

Half-Year Report 2016



July 2016

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Bear: It's great to be here in Paris, isn't it? All that uncertainty in the UK was driving me crazy and the chance to escape to watch some football was just what the doctor ordered.

Bull: Especially after all that dross served up by England! But don't you think the UK is such an interesting place to be at the moment? We have been doing this research thing for more years than I can remember and Brexit is by far and away the biggest political decision of our working careers. Its impact will be generational.

Bear: That we can agree on Bull, but the fall-out since the result hasn't been great, has it? The markets have been all over the place.

Bull: True, but isn't it fascinating? I have to admit that I've found myself glued to Newsnight most evenings since 23rd June. I am exhausted just trying to keep up.

Bear: So am I. But St Bride's don't want us discussing politics. They want us to complete our mid-year UK property market review, and fast. Everyone wants to know what is going to happen next.

Bull: But I thought we'd already completed our review for them at their Annual Seminar in June. I had this review down as a simple cut and paste of the presentations.

Bear: Dream on Bull. Our commentary assumed that the UK would vote to remain in the EU. We followed the bookies remember!

Bull: Oh yeah. That's right. We believed in the saying 'the bookies never get it wrong!' Well if you can't rely on the bookies or the opinion polls, who can you now trust?

Bear: Certainly not Michael Gove!

Bull: Touché Bear, touché.

Bear: The reality is that the world has changed since the Brexit result and pretty much everything we forecast at the beginning of 2016 now has to be revisited.



Bull: Can't we just tell St Bride's that it's far too early to comment on the impact, rehash our latest assignment and then enjoy our summers? We're certainly due some sun!

Bear: Stop it Bull! With all the turmoil out there St Bride's are looking to us for some pearls of wisdom to supplement their own thinking. Their clients, service providers, friends and families want us to help steer them through these choppy waters.

Bull: Well, our 2016 predictions back in January included the assertion that the UK would not vote to leave Europe. We have to admit to being wrong-footed on that score! But what about our other predictions? Shall we see how we fared?

Bear: Good idea. Let's start with our economic and political predictions.

St Bride's January Predictions for 2016 A Reminder

1	UK GDP growth and inflation will be lower than forecast by the OBR
2	Interest rates will not increase before Quarter 4 2016
3	The UK will not vote to leave Europe - Whoops!
4	Donald Trump will not be the 45th US President
5	Total Returns for 2016 will be 8.00%
6	There will be no further yield compression in London
7	2016 investment volumes will not match 2014 or 2015
8	Investment volumes in the regions will exceed those in London
9	Rental growth will remain strong in London and patchy in the regions
10	The alternative sector will increase its share of all property investment in the UK
11	The Private Rented Sector will start to see significant institutional investment

Source: St Bride's Managers

Economic and Political

Bull: Our first economic prediction was that the UK's GDP growth and inflation would be lower than the OBR forecast. We will be proved correct on this. So, one out of one.

Bear: Hold on a second. I am not sure about the inflation bit. Maybe this year yes, but inflation is now expected to arrive at its 2% target within a much shorter time frame than previously forecast due to higher import prices. As for GDP, can you remind me of the latest figures?

Bull: The UK economy grew 0.4% in Q1 2016. However the UK's economy was already slowing and the threat of Brexit, at the time, played a crucial role in this. But it was far from all doom and gloom.

Bear: You can't blame Brexit for all of the economy's ills though Bull. If I remember rightly, there had been a steady downward trend in GDP growth since 2014 anyway.

Bull: All the economy's ills? The UK economy is still growing Bear. They are predicting 0.2% in Q2. Growth is hardly a definition of an illness is it? Employment is still high, borrowing costs are low, inflation is low. The UK economy, which is the fifth largest in the world remember, is in far better health than most of our competitors.

Bear: But the rating agencies have down-graded the UK as a result of the Brexit vote to AA-. That's not good, is it?



Bull: Really? I must have missed that. As I said, it's so hard keeping up with what's been happening. But we're not facing a recession like all those doom-mongers were predicting in the lead up to the vote are we?

Bear: I am not so sure. Goldman Sachs, UBS, Deutsche Bank and HSBC have all warned their clients that the UK is going to enter a period of slower growth. And ING and Investec believe that a recession is a "realistic possibility". Even Nigel Farage admitted we may be heading for a mild recession.

