



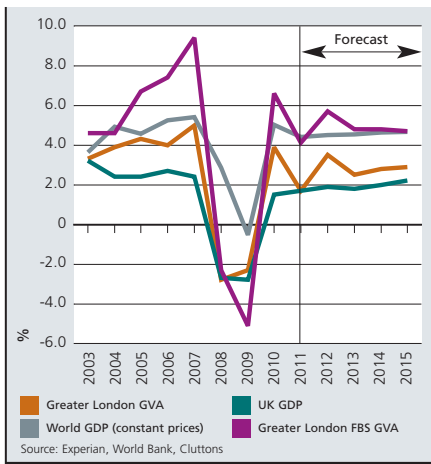
London property market outlook

June 2011

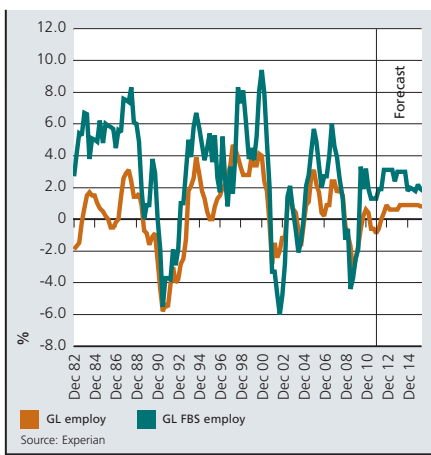
Positive signals driving London In the first quarter of 2011, the UK showed signs of turning a corner following a very disappointing end to 2010. The economy expanded by 0.5% in Q1 which while positive remained lacklustre. However, the story looks considerably more upbeat from a London perspective.

Estimates for economic growth in Greater London suggest the capital is outperforming the UK average significantly. The London Markit Lloyds TSB Purchasing Managers' Index points to a pick-up in the rate of growth of London's private sector economy. The Index reports that output rose at its fastest pace in a year in March, leading to a stronger rate of employment growth. Meanwhile, the capital faced weaker inflationary pressures than any other UK region. This out-performance reflects, in large part, a strong rebound in activity in the service sector which is a key driver of the Central London economy accounting for more than half of all jobs. Service sector output at a national level rebounded by 0.8% compared to a decline of 0.6% in Q4. While in real terms there has been little change over the last six months, the trend direction, combined with strong business sentiment in the sector which has emerged over recent months, indicates positive growth. This is highlighted by the CIPS/Markit UK Services PMI survey which reports on activity in the service sector and showed a surge in activity in March to its strongest level for 13 months, with companies benefiting from improved business conditions, higher sales and increased enquiries.

1. London's economic growth



2. London employment growth



What is driving the out-performance?

The impact of this upturn in service sector output is significant, particularly for London due to the structure of its economy which has a bias towards high value business services in particular those with global reach. These have been the driver of the capital's economic growth for the last two decades, building on the long held historic position of the capital as a global centre for trade. The strength and growth of high value services is seen most acutely in the City. The depth of the capital's financial services sector is imbedded in many of the London-based business services such as accountancy, law, IT and management consultancies, for which the City is the prime business generator. This in large part reflects London's global position in the financial network. According to the MasterCard Global Financial Centres Index, London has retained top position in 2011, although there is little significant difference between the capital and New York and Hong Kong (MasterCard, 2011), which also show similar levels of breadth and depth in their financial services activity.

This highlights the competitive and interconnected nature of global cities and the importance of inter-regional trade and specialisation to maintain economic success. It is these international linkages that provide the capital with its outperformance, reflected in the fact that more than a third of all UK service sector exports are generated in the capital (LDA, 2010) and approximately half of all equity assets on the London Stock Exchange are international (London Stock Exchange, 2010). This aligns London's economic performance with that of high growth economies, in particular the Far East and Asia. This global alignment is illustrated in graph 1 which demonstrates the correlation between London and global economic growth, a relationship which is more pronounced for the capital's financial and business services sector.

Financial services are undoubtedly a core driver of the London economy and its global



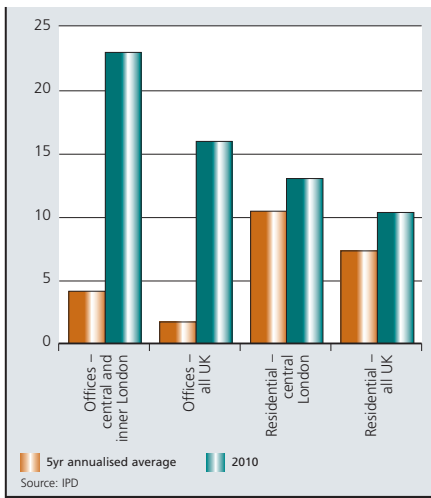
position, but the economy cannot be reduced to that of the City. In fact the diversity of London's economic base provides a depth and resilience, which has been evidently clear in the pace of the rebound after the recent finance and banking driven recession. In addition to finance there is a high level of specialisation in sectors such as ICT, law, accountancy and creative industries and these combine with representation from a broad range of other business sectors.

