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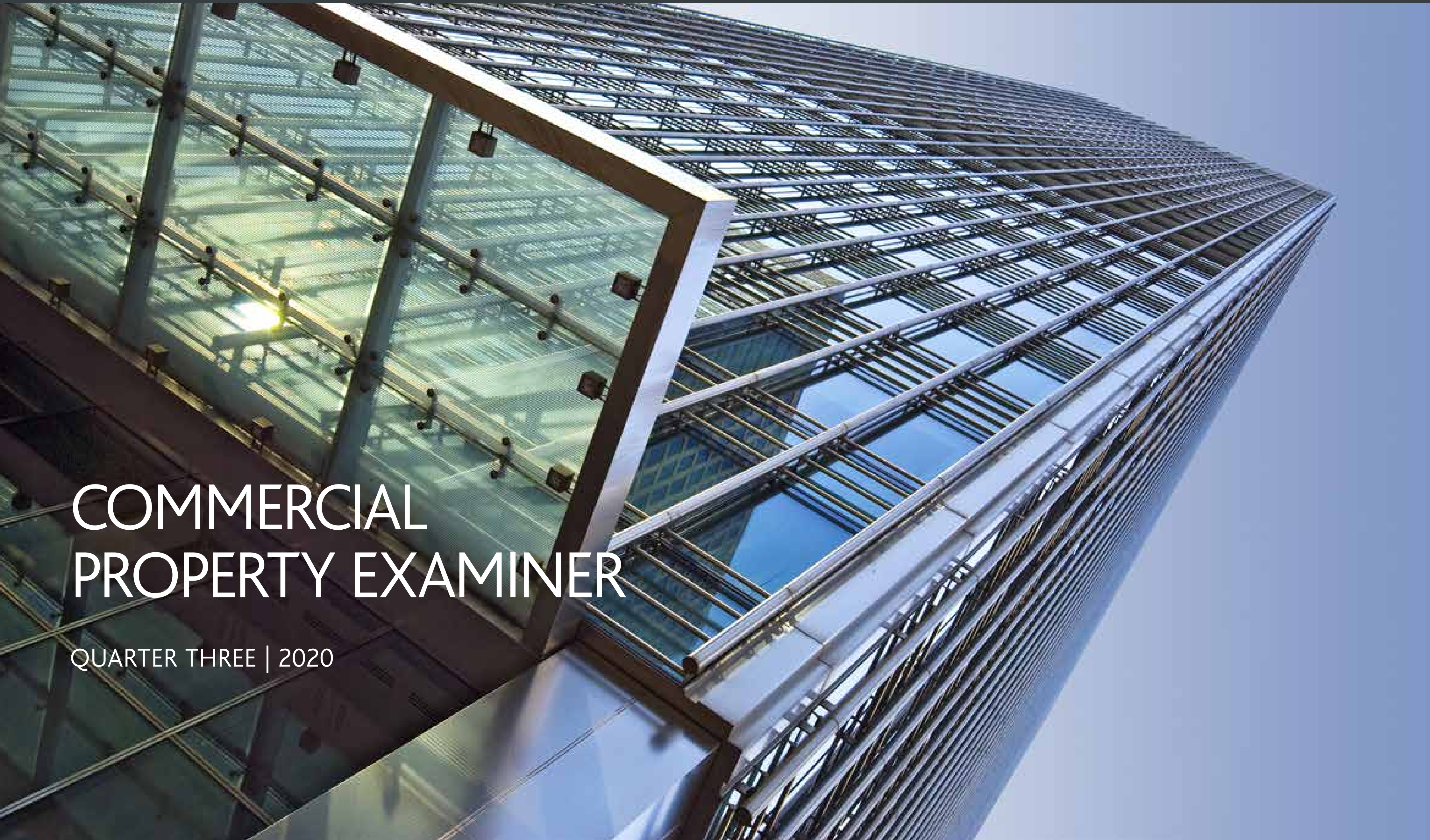


COMMERCIAL PROPERTY EXAMINER

QUARTER THREE | 2020

1. KEY TAKE AWAYS

The combined fall in UK economic output in March and April amounted to -25.3% but was shallower than expected.

The rate of recovery will depend on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors.

All Property total returns returned to positive territory in Q3 at 0.7% as an income return of 1.4% offset a capital loss of -0.7%.

However, the second wave of regional lockdowns and a disruptive collapse of the Brexit trade talks could yet see the market fall further.

