CLUTTONS

# London property market outlook

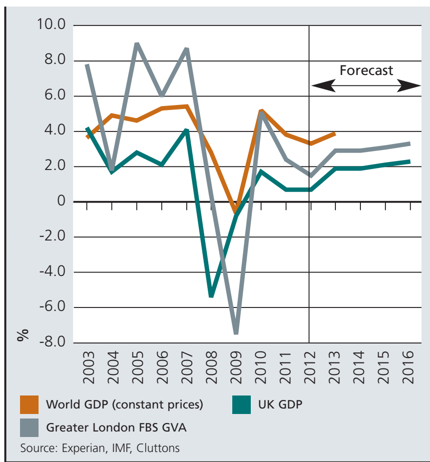
H1 2012

## London stable amidst uncertainty

**The capital's economy has maintained its momentum over the last six months, despite the first quarter of 2012 witnessing the UK economy slide into a historic first of a double dip recession, compounded by the accelerating Euro furore. It will, inevitably, be the evolution of events across the Channel that determines the pace of the UK economic recovery over the year to come; however, London's property market remains robust, attracting international capital looking for a safe haven in uncertain times.**

Against the chaotic economic and political backdrop, the Organisation for Economic Co-operation (OECD) has suggested that despite last quarter's disappointing economic outturn, the UK and German economies may have reached a positive turning point. The OECD's latest forecast is based on its composite leading indicators, which are generally trusted to predict the economic outlook for the next six months. However, it remains the case that, even in the central economic scenario in which the Euro crisis is limited to Greece, the UK economy will deliver mute growth during 2012 which we expect will be in the region of 0.4%, although the risks are of course on the downside.

**London's economic growth**

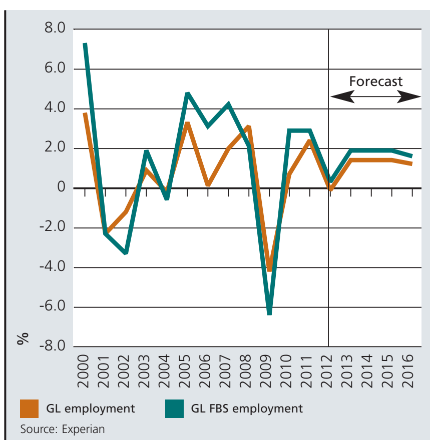


Source: Experian, IMF, Cluttons

The London story remains markedly more positive. The April Markit and Lloyds TSB Commercial Purchasing Managers' Index (PMI) suggests that the London economy continues to show positive growth. The index, while marginally down on strong March figures, remains positive at 54.2. This is reinforced further by a survey by the Confederation of British Industry and PwC which reported an increase in employment in the financial sector, while the Reed Job Index for the capital is currently 7% ahead of the same point last year, although again this reflects a slowing from earlier in the year.

However, external factors will inevitably impact on the capital. The escalating Eurozone crisis and associated political uncertainties will linger for some time to come and have taken their toll on stock market performance. Despite this, expectations for global economic growth have improved in recent months with positive news from some emerging markets and the US. This is crucial for London's economic strength. The slack imposed by Europe's insipid growth story will be absorbed, in part at least, by activity outside the continent, with emerging markets a critical growth driver of the capital's activity and prosperity. Furthermore, uncertainty in the financial markets has reaffirmed attention on prime real estate assets, including Central London offices and residential property investments.

**London employment growth**



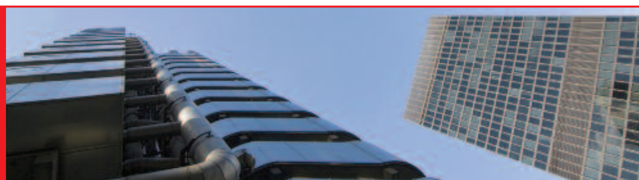
Source: Experian

### Subdued office occupier environment

Given the economic and political backdrop, the Central London office market has, understandably, seen an uncertain start to 2012. Caution remains in the financial services sector where there is still considerable slack in the existing space occupied. This is taking its toll on the City office market in particular, where take-up in the first quarter was down on that recorded in Q4 2011, well below the long run average. There are signs of an upturn in corporate demand for space in the financial centre, although it is notable that the TMT sector has proven a welcome supplement to the traditional financial and banking occupiers.

