DTZ INVESTORS

Market Insights
Office Outlook
2017

The referendum result has significantly changed the outlook for the office market, placing the sector on a different and more uncertain path than the one we had forecast twelve months ago. Politics will be the main headwind to the sector's growth prospects but various other forces will also come into play. Rising supply pressures, an imminent business rates revaluation, increased requirements from local governments and even the possibility of faster than expected interest rate hikes have the potential to influence performance.

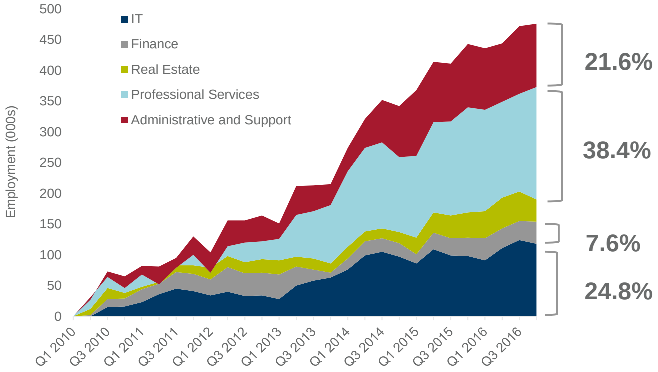
Offices in a Post Brexit World.

The office market will have to brace itself for an environment outside of the EU's single market, given the Prime Minister's confirmation on UK's exit path from the EU. Financial institutions have openly forewarned the government that job relocations to other European CBDs will be necessary if passporting rights (required to sell financial services within the EU) are not granted, but in reality, the physical barriers and costs associated with moving could curb absolute numbers. In fact, recent figures suggests the number of financial job losses from the loss of passporting rights could be in the region of 15,000, considerably lower than the figures quoted pre-referendum (of 60-100,000). This could tentatively suggest that the effects of Brexit on London's office occupier base would be less severe than initially thought.

Will the loss of financial service jobs be a significant threat to London's office sector?

The financial industry was already undergoing considerable change prior to the referendum. Since the Global Financial Crisis, the share of new jobs created by the financial service sector totalled 7.6%, which is low in relation to other business industries. A similar trend can be seen in take up figures with the proportion of total take up from financial and professional services having fallen by half since 2006 (from 50% to 25%).

Cumulative Office Based Job Creation in London since 2009, Source: Capital Economics, ONS



This trend is expected to continue as fintech and digital automation continue to improve efficiencies in the operational models of the financial service industry, meaning future financial employment growth is only going one way. While employment growth and requirements for office space from financial based firms is likely to slow, small and medium-sized creative firms and tech companies are expected to pick up some of the slack, with current forecasts suggesting these industries will experience stronger future employment growth rates over the medium term. This should help to partially offset the loss in demand from traditional industries, diversifying London's occupier base and making it less susceptible to market shocks over the long run.

That said, the terms of the UK's exit from the EU are still unclear. A favourable transitional deal could still be made with Europe on passporting rights, lessening the impact on the financial industry and even if this deal goes sour, options such as relaxed tax arrangements could entice financial corporations to take on the increased future regulatory burden in turn for a lower tax regime. Whatever the outcome, we expect the Brexit negotiations and transitional arrangements will take time to develop, during which time firms will continue to muddle through with a business as usual attitude.

> ***"Effects of Brexit on London's office occupier base would be less severe than initially thought."***

Increased requirements from the public sector to support regional office take up.

The regional office market should see its own share of fortunes supported by the Government's GPU cost savings strategy which aims to sell off hundreds of its freehold estates, consolidating public sector employees from high cost departments in places such as Whitehall into more affordable office space in major regional cities such as Manchester, Leeds, Cardiff and Liverpool as well as Canary Wharf and Stratford. With local authorities looking for more than 2 million sqft of office space, the move should provide a timely boost to regional office take up.

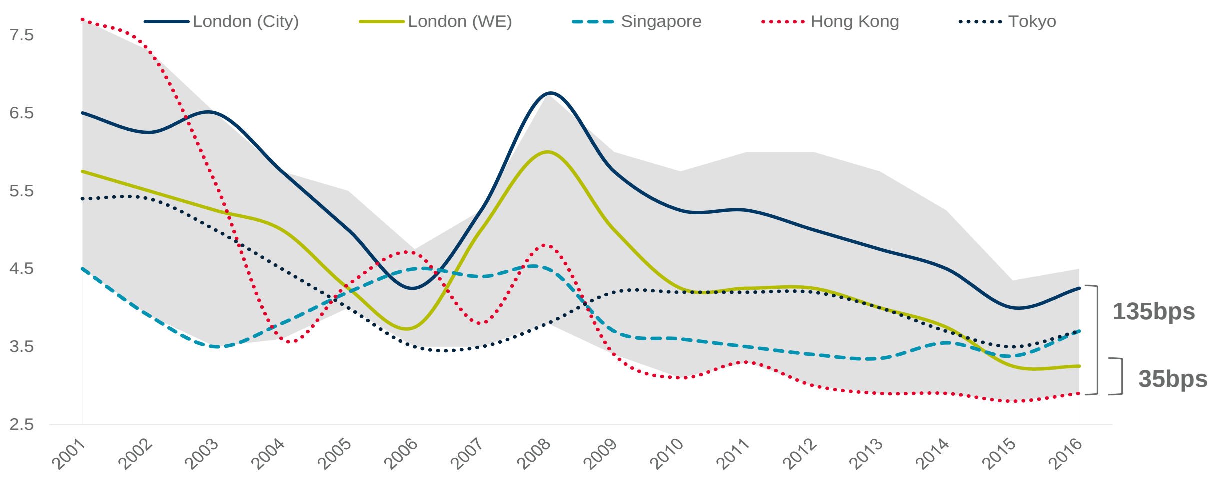
Currency shifts and local governments to support short term investment activity.

