CLUTTONS

London property market outlook

October 2011

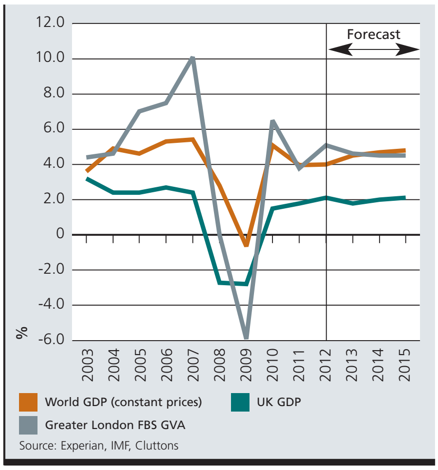
Economic growth despite uncertainty

London maintained its economic strength in the second quarter, moving further ahead of the national picture. While the slowdown in global economic growth is undoubtedly being felt in the business community, it is less apparent amongst households, with buoyant retail sales in the capital and record demand for residential property.

The economic uncertainty is evident in the latest Markit Lloyds TSB London PMI survey which signalled a solid increase in business activity, but also found that the pace of growth eased to a four month low. However, positively for the capital's office market, new orders received showed a marked increase, ahead of both the long run trend and significantly ahead of other UK regions. However, London is not immune to global and domestic economic pressures and the Markit survey reports that businesses in the capital are having to absorb higher costs, while job creation remains flat, although this masks significant variations between business sectors.

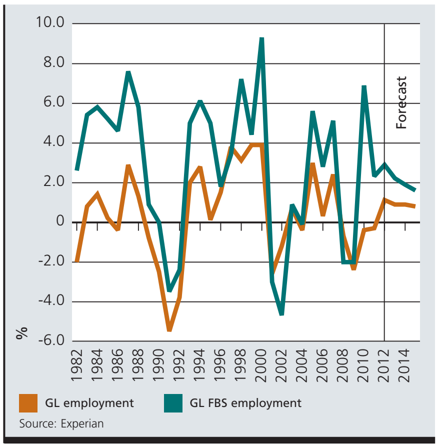
The downward revisions to the UK's economic forecasts for 2011are undoubtedly a cause for concern. The drags on the global economy, in particular that coming from the woes of the Eurozone, will inevitably dent London's economic strength and this is clear in the recent survey evidence. However, the capital's economy and more particularly the financial and business services sector are heavily influenced by the outturn in global trade and economic growth. The latest IMF forecasts demonstrate a clear slowing in global economic output, but at 4% growth this remains positive and will provide London with a strong buffer against the current economic turmoil.

London's economic growth



Source: Experian, IMF, Cluttons

London employment growth



Source: Experian

Mixed fortunes in the Central London office market

The current dynamics are evident in the capital's office market, with economic strength feeding through into the occupier market, although the headline figures mask a mixed picture of performance. The City office market has seen a sharp slow-down in both take-up and occupier requirements. While the demand for floorspace over the next 12 months may improve, requirement estimates should be treated with caution given current economic uncertainty.

In contrast to the City, the West End market experienced a 29% increase in take-up over the quarter, with 78,800 sq m (848,200 sq ft) let. This is nearly 40% ahead of the 10-year average. However, two deals made up nearly a third of the total. Google took 16,968 sq m (182,600 sq ft) in the now fully let Central Saint Giles from Legal & General and Mitsubishi Bank, while Double Negative Ltd took an 8,000 sq m (86,100 sq ft) pre-let at 160 Great Portland Street. Away from these lettings West End occupier sentiment remains very cautious, with demand broadly flat over the quarter and lettings driven by structural events rather than expansion activity given global economic uncertainty. The genuinely new space requirements in the market are dominated by the service industry, particularly the technology sector.

Office availability in both the City and West End fell over the last quarter, but this was more marked in the latter market. The downward trend in availability which started in Q1 2010 was maintained in Q2, when available West End office space fell to a three year low of just 274,800 sq m (2.96 million sq ft). Nearly two thirds of the available space is Grade A, but this is dominated by smaller blocks providing little choice for

occupiers with requirements above 4,000 sq m (43,100 sq ft). This dearth of available space undoubtedly underpinned the market during the 2008 downturn. Good quality space coming to the market is generally going under offer quickly in core West End locations, although there are cases of prime schemes struggling to secure tenants. In the more peripheral submarkets such as Paddington and Victoria space is proving more stubborn to let, although in part this is a function of holding out for target rents.

Office vacancy rates down

Declining availability is evident in the average West End vacancy rate which fell from 5.2% in Q2 to 4.8% this quarter, the lowest level since November 2008. The supply picture is starker in the prime core. Mayfair and St James's have reached their lowest vacancy rates since mid 2008, at 4.2% and 3.3% respectively. The City vacancy rate has also drifted downwards averaging just below 7%. This presents an issue going forward with a significant development pipeline coming through over the next two years, with 278,800 sq m (3 million sq ft) of speculative space currently under construction.

