AXA IM – Real Assets

London office update

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London office rental values have held firm and pricing has recovered despite the fact that aggregate demand has declined.[1] New sources of office demand are emerging, and these companies have demonstrated a commitment to central London. Although heightened uncertainty in the short term could result in softening fundamentals, AXA IM – Real Assets remains optimistic that central London will weather the storm and remain a key global city.

U.K. economy expected to shift down a gear

The performance of the U.K. economy after the EU referendum was surprisingly positive, growing in real terms by 2.0 percent in 2016.[2] This exceeded the performance of the U.S., Germany and Japan. However, signs of softer growth emerged[3] in Q1 2017, specifically in retail sales, where growth has been weakening since the end of 2016. Meanwhile, business confidence has recovered from the Q2 2016 trough, but it is yet to be determined whether this will translate into increased business investment, an important factor for office market growth.

Aggregate office demand is weaker, but occupiers continue to show support for central London

Central London office tenant demand peaked in 2014,[1] in line with real GDP growth. On the whole, central London office leasing declined sharply in 2016, with the trough in Q2 during the run up to the EU referendum. However, pent-up demand due to a recovery in business confidence drove a strong rebound in leasing during Q4 2016.[1] By the end of Q1 2017, aggregate office leasing had fallen further, declining 20 percent during the quarter to 2.5 million sq. ft. compared with the same period a year ago, and was approximately 16 percent lower than the 10-year quarterly average.[1]

Net office absorption also declined at the beginning of 2016. AXA IM – Real Assets expects a period of negative absorption in central London over the next two years, driven by subleasing and the return of older stock to the market as tenants upgrade. New speculative space, as well as the return of older office stock, has resulted in increased availability, forcing the vacancy rate up from 2.6 percent in Q1 2016 to 4.6 percent in Q1 2017.[1]

Recently, central London's office market demand drivers have changed. Between 2005 and 2010, banking & finance accounted for nearly 40 percent of total office leasing in the City. However, between 2011 and 2016, this proportion declined to 26 percent. Creative industries have seen their share of space rise from 12 percent to 18 percent over the same period.[4] The other significant driver of demand has been business services, where leasing activity rose to 18 percent from 8 percent,[1] again over the same periods. This trend of shrinking demand from finance and growing demand from creative industries is likely to continue in the medium term and not only in London, but also in other cities globally, such as New York.

Supply to dampen headline rental values short term, developers potentially become tentative

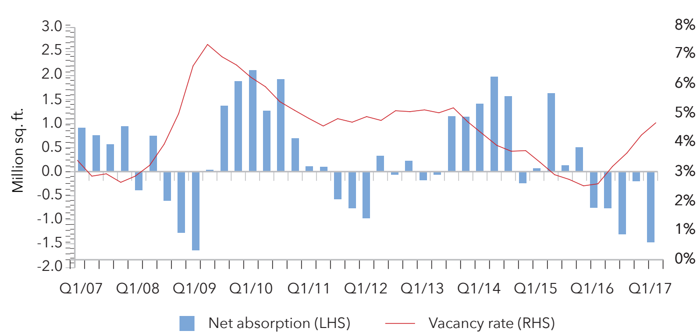
Office development in central London has been widely reported, particularly in the City. AXA IM – Real Assets has reviewed the City supply pipeline through 2019 and believes that the amount of new supply estimated to be delivered has decreased by approximately 30 percent compared to before the referendum.[5] This new supply estimate includes a pipeline of approximately 8.5 million sq. ft. due to come to market between 2017 and the end of 2019, 3.9 million sq. ft. of which has not yet been leased. By way of background, 2016 leasing activity in the City totaled approximately 4.7 million sq. ft., compared to the 10-year average of 4.9 million sq. ft. p.a.[6] Therefore, the potential supply represents a little over 20 months of average leasing activity, suggesting in a historical context, that new supply is high but not excessive. Moreover, developers seem to have become more cautious, with an increase in deliveries not currently expected beyond 2019. This, in turn, may exacerbate the supply/demand imbalance further along the cycle, which could help to drive medium-term rental value uplifts.

There is a risk that speculative (not yet under construction) office supply for 2020 in central London could translate into the highest volume of new space delivered since 1991. However, given that this projection is three years out, there is a far lower degree of forecast confidence, given the political uncertainty that lies ahead. Furthermore, AXA IM – Real Assets believes that rising costs and declining rental values could result in delayed or canceled projects, thereby reducing the volume expected to be delivered.

Heightened medium-term risks, but London is expected to remain a core global business hub

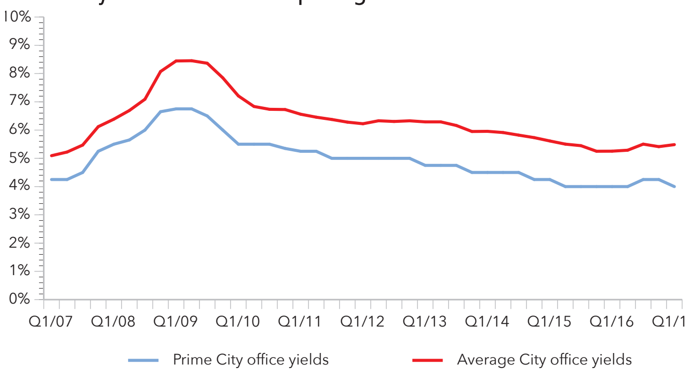
Arguably, the most significant risk over the next two to three years from a demand perspective relates to relocations arising from the potential loss of financial services passporting — the ability for a firm registered in the European Economic Area (EEA) to do business in any other EEA state without needing further authorization in each country. Up to 50,000 workers (the median of all published estimates), primarily in the financial sector, could be forced to relocate in phases over a number of years as a result of Brexit. The losses from relocations are expected to have the greatest impact on the Docklands market (Canary Wharf), given the nature of its tenant base. Moreover, submarkets

Central London office demand has weakened as secondary availability lifts vacancy rate



Sources: AXA IM – Real Assets, CBRE, data as of Q1 2017

Prime City offices lead the repricing



Sources: AXA IM – Real Assets, CBRE, MSCI, data as of Q1 2017

including the City, the Fringe[7] and Kings Cross have seen considerable growth and diversification in tenant demand over the last few years. Any losses from the potential relocation of financial services jobs could be, to some extent, mitigated by demand growth in other sectors, such as the creative industry, over the medium term.