Over the last year, the core West End office market has shown tentative signs of recovery with a sharp increase in take-up in Q4. However, this has been followed by a





slowing in activity in the first quarter, when lettings fell by 18%. This reflected a total of 62,700 sq m (674,900 sq ft) let, and while down, took activity to almost 10% ahead of the ten year average. The majority of lettings were of Grade A office space. The largest was at 1a Page Street, where Burberry took 11,000 sq m (118,400 sq ft) of office space across the entire building on a pre-let from Derwent London plc. The fashion firm will pay an average of £44.92 per sq ft (£484 per sq m) on a 20 year lease in the newly refurbished building.

Available office space increased by slightly over 25% across the core West End market to 265,000 sq m (2.85 million sq ft). This was driven by a number of new offices with floorspace of over 15,000 sq m (16,500 sq ft) coming to the market. This space, the majority of which is Grade A, resulted in an increase in the vacancy rate to 4.6%. This compares to 3.7% in Q4, although still remains well short of the picture at the trough of the market when the vacancy rate stood at 7.5%. This contrasts the City office market where the vacancy rate is falling slowly as excess supply is gradually absorbed, but remains close to 7%.

## TMT sector active

Even in the more positive West End market the shortage of space has been driven by supply constraints rather than buoyant occupier activity. A cautious mood continues to characterise the market; corporates remain extremely wary, with lease events dominating demand, rather than new requirements for space. The TMT sector remains a key source of demand following the satisfaction of the Telefonica requirement in December 2011 at Crown Estate's AirW1. This has been followed by Halfords Media (UK) Limited taking a further 2,787 sq m (30,000 sq ft), while Nokia took 5,435 sq m (58,500 sq ft) at 2 Kingdom Street in Paddington early this year. However, while important, the demand potential generated by this business sector should not be overstated, with its recent prominence in large part driven by the very thin demand from other segments of the traditional West End market.

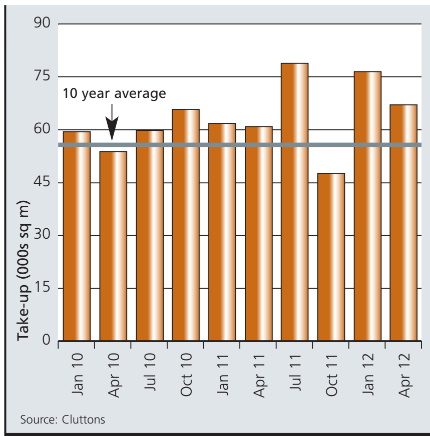
Hedge funds for example, core players in prime markets over recent years, even throughout the recession, have taken a marked step back. While demand for small suites of up to 232 sq m (2,500 sq ft) remains robust, mid sized firms in this sector are showing extreme caution and have generally put requirements on hold. This caution is taking its toll on current take up activity in the prime core, with schemes which were enjoying a steady pace of lettings seeing active demand slip away.

## Value and vitality drive rental growth

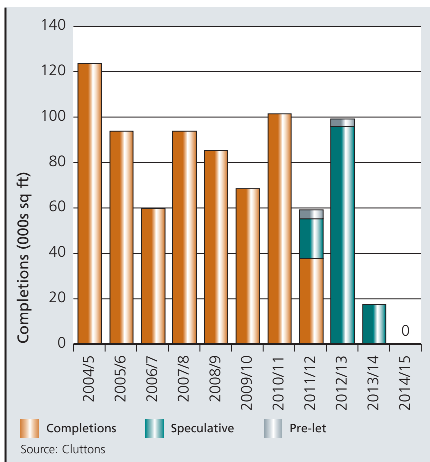
While demand in the prime Mayfair and St James's market has proved more mute over recent months given caution amongst the wealth and hedge funds, submarkets outside the core including the 'Cool Crescent' of Noho, Marylebone, Soho and Covent Garden, are seeing growing demand from a broad range of occupiers. These areas are perceived to offer value in a difficult economic climate, but each also hold strong as locations in their own right. The importance of space and local environs is also illustrated by Google's rumoured move out of Victoria to King's Cross. Such lettings have driven down vacancy levels in these markets with Noho/Fitzrovia, for example, recording just 1.5% at the end of Q1, the lowest level for six years.

