

Half-Year Report 2015



The UK property market - time for champagne and strawberries?

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Bull and Bear have convened for their mid-year review at Wimbledon. With no corporate tickets available, they have joined the long queue outside in the hope of getting onto Centre Court.



Bull: Oh, I do like Wimbledon fortnight. There's always such a great buzz here. The smell of freshly cut grass. Top quality tennis. Strawberries and cream. Pimm's. Champagne. Add this well-organised queue to the mix and this is surely Britain at its absolute best. And to top it all off, we are here under the pretence that we are working!

Bear: I completely agree Bull. I couldn't think of a better place to discuss how the UK property market has fared in the first half of 2015. The only draw-back though is this queue. I know us Brits love them but we've camped here all night and we've still not moved an inch. I'll be gutted if we don't get one of those 500 tickets. I have been practicing my 'Come on Andys' all winter.

Bull: I blame St Bride's...at our age the very least they could have done was sort us out with a couple of tickets. The number of property professionals I have seen already this morning swanning down Wimbledon Park Road is ridiculous. Corporate 'jollies' look firmly back on the agenda.

Bear: It would indeed appear so. And coming here is not a cheap day-out either. Have you seen how much it costs for a tiny pallet of strawberries or a glass of Pimm's?

Bull: Our measly expenses budget is going to take a battering, I know that. This place is a money-making machine. Did you know that over the course of the fortnight 28,000 bottles of champagne will be drunk and around two million strawberries eaten?

Bear: Stop all this talk of food Bull. It is making me hungry. Do we want to come up with a plan as to how we are going to complete this mid-year review? Why don't we revisit the St Bride's 2015 Predictions now, and then, assuming we get in, discuss the state of the UK property market whilst we wait in our seats for play to start? That way we won't be under any pressure to talk 'shop' whilst play is underway, nor allow our opinions to be influenced by Mr Moët or Miss Stella Artois.

Bull: Good plan Bear, although reviewing St Bride's 2015 predictions isn't going to take us long is it? Out of the 14 predictions that they made in January, only one can be judged so far...and that prediction shouldn't even count.

Bear: Which was that? The election one?

Bull: Yup. Even Dove and Hawk would have got that prediction right. What very few of us would have predicted correctly though was the outcome.

Bear: Well I certainly didn't. I fully expected us to still be hearing about coalition deals and squabbles. I am glad we aren't though. The worst scenario would have been a stalemate. That would have been a shocker for business confidence, especially as there was evidence already emerging that economic activity was being hit by the uncertainty of the outcome.

St Bride's January Predictions for 2015 - A Reminder

1	The General Election will take place on 7th May 2015 ✓
2	The market will experience a pause in the run-up and aftermath of the General Election (awaiting statistics)
3	UK GDP Growth will continue at a respectable pace but slower than 2014
4	The fortunes of the global economy hang on the US star continuing to shine brightly
5	The FTSE 100 will recover the ground it lost in 2014
6	England will win their Rugby World Cup group but lose to New Zealand in the final
7	Investment volumes will be good but will not match 2014 levels
8	Chinese investors will accelerate their UK acquisitions in 2015
9	Some overseas investors will become increasingly comfortable investing in the UK regions
10	Rental growth will be strong in London and remain patchy in the regions
11	There will be no further yield compression for prime London assets
12	The yield gap between prime and secondary properties will close further in 2015
13	Property Total Returns will be 10.00% for 2015
14	Property will be the best performing (mainstream) asset class in 2015

Source: St Bride's Managers

Bull: Evidence? Like what?

Bear: Well according to The Investment Association, investors pulled out £2.7bn from UK equity funds in the four months between January and April amid growing fears of a hung Parliament. Although the property market data isn't available yet, there was also a definite lull. Landlords and tenants both sat on their hands waiting to see what would happen.



Bull: The markets certainly liked the result, didn't they? The FTSE 250 index reached an all-time high, while the pound also registered its biggest jump against the US dollar since 2009. Yields on UK government bonds fell sharply too. With the certainty of a winner has come a renewed confidence from investors.

Bear: I still think it is too early to tell Bull. The markets are bound to start accounting for the EU referendum, the influence of Conservative backbenchers and Scotland's future role in the UK.