2. SUMMARY

The IMF's estimate for the World economy in 2020 has been revised up from a contraction of -4.9% in July to -4.4% in October reflecting better-than-anticipated second quarter growth as well as indications of a stronger recovery in the third quarter.

The combined fall in output in March and April amounted to -25.3% but was nevertheless shallower than expected. UK GDP has now grown month on month since the end of April but remains 9.2% lower than the levels achieved in February before the full impact of COVID-19. The pace of the recovery is now decelerating.

UK GDP is projected to continue to recover over the next 2-years but the rate of recovery will depend on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors.

The latest ONS data indicates that unemployment has increased to 1.52 million or 4.5% from 1.34 million or 4.0% at the start of the year. The latest Bank of England projections indicate that unemployment will increase to 8% in the second half of 2020 and is likely to decline only gradually after peaking in Q4 this year.

Since the end of the first lockdown, there has been a strong recovery in physical retailing compared to a slow return to the workplace as "WFH" becomes the new normal, at least for now. Tellingly, those cities that witnessed a quicker return to the workplace are the very same cities that have now been categorised as "Very High Risk".

The current property initial / gilt yield gap has decreased to 4.9% as vacancy rates increase. Nevertheless, the yield gap remains more than 1 standard deviation above the 10-year average. The current level of property yields relative to the risk free rate should provide some level of protection to UK real estate asset prices. But it is also a continuing comment on the liquidity premium required as a result of the collapse in the number of real estate transactions.

Those open-ended property funds closed to redemptions in March are now gradually re-opening. So far, the managers seem to have sufficient cash buffers to manage any demand for redemptions.

All Property total returns returned to positive territory in Q3 at 0.7% as an income return of 1.4% offset a capital loss of -0.7%. All Property equivalent yields were largely stable and had a neutral effect on valuations. The main driver of falling values has been declining market rental values.

All Property investment volumes increased by 35% in Q3 off a very low base in the previous quarter but nevertheless remained 56% below their long run average. Stricter regulation of bank lending and demands for redemptions by property fund investors have limited market liquidity.

UK real estate values will not fall as far nor as fast as initially expected at the outset of the pandemic lockdown. But the recovery stage of the crisis is likely to be more prolonged.

The central forecast from Cluttons' HouseView indicates that capital values could fall by -9% this year. After allowing for an element of tenant delinquency which reduces income return to +4% total return is likely to be -5%. However, there remains a very large degree of uncertainty surrounding this central forecast. On the current trajectory, the decline this year could be limited to capital value falls of -7% and a relatively benign total return outcome of -3%. However, the second wave of regional lockdowns and a disruptive collapse of the Brexit trade talks could yet see the market fall further.

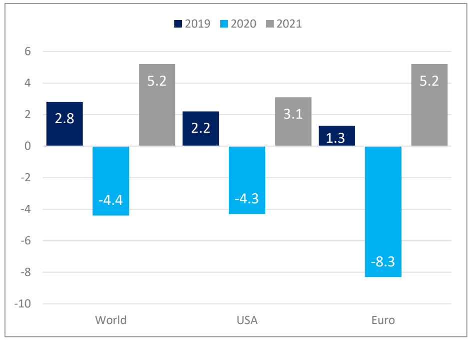
3. THE WORLD ECONOMY

October's edition of the IMF's World Economic Outlook notes that the global economy is climbing up from the depths to which it had plummeted during the Great Lockdown in April. However, the COVID-19 pandemic continues to spread to previously uninfected parts of the world and a second wave emerges in other parts. Many countries have slowed reopening while others are reinstating partial lockdowns. Consequently, the global economy's recovery remains prone to setbacks.

The IMF's estimate for the world economy in 2020 has been revised up from a contraction of -4.9% in July to -4.4% in October (see Chart 1.1) reflecting better-than-anticipated second quarter growth as well as indications of a stronger recovery in the third quarter. Following anticipated global growth in 2021 of 5.2% the world economy is expected to be a modest 0.6% higher than its 2019 level at the end of next year.

The uncertainty surrounding any forecast during this pandemic remains high. Downside risks relate to (1) the path of the pandemic and the necessary public health response; (2) softer demand, weaker tourism and lower receipts; and (3) financial market sentiment impinging global capital flows and new lending. On the upside, progress with treatments and vaccines may allow a rapid return to pre-COVID levels of activity without repeated waves of infection.

