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London, Summer 2018

OFFICE MARKET OUTLOOK

OCCUPIER MARKET

Headline Rents Hold Steady

During Q2 2018, headline rents in the 18 submarkets we monitor across Central London remained steady. As has been the case since the Brexit referendum, net effective rents have continued to decline as landlords ratchet up incentives to encourage activity.

Rent-free periods on 10-year leases, for instance, stand at two-years in markets like South Quay, Vauxhall & Nine Elms, Paddington, the Eastern City Fringe and the City Core. In Canary Wharf, which we have previously reported on as offering 'good value', 27 month rent free periods on 10-year leases are increasingly common.

MSCI/IPD data for the three months to the end of June for Central London offices mirrors our own experience in the market, with a rental increase of just 0.3% being reported. This now means annual rental value growth over the 12 months to the end of June stands at 1.1%, which is at odds with our experience in the market. Any upward movement in rents has been limited to a handful of best in class schemes in submarkets such as Farringdon, Shoreditch and Paddington.

Q2 2018 Central London vacancy rate

VACANT 5.6%

*Long run average is 7.8%

Source: CoStar

Q2 2018 Central London office investment activity

£5.4 bn

Source: CoStar

Central London office completions

2013	2014	2015	2016	2017	2018
2 million sq ft	4.6 million sq ft	2.6 million sq ft	8 million sq ft	4.6 million sq ft	980,000 sq ft

Source: CoStar

Outlook intrinsically linked to Brexit

New office space being delivered in Central London for the first half of the year (c. 980,000 sq ft) is at the lowest level seen in six or seven years, which has shielded the market to an extent from deeper rent falls.

This compares to the 4.6 million sq ft of office space which was delivered to the market in 2017 and an average of 3.32 million sq ft per annum over the last five years. In terms of the supply pipeline, 11.7 million sq ft of space was under construction as at the end of Q2 (CoStar).

The market's stability is in large part linked to low vacancy rates, which continue to sit well below the long term average of 7.8%, standing at 5.6% at the end of Q2. Take up has also recovered to an extent, falling just shy of 3 million sq ft during the second quarter, which compares to the long run average of 3.51 million sq ft per quarter.

Overall, Brexit linked anxiety is undoubtedly continuing to fuel the market's somewhat static conditions, with the complex EU divorce proceedings driving nervousness amongst occupiers.

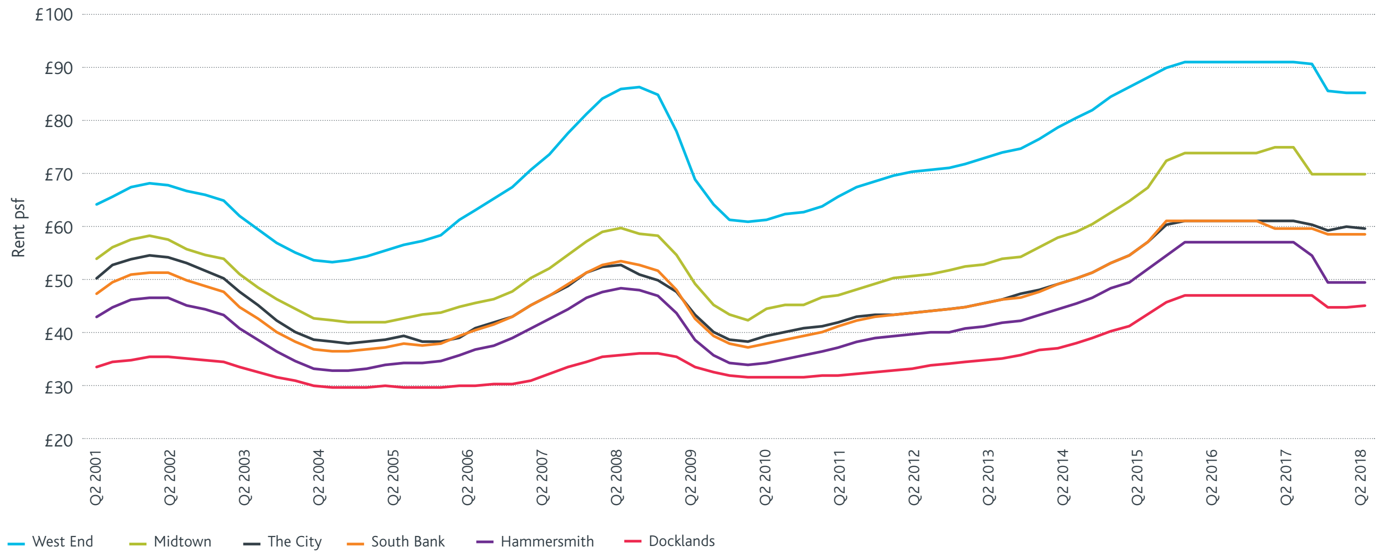
With the UK's departure from the EU now just nine months away, it is likely that we will enter a quieter period for the market as occupiers take stock and move into a holding pattern, similar to what was experienced in the months leading up to the referendum. For the finance and banking sector in particular, the threat of a loss of passporting rights to the EU remains a very real threat. This in turn could undermine demand from this key sector moving forward.

