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Savills World Research
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THE IMPACT ON THE CENTRAL LONDON OFFICE MARKET

Brexit Briefing

BREXIT BRIEFING

OPPORTUNITY AFTER MARKET SHOCK?

SUMMARY

Opportunistic investors are circling as UK funds set up for sales programme

■ The economic shock of Brexit is yet to be felt, and little data has emerged. However, the key questions around whether the UK and London are likely to remain as open as they have been in the past are already being asked.

■ The immediate response amongst investors has been mixed. Many of our global clients are telling us that they expect to see London as a buying opportunity (because of expected price falls and a favourable movement in currencies). Others are increasingly cautious, especially given the recent closure of many of the retail property funds.

■ The occupational markets will respond more slowly, and in a more measured fashion to the recent news. We expect to see lower levels of leasing activity throughout this period of uncertainty. However, we were always expecting take-up to return to "normal" levels. This will combine with a reduction in the number of planned development starts to ensure that while vacancy rates might rise, they will not rise to the levels seen in previous cyclical downturns.

"Generally we do not expect the supply-side story to increase significantly, as the heightened risk-aversion amongst developers, funders and lenders will lead to a reduction in development and refurbishment completions in 2018 and beyond"

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The impact of Brexit on all of the UK's property markets will be very dependant on the macro-economic background, and this in turn is dependant on how the UK consumer responds to the news and the evolution of the story over the next two to three years.

This paper is our first analysis of how this new world might affect the central London office market. It, and its sister papers on other UK and European asset classes, will be updated on a regular basis over the following months as hard data, anecdotal news, and our forecasts evolve.

Macro-economic background

The most optimistic scenario for the UK and London economies assumes that given the fact that the majority of the UK voted for the result, then the scale of the economic shock will be less than that felt around an "external" shock such as the global financial crisis (GFC).

The most pessimistic scenario is that the combination of suspended corporate decision making, sharp falls in consumer confidence, rises in lending rates and other factors leads to a short term recession in early 2017, followed by a period of much lower than forecast growth. We have discounted the possibility of a Eurozone collapse from this scenario, not because it is unlikely, but because if it were to happen it would probably be beyond a reasonable forecast period.

Our base scenario is that the financial markets settle over the summer of 2016, realising that the possibilities of a chain-reaction leading to other countries leaving the EU is low. Indeed the fact that the UK only represents around 3.5% of global GDP does rather question why so many global markets fell sharply this week.

This leaves a situation where it becomes accepted that the issue is local, not regional or global.

The next question is how long it will take the UK to exit from the EU and negotiate its position regionally and globally. The Prime Minister has stated that he does not plan to enact Article 50 immediately, so this leaves us with a base view that this period is likely to continue until the end of 2018. However, we expect that there will be more market clarity by the end of 2017.

This period will undoubtedly see lower investment in domestic and international businesses in the UK, an unwillingness to make long-term decisions, and a need by some sectors (most notably finance) to enact contingency plans.

The response of the major European countries will be important to the prospects for the UK. A vindictive reaction is possible. However, the fact that the UK will become the single largest export market for the EU should temper the likelihood of that sort of reaction.

London will also face a few unique challenges of its own. While much of the recent speculation has been about financial services, there are also questions around how the availability of both skilled and unskilled labour might affect London's competitiveness. On the flip side, tourism should get a temporary boost from the lower pound, and professional services will see increasing activity around the post Brexit negotiations.

Ultimately our core question around Brexit and London is a long term one, and that is whether this might negatively affect the global perception that we are a flexible, progressive, liberal and welcoming destination for people, businesses and investors.

The investment market

The initial response by investors has been mixed. While some deals that were under offer have gone through with price adjustments, other buyers and even sellers have withdrawn from the market entirely.

Larger deals are more likely to be deferred and delayed, and this will affect the City of London more negatively than the West End. (Note that the investment turnover for Jan-May 2016 was 17% down YoY in the City, but 10% up in the West End).

Investor confusion will start to settle once the financial market turbulence and noise around the retail fund closures has quietened, and once the Bank of England's MPC has given several months of guidance on the thinking around the UK base rate.

It is likely to become harder or more expensive for investors to borrow money in London for asset purchases or development in London.

Investors were already moving away from a capital growth driven strategy to an income-focused one, and we expect this trend to be intensified.

