Research & Strategy

The case for investing in London and the UK's key regional city office markets

cordeasavills

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1. Key conclusions

- Strengthening economic fundamentals and rental growth will drive performance in London
- Average 'Big 6' (Birmingham, Manchester, Leeds, Edinburgh, Glasgow, Bristol) regional city office yields are stabilising and prime regional offices yield compression is forecast
- The shortage of high quality supply combined with increasing take up will result in an improving outlook for the regional markets. Expected economic growth may result in rents and capital growth rebounding faster than forecast
- We see opportunities in cities which have strong clusters of employment in technology, pharmaceuticals, oil, insurance and finance sectors.
- Investors and especially UK institutions priced out of Central London are already active in the regions and are targeting higher yielding properties
- We see opportunities to invest in Core and Core-plus strategies and assets in the regions and Core-plus and added value opportunities in London
- Downside risks such as - external shocks in the Eurozone, emerging markets and rising gilt yields could negatively impact the UK investment markets

➡ The case for London continues to be strong

➡ History indicates demand ripples out to the regions as the economy recovers

➡ Will history repeat itself? Yes - due to the fundamentals; demand/supply balance, employment and investment

➡ Are the regions priced accordingly? Yes - higher yields compensate for lagged recovery and illiquidity

➡ Investment has started to pick up from a low base in anticipation

➡ Regional markets are recovering – it is good time to invest

2. Strategies – buy and sell recommendations

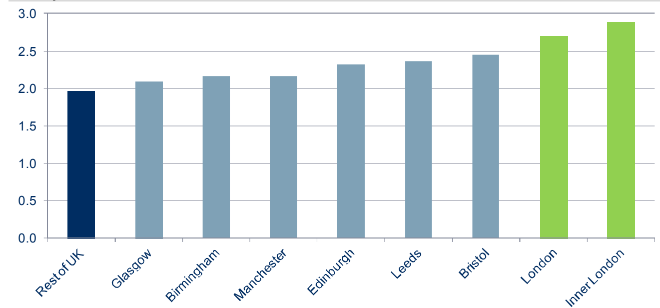
Buy

- Modern/new buildings that are rack rented
  - Preference for good quality buildings in under-supplied locations
- Refurbishment / development opportunities in CBD regional locations
- Buildings with alternative use on planning
- Preference for fringe West End and City location over core West End and City due to concerns over pricing in the West End and supply in the City
- Target pockets of stronger demand, led by the growing sectors such as
  - TMT / digital - M4/M25 West
  - Tech - university cities e.g. Oxford, Cambridge
  - Oil / offshore industries – Aberdeen
  - Finance / insurance – London, Edinburgh CBD

Sell

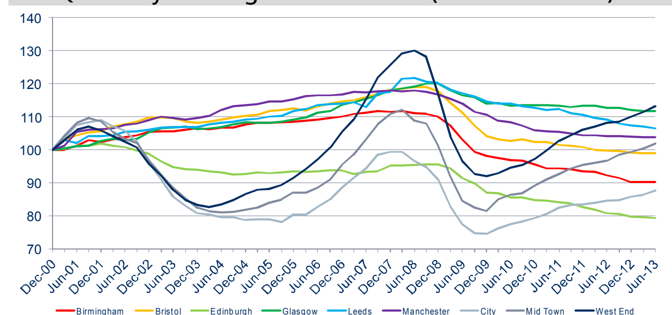
- Older secondary/tertiary offices they tend to have high vacancy, shorter leases and / or to be over-rented
  - Capex requirements are often underestimated
- Locations / properties most affected by office based public sector employment cutbacks (e.g. Non-CBD as Newcastle and Liverpool)
- Business parks outside of London that are constrained by higher voids, incentives and rental discounts, which we believe is not currently fully reflected in the price (higher cap rates)

Chart 1: London economy forecast to outperform but all major cities to benefit from growth – GDP 5 year forecast (% p.a. 2013 -17)



Source: Oxford Economics, June 2013

Chart 2 – Rents already rising in London while the 'Big 6' lag. IPD Quarterly rental growth indexed (End 2000 = 100)



Source IPD

3. The case for investing in London and the UK's key regional city office markets

Favourable economic outlook drives occupier demand

- Rising sentiment indicators and positive economic data are pointing to a sustained recovery
- London is forecast to continue to outperform the UK
- GDP growth in the 'Big 6' cities is also expected to surpass the 'Rest of the UK' (see chart 1)
- An improving outlook is expected to underpin occupier demand in the UK largest office markets

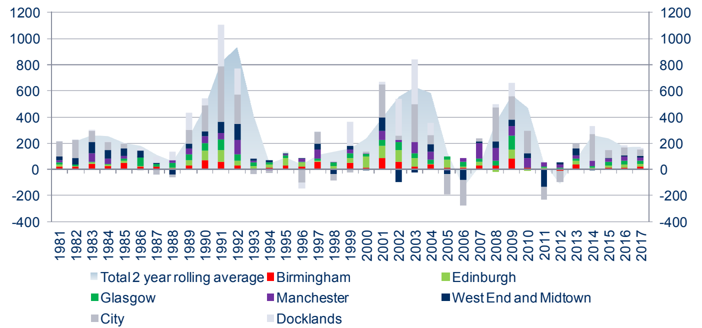
London has seen a strong economic recovery