TMT still active

The TMT sector however remains active, with Facebook for instance recently announcing plans to lease 611,000 sq ft at King's Cross Central in 2021. This highlights that not only does best in class space continue to let well, but also that the TMT sector may be Brexit proof to an extent. Still, demand from this sector is unlikely to be able to fully compensate for a reduction in space requirements from other segments of the economy.

With these factors in mind, it is our view that headline rents in key submarkets like the West End will end the year marginally down on 2017, while the City will likely register a drop of close to 5% on average.

Central London office rents



Source: Cluttons

OFFICE INVESTMENT MARKET

Overseas investment rebounds
In the Central London office investment market, deal volumes have recovered substantially from Q1, rising by 125% to £5.4 billion during Q2, the strongest level of Central London office investment activity for 18 months (CoStar).

Overseas investors continue to dominate investment activity, accounting for £3.27 billion worth of deals. Investors from the Far East (£2.5 billion) remain the largest single investor group. As has been the case for a number of years, the total number of Central London office transactions continued to decline, reaching just 41 deals between April and June, compared to 53 deals during Q1 (Property Data).

Buoyed by sterling's weakness and the perception of Brexit as being a domestic political issue, it appears that overseas investors are unphased by the EU negotiations, with the appeal of a trophy asset in London outweighing any Brexit linked concerns. That said, there are signs that some overseas investors with saturated Central London portfolios are not only looking to the regions for better returns, but other asset classes are also gaining popularity.