Our end 2015 forecast was for a steady decline in investment volumes over 2016-2020, as the return being produced by London office property also reduced. The referendum result will reinforce this, and central London office investment volumes will undoubtedly be lower than expected in 2016 and 2017. We expect that this year's volume may be around £10bn - £12bn (down from £18bn in 2015). However, this is less of a fall that was seen in the GFC, a reflection of the stronger occupational market this time around.

2017's investment market will depend on how much prices adjust. Logically there should definitely be upward pressure on prime and secondary yields in London, however the scale of this will depend heavily on how much distressed selling we see, and how many opportunistic investors focus on this distress. At the moment it is hard to see where the distress will come from. Some investors will also see opportunity around currency movements and thus not need to see an overall change in market pricing to consider an opportunistic bid.

Our discussions prior to the referendum indicated that there is a significant volume of opportunistic capital targeted at London from the US, Middle East, and Asia Pacific. These investors all stated that they would be attracted to the income return of London offices if the yield were to rise 50bps. It is also well known that the major London-focused REITs have been waiting for a downturn in prices to refill their land banks.

We do not believe that there will be a rush of selling outside the funds, primarily because of the very low levels of debt that have been prevalent in the market since the GFC. However, we do believe that some risk-averse non-domestic investors may come under pressure in their domestic markets to sell out of London.

The retail funds (who account for between 5% and 10% of the total UK market) were already seeing a rise in redemptions prior to the referendum. This has intensified in the weeks after the result, and has led to a rush of funds being closed to further redemptions.

We entirely understand the defensive measures that have been taken by a number of fund management houses over the past few days which are a prudent move to protect existing shareholders in turbulent markets. However, sales will come from these funds, and some of them will be in central London. These will undoubtedly be the first port of call for those opportunistic investors who are already looking to the UK for a bargain.

The occupational market

Our end 2015 base case for the London occupational markets was relatively restrained, and thus we do not expect to amend it significantly when we formally review our forecasts later this month.

This base case was for a slowing in take-up from the very high levels of 2014/2015 to a more normal level. For example our forecast for City of London take-up was that it would reduce from over 8m sq ft in 2014 to 6m sq ft in 2017, before a rise in lease events leads to a pick-up in leasing activity towards the back end of the forecast period.

This in turn meant that our end 2015 forecasts for rental growth were also fairly muted, with growth slowing to an average of 2.5%pa over 2016-2020.

The leasing markets definitely slowed in May and June 2016, and we expect that this will continue through the next two quarters as those deals that were in the pipeline complete.

2017 will see lower than expected levels of take-up across the central London office markets.

There will also be a rise in businesses seeking to extend their leases for a short period to allow them to assess the needs of their business in a post-Brexit world.

We do not expect the decline in take-up to be ubiquitous across all sectors:

- **Banking:** Will be the hardest hit in both the short, medium and long term. Questions around passporting will combine with pre-existing challenges such as ringfencing. However, it is important to note that the Banking sector has only accounted for 5.5% of central London take-up since the start of 2010.

Some questions have been raised as to whether the potential implementation of MiFID2 in 2018 means that if we can prove "equivalency" to the standards that are agreed while we are still in Europe, then we will automatically be able to passport out of London into the EU (as MiFID2 is a G20 agreement not solely an EU one). Our lawyers have suggested that this will apply to all financial services other than retail banking across the G20, so if enacted will allow most broking, trading and commercial property lending businesses to remain in London and sell into the EU and the rest of G20.

- **Insurance and Financial Services**: Limited impact on the insurance and re-insurance markets. Hedge funds and similar businesses were widely supportive of a Brexit as they felt it would reduce legislation, particularly the AIFMD.

- **Professions**: Legal and accountancy firms are likely to see higher levels of business due to Brexit, and thus are likely to see stable or higher than expected levels of leasing.

- **TMT**: Stable around an already declining volume of activity. This sector is more likely to be challenged by unrelated global questions around valuations than Brexit. FM tech potentially hit by "brain drain" from UK and future funding issues.

- **Business and Consumer services**: Lower than expected in line with the UK economic outlook.

Following the adaptation period of 2016-2018, we believe that the net impact of all of this will be in the region of 5% lower than normal levels of take-up. This will fall more heavily on Banking dependant markets.

As well as reduced levels of take-up there will be small releases of tenant-controlled space onto the market, again primarily from the Banking sector. Generally we do not expect vacancy rates to rise significantly, as the heightened risk-aversion amongst developers, funders and lenders will lead to a reduction in development and refurbishment completions in 2018 and beyond.

MORE ON BREXIT: We will be publishing further reports on specific topics, see our website for details

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