Bull: Farage! What does he know, or more to the point, care? He's quit to 'get his life back'.

Bear: Which means he's retreated to his local pub!

Bull: Very funny Bear. But this is no laughing matter. There are a lot of people genuinely worried about what lies ahead. I am just hoping that the impact is going to be short-term. ING's economist wasn't predicting a recession at the St Bride's Seminar was he? Has the outlook really worsened? What reasons are they now giving?

Bear: There are plenty of reasons. Like the price of imports will rise and wages are unlikely to match it. Like the uncertainty leading to a pull-back in investment and hiring from both domestic and foreign firms. And nearer to home, the property sector's biggest agents have already effectively frozen recruitment for transactional roles. Why would you hire when you don't know what's going to happen? As a consequence of all this, ING think we are going to see a squeeze in real household incomes, while lower corporate spending and falling asset prices will add to a sense of gloom.

Bull: Hardly cheery stuff is it? Okay I accept that GDP growth is going to slow, so it's all the more vital that the exit negotiations with the EU are concluded as quickly and favourably as possible. We need a speedy and amicable divorce.

Bear: That scenario is exactly what ING have based their forecasts on. I'd hate to think what their outlook would be should there be a slow and acrimonious divorce. And we can't rule that out unfortunately.

Bull: I totally agree. But that's why The Bank of England has already offered emergency liquidity to the markets to the tune of £250bn. They have also eased special capital requirements for banks, potentially freeing up £150bn for lending. And an interest rate cut now looks a certainty, probably in August once the Inflation Report has been published. You can't argue that The Bank of England hasn't acted swiftly.

Bear: I suppose not. Thank goodness that Mark Carney hasn't resigned like everyone else.

Bull: True. We haven't had a resignation for at least a day or so! Hopefully the arrival of Mrs May as Prime Minister and the prospective cut in interest rates will help improve confidence. It also means that our prediction that interest rates won't increase before Q4 will also be right. That's two out of two Bear! Get in!

Bear: But you forget we got our third one horribly wrong Bull! The EU Referendum vote!

UK Economic Forecasts - July 2016

	2016	2017	2018
GDP	1.6	0.1	1.5
CPI	0.7	3.0	3.0
BoE policy rate (year-end)	0.00	0.00	0.00
EUR/GBP (year-end)	0.88	0.83	0.80

Source: ING Forecasts

Bull: Moving swiftly on then. What about "the pound in our pocket"? Surely the recent currency devaluation will be helpful?

Bear: Yes, but The Bank of England feels that the UK economy needs more than just that. You'll have seen how the pound recently hit a 31-year low against the dollar. There's been an 11% fall since the Referendum and remember, they say the pound is the chief proxy for the mood in the markets.

Bull: I know that, but a weak pound also means the UK is more attractive to US Dollar denominated investors. And the depreciation will provide a boost for exporters and businesses who earn their revenues overseas. It will also increase the attraction of the UK property market for overseas investors and they play an ever-increasing role in the UK. According to the IPF, overseas investors now own over a quarter of all UK commercial property by value.

Bear: Given you are being so bullish Bull, can you please explain what on earth has happened to government bonds in the last few weeks? 10 Year Government bonds are now at around 0.90%.



Bull: It's good news for property, isn't it? Low bond yields help make the income return from property appear even more attractive. In 2015 property delivered an income return of 4.80%. That is a whopping 390 basis point margin. This gives significant scope for bonds to rise before they would start acting as a constraint on property yield levels.

Bear: That is true but really low bond yields don't show a great deal of confidence in the economy, do they? Surely investing in bonds at these levels only makes sense if investors are expecting the obvious alternatives, equities and property, to plunge.

Bull: I don't buy that argument at all.

Relative Income Returns

Asset Type	Income Return (% pa)	Margin to Property (%)
All Property Income Return	4.80	-
10 Year Government Bond	0.90	3.90
Base Rate	0.50	4.30
FTSE All Share Dividend Yield	3.90	0.90

Source: IPD / FT - 15 July 2016

Sporting Predictions



Bear: Anyway, shall we quickly revisit our 2016 sporting predictions? I am not trying to avoid the big property questions, but I do think we could all do with a bit of light relief before we get stuck in.