The West End office market has also seen an upturn in the potential development pipeline with a doubling in the amount of office space submitted for planning, with 76,200 sq m (819,700 sq ft) now awaiting permission. Furthermore, there was a 22.5% increase in floorspace achieving consent over the quarter. However, this potential surge in the supply pipeline remains some way off, with space currently under construction stable at 183,600 sq m (1.97 million sq ft). Only one new scheme started on site this quarter at St James's Gateway, 213-214 Piccadilly, to be completed in June 2013.

Supply environment driving office rental outlook

As a result of subdued take up and a more buoyant supply picture, average rents in the City remained stable in the second quarter at £55 per sq ft (£592 per sq m). We expect this trend to be projected forward and forecast rents will grow by an average 1.1% per annum over the period 2012-15 although a softening in the short term is possible. In contrast to the City, the West End office market has seen rental growth maintained in the wake of the depleting supply of quality office space. Average rents increased by 5.5% in the second quarter. This sets them 26.6% above the trough of the market in 2009, but 24% below the peak of the market in Q1 2008.

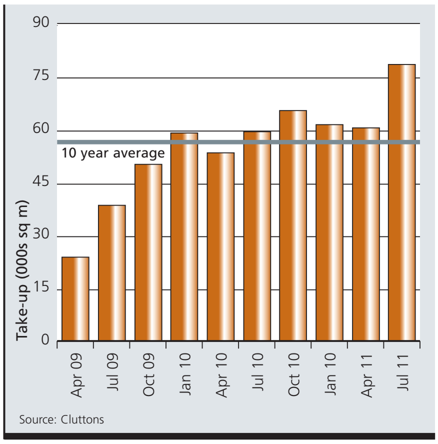
The upturn has been more marked in the West End core with top rents in Mayfair and St James's rising to £95 per sq ft (£1,022 per sq m), from £90 per sq ft (£968 per sq m). Across the other submarkets rents have grown in all but Marylebone and Victoria. While this pace of growth is unlikely to be maintained beyond 2013, we forecast an average 4.9% per annum rental increase from 2012-2015.

Stable office yields but greater focus on rental growth potential

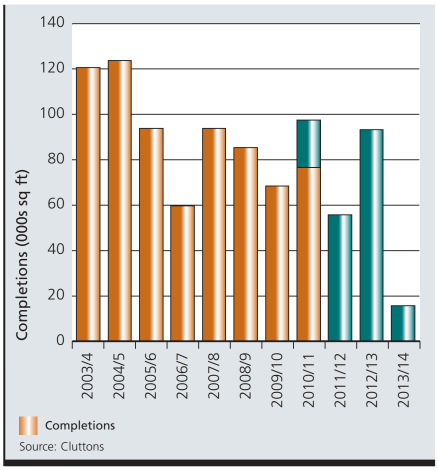
Central London has seen a positive capital flow into the office market over the last 18 months following the 2008 market low. A growing proportion of this is focused on the City due to a greater availability of stock in the market. A total of £5.4 billion of office assets have been transacted in 2011 to mid September, with over 60% of these deals occurring in the City market. This is exemplified by the purchase of 6-8 Bishopsgate by Mitsubishi for a reported price of £95 million, which translates to a yield of just over 7%. The City continues to see more stock come to the market although investors are proving more selective in their purchases given the substantial development pipeline and a degree of concern over rental growth prospects.

Investment activity in the West End also strengthened in Q2 with a 42% increase in volumes transacted, reaching to £962 million. However supply constraints persist, with investor demand for West End offices driven by expectations of future rental growth and a continued preference for prime lower risk assets. This has resulted in low stock levels on the market, driving investment volumes down 21.6% on Q2 2010 and less than half that seen during the peak of the market in early 2007. The severe supply shortage is a characteristic common across most of the West End submarkets, with investment volumes in Mayfair for example, standing 43% below the long run average.