Whilst ongoing political uncertainty is expected to suppress near term occupier demand, its impact on investment activity should be more favourable. The depreciation of sterling combined with falls in office values post referendum has made London offices appear more attractively priced relative to its pre-Brexit level, and has supported investment activity from overseas buyers post referendum. With the yield margin between prime London office assets and comparable stock in global cities between 35-135bps and the political inertia weighing on Sterling in the short term, we expect foreign investors (Asian investors in particular) to continue targeting London offices for a store of value and a mispriced opportunity (see chart below).

Regional offices should also see a boost in investment activity, supported by different kind of buyer, local authorities. The Public Works Loan Board is being used by local authorities (at rates of c.2.5% compared to c.5-6% for private investors) to invest into commercial property principally within their local boroughs. The income streams from the investments will help fund local services, compensating for the loss of funding from public sector cuts. Limited government regulation, should mean that local authorities will be major player in the investment markets in 2017, contending against institutional buyers on more favourable terms. Thus, the combination of a weaker currency and renewed investment demand from authorities should help counterbalance the impact of political uncertainty on capital values over the next 12 months.

Supply pressures to suppress rental growth prospects against a backdrop of weaker demand. Supply dynamics will add another layer of pressure to office rents in the near term. 2017 is the year in which the levels of new supply entering the central London and major regional office markets will reach its highest level since the Global Financial Crisis. The delivery of new space should be less of an issue in regional office markets, where the current availability of grade A space is at a low, but for London, the risk is more potent. On the upside, pre-letting activity will help absorb some of this new supply, (over 40% of new space in London is pre-let) while delays and project cancellations should reduce supply pressures in later years. Plus, recent trends appear to imply that new completions do not necessarily lead to a similar increase in total office stock. During 2014 to 2016, 3 million sqft of new office space was completed in the West End, yet total office stock only rose by a third of that level (due to the removal of stock for residential conversions), similarly 6 million sqft of new space entered the City over the same period, but the impact on total office stock was marginal as older stock was removed from the market. If this trend continues, then supply pressures may not be as damaging to rental growth prospects as initially feared. Nonetheless, it is fair to suggest that 2017 will be a testing time for office rents.

Prime Office Yields across selected global cities, **Source: DTZ Investors, Cushman and Wakefield**



Range incorporates the office yields on other major office markets across world: Singapore (3.7%), Hong Kong (2.9%), Tokyo (3.7%), Frankfurt (4.5%), Madrid (4%), Paris (3.5%), New York (4.0%), San Francisco (4.0%)

From falling rents to rising business rates.

The revised business rates revaluation came into effect on 1st April 2017, with the rateable values of commercial properties being based on the rental values of properties as at April 2015. The changes will have higher cost implications for tenants across London, and will be particularly onerous for those areas that have undergone significant regeneration over the period. With business rates on their way up and rents set to soften, we have assessed what the divergence in both measures will mean for total office occupancy costs over the course of the next couple of years. In a phase where the bargaining power is shifting from landlords to tenants, and new efficient, cost effective workspace is appealing, these cost pressures could potentially spur new start-ups and other cost-sensitive occupiers such as 'SME's and tech firms and serviced occupiers' to consider relocating to more affordable, better quality, well connected space over the medium term.

Could rising bond yields be a potential threat to low yielding offices?

It may seem premature to consider interest rates as a risk for the office market, but with the consensus pricing in interest rate rises over the course of the next five years, the risk of this event occurring is increasing. To date, the MPC have been reticent to tighten monetary policy against a temporary rise in inflation, but this view could be challenged if the economy's post referendum resilience continues and domestically driven inflation picks up.

To a certain extent the threat to low yielding office markets will be dependent on the factors driving an outward shift in bond yields. A rise in bond yields in anticipation of future inflation pressures and stronger economic growth (which will therefore precipitate better rental growth expectations for commercial property) can have an entirely different impact on property yields than a rise in gilt yields driven by a rise in investor's risk premia. Nonetheless, with initial yields on London offices 150bps below All Property (and 85bps lower than its long term yield discount to All Property) and our expectations for the segment to deliver more muted rental prospects over the next five years could make office yields susceptible to future yield increases on fixed income investments.

Is the office sector witnessing the calm before the storm?

The balance of risks are firmly tilted to the downside for the office market, particularly for the London office market, but despite of all of the upcoming political and economic worries we find it hard to envisage a deep Brexit induced correction in performance, but rather a more shallow correction in London office total returns. There are many future unknowns, most notably to the extent in which Brexit will shape the market, but with major tech operators (Google and Apple) making long term commitments to the capital, and others (such as Facebook) in expansion mode, as well as reports that some European banks (UBS, Credit Agricole) are extending their leases on headquarter space in the City, this post-referendum activity provides a sense of optimism that London will remain a favoured business district for corporates for years to come.

In the near term, increased flexibility and lease breaks and longer incentives will be commonplace, as businesses adjust to a post Brexit arrangement. A cautious attitude amongst occupier's will lead to delayed business decisions and lower levels of take up in the short term. Office rental growth is unlikely to be exciting over the next five years, while capital values will remain vulnerable to outward yield movement as markets continue to price in their views on forthcoming risks.

As a result, we anticipate the regional office market will deliver better return prospects over the next 12-18 months, rents are less advanced in their cycle, (below their previous 2007 peak) and the sector's above average income yield will mean the segment is better positioned to deliver decent income driven performance. Plus, a more domestically orientated occupier base and increased requirements for space from government bodies should mean demand remains steady for core regional hubs.

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