Henderson Research

Think/UK

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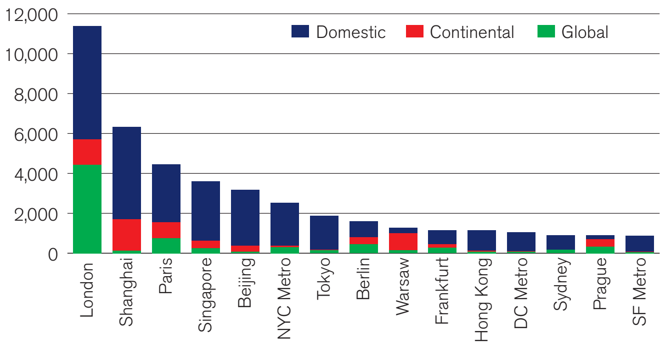
Unsettled UK outlook, but high pressure from overseas benefits London

The yield-driven recovery in UK capital values is drawing to a close, leaving the spotlight focused on performance fundamentals. There can be no grounds for complacency with rental values still falling across many areas of the country. Central London, however, has a different dynamic because of its global-facing position. According to CBRE, the Capital ranked in joint first place as the most popular retail destination in the world in 2010, and global firms accounted for half of occupier take-up in the Square Mile. Central London prime office and retail rents are soaring as investors continue to buy into the story.

London's global exposure is providing investors with opportunities for diversification from domestic woes. The sterling exchange rate against a basket of world currencies is still 14% lower than pre-crisis levels and this is leading to higher tourist spending, while the Olympic Games is expected to provide a boost to London's retail and leisure sectors in 2012. In terms of general economic activity, *Oxford Economics* predict London GDP will increase by 3.8% per annum, over the next five years compared with 2.5% per annum for the rest of the country.

Fig. 1. Investment volumes by destination



Source: RCA

Retail

UK retail sentiment ebbed in May following the temporary respite provided by the Royal Wedding, an extra bank holiday and warm weather, which led to an earlier than normal seasonal shift in consumer wardrobes. There are, however, significant variations in performance between retail sectors and regions. Clothing and footwear maintained positive growth in contrast to a decline in sales of household goods, and London is in pole position among the UK regions, generating significant outperformance. *New West End Company* reported May's retail sales growth on Oxford Street outperformed the BRC national average by 460 basis points.

IPD reported a strong recovery in the Central London retail market in 2010 with rental increases of 6.1% contrasting with declines of 1.4% for the UK as a whole. London's momentum continued into early 2011 with impressive quarterly growth of 3.2% versus no growth for the UK overall. Anecdotal evidence of rental deals in some of the Capital's primer pitches indicates rental uplifts that would not look out of place in a booming City office market e.g. Forever 21 and Desigual on Oxford Street. Retailers know where they want to be and are willing to pay. London landlords are reaping the benefits of both buoyant retailer demand and the distinct lack of space capable of fulfilling these requirements. As a result, even off-prime locations within the Central London area are reaping the benefit.

Can this seemingly anomalous situation in Central London retail persist as households get to grips with repairing balance sheets, negative real wage growth and potential falls in house prices? The answer, most likely, is yes. London has a diverse economic backdrop and relies less on public sector employment. As job levels in financial and business services expand, consumers' propensity and ability to spend will be enhanced. Central London retailers benefit from various sources of sales demand: the daytime workforce, weekend destination shoppers, and tourists who are getting more value for money as they access the Capital's culture, leisure and retail offering. *Visit Britain* reported 5.3% annual growth in overall tourist spend during 2010, four times the growth rate experienced the previous year.

IT IS HARDLY SURPRISING THIS POSITIVE BACKDROP TO INCOME GROWTH HAS GENERATED SUCH A RAPACIOUS INVESTOR APPETITE. CURRENT NET INITIAL YIELDS FOR PRIME SHOPS ARE BETWEEN 3.0 AND 3.5%.