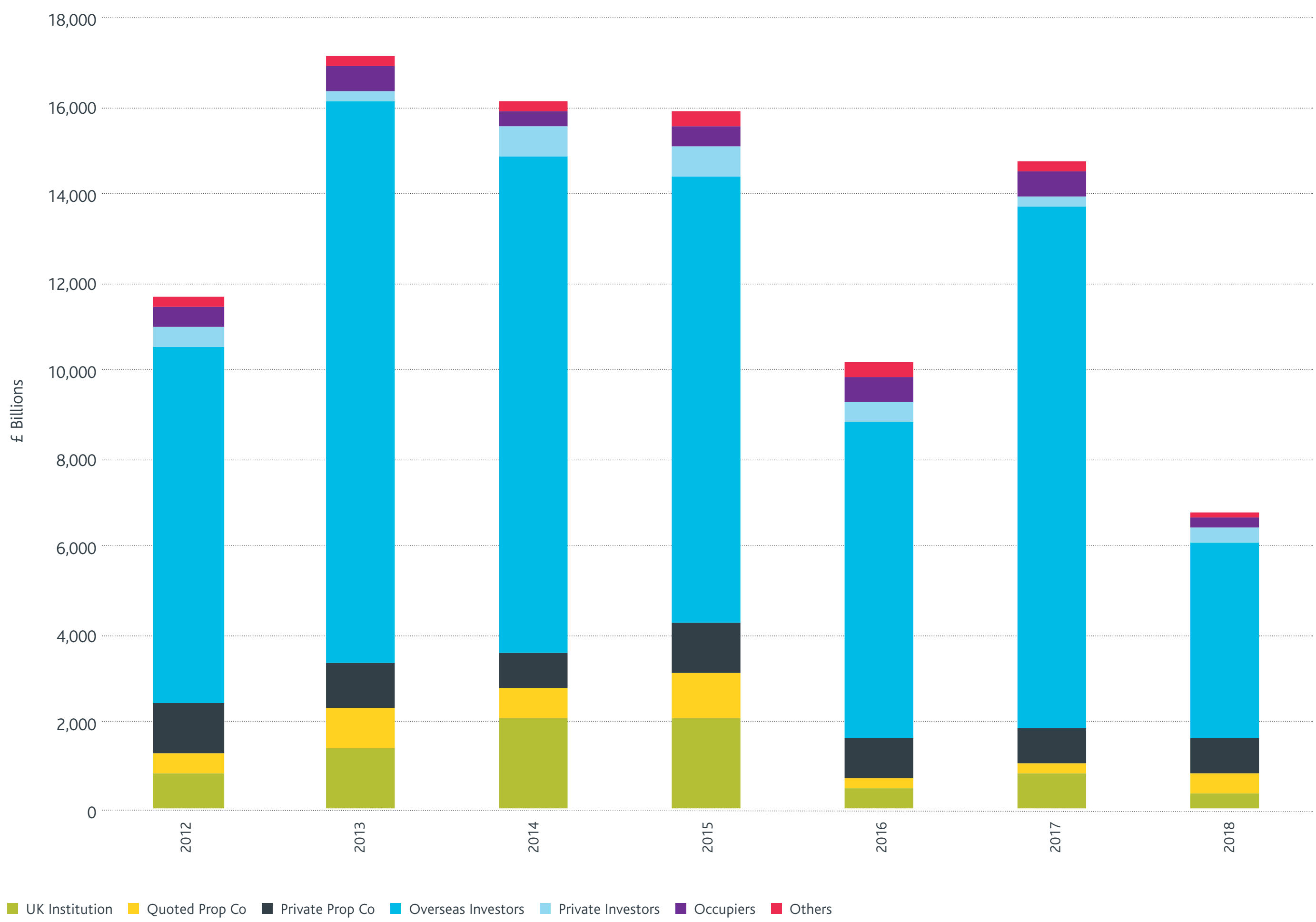
Notwithstanding, with total returns for the 12 months ending June 2018 standing at 6.7% and annualised capital value growth of 3.1% over the same period, the appeal of Central London offices remains strong, outperforming gilts, equities and shares (MSCI/IPD).

However, with capital values expected to recede this year in key markets, albeit marginally, total returns for Central London offices are forecast to dip back to between 0.4% and 0.6%, which may enhance the attractiveness of the regions.

Central London vs national investment market
In contrast, deal activity at a national level has retreated, reaching £4.3 billion in Q2; down from £5.6 billion in Q1. Like previous quarters, UK institutions (£1.4 billion) account for the bulk of activity for all areas excluding London.

Rest of the UK offices (£1.3 billion) dominated commercial transactional activity outside London between April and June (Property Data).