Bull: You are so pint-half-empty Bear. Why, when things are good can you never concede that they are? Why are you so worried?

Bear: The scale of the SNP's victory in Scotland and UKIP's share of the national vote for starters. This clearly shows the UK is a divided nation. The prospect of an in-out referendum of Britain's EU membership has gone from a risk to a reality. Investors will become increasingly worried, you mark my words. Did you not read CBRE's recent *Viewpoint*?

Bull: I must have missed that edition. What did it say?

Bear: Well their research team has examined the implications of an 'in' or 'out' vote on the potential impacts for the UK property market. 60% of their respondents believe that the effect of a British exit would be negative.

Bull: But no-one has the faintest idea what being 'out' would actually mean in practice! Anyway current polls show that the public will favour the status-quo and vote Yes, so there is nothing to worry about.



Bear: You've got your head buried in a trough again Bull. The election success of UKIP means the result is by no means a foregone conclusion. And the polls aren't as clear-cut as you make out.

Bull: Whilst the prospect of a 'Brexit' may well result in a period of uncertainty, the UK would do just fine anyway if the electorate decided to ditch Brussels. British business is not as dependent upon Europe for growth as it once was. The 28 member states of the EU only make up 19% of the world's GDP. The world's economy has moved on Bear. Plus the UK's economy remains in rude health.

UK vs Rest of World

	UK	G7 (exc UK)
GDP Annual Growth	2.80%	1.26%
Unemployment	5.43%	7.33%
Consumer Confidence	102.27	100.85
10 year Benchmark	2.14%	1.54%
Inflation	0.1%	0.33%
Budget Deficit	-5.69%	-3.6%

Source: OECD, ONS (most recent period)

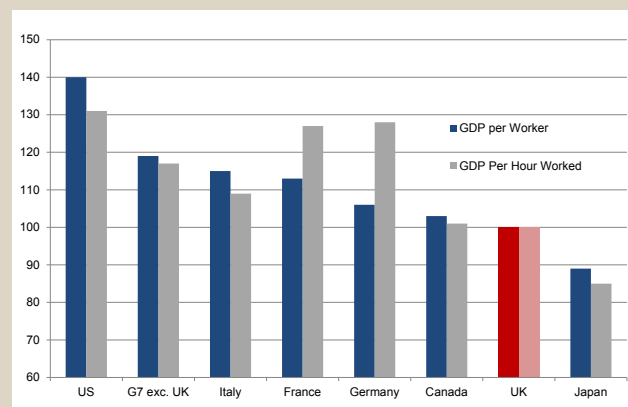
Bear: Did you not see that the rate of economic growth halved in the three months to the end of March.

Bull: All I said was that it remains in rude health. The economy is 2.8% larger than the same period a year ago. Compare the UK with the other G7 countries and we look in decent shape – lower unemployment, higher annual GDP growth, as well as higher consumer confidence.



Bear: Apart, of course, from our larger budget deficit which you conveniently missed off. And then there's our relative lack of productivity. Even the Italians and French are more productive than us! We are again spending tomorrow's wages. The UK household savings ratio is back down at 2006/2007 levels.

UK Productivity vs G7 Peers



Source: OECD, ONS (UK = 100)

Bull: Good points, well made Bear, but even you must agree that life feels pretty good at present. I have heard more and more people say recently that it feels a bit like 2006 all over again.

Bear: Well, if you are suggesting there's going to be another melt-down, we'd better make the most of our day-out today, hadn't we? It looks like we are both going to get a ticket for Centre Court so let's pay, grab our strawberries and take our seats. We can pick up our conversation then.

Bull: Good idea. You pay for the tickets, I'll pay for the strawberries... they both cost about the same.

Property's Attractiveness

Having taken their seats, Bull and Bear discuss the current attractiveness of property as an asset class and the continued popularity of London as an investment destination.

Bull: I know tickets for Wimbledon are in high demand Bear, but for £98 it would have been nice to have a bit more room wouldn't it? They have certainly crammed us in here.

Bear: Stop whinging Bull. If you'd done some training for last week's Property Triathlon and got yourself into shape, both of us would be set for a far more comfortable afternoon than we currently are.

Bull: Let's move swiftly on. What were we discussing outside the gates?