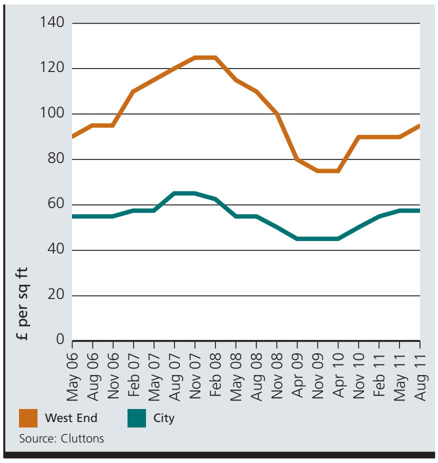
West End take-up



West End office development pipeline



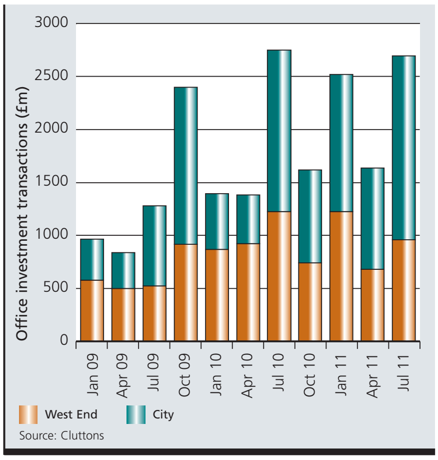
Prime office rents



Overseas investors, benefiting from currency advantages and seeking the security of real assets in prime Central London, continue to dominate the market representing 62% of purchases in Central London by volume in 2011 to date. This dominance is more pronounced in the West End with non UK investors responsible for over 70% of purchases by volume during 2011. This is evidenced by the largest transaction in the West End in Q2, in which PonteGadea Immobiliaria purchased 197-213 Oxford Street, Soho, from Cosgrave Property Group for £160 million, reflecting a yield of 4.51%. In general Canadian and Malaysian funds lead the West End buying league.

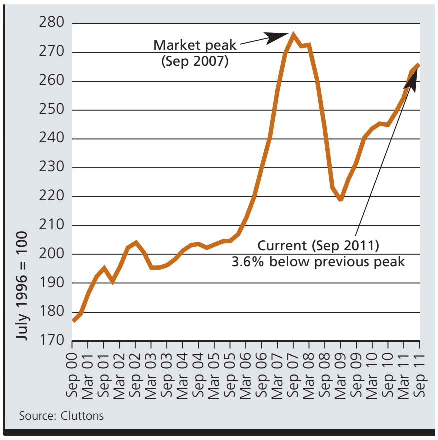
Despite general supply shortages, office values have remained stable across the capital, with prime yields in the City and West End standing at 5.25% and 4.00% respectively. This stability in pricing masks a change in the underlying dynamic. Proven and anticipated rental growth is driving values rather than expectations of further yield compression driven by investor competition. Current global economic dynamics and the prospect of a stronger pound could dent overseas investor demand for UK property in the medium term. However, the pricing impact will be considered against the perceived security offered by prime West End assets in an otherwise uncertain global investment market. Furthermore the fall in swap rates and gilt yields over recent months has provided a cushion for domestic investors, mitigating potential outward pressures on yields.

Central London investment activity



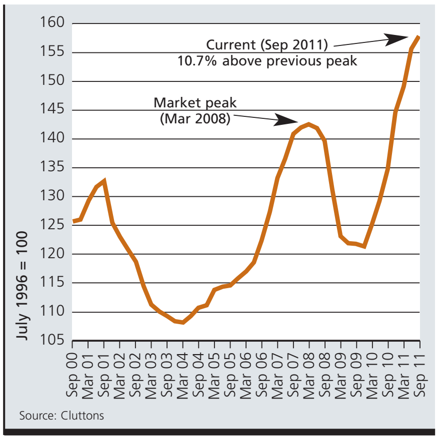
Source: Cluttons

Prime London residential capital value index



Source: Cluttons

Prime London residential rental value index



Source: Cluttons

Record activity in the Central London residential market

In contrast to the cautious activity of the corporate sector in the capital's office market, the residential market is demonstrating a buoyancy not seen since the 2007 market peak. The Central London lettings market has remained active throughout the summer, with demand almost 60% higher than the same time last year. While activity continues to be underpinned by demand at the lower budget end of the lettings spectrum (£250 to £600 per week), there are signs that the budget spread is widening, with strong demand for £325 per week studios in Hyde Park to £8,000 per week large family homes in Holland Park. The strong demand from North African in-movers to London eased over the late summer, but international student demand from September starters has compensated, leaving summer lettings demand at record high levels. Furthermore, demand has also been generated from a continuous flow of new job starters in the City's finance and banking sectors despite uncertainty in the financial markets.

The upturn in rental demand is in contrast to the supply picture which has dipped by a third over the summer months for Central London as a whole. This dynamic is inevitably driving rental value growth which is currently 10.7% above the peak of the market in Q1 2008 and will be 30% above the December 2009 trough by the year end. However, tenants are demonstrating more caution given the economic climate which is placing pressure on household finances. Current rental uplifts are showing signs of slowing, as landlords seek to sacrifice a degree of uplift to maintain occupancy levels. This points to a slowing in rental value increases over the coming quarters and as a result we forecast growth for 2011 will be 11%, easing to an annualised average trend level growth of between 2% and 3% between 2012 and 2015.

