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cutting through complexity

Will London retain its dominance of the global property market over the next decade?

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INTRODUCTION

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Nothing is certain in London but expense

claimed William Shenstone, the 18th century poet and landscape gardener. The commercial real estate market has been as close to a certainty as any investment, but it is undoubtedly expensive.

Central London offices and retail units are changing hands at such high prices that some investors are being forced out of prime areas. Instead, they are looking to expand their horizons to the zones closer to the M25 or into hotels and student accommodation. Turnover has reached levels last experienced during the 2007 peak, and as prices head further upwards it becomes ever more difficult to achieve attractive yields.

London has undoubted attractions for investors. Being a major financial centre, home to large numbers of global investment and professional services firms guarantees high occupier demand. London has proved extraordinarily resilient over the years to political, social and market change, its citizens adapting to new circumstances to maintain the capital’s status as one of the foremost cities of the world.

But can London retain its crown? The changing geo-political climate creates threats that are largely beyond the control of its citizens. As power shifts towards the East, will investors leave London in favour of Shanghai, Singapore or Hong Kong?

How will the political situation in Europe affect the London market? London’s influence and power is linked to its status as Europe’s financial centre, the gateway to Europe for investors. If London were marginalised in the event of a British exit from the EU, might Frankfurt take its place?

In an environment of high prices and low yields, amid growing concerns about the inflating of a bubble, our specialists asked themselves whether the city’s standing as the world’s leading real estate investment location could remain over the next decade and what would make London more or less attractive in this period.

Andy Pyle takes the resolutely positive view, suggesting that the factors which made London great in the first place will continue to stand it in good stead *(Page 3)*. However, Richard White fears that growing competition from the east - and even from closer to home - will place that number one spot under increasing threat *(Page 5)*.

Douglas Marvin *(page 7)* and Bill Holland *(page 9)* add their own notes of caution, fearful of the impact of political uncertainty and insufficient infrastructure investment.

WILL LONDON RETAIN ITS DOMINANCE OF THE GLOBAL PROPERTY MARKET OVER THE NEXT DECADE?

THE QUESTION IS:

WHO DO YOU BELIEVE?

WILL LONDON RETAIN ITS DOMINANCE OF THE GLOBAL PROPERTY MARKET OVER THE NEXT DECADE?

01

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YES » EIGHT REASONS WHY LONDON'S PROPERTY LUSTRE WILL LAST

London's streets are still paved with gold for commercial real estate investors, despite the high prices. Strong legal frameworks, political stability and a transparent and liquid market continue to make London their number one choice.

> **In my opinion, the factors pulling business into London will not change and occupier demand will remain high.**

The central London commercial market is booming with sales of over £20.9 billion in 2014, according to research firm Savills, and high occupancy among the many companies that choose to base themselves in London means commercial real estate is a low-risk investment for many. In my opinion, the factors pulling business into London will not change and occupier demand will remain high. Those factors are:

01. Position. Apart from its obvious cultural attractions, London will remain a major financial centre in part because its trading hours overlap with those in both Asia and the US.

02. The English language. Despite China's huge economic growth and the probable shift of global influence to the east, English is likely to remain the language of business. Chinese officials stated that more than 300 million Chinese were learning English in 2006.[1] Far fewer people are learning Mandarin.

03. Still an important part of the investment mix. Investors may well look to Shanghai and Hong Kong in the long-term, but that does not mean they will stop investing in London. Global investors want balance in their portfolios. Many of them have more to invest each year. Asia is likely to receive a bigger slice of the pie, but London will not get nothing, as its fundamental appeal is sustainable.

04. Stability. Investors are deterred by the lack of transparency and issues around the rule of law. Although investors' perceptions about countries can change quickly in this regard, the UK's political stability and London's adaptability to global change has a long track record

that has enduring appeal. Investors such as sovereign wealth funds - looking to lock in their money for 50 to 100 years - already recognise London to be a positive long-term option. Long-term investors are less worried about a temporary price correction or a change of government.