Bear: You were telling me that industry professionals were more and more comparing the current market to that of 2006. I don't see it myself.

Bull: I can. Investment volumes are similar. Total returns are similar. If you look at the capital value and rental value growth experienced in 2006 and 2014, they too are very similar.

UK Property Market - 2006 vs 2014		
	2006	2014
Total Investment Volumes	£56.1bn	£61.7 bn
Total Return	18.1% pa	19.3 pa
Income Return	5.2% pa	6.2% pa
Capital Value Growth	12.4% pa	12.4% pa
Rental Value Growth	3.6% pa	3.1% pa
IPD Capital Value Pre-Crisis Peak to Present	100	79
Prime / Regional Secondary Yield Gap	100 bps	300 bps

Source: LSH, Savills, IPD, CBRE

Bear: Fair enough Bull...but significantly the income return is still 100 bps higher than it was in 2006. That's a massive difference. In addition, across the property sector as a whole, capital values are still 20% lower than they were back in 2006, and more like 40% in real terms. And don't get me started on the yield gap between prime and secondary regional yields.

Bull: That's all very well, but the property lending market is back to where it was back in 2006. More debt available, higher loan-to-value ratios, as well as more lenders than you can shake a stick at.



Bear: Yes the lending market recovery is established, but it is nowhere near 2006 yet. Okay, property's debt mountain is falling and new loan originations are on the up, but the number of new originations is still only 55% of the level in 2006.

Bull: But I'm convinced I read somewhere that there had been a recent surge in loans with higher LTV's.

Bear: You are right Bull, but the percentage of higher LTV loans is still some way behind the average 2006 ratio. Take prime offices for example. Today the average LTV ratio is 70%, up from 64% in 2010, but this is still way below the 80% back in 2006. Another big difference to point out is the cost of money.

Bull: Property debt is so cheap isn't it?

Bear: It sure is. The difference between 2006 and today is huge - about 240 basis points.

Bull: With the IPD All Property Equivalent Yield above 6% it's not hard to see why investors are looking at the debt markets so intensively and why property is currently so popular.

Bear: Property is only attractive because of the unattractive income returns from other low growth/risk-free assets. When bond rates and interest rates both rise, that attractiveness will wither away.

Bull: Rubbish. The scope exists for bond yields to rise a fair bit before they start beginning to impinge on property yields. Government bonds are currently hovering around 2%. That's a massive 420 basis point margin to property's income return. Would a 50 or even 100 basis point rise in bond yields really make a difference? St Bride's don't think so and I agree with them.

Relative Income Returns		
Asset Type	Income Returns % pa	Yield Gap
All Property (IPD) as at December 2014	6.20	-
FTSE 100	3.72	2.48
10 Year Government Bonds	2.14	4.06
Base Rate	0.50	5.70

Source: FT, IPD - 30 June 2015

Bear: But St Bride's thought the UK gilt yield would breach 3.5% over the course of 2014. Okay they changed their tune for 2015, but how can you really trust them when it comes to advice on gilts?

Bull: That's a fair point, but does anyone really know? The current economic environment of low inflation and low interest rates should keep bond yields down. Even if they do rise next year, the gap is still wide enough to keep property popular.



Bear: You are not going to try and convince me that this popularity is going to drive further yield compression in London are you? Have you not seen the yields being paid at present?

Bull: Further yield compression is just possible. £7.6bn was invested in London in Q1 2015, compared with £4.88bn in Q1 2014. That equates to a 55% increase. Investors are still finding it really difficult to buy and when the right asset does become available, the stiff competition is driving down yields. I can't see this changing soon.

Bear: Is the London market still being dominated by overseas investors?



Bull: Absolutely. Q1 2015 saw the highest-ever proportion of London transactions completed by overseas investors. North American investors are currently dominating.

