Finding value in the London office markets

*Recently, **Sheila Hopkins,** managing director – Europe and infrastructure with Institutional Real Estate, Inc, spoke with **Bill Page** and **Derek Gilby** of Legal & General Property for their views on London property investment. The following is an excerpt of that conversation.*

There has been a lot made of the weight of international money competing for central London office assets, but do you believe that there is still value to be sought within this market?

Derek Gilby: The outperformance of the London office market has been a defining feature of the market in the past several years, yet yields have fallen as international capital looking for wealth preservation, and long-term UK pension funds seeking stable assets that have the capacity to match future liabilities, have continued to fight for prime assets. As a result, we believe investors looking for strong returns have needed to become a lot more tactical and astute in seeking out investment opportunities.

With this in mind, how do you approach the London office market?

Bill Page: In order to decipher what an outperforming London exposure might look like, we have taken time to analyse the different office submarkets within London and, as a result, have found it necessary to break these submarkets down into their constituent parts.

Gilby: Typically, the market tends to divide its outlook for London offices into City, Midtown and West End, but the subsectors within these markets are not homogenous; they are very diverse, so we have drilled down and identified eight submarkets within the West End and four within the City. Our objective is to look at relativities within these individual submarkets in order to indentify areas where we can find value. We are taking a more advanced approach to forecasting methodology and applying that to the London market in order to provide us with a more informed view as to where we believe the market and its constituent parts will go in the future.

Page: Supporting our investment strategy, this also provides valuable data about relative performance, so in various different market cycles we can see how a distinct geography performed relative to its benchmark. Some of it is very intuitive, but the data and the analysis also pick out things you might not expect. For instance, in the West End, the property market often perceives the areas of Mayfair and St James's as a combined "West End Core". What this research proves is that they actually perform very differently from one another.

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Derek Gilby is Senior Fund Manager and London Offices Sector Specialist at Legal & General Property

Gilby: We believe that we need to look at an analysis of these submarket villages, such as Victoria or Bloomsbury or Southbank, in the same way as we would any regional city in the UK, because they are of a similar size in terms of value. London submarkets do not behave in the same way as each other; they are diverse and different. In-depth research has allowed us to gain an understanding of the dynamics, so we can get a feel for where those submarkets are going in the future.

How much variation do you find between these submarket villages?

Page: If you look at total returns in the individual villages, on average the range in total returns in any given year is about 14 percent, so that is quite material. Picking winning and losing subsectors within these markets, therefore, is clearly very important to driving our performance. The biggest single range in any one calendar year was in the early 1990s and that was over 30 percent in terms of total returns from the best performer to the worst performer.

Gilby: It has long been known that the volatility of the London market is something to watch out for, but we also believe that it is this factor that provides opportunities to make significant gains. It is therefore important for us to look at that volatility on a more granular approach and be more specific about our forecasting, allowing our funds to take appropriate action accordingly as to where they invest.

Has your analysis come up with any surprises?

Page: Within the West End, Mayfair has consistently outperformed St James's, with less risk; the volatility has been much less. Mayfair has pretty much always outperformed its West End peers. In fact, it has outperformed across all of our chosen historic time horizons. Jumping ahead slightly, we don't think that this outperformance will continue over the next five years. The rental value growth prospects are sound, but yields have become so low that its rental value growth would have to exceed that of every other village by such a high margin in order to outperform over the five-year period, and we don't think that is likely.

Gilby: With picking an investment, it is not just about absolute growth. Every investor wants growth, but they also want to understand how volatile that growth may be. Some submarkets are showing a much less volatile pattern in growth historically, and we believe that they will continue to do so going forward, whereas others may have a bit of a health warning: "You may get some good growth here, but it is a volatile market, so beware." We may want to come in and out of these markets in reasonably short time scales, rather than investing over the longer term, and that is an interesting point to make.

Page: The City is a good example of that. Geographically, the City encompasses quite a diverse range of areas, from City Midtown to Southbank, but the spread in performance is also quite stark. The City core, the main "square mile" area, has actually performed quite poorly over the long term relative to the City benchmark. The Southbank really came into its own as an office market 15 to 20 years ago now, and has consistently outperformed the City benchmark as a whole and especially the City core over that time. The Southbank has done so well because, firstly, it comes from a higher starting yield as a more peripheral market, secondly, you have an infrastructure accruement over the past 15 years with the extension of the Jubilee Line from the West End through Southbank out toward Canary Wharf, and, thirdly, you have a tremendous improvement in office stock.

What are your five-year forecasts? How are these markets going to perform over the medium to long term?

Gilby: Infrastructure and regeneration will play a defining role in this. Submarkets that we believe will be stronger on an absolute but also risk-adjusted basis, accounting for volatility, include Southbank and City Midtown, of which the latter will be influenced greatly by Crossrail coming alive and also the improved Thameslink infrastructure. City Eastern is another market that is well worth mentioning.

Page: If you sat down and looked at Central London as an aggregate and saw hypothetically a lot of new supply coming next year, you might think that is a supply risk and it would be depressive to rents and rental value growth, but when you take a more granular approach, the opposite can be true. For example, in City Eastern, the creation of new high-profile buildings and the addition of new supply to the market is actually a good thing because it can establish a new rental profile. Other areas are undergoing significant regeneration. In Kings Cross, for instance; there is a lot of new stock being created to the north of Central London with good transport links. Victoria is already an established market, but there is a lot of development planned for that area, we believe the critical mass in these areas and creation of new public realm helps the market.

Gilby: We also think that Hammersmith is an interesting market. It is not a typical London market; it wouldn't necessarily be classified in that bracket because it is well out to the west of London.

Page: Yes, Hammersmith has historically underperformed relative to Central London, but has outperformed relative to the wider UK office market. Going forward, however, it looks interesting within a Central London context as a higher starting yield coincides with strong expected rental growth from a base of affordable rents.

What are your conclusions?

Gilby: We will continue to be an active developer and investor in central London, with a compelling story across a number of the submarkets or villages. Our focus will lean toward situations where there is a skills or capital gap and the opportunity exists to generate improved returns by adding value to assets, in contrast to passive positions where the market has become expensive. ❖

Completed at the end of October, 76–78 Wardour Street, LGP's Soho office-based redevelopment scheme, has involved an extensive refurbishment of the existing period building in order to create 33,000 square feet of premium office space spread over the five upper floors of the building. The new floor plates range from 5,414 sq ft to 7,115 sq ft and benefit from a triple aspect and terraces at all levels. The property, which is located in the heart of the Soho conservation area, occupies a prominent corner position between Wardour Street and Meard Street and incorporates a number of sustainability initiatives.