Since the EU referendum, major creative industry leasing activity has occurred. This includes Apple with a 500,000 sq. ft. lease in Battersea; Google with a 650,000 sq. ft. complex in Kings Cross to supplement its existing accommodation; and Snapchat, which recently announced the location of its new headquarters in London. However, it is also important to note that financial services firms appear to have confidence in the importance of London as a long-term business hub. This was demonstrated by Deutsche Bank's decision to relocate to 21 Moorfields, an office scheme totaling approximately 500,000 sq. ft., and Wells Fargo's acquisition of 33 Central in mid-2016.

Prime office rental values expected to record modest declines before recovering in 2019

Following the EU referendum, central London office rental values declined by about 8 percent as of Q1 2017.[1] City office rental values have remained firm while rental values in the West End and Midtown have suffered declines of approximately 8 percent and 4 percent, respectively.[1] This reflects the fact these markets have become expensive in relative terms. Furthermore, with the re-setting of business rates in April 2017 (a tenant tax linked to rental values), costs for tenants in submarkets, where the office stock has recorded strong rental value growth in the past five years, notably the Fringe and Midtown, will rise significantly. The central London office market average rent-weighted lease length has declined from 11.5 years in 2011 to 7.3 years in 2016.[8] This may result in tenants relocating to markets offering modern space at a relatively comparable or lower cost, such as the City.

AXA IM – Real Assets' assumption of a short, sharp correction in prime rental values remains the base case: for example, City office rental values are forecast to decline by about 2 percent in 2017, with further declines of between 2 to 3 percent in 2018,[9] and recovering in 2019. According to AXA IM – Real Assets' scenario, much of the correction in rental values is expected to occur through the adjustment of incentives and granting tenants greater flexibility on lease terms. Headline rents may fall, but that could be reversed quite sharply, given constrained new supply, and as tenants continue to pre-lease. Average headline rental values are expected to fall further for longer, reflecting the inferior quality of second-hand accommodation and the drag of a higher average vacancy rate. AXA IM – Real Assets acknowledges that this view does not accommodate the average vacancy rate.

Overseas investors dominate investment markets

Central London office investment volumes increased rapidly in Q1 2017 to £4.8 billion, versus £3.7 billion in Q4 2016 — itself a strong quarter — and comfortably ahead of the 10-year quarterly average for central London offices of £3.4 billion.[10] Unlike during the Global Financial Crisis (GFC), when very few large office assets were traded, volumes since the end of the summer 2016 have been driven by large transactions. Additionally, 80 percent[1] of all investors in the central London office market during Q1 2017 were based "overseas," notably Asia (49 percent), which accounted for the highest total, and the majority of these were private rather than institutions. Acknowledging the lack of institutional investors, many of whom hedge currency exposure, suggests a combination of dampened confidence and concerns around hedging given the recent FX volatility.

Average City office capital values in the immediate aftermath of the referendum declined by about 4 percent, subsequently ending 2016 down 1.6 percent.[11] Despite the heightened uncertainty, the annual INREV *Investment Intentions Survey*[12] of global investors placed the U.K. at the top for investment destinations in 2017, alongside France. Indices have shown that average prime yields have steadied and in some cases retraced the rises following the EU referendum. Lower total trading volumes are expected in 2017, but not to the extent that liquidity is a concern. Given limited stock (particularly large prime assets, given the number of high-profile transactions) and relatively robust global investor demand, pricing for prime City offices has stabilized at about 4 percent.[13] However, with further political uncertainty and an expectation of rental value declines, central London office yields may face upward pressure in the near term.

In summary, although central London pricing has stabilized, investor confidence is susceptible to political events. As a result, AXA IM – Real Assets acknowledges downside risks to yields in the short term. This is particularly the case for small and medium secondary assets where global investor appetite has been weaker. With global interest rates low and the search for income still driving investor behavior, the central London office market is expected to remain a key hunting ground for global investors.

[1]CBRE, Q1 2017 (referenced throughout report)
[2]AXA IM Research, March 2017
[3]ONS Statistical Bulletin, May 25, 2017
[4]CBRE, City take-up by business group, as of Q1 2017
[5]AXA IM – Real Assets, CBRE, forecasts as of February 2017
[6]CBRE, City office take-up and 10-year average take-up 2007–2016
[7]According to JLL the "Fringe" includes areas such as Shoreditch, Hoxton and Clerkenwell; JLL *The Central London Market Q1 2014*
[8]*UK Lease Events Review*, November 2016, MSCI and Strutt & Parker
[9]AXA IM – Real Assets, forecasts as of February 2017
[10]CBRE, data as of April 28, 2017
[12]MSCI Q1 2017 UK Quarterly Index
[13]INREV, *Investment Intentions Survey 2017*
[14]CBRE, UK Property Investment Yields, May 2017 — refers to an equivalent yield for a prime (well specified, well-located and rack-rented) office property

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