Bull: Okay, but all we are going to do is show that we haven't got a clue when it comes to predicting sport.

Bear: You can say that again! First up, we said that England would win their Group at Euro 2016 and then lose on penalties in the semi-final. And we all know what happened there.

Bull: How can I forget? We were out-fought and out-thought by Iceland, a country whose manager is a part-time dentist and where there are more volcanoes than professional players!

Bear: England's performance was nearly as feeble as our sporting predictions. It's embarrassing just how bad we've been so far.

Bull: I know. Our "safe-bets" for Euro 2016, The World Twenty 20, The Six Nations, The Premier League, The Masters and Wimbledon were all wrong! But, at least there is a silver lining on the sporting front. England won the rugby series against Australia 3-0, Wales were a revelation at Euro 2016, Danny Willett won The Masters, Andy Murray won Wimbledon and England whitewashed Sri Lanka at cricket.

Bull & Bear's January 2016 Sporting Predictions

Competition	January Prediction	Winner
World Twenty20	India	West Indies
Six Nations	Ireland	England
Premier League 2015/16	Manchester City	Leicester
The Masters	Rory McIlroy	Danny Willett
Euro 2016	Germany	Portugal
Wimbledon	Novak Djokovic	Andy Murray
Olympics	Team GB will not better its London 2012 medal tally	TBC
Ryder Cup	America	TBC

Bear: Very true. And let's hope we do well at Rio and the boys retain The Ryder Cup.

Bull: Ah! One big happy European family again! Let's grab a stiff drink as we consider what Brexit is going to mean for the UK property market.

Bear: Good idea as I suspect we might need it! So how are we going to tackle this, Bull? Our June Seminar stuff is already out-of-date.

UK Property Market

Bull: That's true. But remember the main question that was being asked in June was had we reached the top of the UK property market? There was no consensual answer between us, remember?

Bear: I think you'll find you agreed with me that we had reached the top. The only bit I conceded was that the top should not be regarded as a sharp peak with a big fall but more like a plateau. Remember we said it was like climbing to the top of Mount Everest only to find that it was Table Mountain up there. I am sure that's not the case now though, is it?

Bull: Probably not. We did say that the UK property market would be set for a bumpy ride over the next few years if we voted to leave. We covered our backsides there. The issue for us is that no-one in the industry really expected it to happen, or prepared for it, did they?



Bear: That's true. But we had low yields, falling investment returns, falling investment volumes and significant outflows from the retail funds before the vote was announced.

Bull: No, no, no Bear. Yields were stable. Investment volumes were still very much in line with the long-term average. Overseas investors were still buying across the whole of the UK, not just London. Rents were growing too and supply was tight.

Bear: But you're not seriously still arguing that we haven't reached the top?

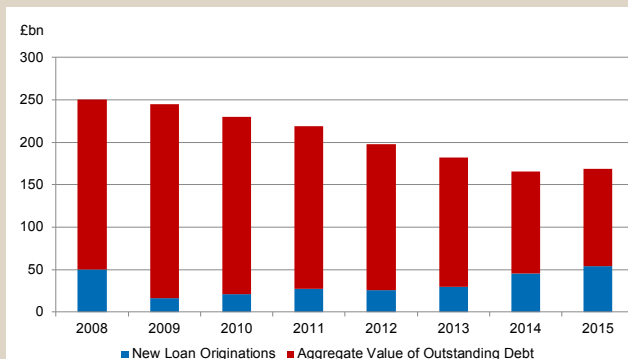
Bull: No I am not, but we are not looking at a re-run of 2007-08. The UK property market is in far better health now than it was then.

Bear: What makes you so sure about that?

Bull: Did you really not listen to any of my arguments at the St Bride's Seminar? Take bank lending as an example. The most recent De Montfort report shows a robust and stable commercial property lending market. Loan to Value Ratios of outstanding debt have continued to fall over the last 5 years. At the end of 2015, 88% of outstanding debt had a LTV ratio of 70% or less.

Bear: But you'll recall my concern that high valuations and increased banking liquidity had raised the prospects of the lending market over-heating. New loan originations hit a post-2007 high last year.