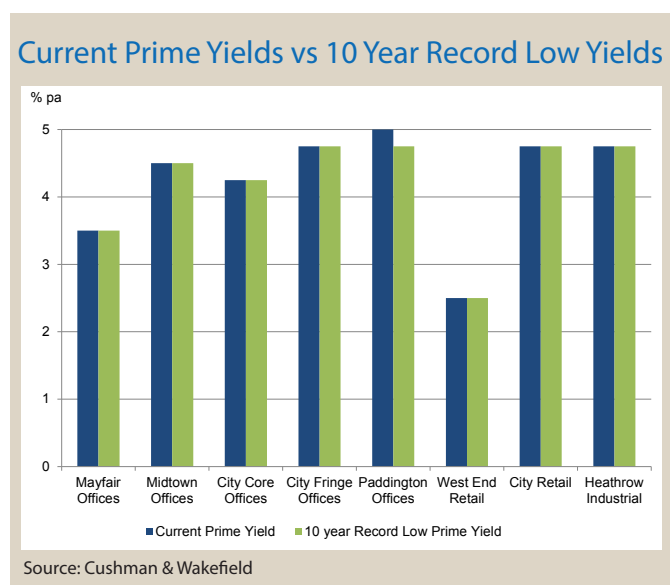
Bear: Dare I ask about the UK institutions?

Bull: Could do better... but to be fair, their investment in London reached £1.7bn in Q1, its highest quarterly total since Q3 2006. But going back to your question about possible further yield compression, we have to remember that overseas investors do not always look at pricing in the same way as domestic institutions.

Bear: How do you mean?

Bull: Well for some overseas investors they are happy to acquire assets at 3.0%-3.5% because either comparable yields back home are keener or there is a significant geopolitical risk that jeopardises their wealth. The reality is that unless something major happens either economically or politically to the UK, overseas investors will continue targeting London and yields will continue to be squeezed.

Bear: I don't see it myself. According to C&W, prime yields across London are now, on the whole, at record low levels. That screams out that London has topped out.



Bull: Okay so that's your assessment Bear, but a simple peak-of-market comparison just isn't a reliable benchmark.

Bear: Give me another good reason then.

Bull: Rental growth. Take West End offices. According to CBRE, rents are forecast to rise by 15.6% this year, with an average growth rate of 6% over the next 5 years. For the City, rents are forecast to rise by an average 3.2% pa. If this rental growth can be captured, along with any existing vacant space let up, it is easier to justify the current yields being paid, isn't it?

Bear: Those rental growth forecasts are laughable. Have you not seen how many cranes there are at present? According to Deloitte, 31 schemes started in the last 6 months, totalling 4.4m sq. ft. This is the second highest volume of space started in the last 20 years. This new wave of development is bound to act as a brake on rents.

Bull: Nonsense. 37% of the space under construction is already pre-let.

Bear: But what about the amount of space due to complete in 2017 and 2018? Delivery then is set to exceed the long-term average annual delivery figure of 4.7m sq. ft.



Bull: But there is such strong tenant demand at present Bear that it's quite feasible a significant proportion of this space will be pre-let before it is built. We also have to remember the complete lack of development activity in 2011-2013, and what's more, the potential increase in supply will be felt at different times in different parts of Central London. That's a real change from the past.

Bear: So are you buy, sell or hold London?

Bull: It depends on what type of investor you are and what your return aspirations are.

Bear: Come on! Get off the fence!

Bull: Okay. For certain overseas investors I reckon London still looks an attractive location to invest or 'place' their money. London remains a buy for them.

Bear: And for the UK domestic investor?

Bull: A harder one to call but now is certainly not the time to sell. London remains the World's #1 City and buying back into this market in the future may be incredibly difficult. Furthermore, if you take the rental growth forecast, complete the right asset management initiatives, then....

Bear: And your answer finally is?

Bull: London is a hold and a 'buy' if you can find the right property at the right price. London is definitely not a sell. Happy now?

Bear: Well I could do with stretching my legs if I am honest. You are a right old lump Bull. Given this match has just finished, shall we have a wander outside and see what else is going on? We can have a chat about the regional markets out there.

Bull: Sounds like a good plan.

Regions and Residential

Sat amongst the crowds, Bull and Bear discuss the regional markets and the growing institutional interest in the residential sector.

Bear: So then Bull. What do you reckon this place should be called? Henman Hill or Murray Mound?



Bull: You've missed off Rusedski Ridge, Robson Green and Heather Hill. But for me it has to be Murray Mound. He's won here whilst all Timmy boy could do was build up our hopes, clench his fists and lose 4 semi-finals. I am not one for rewarding failure.