- London has benefited from increased demand from international occupiers attracted by London's global city status and clusters of highly skilled employees
- This has fed a 'virtuous circle' attracting further business activity to the capital (e.g. insurance, technology)
- Office employment growth, which has been significantly higher than the UK average, has driven demand for space
- The impact of rising demand with a 'fixed' short term supply has reduced vacant stock and triggered an increase in rents resulting in a cyclical recovery in rental levels (see chart 2)
- As high land values prohibit developers from land banking, the recovery in rents in the City has led to the simultaneous construction of a number of new towers which will result in an increase in the supply of Grade A space (see chart 3)
- We expect new supply to limit rental growth in the City in the medium to longer term
- Supply remains restricted in the West End where strict planning limitations support further rental growth

Regions - demand strengthening and lack of new supply to result in a sharper rental rebound

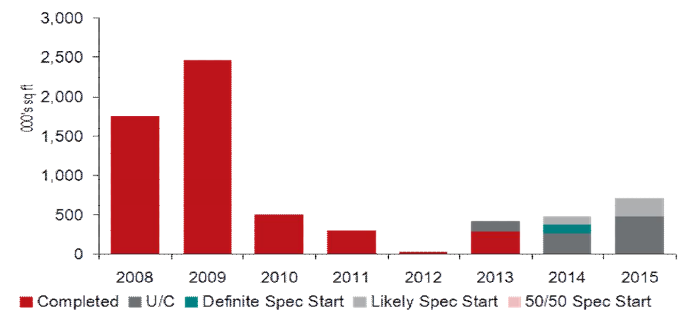
- Occupier demand in the major regional office markets started to strengthen in H1 2013. JLL report that leasing volumes have been boosted by an increase in both the volume and number of larger deals, resulting in a significant increase in the average deal size
- The lack of new construction over the past four years combined with improving take-up has resulted in lower availability of quality space, which will limit further falls in rents in existing properties
- In many areas rents are below the threshold levels required for developers to supply new stock, and even when this threshold is reached, we expect a lag period of 2-3 years before supply and demand reach a new equilibrium
- Regional rental recovery will lag London. However, as occupier demand improves, the lack of new build space is expected to result in a stronger rental rebound for the best space
- On the upside, if economic growth accelerates more strongly than anticipated, rents and capital growth will rebound quicker than forecast

Chart 3 – Less new supply than previous cycles
Net additions (000s sqm net)



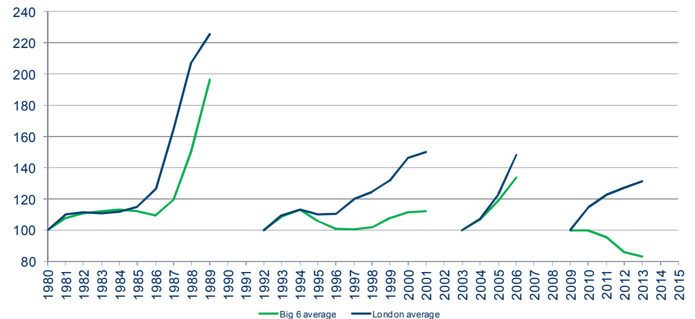
Source: PMA (Spring 2013 forecast)

Chart 4 – Regional development remains restricted
'Big 6' completions and speculative development



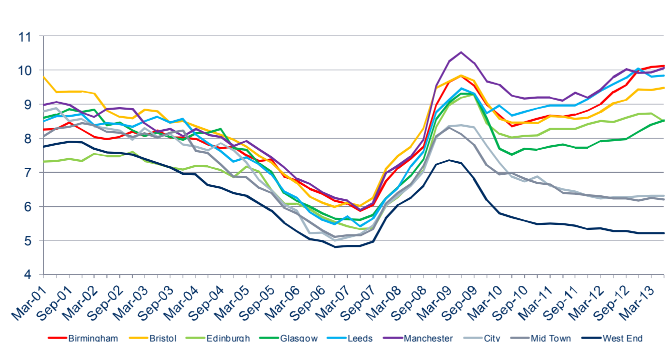
Source: JLL

Chart 5 – Capital values - ripple out from London
Annual capital growth re-indexed (100= '80, '92, 03, 09)



Source: IPD

Chart 6 - Equivalent yields continue to diverge
IPD Quarterly equivalent yield (% pa)



Source: IPD

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Pricing – divergence in yields and capital values

- Historically regional rental growth has lagged London and investment has rippled out from the capital, resulting in the build-up in regional capital values lagging those in London (Chart 5)
- Over the last few years IPD All Office commercial capital values have broadly tracked sideways. However, this is misleading due to regional differences, with capital values rising in London, due to rental growth and yield compression, which has off-set falls in the regions, where yields have moved out (see charts 6 and 7).
- City, Midtown & West End average office yields are currently below their average whilst the 'Big 6' average office yields remain above their long term average (see chart 8)
- Latest transactions data suggest that the yield gap between primary and secondary offices is starting to narrow

