor demand for UK property, especially from overseas buyers is likely to remain strong.

**May Top 5**

1. Positive data indicates that the European economic recovery remains on track
2. Election relief following Macron's resounding victory over Le Pen in the French elections
3. London property continues to be perceived as a relative safe haven by overseas investors
4. Occupier fundamentals remain solid as total employment growth in the capital show no signs of slowing
5. Demand for city fringe property could be close to double the long term average by the end of 2017 as Tech and Media continue to drive take up

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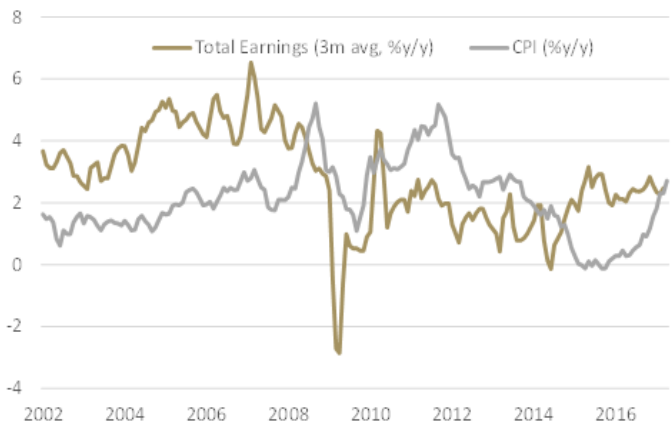
**The outcome of the French election is not likely to have a major impact on the outcome of the Brexit negotiation.** Granted, Macron has stated that he is "determined that there will be no undue advantages" for the UK outside the European Union. However, this has merely aligned France's official stance with the current consensus among other EU member states. Perhaps more importantly, the European Court of Justice ruled that the Singapore-EU free trade deal must be ratified by all member states. This could signal that any post-Brexit UK-EU trade deal may be difficult to rush through.

**With just over one week to go until polling day, the Conservatives' lead over Labour has been steadily narrowing.** Some early polls had the Tories at almost double the vote share of the Labour party. However, the Tories' lead has shrunk since the party's so-called "dementia tax" announced in its manifesto launch on 18 May. That said, even with a mere nine-point lead, the Conservatives would still win comfortably.

**Nevertheless, one concern for the Conservatives must be the latest economic data which show that households' real incomes are beginning to be pinched.** At 2.5% in March, the pace of wage growth edged up, from 2.3% in the previous month, but that increase was overshadowed by April's jump in CPI inflation, from 2.3% to 2.7% (Chart 2). However, while the exchange-rate driven increase in CPI inflation has been a little faster than anticipated, survey evidence suggests that it is unlikely to surge too much further. Thus, the squeeze on real incomes should not be too protracted.

### 2.0 Total Earnings and CPI Inflation

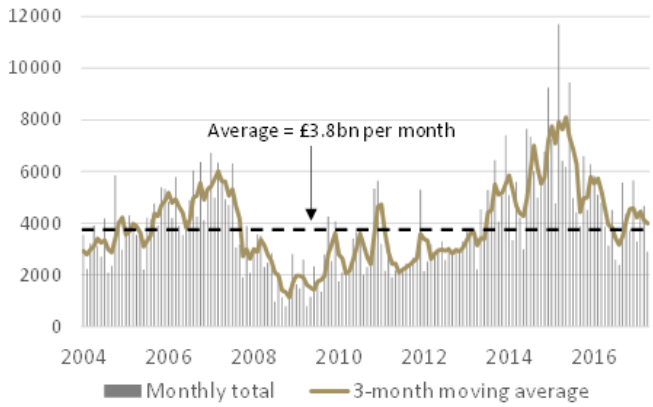



Source: Thomson Datastream

## Property Overview

**Since the turn of the year, UK commercial property investment activity has been relatively subdued.** Indeed, at £2.9bn, April's total was down by 37% compared to March, and down by around a quarter compared to April 2016. However, the bigger picture is that, on a three-month average basis, the value of transactions has been roughly in line with historical norms (Chart 3).

### 3.0 Value of Commercial Property Transactions per Month (£m)




Source: Property Archive

**As has been the case for some time, overseas investors have been the main drivers of investment activity.** In April alone, foreign buyers made £1.1bn more purchases than disposals. That was broadly in line with the average seen over the last four years. Breaking down the data by purchaser nationality, the most active purchasers have come from the Far East.

**That said, sterling has recovered of late.** Indeed, the pound has risen to 1.30 against the USD, and 1.17 against the euro. Those rates compare to post-referendum lows of 1.21 and 1.11 respectively. In turn, the fact that overseas demand is holding firm gives weight to the view that, while the weaker pound has been supportive, overseas investors find the long term prospects for UK commercial property attractive.

