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Savills World Research
UK Offices
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THE IMPACT ON THE CENTRAL LONDON OFFICE MARKET

Brexit Briefing #2

BREXIT BRIEFING

MARKET STABILISING IN A POST REFERENDUM ENVIRONMENT

SUMMARY

Uncertainty will be a drag on activity, but London still looks comparatively attractive

■ Despite some recent clarity on what path the UK government hopes to take for our exit from the EU, uncertainty about the likely outcomes of these negotiations is still substantial. This makes it hard to chart an accurate path for the London office market over the next five years.

■ While neither our upside or downside scenario is positive for the market, we believe that the risks of London losing large numbers of jobs to other EU cities has been significantly overplayed.

■ Investor demand for London offices has undoubtedly changed since the referendum, but the fact that 2016's turnover was 45% above the 20 year average is a clear indication that investors are taking a balanced view of risk and return.

■ The occupational markets will be negatively affected by uncertainty. However, heightened uncertainty will be felt both in terms of lower take-up and lower levels of development activity. This will create a lower ceiling for vacancy rates than was seen in previous cycles. This in turn will limit the rental falls, even under our worst case scenario.

"In the short term we expect that 2017 will be similar to 2016, with average levels of take-up and slight rises in vacancy rates. Non-domestic investor demand is expected to remain fairly strong."

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With the referendum result now six months ago it is clear that both the investment and occupational markets in central London have started to accept that Brexit is more of a process than an event. This has resulted in a cautious return of confidence, combined with the acceptance that decision-making has to continue.

There are undoubtedly challenges ahead, particularly for the occupational markets, but the short-term outlook for the market is more connected to its late cycle characteristics than the changes that may or may not occur due to Britain leaving the EU in 2019.

Macro-economic background

The major London-specific debate of the last six months has been around the possible impact of a loss of passporting agreements for financial services and what this might mean for London's position as Europe's financial centre.

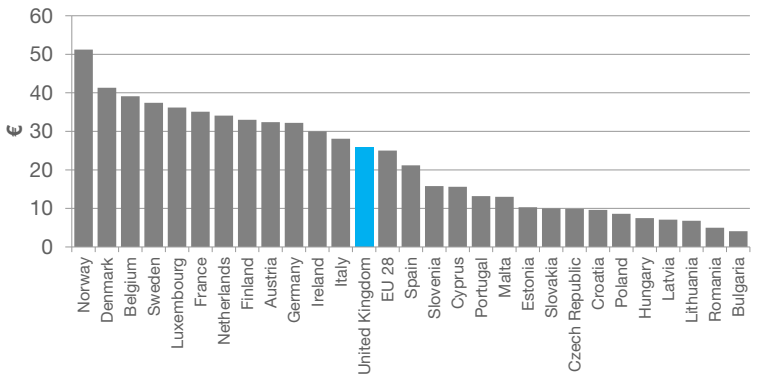
Our view is that this debate has been clouded by a significant degree of posturing, with a number of businesses and commentators over-emphasising the risks of large numbers of jobs needing to be moved to other locations in the EU. Their rationale for this is fairly obvious, a desire to ensure that the topic of trade agreements is front and centre in the UK government's negotiations with the EU. This noise has been further amplified by the leaders of a variety of European cities setting out their stalls as to why their city is the obvious successor to London's crown.

For example, the head of the Association of German Banks has urged the German government to do more to lure businesses away from London by relaxing both tax regimes and labour laws to make Germany as flexible as London. In our opinion, the factors that have made London such a popular location are unlikely to be changed at a local or even a regional level in the EU. This leaves CEOs of London-based businesses facing the simple fact that on employment costs alone France and Germany are 30%-40% more expensive than the UK (Graph 1). By the time you have addressed the lack of flexibility in many European labour markets these two factors alone mean that the operating costs in London in a post Brexit world will have to rise by at least 40% to make a significant relocation away from London a sensible financial decision for many businesses.

Some property market commentators have suggested that another barrier to such moves would be the lack of office space in competing European cities. However, given the long decision-making time scales that are likely to be involved in such moves, we would suggest that suitable space could be delivered in both Paris and Frankfurt if there was evident demand. A more significant barrier to entry for London-based businesses will be the size of the local labour market in other European cities. For example, while Finance and Insurance employment in London totals around 400,000 people, the next biggest European city (Paris) has less than 250,000 workers in its own Finance and Insurance sector.

GRAPH 1

Estimated hourly labour costs (2015)



Source: Savills, EuroStat

Of course the question of relocation of jobs might not only be one facing Finance employers. If the barriers to cross-border trade (as well as the ability to hire non-domestic workers) become more significant in London, then this will affect many more business sectors than just Finance, and some of the these sectors (such as TMT) have been much more active players in the London office market than Finance in the years since the Global Financial Crisis (GFC).