Economic outlook: diverging paths

The fundamental strengths of London's economy, including the transparent and stable political and tax environment, a relatively light-handed regulatory and taxation touch, even after recent events, time zone position and accessibility; combined with its overall sector diversity; have aided the resilience of its economy in the face of wider economic difficulties. This will be significant going forward with continued weakness expected in the UK economy as a result of the debt reducing policies shared by many other developed economies. Certainly, the impact of austerity measures on Central London is likely to be less significant than in other parts of the country, due to the focus on higher value functions, whether it be in government departments, or teaching hospitals. Furthermore, it remains the fact that, as described above, a large proportion of companies in Central London do not rely on the domestic market and are therefore immunised to a degree from weakness in the broader UK economy.

The structural differences between London's economic make-up and that of the UK as a whole are evident in the forecasts for growth going forward which suggest two diverging paths. Economic output and employment growth in the capital is predicted to continue to grow ahead of the UK average as illustrated in graph 1. The downgrading of economic growth expectations for the global economy given recent tragic events in Japan and political instability in North Africa will inevitably be played out in London as in other global cities. However, our forecasts with Experian Economics indicate that London will follow a cyclical recovery with average GVA growth for Greater London forecast at 1.7%, compared to 1.1% for the UK as a whole. As the economic upturn gathers pace from 2012 onwards, the outperformance of the capital grows, with GVA growth of 3.0% compared to just over 2% for the UK as a whole. As a result we expect employment levels to surpass those seen before the recession by 2015 at the latest, again with the financial and business services sector leading the way (graph 2).

3. London's out-performance



4. Global trade and office rents



Implications for the Central London property market

While the London economy is not uncoupled with the domestic market, its exposure to global growth across a broad range of business sectors inevitably translates to the occupier base of its property market. This is illustrated by the fact that the capital's office market is home to the European headquarters of 33% of the world's largest companies, the centre of operations for 65% of Fortune 500 companies and home to more foreign banks than other global centres (LDA, 2010). Furthermore, the investor base of London reflects its international profile and provides protection against the ebb and flow of capital from specific regions and markets. Over the last five years, overseas investors have comprised a minimum of 60% of office investment in Central London by value, while international purchasers are responsible for approximately half of all purchases in the prime residential core.

This international profile has driven an upturn in both the office and residential sectors well ahead of the market outside the capital. The West End office market delivered returns of almost 23% compared to just over 16% for UK offices as a whole in 2010, while Central London residential tells a similar story with total returns of over 13% in the capital compared to 10% as a national average (graph 3). In fact, the real performance differential in both cases is significantly greater since London comprises a large proportion of the national indices and therefore has a significant impact on the national average. This diversity provides London with greater capacity to weather domestic and global economic uncertainty as well as benefit from the high growth environments in the emerging economies in particular. The impact of this global

alignment is illustrated in graph 4 which demonstrates the correlations between global trade volumes and the performance of office rents in the West End, a pattern also common to the City office market. The following sections consider the outlook for the Central London office and residential sectors in more detail.

Central London residential market

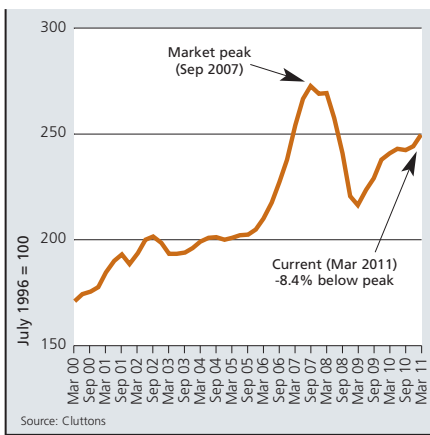
At a national level the weak consumer environment is evident in the housing market. UK house price indices have shown a mixed picture of movements during the first quarter of 2011. Households are choosing to put house moves on hold reflecting the economic uncertainty, while vendors needing to sell are gradually lowering asking prices. However, the paucity of transactions is expected to protect the market from significant falls, with average UK residential prices remaining flat during 2011, before returning to growth in 2012. This average of course masks significant regional variations and the story for London remains altogether different to the national narrative. During 2010, the Cluttons Central London Residential Index recorded house price growth of 2.6%, significantly ahead of the 0.4% decline in prices at a national level as reported by Nationwide. During the first quarter of 2011 the market strengthened, with prices rising 2.5%, compared to 0.6% during the last three months of 2010. On an annualised basis to the end of Q1, prices have risen by 3.8% and now stand at 8.3% below their Q3 2007 peak and 15.6% above the trough of the market experienced in Q1 2009 (graph 5).