As a result of these positive factors, Henderson expect strong growth in Central London retail rents of 3.5% per annum over the next five years, way in excess of the wider UK market of 1.8% per annum. There should be stronger growth in the earlier years, particularly while tourist spending remains strong and with the boost from the Olympics in 2012. Looking ahead, we suspect there will be more opportunities for investsors higher up the risk curve. These may occur in off-prime pitches in which investors can expect a location discount, but where supply and demand influences are nonetheless compatible with rental uplifts.

Fig. 2. IPD quarterly rental value growth (%)

Source: IPD UK Quarterly Index, March 2011

Henderson GLOBAL INVESTORS

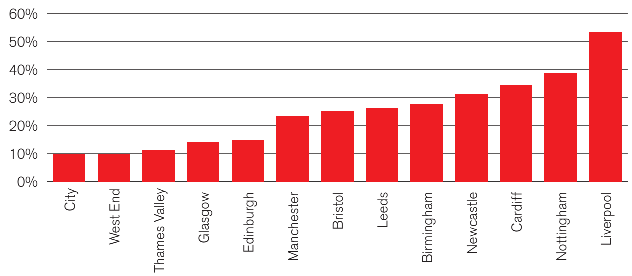
Offices

Despite keen pricing in capital markets, the case for investing in Central London offices has not diminished. There are a number of reasons to be optimistic that the rental cycle will generate enhanced performance over the next few years.

WITH ROBUST DEMAND, SIGNIFICANT FURTHER UPWARD PRESSURE ON CITY RENTS SHOULD RESULT AS GOOD QUALITY AVAILABLE STOCK ERODES. OUR FORECASTS INDICATE RENTAL GROWTH OF CIRCA 5% PER ANNUM FOR LONDON OFFICE RENTS OVER THE NEXT FIVE YEARS.

Although there are risks that the domestic economy and stock market will experience greater volatility than usual, independent forecasts from *Oxford Economics* predict more new jobs will be created in London's financial and business services over the next five years than were generated in the five years prior to the recession. A further boost to London's letting activity is expected from overseas with forecasters predicting much stronger growth globally than domestically. London ought to be a key beneficiary of this growth since it consistently ranks number one on the *Global Financial Centres Index*. Indeed, the overseas share of letting activity has accounted for more than half of all City and circa 30% of West End take-up over the last two years. Furthermore, while public sector restructuring should prove to be the 'Achilles heel' of regional occupier market recoveries, Fig. 3 shows the share of take-up accounted for by public administration is very low in both City and West End markets.

Fig. 3. Public administration take-up as a % of total, 2002-10



Source: King Sturge (now JLL)

AWAY FROM LONDON, THE MANTRA LOCATION, LOCATION, LOCATION HAS NEVER BEEN MORE RESONANT. MOST QUALITY ASSETS ARE FULLY PRICED AND RENTAL GROWTH IS LIKELY TO BE SPECIFIC TO MICRO-LOCATIONS.

Outside the Capital, letting markets cannot rely to anywhere near the same extent on overseas demand, while public sector accounts for an important component of letting activity. The last recession produced an overhang of vacant space and rental declines have left many buildings over-rented with poor prospects for growth. With investment pricing for well-located assets already keen, opportunities will depend on identifying early recovery micro-locations. From an investment perspective, decent locations and longer income security often fail to offer enough of a discount to compensate for building risk. It has arguably become necessary to focus on shorter income where low levels of Grade A supply in future will lead to fewer and shorter interruptions to cash flows and underpin rental growth. Building quality and location remain too important to compromise. Given the development cycle was curtailed in mid-2007, rental growth is likely to be generated by pre-let developments from 2013. A strategic shift from Central London to the regions might be considered at this point.

KEY CONTACTS

Andy Schofield
Director of Research, Property
T: +44-207-818 5452
E: andy.schofield@henderson.com

Angela Keane
Associate Director of Research, Property
T: +44-207-818 4132
E: angela.keane@henderson.com

Michael Sales
Head of Global Property Investment
T: +44-207-818 4376
E: michael.sales@henderson.com

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