05. **In Europe, but outside the euro.** London is still attractive to investors with a shorter time-horizon, as it represents a lower-risk than other European cities. Fears about currency instability within the Eurozone give London an edge over Paris or Berlin, which are equally expensive.

06. **Open markets.** Foreign investors perceive London and the UK as a welcoming investment destination, with a transparent market in which they can transact without the need for local partners.

07. **Multiple choice.** While prime central London may be beyond the reach of some, I would argue that the risk-adjusted returns are still attractive in alternative investments such as student housing or in outer London boroughs.

08. **Cheap funding.** Continuing low-interest rates allow investors to lock in low-cost debt for a long period.

The outlook for London is not uniformly positive. If the British voted to quit the European Union, Frankfurt might leapfrog London in importance as a financial centre. London's property market would suffer a corresponding loss of investment and a drop in values. However, even in the worst case scenario, London would remain in the global top 10 or 20 property investment locations, although that is a dizzying drop from number one. I am relatively sanguine about this risk in any case. Politicians in all parties are aware the damage this would do to the UK economy and I am confident they will do enough to avoid such an outcome.

The UK government must also secure sufficient infrastructure investment and ensure enough affordable housing is built to accommodate London's growing workforce and to keep them moving. While London's charms will never entirely fade, we should not take them for granted. Prompt decisions about funding the Crossrail 2 project running through the capital, as well as the need for extra runway capacity, would provide a timely boost. It will be important for political leaders to continue to look forward and anticipate projects that meet our future needs, not only those that are already in train.

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01: People's Daily Online (English edition), 27 March, 2006

WILL LONDON RETAIN ITS DOMINANCE OF THE GLOBAL PROPERTY MARKET OVER THE NEXT DECADE?

02

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NO » THE THREAT OF INCREASED COMPETIVENESS FROM OTHER COUNTRIES IS TOO GREAT

London's commercial real estate market is due a correction. Last year, investors ploughed over £20 billion into central London - only a shade lower than its 2007 peak. Even though fund managers sense the ghosts of 2008 all around them, poor returns elsewhere keep the money flowing in. I believe they need to wake up and investigate the alternatives now or risk disaster.

London is riding a wave of high occupier demand, low interest rates, and a short supply. Positioned outside the Eurozone, the city looks even more attractive versus its European peers. However, as prices rise, the risk-reward looks increasingly skewed.

In the medium term, I suspect that London's dominance will come under threat as more viable alternatives emerge from within the Eurozone. If the euro stabilises, or Italy and Spain's economies recover, cities like Barcelona, Madrid and Milan will offer far more attractive returns than London's over-cooked market.

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If the euro stabilises, or Italy and Spain's economies recover, cities like Barcelona, Madrid and Milan will offer far more attractive returns than London's over-cooked market.

I don't expect to see the deserted office blocks that were a feature of 1990s London, but the turnover of buildings will slow as demand eases off. In the best-case scenario, we will see a gentle price correction, as other markets become more fashionable.

In the longer-term, the Far East will overtake London as an investment destination as economic power shifts from Europe. In general, investors tend to look at local markets first, then regional and then global. If investment pools are increasingly concentrated in the Far East then it is unlikely the money will flow to Britain, particularly given the vast investment opportunities in the Far East. London will be yesterday's news.

London will remain a major European financial centre, but that is a significant fall for what is now one of - if not the - world's financial capital. The markets in the Far East will have significant growth potential, leaving London behind in the investor mind-set. As capital flows away for faster-growing Eastern markets, demand will fall further, potentially sparking a vicious circle in which prices drop sharply.

London is particularly vulnerable to changes in the geo-political environment. Over 70% of its commercial real estate[2] stock is held by overseas investors. While some of these investments will be held by sovereign wealth funds seeking returns over the long term, private equity investors will quickly chase higher returns available elsewhere.