Chart 1.1 World growth projections (%)



4. THE UK ECONOMY

The combined fall in output in March and April amounted to -25.3% but was nevertheless shallower than expected. UK GDP has now grown month on month since the end of April but remains 9.2% lower than the levels achieved in February before the full impact of COVID-19 (see Chart 1.2). The pace of the recovery is now decelerating. The Business Impact of Coronavirus Survey, undertaken in September, found that of businesses currently trading, 45% reported their turnover had decreased below what is normally expected for September.

The service sector remains 9.6% lower than the level in February. Only two sectors remain above their February levels, namely Public Admin and Defence; and Wholesale and Retail Trade and Repair of Motor Vehicles (see Chart 1.3). Presumably, the robust performance of Public Admin was related to pandemic management. And the Retail Sector was buoyed by the relatively strong performance of online sales; Household Goods perhaps reflecting the panic buying of toilet rolls in March and April; and the re-opening of car showrooms.

Consumer-facing services experienced the sharpest declines during the initial lockdown but bounced back strongly once restrictions were lifted. Food and beverage activities grew 69.7% in August as the combined impact of easing lockdown restrictions and the Eat Out to Help Out Scheme boosted consumer demand for bars and restaurants.

Manufacturing remains -7.6% lower than in February but was supported by strong performance from manufacturers of pharmaceuticals, chemicals and electrical equipment reflected by strong sales of anti-bacterial sprays and wipes, hand sanitiser and ventilators and CPAP breathing aids. Output from petrol refiners and transport manufacturers fell furthest despite or because of a growth in the popularity of cycling (see Chart 1.4).

IHS Markit/CIPS October survey data suggests that UK economic growth in September eased from August's 6-year high but nevertheless grew strongly. Manufacturing expanded at a faster pace than services for the third month in a row. But September witnessed the seventh consecutive month of private sector job losses with services suffering the greater number of redundancies.

Chart 1.2 UK economic growth

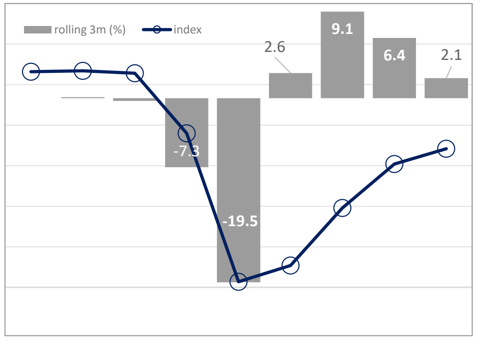


Chart 1.3 UK service output by sector

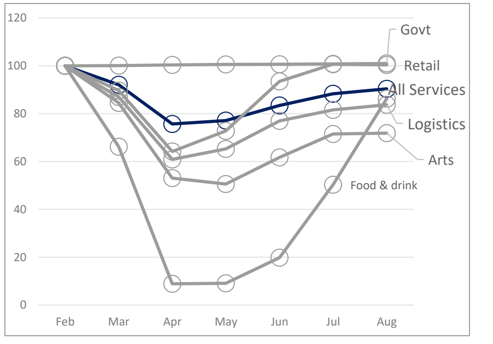
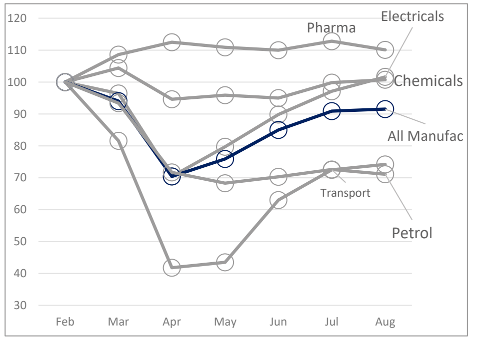


Chart 1.4 UK manufacturing output by sector



In August's Monetary Policy Report, the Bank of England warned that the outlook for the UK and global economies remains unusually uncertain. UK GDP is projected to continue to recover over the forecast period (see Chart 1.5) but the rate of recovery will depend on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors. Critically, the MPC's projections assume that the direct impact of COVID-19 on the economy dissipates gradually over the forecast period and that there is an immediate but orderly move to a comprehensive free trade agreement between the UK and the EU on 1 January 2021.

The recovery in UK output has been somewhat more rapid than was assumed in the MPC's illustrative scenario in the May Report (see Chart 1.6). That partly reflects lockdown measures being eased earlier than had been assumed. It also reflects activity having been stronger than assumed under lockdown, partly due to greater online spending. Activity is also supported by substantial fiscal and monetary policy actions. Nonetheless, the recovery in demand takes time as health concerns drag on activity.