So, with clarity on passporting of financial services and other matters unlikely to emerge for several years, we have not dramatically revised down our forecasts for employment in London. Indeed, even before the EU referendum these forecasts were based around the view that Financial Services employment in London was likely to remain static for the foreseeable future.

The investment market

Investor appetite for central London offices definitely changed in the period following the referendum. However, the change was more in terms of the source of investor interest in London, rather than the overall volume of capital targeted at the London office market.

Heightened occupational uncertainty, as well as structural issues in the retail fund sector, definitely has led to less institutional investor activity in London over the last six months. However, this was more than compensated for by a dramatic rise in non-domestic private investor interest in London. This rise in interest was driven in part by the weakening of sterling against most other currencies.

The most active group of non-domestic investors in London in 2016 were those from the Asia-Pacific region, who deployed in excess of £4.7bn in 2016 and accounted for one third of total turnover (their greatest market share on record). The share was even more pronounced in the City of London, where investors from Asia-Pacific have accounted for 85% of purchases by value since the EU referendum.

This surge in investor interest in London led to the total investment

turnover reaching £15.9bn, 45% above the 20 year average, and only 17% down on the near-record level reached in 2015. This total is actually higher than the level that we were predicting for 2016 at the start of last year.

Of course, if this rise in investor interest was in part motivated by currency movements then it could disappear if the pound starts to recover, or if the occupational outlook worsens. A sharp recovery in the value of the pound looks pretty unlikely at the moment, and some economists are predicting that 2017 will see a return to $/£ parity, though the current consensus view is for the rate to stabilise in the 1.2-1.3 range for 2017-2019. This should ensure that UK and London property continues to look comparatively cheap to many non-domestic investors.

One area where the referendum has definitely had some effect on the investment market has been pricing, and we moved both our prime City and West End office yields outwards by 25bps in the immediate aftermath of the result. However, stronger investor demand in the West End led us to move the yield back down to 3.25% in November 2016, while the City yield has remained at 4.25%.

The future path of central London office yields is likely to be volatile, with any occupational or economic shocks likely to be reflected in a short term weakening in investor demand and hence yield rises. However, we believe that the occupational story, the global investor appetite for real-estate, and the stability of the lending market will all combine to put a lower ceiling on prime property yields than was seen after the GFC.

Indeed, any further rises in prime yields in London over the next few years may well result in a renewed surge in investor interest in London, particularly from non-domestic institutions. As a group they have been comparatively inactive since the referendum, citing concerns that the combination of occupational uncertainty and the costs of hedging the pound make London look comparatively unattractive compared to other Tier 1 European cities. However, a number of major European institutions have told us that even a further 25bps rise in London would start to make the comparative yields on offer start to look attractive, and that such a move would cause them to reassess London in a pan-European context.

The occupational market

The occupational markets in London are undoubtedly facing a sustained period of uncertainty over the next few years, though the likely length of the Brexit process will mean that most businesses will continue having to make real-estate decisions, albeit with a heightened desire for flexibility.

2016's occupational trends were again broadly in line with our predictions at the start of the year, with a slowdown in take-up and small rises in the vacancy rate. However, what we did not predict was the downward pressure on net-effective rents that took place in the second half of last year.

Overall, the headline statistics for both the City and West End office markets in 2016 look fairly sound. Take-up in the City was well down on 2015's record level (but well above average), at 5.8m sq ft. However, the West End market was boosted by Apple's pre-let at Battersea Power Station, and the full year take-up figure was ahead of expectations at 3.9m sq ft. Furthermore, in both markets the volume of active tenant requirements picked up in the third and fourth quarters of 2016, and ended the year at much the same level as they were at the start of last year.

Vacancy rates in both the City and West End rose during the second half of 2016, reaching 5.7% and 3.9% respectively. However, this was more down to development and refurbishment completions than occupier downsizing.

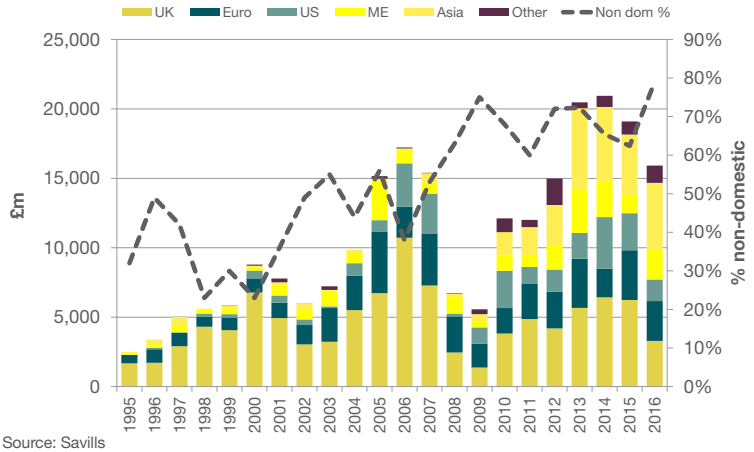
These low vacancy rates helped to support headline rents, with new highs being reached in the City of London in the second half of 2016. However, the West End has seen some tenant reluctance to pay ever higher rents, and the average prime rent achieved remained flat in 2016. Landlord and tenant uncertainty has however been reflected in the recent trends in the net-effective rents being achieved in both markets. We estimate that the average rent free period on a 10 year lease in both the City and West End has lengthened to 20 months.