There is little any of us can do to control such a shift of economic power on this scale. However, the government can mitigate some of its effects by ensuring London holds on to its European top spot. London is an old city, and the more buildings and people it hosts, the more infrastructure it will need. Government's willingness to actively promote infrastructure investment, and more generally to adopt policies that reinforce London's status, will be a key factor in its longevity.

For example, a clear decision on runway capacity in the south east is essential. If those controlling global capital cannot easily access the capital, they are less likely to invest here. London must remain a gateway for international investors into Europe. That would also naturally be far harder if Britain left the EU.

It impossible to predict what will trigger a price correction. It might be the emergence of new markets, uncertainty around Britain's status within the EU or something else entirely. What is certain is that the current price increases are unsustainable and yields are too low given the current level of risk. Ultimately, values will fall. Investors need to be alert to the herd mentality, and should seriously consider the challenges to longer term London property values when making their investment decisions.

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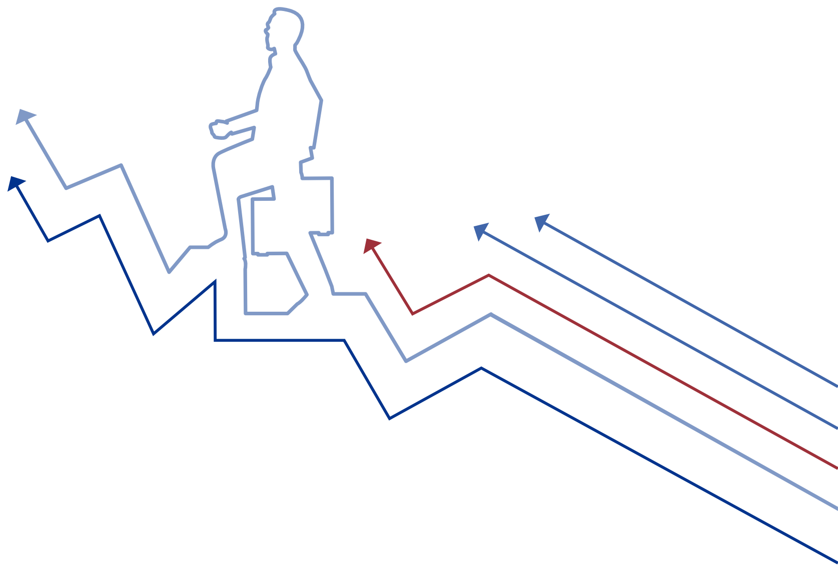
02: Financial Times, 17 July 2013



03

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A NOTE ON POLITICS » LONDON NEEDS STRONG POLITICAL LEADERSHIP TO STAY AT THE TOP

Douglas Marvin, a Corporate Finance associate director at KPMG in the UK, fears that the biggest threat to the continued attractiveness of the London market is posed by political instability and uncertainty.

Political equivocation is a threat to London's long established dominance of the international real estate market. Without strong and decisive leadership to maintain business confidence, London's status as a top investment destination could be in jeopardy. That any such decline would be long-term and gradual, not short-term and dramatic, will be of little consolation.

London has a stable society, with a highly educated workforce and the cultural and business opportunities to attract the best global talent. The regulatory and fiscal environment is long established and the legal system is perceived as one of the best in the world.

These historic advantages are not going to disappear. However, political interference or inaction can undermine them.

As I see it, a major threat to London's position in the real estate world would stem from political inaction on: engagement with the younger generations; engagement with the wider world; and on the important decisions required at home.

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I think we forget how the UK is so well respected as a bastion of fairness, openness and pragmatism.

Failure to engage with our youth could lead to political instability (think of the London riots) or a tendency towards more extreme politics. This could either disrupt confidence in London or lead to policies which are not in London's long term interests.

As for the wider world, I think we forget how the UK is so well respected as a bastion of fairness, openness and pragmatism.