UK Commercial Property Lending



Source: De Montfort University

Bull: I know that, but the UK banks have so much more capital now than they did back then. This has given The Bank of England the freedom to relax its requirements in order to allow the banks to carry on lending. The property companies are also far less indebted than they were. In the listed sector, levels of leverage were about 45% in 2007. Today they are in the mid 20's to 30's %.



Bear: Yes, but those numbers are based on historic valuations. If you ask me, the recent gating of the large open-ended retail funds brings back bad memories. 2016 could be shaping up to be a re-run of 2007.

Bull: Crickey Bear. A few retail funds suspend trading and you start thinking it's Armageddon out there. This is not a Lehman Brothers moment. Not by a long shot.

Bear: So can you explain why so many of the retail funds have gated? In total that's about £18bn of assets, you know.

Bull: The main reason is that investors hate uncertainty, despite property's stellar performance over the last few years. Once one starts it's really hard to stop the dominos falling.

Bear: So that's why there has been a rapid increase in redemption requests. The simple herd mentality?

Bull: Yes and the funds' arguments are that suspending dealing protects the interests of all their investors. I accept though that it's not great news.

Bear: But again you can't simply blame Brexit, Bull. Retail investors were coming out of property funds well before the result was announced. According to the Investment Management Association, Q1 2016 saw the lowest amount of money being invested into property for 2 years. Quarter on Quarter outflows in Q1 2016 from property funds equated to -118%. The May 2016 data shows retail investors withdrew a staggering £360m from property funds! Goodness knows what June's figure will be.

Bull: But let's remember that the institutions were still investing and there were significant outflows from all the other asset classes too! Yes property funds were seriously affected, but it's not fair to look at them in isolation. Equity funds have experienced bigger outflows, with £439m out in May alone.

Bear: The trend is worrying for property though. It was the least popular sector in the week after the Referendum according to Hargreaves Lansdown. The risk of contagion is the real problem now.

Outflows from Property Retail Funds

Net Sales	Q1 2016 (£m)	2015 (£m)	2014 (£m)
Retail	-166	2,748	3,805
Institutional	67	582	744
Total	-99	3,330	4,549

Source: Investment Management Association

Property Pricing

Bull: I don't agree Bear. The open-ended property funds only own about 5% of the UK commercial property market. Okay this is up from 2% in 2007 but I just can't see why a relatively small section of the market could have such a big impact.



Bear: Two reasons. Firstly because many of the funds have already written down the value of their assets. And these haven't been immaterial cuts either. L&G has cut the value of its fund by 15%. Aberdeen slashed the value of its fund by 17% in an effort to stem outflows. The list goes on and on unfortunately.

Bull: 17%! Where on earth did they pluck that number from? I think the market recognises that property values are going to fall, but I've not heard anyone be that bearish.

Bear: The market seems to be thinking that as a rule of thumb, yields may rise by 0.50%. Based on the IPD All Property income return of 4.80% at the end of 2015, that would translate into an average down-valuation of just less than 10%. But, let's be clear, there is no evidence of this. It is pure speculation.

Bull: Hmmh! What's the second reason?

Bear: The fear that forced property sales by the open-ended retail funds will act as a catalyst for the wider market. According to Stifel, the UK Property REITS are trading at an average discount of 22% to the NAV of their assets. Whatever the NAV is of course!

Bull: So are you saying that we should expect a plethora of sales brought to the market in the coming weeks? The return of the fire sale?

Bear: In my opinion it's inevitable, yes. The retail funds are obliged to hold significant cash and near-cash (mainly property company shares), and they will need to sell assets to retain that buffer. And they need to sell fast. That's my big worry.

Bull: So how much property are we talking about?

Bear: The current rumour is that UK property funds have already lined up disposals worth hundreds of millions of pounds – and could even end up flooding the market with up to £5bn of assets!

Bull: Blimey. But surely that creates an opportunity for someone. Those domestic investors with cash burning a hole in their pocket or those overseas investors who still like the fundamentals of UK real estate should have a field day and can benefit from the depreciation of Sterling into the bargain.

Bear: That's true but would you buy now if you expected the price to fall in the coming months? What's the saying? Catching a falling knife? I can't see many investors buying into that investment strategy!