The outperformance of prime Central London homes reflects a continued imbalance in the demand and supply equation, with transaction levels remaining severely subdued as households opt to sit tight, further compounding the supply shortage. Economic uncertainty is inevitably impacting confidence in some segments of the market, deterring households from upgrading or moving home. However, it is also evident that even where homeowners are moving for domestic reasons, they are reluctant to sell in the capital and prefer to retain property in order to capture the long-term capital growth premium associated with Central London. This has resulted in a sharp reduction in market activity, with turnover estimated at half that of 2009. The position is hindered further by a sharp slowdown in new residential development in the wake of the global banking crisis and the severe planning restrictions in place in the capital.

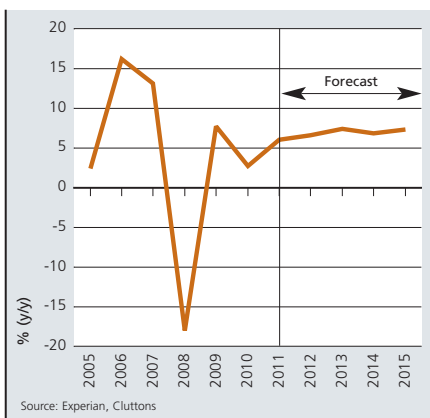
The net effect of this has been an acute shortage of options for the active cohort of homebuyers. International buyers, benefiting from the weak pound, continue to comprise approximately half of demand requirements in the prime core. Purchases are driven by acknowledgement of the long-term capital growth potential, the security offered by the Central London economy and market, as well as the practical need for a home in the capital; perhaps for children attending school or university. This imbalance between supply and demand in the Central London residential market will maintain the price growth until the pace of the global and London economy returns to trend levels. We therefore anticipate price rises of around 6% in 2011, accelerating to 8% in 2012.

The severe constraints in the sales market and growing demand for rental accommodation in Central London drove record rental growth of over 19% in 2011. While this pace of growth slowed to 3.1% during Q1, from 7.3% in Q4; this remains ahead of the long-term quarterly trend. Rents are 4.6% above their peak in Q1 2008 and 22.8% above the trough of the market in Q4 2009. This rate of rental growth is expected to steady to around 8-10% over the coming year, although this will mask variations between markets. While the 2011/12 UK Budget in March provided some support for domestic first-time buyers, the extraordinary challenge of purchasing a first home in London will persist. Certainly there is growing demand for lower budget rental accommodation in the capital reflecting the challenges facing households particularly those saving for deposits for home purchase. Furthermore, relocation budgets have also been squeezed: a sign of global businesses seeking to contain costs. A current upturn in demand in markets perceived to offer greater value will be maintained as both corporate lettings and households carefully monitor costs during 2011. However, the central core remains the main focus for demand and given supply restrictions this market is likely to continue to lead rental performance.