Bear: Clearly not. But whatever it's called it's a great place to soak up the atmosphere, isn't it? That said, it would be even better if they installed a second large screen so we could watch the Ashes in parallel...after England's reincarnation against New Zealand, this series has the makings of a belter.

Bull: Agreed, but as much as I would love to debate the pros and cons of the Test team shall we finish off our half-year review? If we rattle through it in short order we can be back at Centre Court in time to watch Mansour Bahrami do his tricks.

Bear: Good plan. So what would your response be if I said that the UK regions were overpriced?

Bull: I would give you a politician-style answer.

Bear: That's a given Bull but even you must be slightly concerned about current pricing levels. The investment market has left the occupational market behind.

Bull: A lot of investors disagree with you Bear. They are now putting their faith, and their money, into the UK regions.

Bear: A lot of demand all pointing in the same direction doesn't necessarily mean that they are all right!

Bull: But the investment case does look compelling if you ask me... although being selective remains crucial.

Bear: What like St Bride's regional strategy? What do they call it again?

Bull: 'Favoured Five'.

St Bride's Favoured Five Locations

Offices	Retail	Industrial
Leeds	Leeds	Leeds
Bristol	Bristol	Bristol
Manchester	Manchester	Manchester
Edinburgh	Edinburgh	Cardiff
Cambridge	Guildford	Milton Keynes

Source: St Bride's Managers

Bear: That sounds like a children's book! Hopefully their strategy contains more of an investment case than Enid Blyton's books do.

Bull: Of course it does. Building on their top 20 Long-Term Sustainable Locations, St Bride's have added a further layer of property specific screening to establish their "Favoured Five" long-term cities for each asset type. Overall 8 cities feature, with Leeds, Bristol and Manchester appearing across the board.

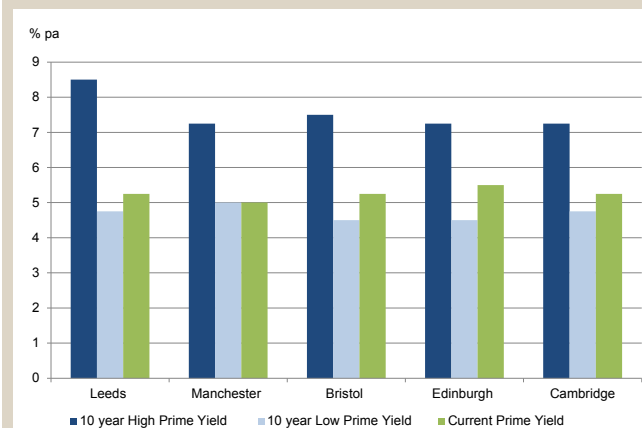
Bear: That sounds a sensible approach to me, rather than the traditional 'catch-all' regional approach to property portfolio diversification. But given their credentials, aren't these cities on every investor's radar?



Bull: They are popular but there are still plenty of opportunities available offering decent returns. Investors just need to think outside the box...whether it be via lot size, lease length or asset class.

Bear: But aren't prime yields back where they were at the peak of the last market?

Prime Yields vs 10 Year Record Yields for St Bride's 'Favoured Five' Office Locations



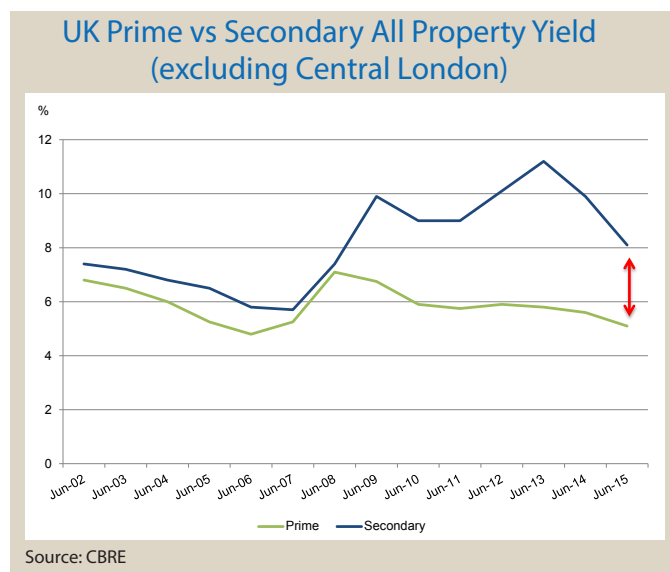
Source: Cushman & Wakefield

Bull: It depends on the location and asset class. Take offices. Prime yields are now close to where they were back in 2006/2007. In fact in Manchester's case the current prime yield of 5% is a 10 year record low. On the flip-side, prime retail and prime industrial yields still have some way to go before they reach record lows.