Accordingly, I believe that the manner in which we now deal with membership of the EU will be more important than the outcome itself. London can deal with staying in or leaving the union, provided a sensible solution is reached and competently executed.

As for the closer to home decisions, top of the priority list must be the third runway (which requires political decisiveness) and the housing crisis (which requires acknowledgement of the housing supply issue). Both areas feed into the points on retaining talent and social stability.

Despite its success, London's exposure to highly mobile equity funds makes its market extremely volatile. A single company moving headquarters would not be a disaster but if a critical mass of business were to leave London, the fall in occupier demand would result in major concerns for real estate values. With domestic buyers largely displaced by foreign investors, any change in the environment could spark a rapid outflow of capital (for example as a result of changing exchange rate or inflation expectations).

To reduce the threat outlined above, we need brave politicians. Prompt decisions on infrastructure spending and effective policies to tackle social problems are essential if the UK is to maintain its political stability, and London its business advantage.

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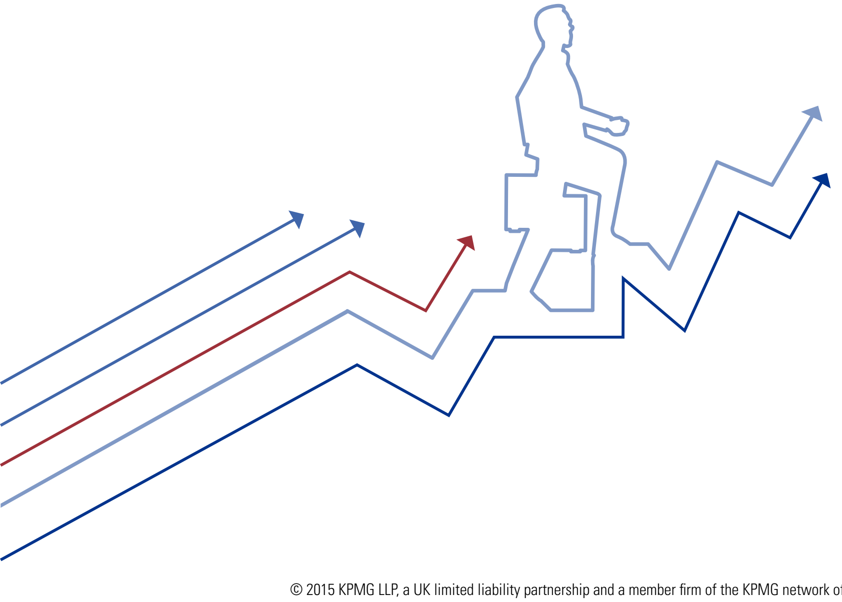

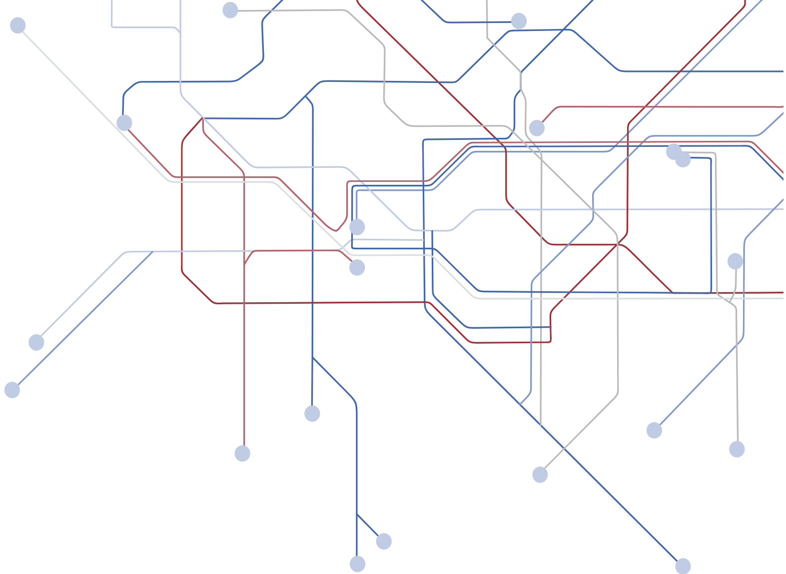

WILL LONDON RETAIN ITS DOMINANCE OF THE GLOBAL PROPERTY MARKET OVER THE NEXT DECADE?