Weight of money starting to flow into the regions

- Equity from overseas investors continues to flow into the UK
- Much of this equity continues to target London, which is the largest, most transparent and liquid market and has safe-haven status
- Investment volumes in the regions have diverged from London since end-2010. However, regional investment volumes have started to pick up (see chart 9)

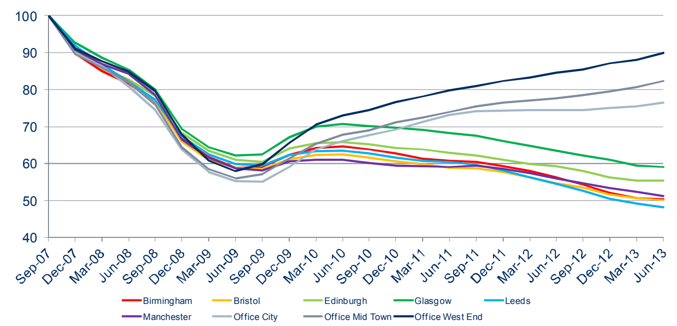
Total returns in key regional cities turning positive

- Following a period of capital declines, the weighted average 'Big 6' total return has re-entered positive territory as capital declines have lessened
- Over the long run (1981-2012), capital growth has been positive for the 'Big 6' and Central London, but income returns have been higher in the 'Big 6' than in Central London (see chart 10)
- We expect rental growth to outperform in Average Central London compared with average regional offices. However, the best prime regional offices markets are forecast to outperform prime London due to forecasted inward yield shift

London and key regional markets well positioned to benefit from a sustained economic recovery

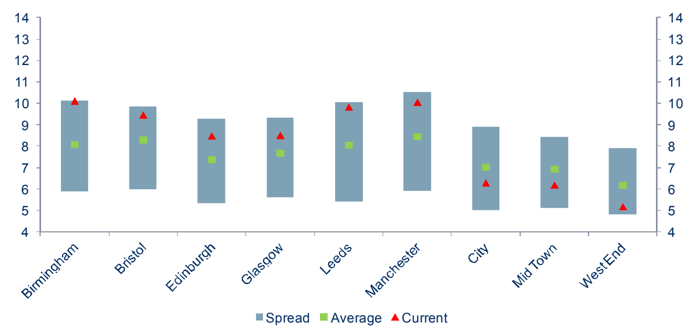
- Based on previous cycles, rents do not actually need to be rising, or even to be at a floor, for yields to start falling
- Lower yields can start to boost capital values before occupier recovery has fully taken hold
- Prime office capital values in the Big 6 regional cities have started to recover, but are still about 29% below their 2007 peak and we believe look well-placed to recover
- Prime London offices estimated capital values remain 14% below their 2007 peak, a similar level to Paris (-11%) and in marked contrast to Frankfurt (+1%) and Munich (+20%)
- We remain optimistic about London. With the economy continuing to recover we expect a ripple into the regions. This bodes well for rental growth upside.

Chart 7 – Capital value recovery has diverged this cycle
Capital value indexed (recent peak (Sep 07) = 100)



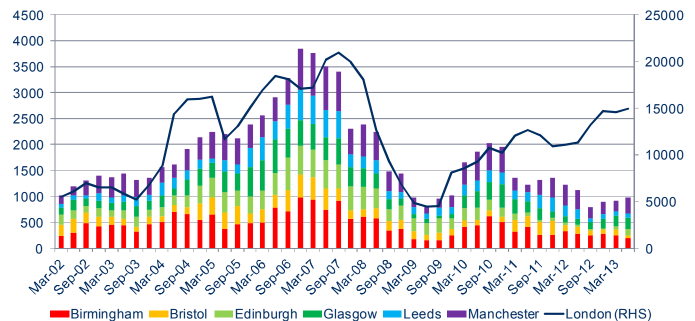
Source: IPD

Chart 8 – Regional yields above historic average
IPD Quarterly equivalent yield (%, Mar-01 to Jun-13)



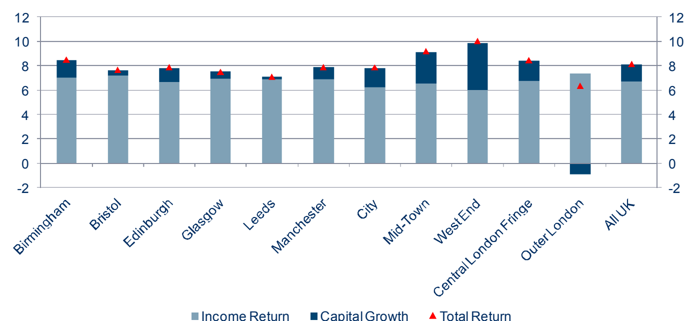
Source: IPD

Chart 9 – Regional office investment volumes returning to growth (12 month rolling, GBP million)



Source: Real Capital Analytics (Note: Deal lot size in excess o USD 7.5 million)

Chart 10 – IPD Annual average income return, capital growth and total return (% pa, 1981-2012)



Source: IPD

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