Bull: But I am not talking about entering best bids races. I am talking about finding 'deals'! After all, the fundamentals of the UK property market are still strong and some sectors, like logistics, and some assets let on long leases to strong covenants really should remain popular.

London

Bear: But the numbers post-Brexit suggest otherwise. The last I'd heard was that over £650m of deals in London had been pulled, or put on hold since 23rd June.



Bull: But isn't this an unbelievable buying opportunity? We all know how incredibly tough it has been to buy in London of late. If there is less competition and pricing has cooled, why wouldn't you get in whilst you can? London is the World's Number 1 City remember?

Bear: How can I ever forget? You tell me that every time we meet Bull! You do ask a valid question though but I think the uncertainty of what will happen to London's financial markets is going to weigh heavily on investors' minds.

Bull: Rubbish. London is London.

Bear: Just imagine the scenario if our City players lose their European financial passports. The consequences would be really damaging. And this would knock-on to occupancy rates, rents and pricing should they relocate staff elsewhere in Europe.

Bull: But surely whenever there is uncertainty, there is a flight to core? Cities don't come more corer, if there's such a word, than London! With the rebasing of Sterling, I'll be staggered if overseas investors are not lured to London in their droves.

St Bride's 20 World Cities (London - 100)

Rank	City	Score
1	London	100.00
2	New York	99.4
3	Singapore	89.4
4	Tokyo	88.2
5	Paris	85.1
6	Hong Kong	85.1
7	Chicago	79.5
8	Los Angeles	79.3
9	San Francisco	78.6
10	Sydney	78.0
11	Toronto	76.7
12	Boston	76.0
13	Washington D.C.	75.1
14	Geneva	74.9
15	Amsterdam	74.6
16	Vancouver	73.6
17	Seoul	72.9
18	Melbourne	72.8
19	Stockholm	72.6
20	Berlin	72.5

Source: St Bride's Managers, June 2016 update

Bear: But international investors are savvy Bull. They don't make property acquisition decisions based on currency alone. The depreciation will clearly help them, but that is just the cherry on the top, not the cake itself. I think, like many, they will be sitting on the side-lines watching London's occupational markets with a great deal of interest.

Bull: But are London-based occupiers really that worried? HSBC have announced that they will keep its headquarters in London. People still need to occupy space and vacancy rates are currently at record lows, so even if there was a sharp fall in demand, it is not likely to lead to a sudden glut of office space. The same goes in the regional occupational markets.

The Regions

Bear: How on earth do you know that?

Bull: From the feedback I've been getting from some regional agents post-Brexit. Local occupiers are, in the main, carrying on as normal. We have to remember that the UK is not just made up of large, international companies based in London. Small businesses account for 99.3% of all private sector businesses by number.

Bear: Bull, if you don't think global businesses are going to delay making decisions on investment until we have established what our future trading arrangements are going to be, then you're more deluded than I thought you were.



Bull: As I have said, it's not all about global business Bear. And thankfully the occupational markets across the country are generally characterised by a shortage of good quality space and limited development pipelines. I just do not foresee a raft of tenant failures or rental corrections.

Bear: I disagree. I bet you vacancy rates will rise and rents will fall. It's inevitable, especially if we go into recession.

Bull: So are you saying there'll be no rental growth?

Bear: I recognise that in 2014 rental value growth was 3.1% and 2015 saw 4.00%, but the IPF forecast, pre-Brexit, was only 2.1%. Their next edition is bound to have this projection scaled back significantly.

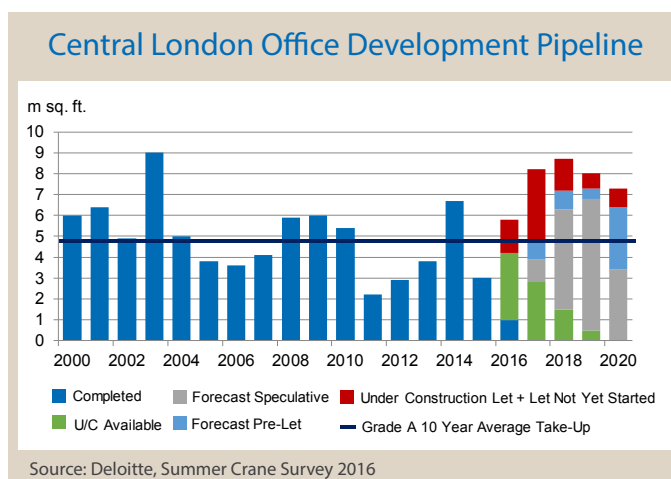
Bull: Okay the rate of rental growth may be less, but supply in the regions is tight, especially for offices. According to Knight Frank, the overall Grade A availability in the ten regional markets they monitor fell by 9% in Q1 2016 to reach 2.2m sq. ft. This is 22% below the five-year average of 2.8m sq. ft. Aberdeen is the only city to have greater Grade A supply than their five-year average.