The biggest questions for the market are around how long that period of uncertainty will last, how much sub-letting a weaker trade situation might precipitate, and how many developments are delayed as a result of this uncertainty.

Nowhere is uncertainty more rife than in our forecasts for the occupational markets over the next five years, and for the first time in nearly twenty years we have been unable to settle on one scenario over another. The key difference between our two scenarios is around the question of whether the UK government manages to achieve all or some of its aims, and how quickly negotiations can be concluded with the EU and other organisations so as to allow businesses to adapt to this new

GRAPH 2

Central London office investment volume



Source: Savills

world.

While Mrs May has now announced that she is hoping for a result that embraces both immigration control and new trade agreements, the degree of aspiration in that statement is significant. Immigration controls will have to be flexible enough to allow students and highly skilled workers in as easily as before, but we must not forget that London and the UK still need less skilled workers.

Under our 'Soft' scenario we have assumed that some kind of limited immigration control is put in place fairly swiftly after the UK exits from the EU, and this then leaves the government as much time as possible to negotiate a series of transitional trade agreements with the EU that will stabilise business confidence in 2019 and beyond. This results in a shorter period of occupational uncertainty through 2017 and 2018 as transitional agreements are start to look more likely of being signed, and also as some kind of "equivalency" is established for cross-border financial services.

The swifter return of confidence under this scenario leads to only around 15-20% of development starts being delayed, but also a corresponding pick-up in leasing activity in 2018-2020. This means that vacancy rates do not rise above 8% in the City and 5% in the West End. This also means that while headline rents do fall under this scenario, the period of falling rents is short and the quantum of the fall is significantly lower than was seen in either the GFC or the early 1990's downturn.

The 'Hard' scenario envisages that our focus on immigration control makes the negotiations over both transitional and future trade agreements with the EU more challenging and thus longer to agree. This means that the period of uncertainty is lengthened, at least in terms of trade with the EU, though we are assuming that soon after the UK exits from the EU some trade agreements with other countries will be relatively swiftly established.

The lengthened period of uncertainty feeds through to the occupational markets both in terms of a longer period of below average levels of take-up, but also through a rise in tenant returns and subleasing of space (to the 30% and above levels seen in the dotcom crisis of the early 2000's).

The flip side of the 'Hard' scenario is that 40-50% of development starts are delayed, and this puts a ceiling on vacancy rates, which is reached by 2019/2020. However, this does mean that the City vacancy rate pushes above 8% (historically the figure at which headline rents start to fall significantly), though the more supply-constrained West End market only rises to 5%.

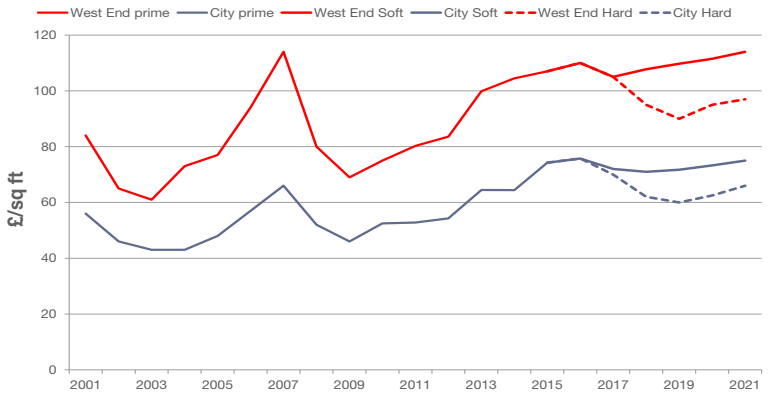
Weaker demand, a rise in tenant-controlled subletting, and rising vacancy rates all combine to deliver falls in headline rents of around 20% in both the City and West End, before the beginnings of a recovery in 2020.

At present, given the need for negotiations around 11 of Mrs May's 12 aspirations, it is virtually impossible to put anything more than an equal weighting on the likelihood of either scenario being the actual path of the market over the next five years. However, in the short term we expect that 2017 will be similar to 2016 in the leasing market, with average levels of take-up, and slight rises in the vacancy rates.

However, as we explored in the investment section of this report, non-domestic investor demand is expected to remain fairly strong for well-let London offices and this should limit the downside for yields.

GRAPH 3

Two scenarios for central London prime office rents



Source: Savills

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