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## Regional Property Market

**Generally speaking, prime rental values in regional property markets held firm during the first quarter.** According to CBRE, in the prime regional office markets, Southampton, where rents rose by 2.5%q/q in the first three months of the year, was the only exception. High street rents in Birmingham, Glasgow and Manchester also bucked the flat trend, increasing by 6.6%, 3.5% and 1.7% respectively. But there were no notable changes in industrial warehouse rents.

**Given the general stability in occupier markets, it is perhaps a little surprising that the slowdown in investment activity has been more notable in the regions than in London.** Indeed, at £1bn in April, the value of deals struck outside of London was almost half the average seen since the early 2000s. Even looking at the numbers on an annual basis shows that activity is down by 48% compared to its 2016 peak. The comparable figure for London is a 40% drop.

That said, at 108 in April, the number of deals signed in the regions was identical to the long-run average. In London, by contrast, there were 31 deals, a total that is a third below the average. **Hence, the comparatively low level of activity by value in the regions reflects a lack of large deals.**

## Sector Spotlight - London Offices

**The capital's economy has grown strongly in recent years. At 3.6% per year between 2010–15, growth has been well above the national average of 2%. Performance in 2016 continued to remain robust at 2.9%, only slightly below that in 2015, confounding post-referendum predictions of an immediate slowdown. London's economy (baseline forecast) is projected to outperform the UK average over the next five years albeit with an increased level of uncertainty given the impending Brexit negotiations.**

**Prime office rental values in central London fell slightly in the first quarter.** According to CBRE, at 2.2%q/q, the decline was smaller than the 6.3%q/q drop recorded in the final three months of 2016. However, rents in the City held firm, meaning that the latest fall was entirely down to a softening in the West End. Two sub-markets saw a rise in rents between Q1 2016 and Q1 2017: Shoreditch and City East/Aldgate(Jones Lang La Salle, Central London Office Market Report, Q1 2017).

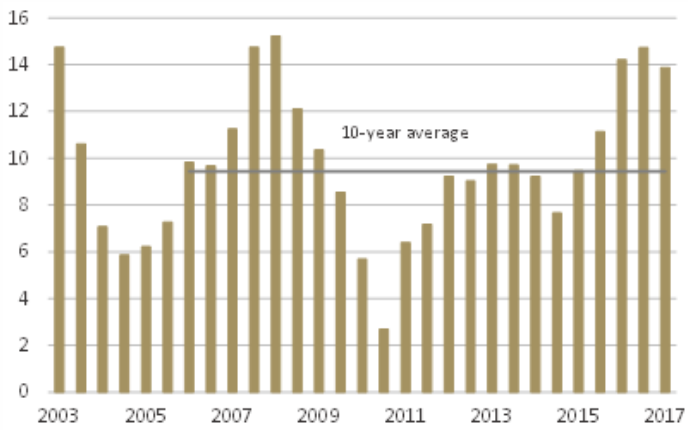
**Nevertheless, investor demand has held firm during the first four months of the year.** In fact, as discussed above, London's share of investment has been elevated over recent months, reflecting the completion of some very large deals. The £7.7bn worth of property assets traded in the capital are equivalent to half of all UK-wide transactions, above the long-term average share of around 46% (Property Archive).

**Therefore, with investor demand still solid, prime yields fell in the City and were flat in the West End.** In fact, the 24bp drop in prime city office yields in Q1 took them back to 4% - in line with their pre-referendum level (CBRE). At 3.75%, West End prime yields are still 25bps above the equivalent benchmark.

**Encouragingly, office availability also ticked down in April.** Indeed, the amount of space available to let fell by 2%, to 14.4m sq.ft. according to CBRE. Not only was this figure slightly below the 10-year average but it also marked the second consecutive monthly fall.

**Finally, the risks of a supply glut appear to have begun to recede.** Deloitte's Crane Survey showed that space currently under construction fell for the first time since 2014, from 14.7m sq.ft. last November to 13.9m sq.ft. in May (Chart 4). Furthermore, at 8m sq.ft., demolitions are still high by recent standards, suggesting that net additions to the stock of office property will be far lower than the headline figures imply. Admittedly, at 3.1m sq.ft., new development starts are above the 15-year average. But that is unsurprising given than the vacancy rate is still very low (CBRE). If the vacancy rate rises, it would be logical to expect starts to slow.