04

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A NOTE ON CONNECTIVITY » GRIDLOCK WILL DIM LONDON'S ALLURE

London's property market risks becoming a victim of the capital's success. The inexorable rise in house prices and the scarcity of commercial space is testament to London's enduring appeal. Yet this popularity comes at a price: a city straining under the ever-growing weight of workers, residents and visitors. Its roads are grinding to a halt. Meanwhile public transport is struggling to keep pace with demand: Tube passenger numbers are forecast to rise 60% between now and 2050 as the city's population jumps from 8.6 million to 11.3 million[3]. London's authorities have a huge task to meet this transport challenge and, at a time of fiscal tightening, I fear it will prove impossible.

London's popularity - and its spiralling house prices - will also increase the pressure on the rail network as it carries in the growing ranks of people who have been priced out of the capital. Train journeys are forecast to increase 80% in the next 35 years[3]. A survey by Randstad, the employment agency, showed that the number of "extreme commuters" travelling more than 90 minutes each way increased by 50% between 2008 and 2013 to 1.8 million workers[4].
At what point does the city begin not to function properly because key workers - shopkeepers, cleaners, civil servants or bus drivers - can no longer afford, or bear an increasingly uncomfortable and longer journey to work?

At what point does the city begin not to function properly because key workers - shopkeepers, cleaners, civil servants or bus drivers - can no longer afford, or bear an increasingly uncomfortable and longer journey to work?

Poor connectivity in and around town is compounded by poor connectivity to the rest of the world. More and more business leaders are based in the Far East. If they cannot get to London - or at least get here in a timely and comfortable way - that reduces London's global competitiveness.

As the UK dithers over whether to build one extra runway in the South East, Amsterdam's Schipol - with six runways - and Frankfurt and Paris - both with four - are making new connections to developing economies. For example, Schipol has direct flights to six Chinese cities, while Heathrow has four.

I am not suggesting that London faces an imminent crisis: only two or three other cities in the world can rival London as a place to work, live and play. And even if a large number of companies did decide to leave (in the wake of a 'Brexit' for example) other major European cities do not currently have the capacity to absorb them.

In the longer term however, there will come a point when more companies question whether the expense, effort and time of London is worth it when cities like Paris and Frankfurt could position themselves to offer a more connected and efficient alternative.

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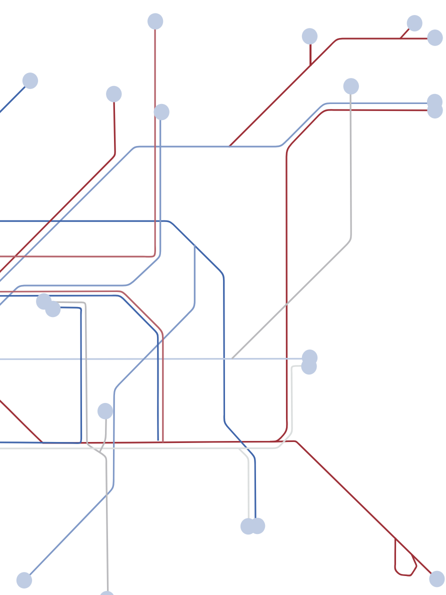

03: http://www.totalrail.org/2014/08/04/london-infrastructure-plan-2050-demand-underground-rail-likely-go-60-80-per-cent-respectively
04: https://www.randstad.co.uk/about-us/press-releases/randstad-news/savvy-super-commuters-spend-time-wisely

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