The high demand in the letting market is in part a reflection of the continued problems facing potential homebuyers in Central London. Ongoing mortgage finance restrictions, combined with rising capital values since mid 2009, have placed Central London property out of reach of a significant number of buyers. The pace of growth has accelerated during 2011, with year-on-year residential values in the capital growing by 8.6% to the end of Q3, rising by 1% in the third quarter alone, following a 3.5% increase in Q2. This reflects the strong demand in the market which, at the end of Q3, stood almost 50% higher than at the same point last year. This has driven the momentum in sales prices with some submarkets recording deals at levels almost 10% above peak levels. Particularly strong growth was seen in the prime core with price growth over the 12 months to the end of Q3 in South Kensington, Knightsbridge and Chelsea recorded at 11.6%, 14.9% and 15.4% respectively. For Central London as a whole, average residential prices are now just 3.6% below peak levels recorded in Q3

2007, although this looks set to be exceeded by the end of this year. In 2011 we forecast values will rise by close to 9%, slowing to 7% in 2012.

Can supply constraints be eased by office to residential conversions?

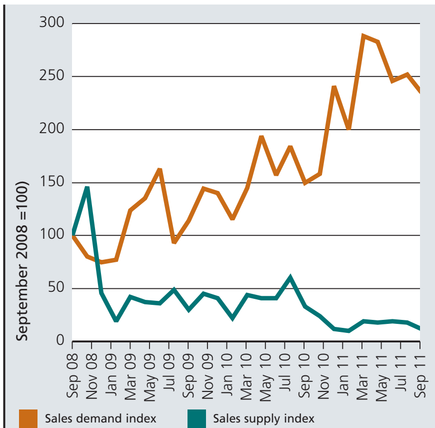
Expectations for capital value growth in the residential market are set against a backdrop of a highly restricted supply in the prime core, a pattern in common with the West End office market. The dearth of residential opportunities is in large part driven by domestic and overseas homeowners retaining assets in a market perceived to offer security in the face of global economic uncertainty. However, the restricted development pipeline over recent years as a result of both limited development finance, and a challenging planning environment in Central London, has compounded the supply issues underpinning price growth.

Driven by a desire to boost housing supply nationally, the government announced in the April 2011 Budget a consultation on a change in the planning treatment of unoccupied commercial buildings with a presumption to allow conversion to residential use. Conversion activity of this nature had largely stalled in the capital over the last decade with many of the prime London boroughs, concerned about the loss of business space, blocking potential applications through their Local Development Frameworks. While the results of the consultation exercise have not yet been published, a number of transactions have pre-empted the outcome. In Q3, over 12% of the total West End office investment volumes were focused on buildings earmarked for residential conversion, whether in the near-term or as leases expire. This is illustrated by the purchase of 66 Chiltern Street W1 by Heron for a residential conversion on lease expiry in 2014. Such transactions assume the relaxation in planning will come through prior to the lease expiry, or a case will be made for formal planning consent.

The potential for conversion is already driving the pricing of Grade B West End office stock, particularly with short leases, due to the disparity in pricing between the commercial and residential sectors which can be double the office equivalent. While the limited supply of new office space in the West End and the subsequent resurgence of rents in this market have reduced the gap between office and residential values, the financial case for conversion stands for appropriate property. This is less the case in the City where the relatively immature residential market attracts greater developer caution.

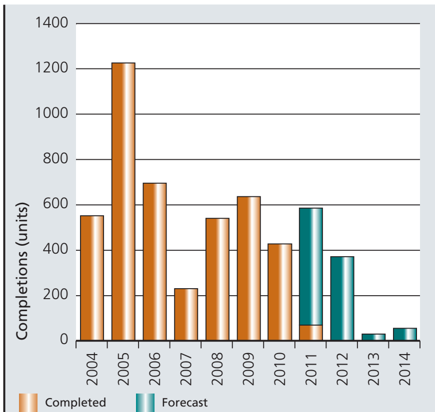
We estimate that in Mayfair almost 23,000 sq m (246,900 sq ft) may potentially be lost to residential use over the coming years, including those schemes at application, with permission, or currently under construction. This is equivalent to six months' worth of take-up and equates to losing 25% of the planned office development pipeline in Mayfair. While there is undoubtedly considerable interest in the potential for conversions, particularly in the West End, the level of activity remains limited, in large part due to ongoing difficulty in securing finance for residential development. However, private investors, including overseas interests, are demonstrating a growing appetite to enter this market on a joint venture basis and this is likely to move a number of schemes forward over the next 12 months. However, it is unlikely that planning barriers will be lifted lightly with Central London boroughs remaining resistant to the policy. The Corporation of London is, for example, lobbying for the square mile in the City to be exempt from the proposals. Given this resistance and continued finance constraints we do not expect to see a surge in conversions in the near term which will maintain values for those that do achieve the go ahead.

Central London residential supply-demand imbalance



Source: Cluttons

Central London housing completions



Source: Egi

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