Despite a marginal increase in the space under construction in the West End in Q1 to 141,400 sq m (1.52 million sq ft), 31% below the ten year average, even a small improvement in corporate activity this year and next could have a marked impact on rental growth. The upturn in demand in the edge of core market such as the South Bank has served to quickly absorb available supply. This has driven rental pressure, rising by an average of 6% in the 'Cool Crescent' in the six months to the end of Q1 alone, resulting in greater uniformity in pricing across the West End quality fringe sub-markets. This is illustrated in a letting at 24-27 Great Pulteney Street, where the hedge fund Zebedee Capital Limited took 308 sq m (3,311 sq ft) at a rent of £90 per sq ft after competitive bidding.

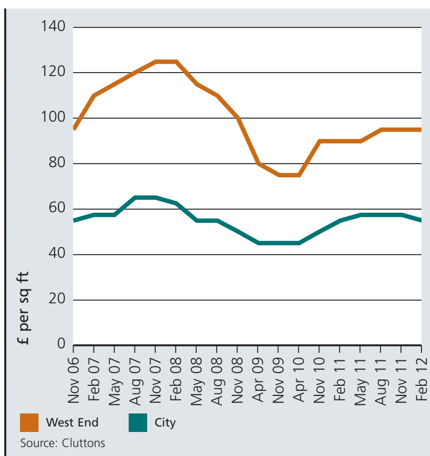
**West End take-up**




**West End office development pipeline**




**Prime office rents**



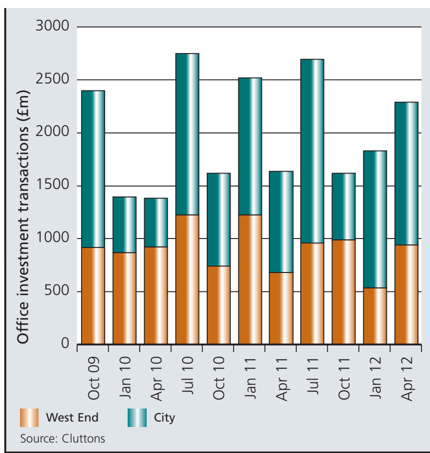
Prime rents in the core Mayfair/St James's market have remained stable at £95 per sq ft (£1,022 per sq m) for three quarters, and we expect little change this year. This will however mask further growth in those edge of core sub markets offering both value and vitality, driving an upturn in average rents of around 2-3%. The City office market will face greater challenges, even with a quick resolution to the Euro crisis, with at best flat growth in average rents this year but greater downside risk given the renewed threat to the financial sector.

## Residential aspirations take hold in the West End

A challenging funding environment, combined with a limited number of investments in the market, resulted in a dip in Q4 transaction volumes to £534.9 million, down 46% on Q3 and less than half that seen in the last quarter of 2010. However the new year saw the market return with vigour. We saw a sharp increase in investment activity in the first quarter, with volumes 40% up on the last quarter of 2011. The focus of activity was dominated by the West End which saw a 125% increase in activity, while the City office market experienced a mere 4% upturn, reflecting investor caution towards financial occupiers. However the upturn in activity should not be overstated. Central London investment volumes during the six months to the end of Q1 2012 were in line with the previous six months and levels remain thin when compared to the peak of the market, with the value only two thirds of that in 2007 when over £19 billion was transacted.

Purchase activity to date in 2012 shows the continued dominance of overseas investors, responsible for 88% and 60% of deals in the City and West End office markets respectively. Their focus remains on core prime assets although there are examples of investors looking to deliver capital returns through development or refurbishment activity. The West End market has seen a sharp upturn in activity by private and public property companies benefiting from replenished cash coffers, focusing on assets with the potential for refurbishment or conversion to residential use.