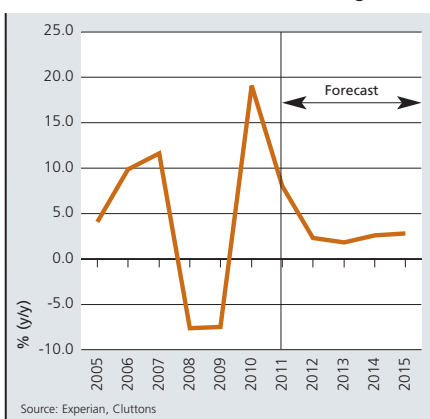
5. Prime London capital value index



6. Cen London residential capital value growth



7. Cen London residential rental value growth



Central London office market

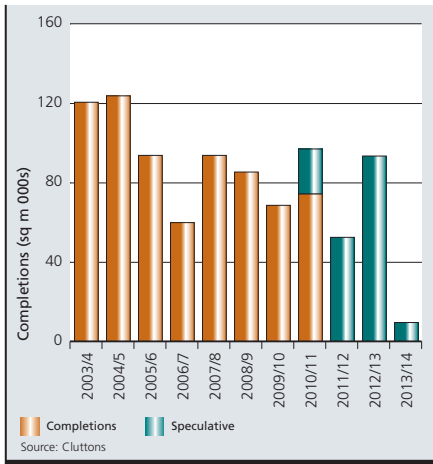
The turning point in the capital's economic fortunes in Q4 2009 translated rapidly into positive activity across the prime Central London office market, with take-up in the West End and City in 2010 increasing by 40% and 44% respectively on that recorded in 2009. The first quarter of 2011 saw occupier activity cool slightly reflecting both the satisfaction of a number of large requirements in the market during 2010 and continuing caution in the occupier environment. Despite the recent tempering of activity, occupiers face severe stock shortages, with the vacancy rate across the West End and City sitting below the long run average.

The strength of the recent recovery is marked. In the current cycle the vacancy rate in the West End peaked at 7.6% in Q3 2009, compared to a high of nearly 9% in previous downturns following the dot com boom. The withdrawal of development finance has been a large contributor to this, restricting options for occupiers. However, since London's economy has remained relatively robust as a result of the greater than perceived diversified nature of the economy, a base line level of take-up persisted even during the worst of the financial turmoil. More than half of the space completed during the last quarter is already let and in some submarkets, such as Soho, the shortage of stock is more acute with a vacancy rate at below 3%. The headline figures mask a highly layered market, with greater availability in grade B space, but very limited grade A options. This pressure will intensify over the next two years given the cohort of occupiers with leases taken out in 2006/07 facing breaks or expiries.

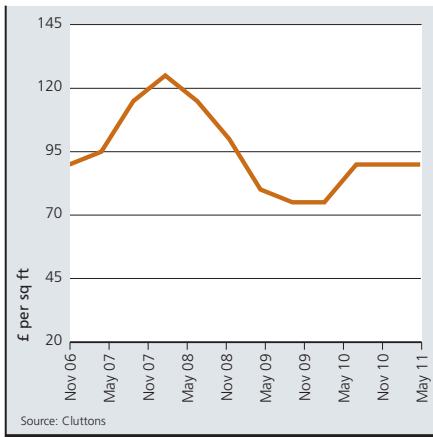
The West End development pipeline continued to improve over the last quarter, resulting in a 12% increase in space under construction, all of which are speculative. This will provide occupiers with some options. However, development activity remains below the 10-year average and over 35% of the pipeline is in the Victoria submarket, with less than 16% in the highly sought core of Mayfair and St James's. The City presents a similar picture, with minimal speculative space currently scheduled for completion beyond 2012. We therefore expect pre-let pressures to stimulate further starts over the coming quarters. This will provide occupiers with the option to secure rents, while also offering them the potential to move to a preferred location within the West End. We forecast rents will rise by an average of just over 8% per annum over the next four years; therefore the need to fix costs early is likely to prove a strong driver.

Investment volumes remain buoyant in both the West End and City markets, as investors look to wealth preservation through good quality stock providing a stable return. Quality investments in the market remain limited and this has left prime West End yields at 4.00%, with transactions in Mayfair and St James's closing in around this figure. Meanwhile, prime City yields remained at 5.25%, sitting 125bps above peak 2007 levels (graph 10). In the face of the persistence of relatively low income returns there is growing interest in the repositioning of investments through the re-development, refurbishment and asset management opportunities presented by more secondary stock, including that outside the prime core. These fringe areas are increasingly attractive to some tenants, offering lower cost, but lively and highly accessible locations. Furthermore, planning changes, which will ease the process of highly valuable office to residential conversions, are resulting in the decommissioning of office stock further denting the supply picture.

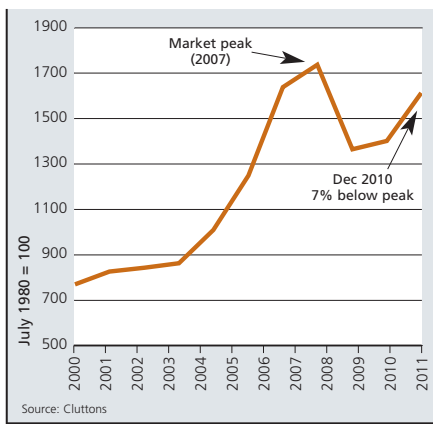
8. West End development pipeline below trend



9. Prime rents steady but growth forecast



10. West End office capital value index



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