RESEARCH

CENTRAL LONDON OFFICES

OCTOBER 2016

LONDON AND BREXIT

Market sentiment in the capital's office market is better than one would have expected back in June, although the Q3 figures will remind us that we should be ready for air pockets ahead.

Headlines

Q3 has effectively been a one month quarter for Central London offices, with most activity in September

The quarterly figures will show activity down markedly for both the investment and leasing markets

The leasing market is seeing mixed conditions, with supply gradually rising, but rents mostly stable

The investment market looks set to benefit from the Pound's fall, and negative interest rates abroad

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Chief Economist

"There is understandably a lot of discussion about the future of finance, although it should be remembered that office demand in London has been gradually becoming less dependent upon this sector for some time."

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The London office market today is facing a situation very different to that seen in the weeks after the referendum – the impact on the market has not been as great as originally feared. Some of the UK property funds that were gated in July have re-opened. Several investment banks have torn up their previous forecasts for a UK recession. This is all encouraging, but we need to be mindful of the challenges still facing the market.

In the next few weeks the Q3 Central London statistics will be released and it is a near certainty that activity (both leasing and investment) will be down significantly on long-term average levels. Effectively, Q3 was a one month quarter, with September the only 'normal' month of trading.

Arguably, the approaching reality check of the Q3 figures will be good for the Central London market, as it will encourage everyone to focus on genuine strengths and weaknesses.

Some say that rents have not fallen and leasing supply is low, although both points are only partially correct. In the City we have seen deals on rents above the £70 mark, including the square mile's first rent over the £100 mark, although there have been concessions on rent free periods. However, in certain West End sub-markets asking rents are softening, albeit in places like the Core, where rents were looking over-extended back in the spring.

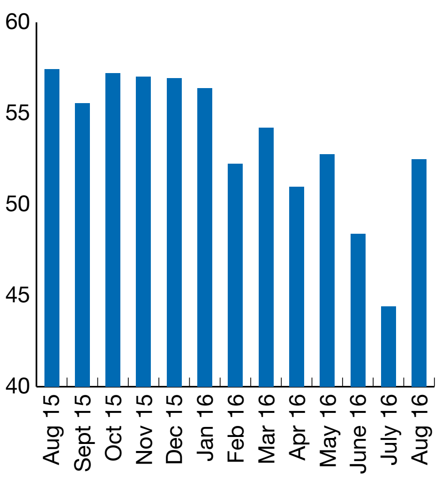
Also, the next two years will see a lot of political sabre rattling as Brexit is negotiated. There will be times in 2017/2018 when the raging geo-political backdrop, which will be mirrored by stock market volatility, prompts some landlords to reduce asking rents in order to get a tenant signed up.

Leasing supply is below long-term average levels, but gradually rising. While there is little development pipeline pressure on supply, take-up will need to be higher in the next six months if it is to absorb the second hand space returning to the market; particularly as we were already anticipating bank release space before the referendum. It is worth noting that Brexit is only one of several problems facing the global banking industry, and restructuring has started.

Turning to demand, there is news to support both optimism and caution. Some landlords are now regearing leases in buildings they had planned to redevelop, creating a short-

FIGURE 1

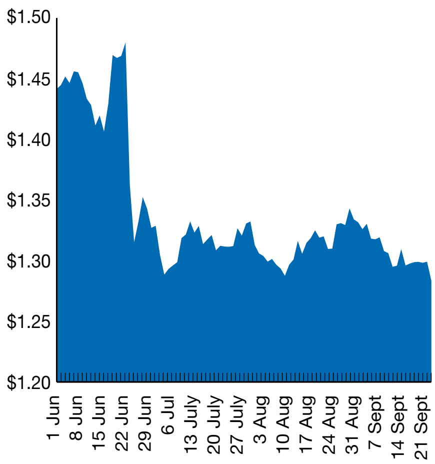
PMI London Business Activity Index (a reading over 50 suggests growth)



Source: Markit

FIGURE 2

USD:GBP exchange rate



Source: Bank of England

term hit on demand as tenants stay put, albeit with the long-term fillip of less future supply. On the positive side, major deals by Apple and Wells Fargo have provided a welcome boost to sentiment both for the property market and the London economy.

Interestingly, there is a tech flavour to the current crop of active office requirements, which is an encouraging sign. Tech is an industry the London economy will look to more for growth in the post-Brexit world. 2016 looks on course to be the sixth consecutive year that technology, media and telecoms (TMT) is Central London's largest source of office demand. There is understandably a lot of discussion about the future of finance, although it should be remembered that office demand in London has been gradually becoming less dependent upon this sector for some time.

For the leasing market, conditions are mixed but gradually improving. It is encouraging that demand has not slumped in the way many feared it might in late June, but the economy of London needs to gain some momentum, in order to push more occupiers out on the road. This is a good start to the post-referendum period, but there is still an uphill gradient to the leasing market.

Turning to the investment market, despite it displaying the same key symptom as the leasing market (low activity), and a more worrying sign (prices have clearly fallen), there is more reason for genuine optimism.

The IPD monthly figures show a 4%-5% drop in capital values in Central London in July and August. There is probably an element of valuation caution in those figures, and we see the IPD figures going lower in the coming months. However, that will be the valuers marking to the deals whose pricing is being hammered out now. The combination of a single digit fall in capital value, when combined with the drop in Sterling means that many overseas investors are looking at a market that has just seen a double digit price correction, but without the level of occupier market distress one would have expected back in June.

Moreover, with the market showing signs of returning to normality, the debate will shift from "are there more distressed sales ahead?" to "is it time to buy?". For some time, the UK funds have not been large holders of Central London properties, and a realisation is building that the capital is unlikely to see a run of fire sales in the coming months.

Moreover, Central London property is a global market, and has to be viewed in the context of the international investment landscape. Negative interest rates are becoming an embedded reality in some of the largest economies in the world, and near zero rates in many others. To an overseas investor faced by a negative yield on government bonds at home, the 3.75% to 4.50% yields offered by prime Central London offices look significant.

In conclusion, the prevailing air of optimism in the leasing and investment markets reflects relief that the worst fears over the referendum have failed to materialise, but there are probably air pockets ahead. We have yet to see the Brexit plan, which will test business confidence in all parts of the economy. Three months on from the referendum, the semblance of a functioning market is in place, however the test will come during the Brexit negotiations, when we discover whether market participants keep their nerve during the volatile times ahead.

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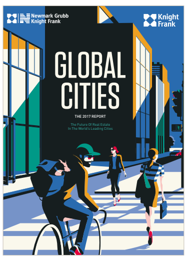

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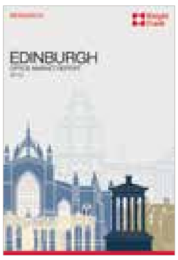

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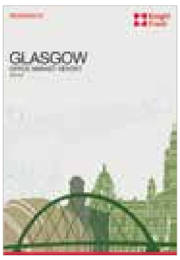

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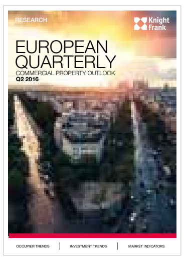

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