### 4.0 London Office Space Under Construction (Sq.Ft.)




Source: Deloitte

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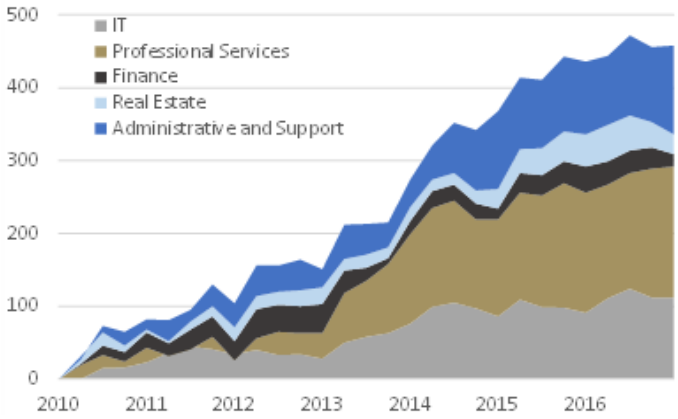
**Looking ahead, press coverage continues to highlight the plans of some financial institutions to desert London or scale back their presence as a result of Brexit. Yet the latest signals suggest that occupier fundamentals are pretty solid.** For a start, total employment growth in the capital shows no signs of slowing. Over the year to March, London has created 19% of all jobs nationally, up from 14% during 2016. Granted, financial services make up a large proportion of existing jobs (7%). But there are good reasons to think that, even if demand from financial firms softens, other occupiers will plug the gaps. In fact, London's post-crisis jobs recovery has not been driven by financial services, but by business services and tech (IT). Together they have accounted for 64% of all new office-based jobs created in London between 2010 and 2016 (Chart 5).

### 5.0 London Office-based Job Creation by Sector (000s, Cumulative)




Source: Deloitte

The Atlas Building, City Road, London, EC1V

## City Fringe Sub-Market Trends

The City Fringe submarket forms an arc around the City Core, stretching from Aldgate in the south-east to Barbican and Goswell Road in the north-west. The area has come to prominence in recent years as a tech heartland centred on 'Silicon Roundabout', aided by government incentives. It has become a home for startups and tech firms. Developers have responded accordingly and created the warehouse-style space that these firms desire. Prominent City Fringe occupiers include Uber, Google, and Amazon.

**Robust TMT demand and limited new supply have resulted in rapid rental growth in recent years, with the City Fringe experiencing some of the strongest growth of any submarket in London.**

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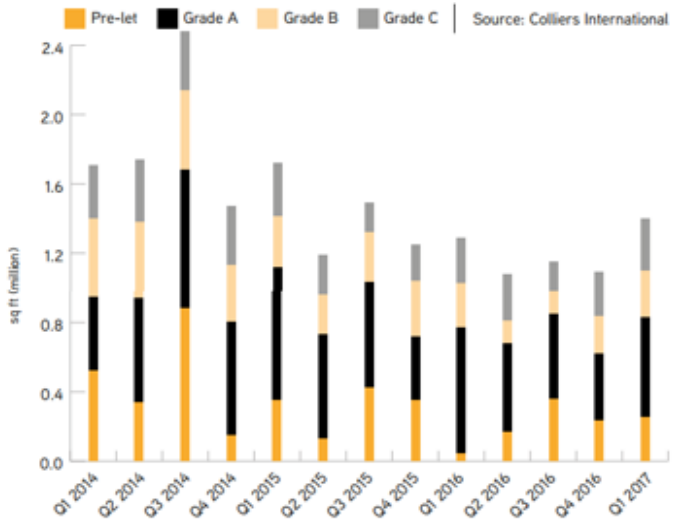
Looking ahead, continued strong leasing—in contrast to other City submarkets, where leasing has slumped in recent quarters—suggests absorption will recover in 2017. Indeed, absorption spiked upwards in Q1 2017 when Amazon announced that they had pre-let over 500,000 sq.ft. at Principal Place, with plans to move in later this year.

**New supply is also on the rise, with soaring rents and the success of recent schemes encouraging developers.** The City Fringe vacancy rate is therefore expected to increase as big schemes like One Bartholomew Close deliver in 2018, albeit not to the extent of submarkets in the City Core.

The strength of the City Fringe market is underlined by take-up stats (Chart 6), showing that if demand remains steady throughout 2017, annual take-up could be close to double the long-term average by the end of 2017. Tech and media continue to drive take-up.

**With the downside risks to both occupier demand and supply looking overdone, the capital's main office markets look likely to hold up fairly well over the short-term. However, as monetary policy begins to be tightened next year, office yields in certain markets may drift a little higher alongside a rise in risk-free rates.**

## 6.0 City Take-Up by Grade, Q1 2014 - Q1 2017




Source: Colliers International

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