**Central London investment activity**

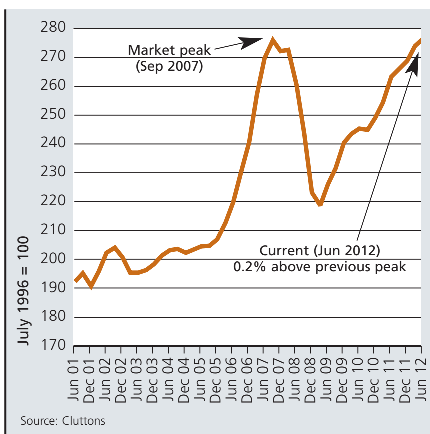



## Capital raising compensates for Euro driven debt constraints

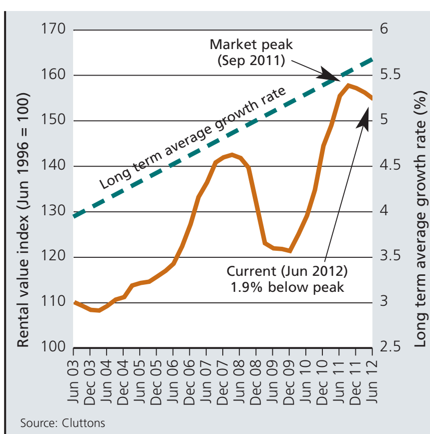
The recent upturn in investment activity has occurred despite fresh constraints on finance following the renewed uncertainty surrounding the sustainability of the Eurozone which again came to the fore in Q4 2011. Transactions over recent months have been slower to pass through the financing system. More significantly, with many investors not reliant on finance for purchase, but wanting to reserve that option for the future, the tighter finance environment has derailed a number of transactions, pushing them down the line to second and third bidders. Given banking sector uncertainty we may well see a further retraction of debt for all but prime well let assets.

While renewed risk has thinned the Central London investor pool, multiple bidders remain on the few investments that do come to the market pushing well capitalised investors to look towards development to build portfolios. The UK listed REIT Great Portland Estate is to raise £150m in a rights issue to expand its estate through the development of seven London sites for £53m. This will potentially include the development on the former Royal Mail Rathbone Place site, W1, which it bought for £120m in 2013, as well as speculative starts on buildings in the West End and City. Likewise West End REIT Shaftesbury, which owns 470 properties in the central core, is also considering raising capital to develop new clusters or villages in its core locations. Looking ahead, it is not clear how the Eurozone crisis will impact on investor capital flows going forward, however current evidence suggests that London's safe haven status will be reinforced. The depth of capital in the market, combined with an extremely tight occupier environment, will underpin prime yields in the Central London office market over the coming 12 months, with the West End market and environs forming the focus of attention.

**Prime London residential capital value index**




**Prime London residential rental value index**




## Uncertainty drives demand for prime residential assets

Global economic and financial instability has shown itself in the prime Central London residential market. Supply levels in the sales market remain close to an historic low as home owners and investors alike sit on prime assets in the face of economic uncertainty

and instability in the financial markets. The same drivers are stimulating intense demand pressures from investors and home hunters and this ongoing imbalance between supply and demand pushed house prices in Central London up by 1.9% in the first quarter, taking annualised growth to 7.7%.

Securing finance and accumulating the necessary deposit remain major hurdles for purchasers; however there is evidence of an upturn in first time buyers in the capital. Furthermore the 'Bank of Mum and Dad' is being supplemented by other older relatives coming to the rescue of younger house hunters. Domestic buyers continue to dominate demand; however the proportion of overseas buyers, estimated to be 20% of all buyers in the capital, rises to between 35% and 40% for properties valued over £5 million. The reputation and security offered by a prime Central London asset continue to drive such inward investment, with overseas buyers keen to secure part of their savings in the capital given events elsewhere. Certainly we have seen an upturn in Greek, Italian and even French buyers in recent months.