Bear: So does all this mean there is still further scope for yield compression in the regions?

Bull: Probably. Take another look at the gap you mentioned earlier between prime and secondary regional assets. Back in 2006 the gap was 100 basis points. Today it is 300 bps.

Bear: But the gap has narrowed significantly recently hasn't it?



Bull: It has - by approximately 250 basis points since 2012. However the gap is still 100 basis points wider than the 30 year average. I know history can only act as a guide, but if you ask me, that suggests there is still room for further yield compression. Especially given the generally positive noises coming out of the occupational markets.

Bear: Noises? Like what?

Bull: Well more and more firms are pursuing expansion plans or upgrading their existing accommodation. Take Manchester and Edinburgh for example. Manchester had its best year in terms of take-up since 2001, whilst Edinburgh recorded its best year ever.

Bear: So are wild rental growth forecasts now doing the rounds?

Bull: You are such a cynic Bear. But with strengthening occupational demand it won't come as a surprise to hear that prime rents are under pressure to grow. But overall, rental growth still remains patchy.

Bear: I suppose this reported upward pressure is being helped by the fact that most office markets, and industrial for that matter, currently face an undersupply of good quality stock?



Bull: Absolutely and this has certainly been helped by 8m sq. ft. of space being lost to alternative uses in the last two years. In fact development is back on the agenda, and not just in the core office markets.

Bear: Madness. Developers and investors are so short-sighted.

Bull: You forget though Bear that most of the main regional centres are sitting on current historic low levels of supply after 5 years of almost no development. The current development planned is unlikely to hinder the rental growth prospects in the coming years, thus adding to the positive story of investing in selective regional markets.

Bear: So the regions are a 'buy' then are they?

Bull: On a selective, locational basis yes. I also strongly believe that the high demand in the current market offers investors a genuine opportunity to get rid of their 'dogs' and reposition their portfolios.

Bear: So you are covering all bases then. Buy, hold and sell. Another politician's answer from you Bull.

Bull: Indeed so. Buy into selective locations, sell only dying assets and hold everything else.

Bear: Before we wrap things up, can we just quickly discuss residential? It feels like there is more noise about this asset class than ever before.



Bull: Well demand is certainly there. The Private Rented Sector Taskforce says it has identified a pool of more than £10 billion that institutions would like to invest in PRS. However not many cheques have been written.

Bear: So why the hesitation?

Bull: The excuse list is as long as your snout. Dealing with residential tenants, the dread of the morning's headlines, management issues, lack of product, too small lot sizes. You name it, they'll use it.

Bear: But surely the excellent returns should compensate? It hasn't stopped US institutions investing has it? Multi-family, as they term it, is the second largest asset class over there. They like the diversification of income from having so many tenants. They like the shorter leases so they can capture the increases annually. In fact there isn't much they don't like about the sector.

Residential vs Commercial Property Total Returns

Property Type	1 Year	3 Year	5 Year	10 Year
Residential	13.3%	12.0%	11.5%	9.9%
All UK Commercial	17.8%	10.5%	10.9%	6.2%

Source: IPD

Bull: Indeed. There are so many lessons from over in the US that can be adopted here. The quality and scale of the operators for example. That said our Housing Associations have made a pretty good start.

Bear: Housing Associations? What relevance do they have?

Bull: A lot. They own 2.5 million units, equating to 28% of all rented homes in the UK. They have the infrastructure already in place, whilst they already own and are developing market rent properties as a way of generating income. Perhaps they are worth cosying up to?

Bear: Now there's a thought...for another day though. If we delve into that topic now we'll miss the men's vets doubles match.

Bull: At least I know where your priorities lie Bear. Come on then. Let's go.

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