Central London office investment activity



Source: Property Data

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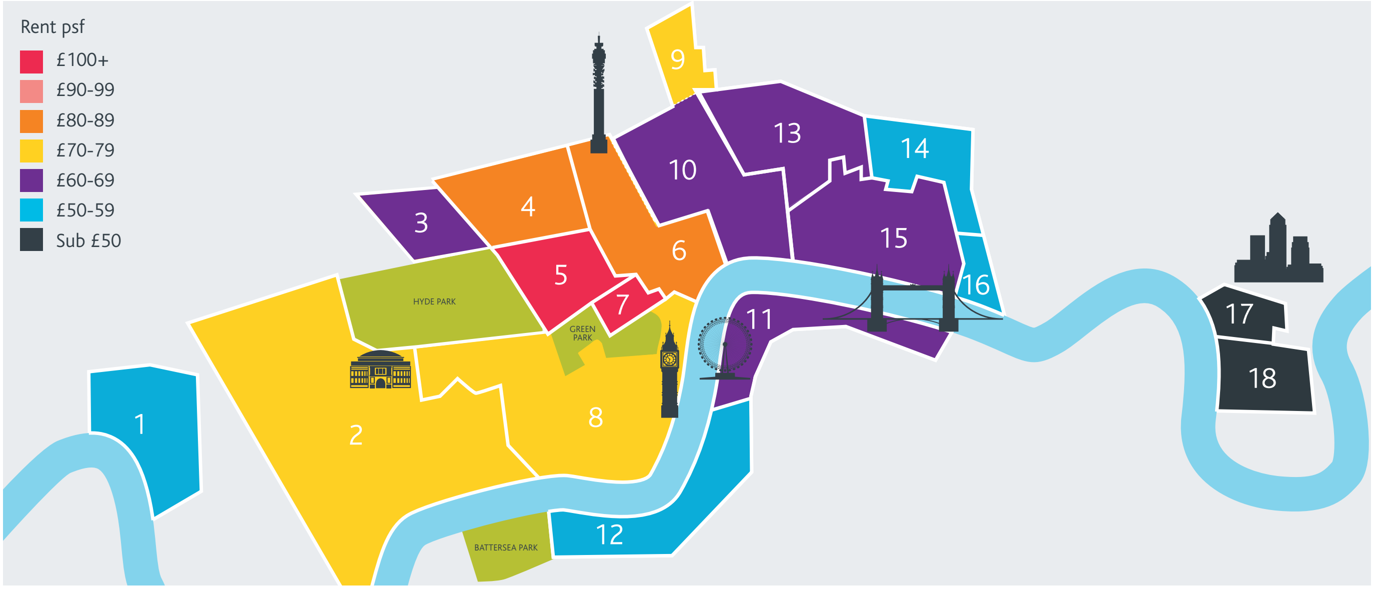
Central London prime office rental market heat map (Q2 2018)



Market	Submarket	Prime headline rent* (£ psf)	Q/Q % change	12 month % change	Prime capital values (£ psf)	Q/Q % change	12 month % change
Hammersmith	1. Hammersmith	50	0.0%	-13.0%	840	0.0%	-6.7%
West End	2. Kensington & Chelsea	70	0.0%	-9.7%	1,150	0.0%	-9.8%
	3. Paddington	63	0.0%	4.2%	1,070	0.0%	1.9%
	4. Marylebone	85	0.0%	-5.6%	1,690	0.0%	-4.8%
	5. Mayfair	110	0.0%	-8.3%	2,500	0.0%	-9.1%
	6. Noho, Soho & Covent Garden	85	0.0%	0.0%	1,600	0.6%	-3.0%
	7. St James's	110	0.0%	-8.3%	2,500	0.0%	-7.4%
	8. Victoria, Westminster, Knightsbridge & Belgravia	73	0.0%	-12.1%	1,260	0.0%	-10.0%
Midtown	9. King's Cross	75	0.0%	-6.3%	1,230	0.0%	-1.6%
	10. Midtown	65	0.0%	-7.1%	1,150	0.0%	-2.1%
Southbank	11. Southbank	65	0.0%	0.0%	1,040	15.6%	18.9%
	12. Vauxhall & Nine Elms	53	0.0%	-4.5%	690	0.0%	-4.8%
City	13. Clerkenwell & Farringdon	65	0.0%	0.0%	1,110	0.0%	3.3%
	14. Old Street & Shoreditch	59	0.0%	0.0%	1,020	0.0%	4.6%
	15. City Core	65	0.0%	-7.1%	1,230	1.6%	-5.4%
	16. Eastern City Fringe	53	0.0%	-4.5%	820	0.0%	-3.5%
Docklands	17. Canary Wharf	43	0.0%	-10.5%	710	2.9%	-8.4%
	18. South Quay	35	0.0%	0.0%	500	0.0%	0.0%

Source: Cluttons

*Rents quoted are headline, not net effective

Prime rents are defined as the top quartile of headline rents: excluding penthouses and floors with large terraces, as well as suites in large, iconic towers.

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