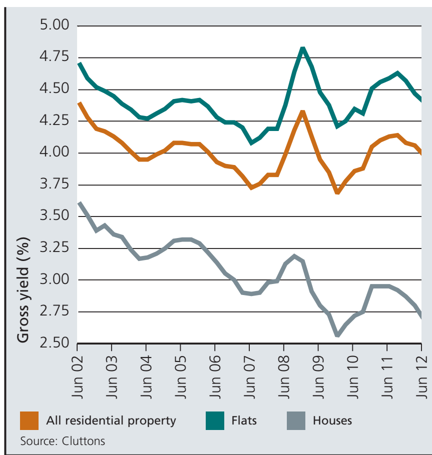
With no immediate relief to the supply drought in sight, house prices are expected to grow by 2% to 3% this year. The full impact of the new 7% stamp duty on purchases valued over £2 million (and 15% for those buying in the name of a company) may not be felt for a few months, but it will inevitably impact on the borderline properties at the higher end of the market. This, coupled with the disruption of day-to-day life in the capital during the action-packed summer months will compress the market window, with buyer activity resuming in earnest during the autumn. Despite this, we project that average values will end the year above the pre-recession peak (Q3 2007), albeit with aforementioned downside risks.

## Residential rents return to trend

In contrast to the sales market, the Central London rental market has seen demand weaken. Job losses in the City's finance and banking sectors have combined with growing budget pressures on prospective tenants who have faced sharp inflation in the sector since 2010, pushing rents 9.6% above their Q1 2008 peak. This has driven demand in lower cost locations and also stimulated a greater degree of sharing amongst young and not so young professionals. New areas of demand are however coming through, with rising requirements for example from the ICT, entertainment and oil & gas sectors, compensating for declines in other tenant segments.

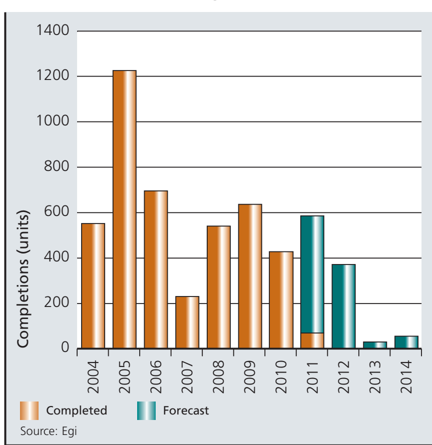
Despite recent readjustments in rental levels back to trend trajectory super growth last year, we have seen the long term average rental growth increase over time, now standing at 5%, well ahead of inflation. This has been driven by the capital's close relationship to global economic trends underpinning growing demand for housing in the capital which is reflected in the growth in rents and capital values. The long run story for Central London residential investment is persuasive. According to Investment Property Databank (IPD), the sector delivered an annualised total return of 9.8% for the 10 year period to the end of 2011, with a return of 14.1% in the capital in 2011. This said stock picking remains important. The Cluttons residential yield index shows a marginal fall in the average prime Central London residential yield to 4.06% in Q1, whilst out-performance was seen in Maida Vale, St John's Wood and Hampstead, all in Central North West, with gross yields of 6.91%, 6.67% and 6.39% respectively.

**Prime Central London gross residential yields**



Source: Cluttons

**Central London housing completions**



Source: Egi

## Contacts


| | | | |
|---|---|---|---|
| Ross Owen | Investment | ross.owen@cluttons.com | 020 7647 7186 |
| Tim Warren | Investment | tim.warren@cluttons.com | 020 7647 7156 |
| James Hyman | Sales | james.hyman@cluttons.com | 020 7407 3669 |
| Lynn Hilton | Lettings | lynn.hilton@cluttons.com | 020 7647 7280 |
| Sue Foxley | Research | sue.foxley@cluttons.com | 020 7647 7023 |




Whilst every effort has been made to ensure the accuracy of the data and other material contained in this report, Cluttons LLP does not accept any liability (whether in contract, tort or otherwise) to any person for any loss or damage suffered as a result of any errors or omissions. The information, opinions and forecasts set out herein should not be relied upon to replace professional advice on specific matters and no responsibility for loss occasioned to any person acting, or refraining from acting, as a result of any material in this publication can be accepted by Cluttons LLP. © Cluttons LLP 2012