Bear: All valid points Bull, and I also agree with your view that it's hard to imagine anyone starting a new development any time soon, especially with no pre-let in place. Developers will want much more clarity about the level of prospective demand in the economy.

Bull: Yes, and I am particularly interested in seeing what is going to happen to the development pipeline in London.

Development Pipeline

Bear: So am I. Remember Deloitte has predicted that the combination of the schemes currently under construction and those yet to start will deliver a staggering 38 m sq ft over the next 5 years. Given that the 10 Year Average Grade A take-up is less than 5 m sq ft per annum, this ongoing/future development looks like it will inevitably lead to a significant over-supply.



Bull: But with new schemes on hold, this will help to some extent and ultimately result in new supply restrictions. It's not all doom and gloom you know!

Bear: Maybe, especially as bank funding isn't going to be so readily available. Appetite for risk will surely dry up, margins are bound to rise as competition falls and lenders demand higher returns for the higher risk they take. The number of lenders willing to fund secondary property and back developments is bound to thin out. They will surely refocus on prime and core.

Bull: I accept that. But the world isn't going to stop spinning. For instance, the shortage of houses across the country isn't going away. And the population is growing, immigration or no immigration.

Bear: True, but what about construction costs rising and work-force issues? Restrictions on free movement of workers are bound to adversely impact the UK construction industry. Losing EU labour could exacerbate the industry's skills crisis and drive up costs, not to mention the impact on the cost of importing from abroad. Construction costs are already up 10% in the past year alone.

Bull: So I suppose you are now going to tell me that Brexit is going to put pay to all those infrastructure projects that have been earmarked to start in the next few years.

Bear: There is a real danger of that, yes. I mean have you heard anything about airport expansion in the South East post-Brexit?

Bull: Only that the decision has been put on hold until at least October. But irrespective of where it goes, airport expansion is needed more than ever.

Bear: So are you as upbeat about HS2? That's not only ambitious but also incredibly expensive.

Bull: You know me. I am all for closing the gap between London and the regions. Brexit demonstrated just how big that gap is. I am concerned that the UK's exit from the EU will scale-back investment for infrastructure. The Government has pledged £100bn by 2020-2021 but this needs to be matched by private investment.



Bear: Fingers crossed the private sector delivers, but I am not holding out much hope for the wider property market. In the space of four weeks we've found ourselves in a bit of a mess, which will inevitably reverberate around the property market.

Bull: If you keep talking the market down Bear, sure enough it will go down. The drama of what we have seen in the last few weeks has caused imaginations to run wild. People are panicking without really knowing what lies ahead. We haven't even triggered Article 50 yet. We need to keep calm and make balanced decisions. It's completely illogical to believe there are no upsides or opportunities.

Bear: That sentiment I can agree with. But it's easy to get sucked in by pessimistic headlines. Perception can quickly become reality.

Bull: So shall we end by offering our do's and don'ts plus a conclusion?

Bull: Yes. Let's jot them down in a table and we can then revisit them next time we meet, provided of course we continue to be engaged by St Bride's!

Do	Don't
Remain calm	Panic
Talk to your clients, investors, suppliers and tenants	Bury your head in the sand
Be patient	Do any new speculative development... yet
Prepare to act, either buying or selling	Invest in an open-ended retail fund (for the time-being)
Buy if the price is right, both directly and indirectly	Forget the fundamental attractions of property
Keep an eye out for mis-pricing	Forget chaos brings opportunity
Enjoy your summer	Forget your sunscreen. It's going to get hot (we hope)

Capital values may slip by 10% (on average), but the silver lining is that the comparatively high income return from property looks very compelling.

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