CPI inflation is projected to remain well below the MPC's 2% target in the near term, largely reflecting the direct and indirect effects of COVID-19. These include the temporary impact of lower energy prices and cut in VAT, as well as downward pressure from spare capacity in the economy.

Chart 1.5 MPC GDP forecasts Aug 2020

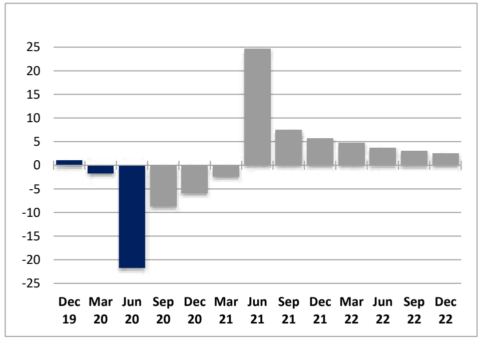
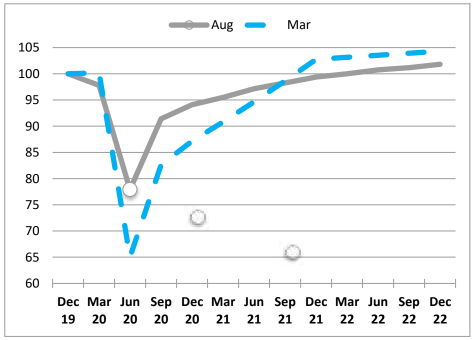


Chart 1.6 MPC economic projections



5. OTHER ECONOMIC INDICATORS

The UK is now in the midst of a second outbreak (see Chart 2.1). Merseyside, Lancashire, Greater Manchester and South Yorkshire are on a Tier 3 alert level. Once again, the Hospitality sector will bear the brunt of the enforcement measures. Pubs and bars can only be opened if they serve a "substantial" meal. Following consultation, leisure centres and gyms, entertainment venues, hairdressers and beauticians could also be asked to close.

The whole of the North East region and much of Yorkshire, Cheshire, London and Essex have been placed in Tier 2 meaning that pubs and restaurants close at 22.00. Socialising indoors is prohibited in both Tiers. For the moment schools and universities remain open. In the central belt of Scotland pubs and restaurants are closed. And Wales has announced an emergency 2-week lockdown known as a "firebreak".

Last quarter we noted that the OBR's worst case scenario pondered the impact of a second outbreak and consequential lockdown of the economy which could result in "a significant loss of business investment, more firm failures and persistently high unemployment". In such a case output only recovers to its pre-virus level in Q3 2024. Since then, increased testing, improvements in the treatment of COVID-19, increased ICU capacity and a decoupling between infection rates and mortality compared with March and April, seemed to have made a second complete lockdown unlikely (see Chart 2.2).

Governments throughout Europe are attempting to balance the competing demands of national finances, public health and the economy. Despite the ability to borrow for 20 years at 0.7%, the Treasury and the Chancellor of the Exchequer, Rishi Sunak, do not so far seem inclined to do whatever it takes to fight the virus and support jobs and the economy. Bar a return to austerity it seems likely that tax rises will be employed in an attempt to "balance the books". Perhaps tellingly, after his Tory Party conference speech in October, Sunak was unable to comment on the manifesto pledge not to raise taxes.

In the recession of the early 1980's and again in the early 1990's the number of jobless rose to over 3 million. Following the GFC, the number of unemployed increased to more than 2.5 million. Okun's Law describes the statistical relationship between unemployment and the rate of growth in the economy. Conventionally, it states that every 2% fall in GDP below trend results in a 1% increase in the unemployment rate.

During lockdown incomes were supported by the Coronavirus Job retention Scheme (CJRS) and the Self Employment Income Support Scheme (SEISS). At the peak in May, the Bank of England estimates that over 7 million employees were on furlough and a further 2.5 million claimed under SEISS. The level of support has tapered from 80% of wages to 60% of wages in October and will be suspended from the end of October and replaced by the Job Support Scheme (JSS) for those Tier 3 businesses facing closure. The latest news suggests that JSS could now be rolled out to Tier 2 businesses as well.

Employers who have been able to issue notice of redundancy to employees on the CJRS will not be able to do so under the JSS meaning a sharp rise in unemployment is possible following the end of the CJRS in November; and again, in April 2021 when the JSS is scheduled to cease. According to the Office for Budget Responsibility up to 20% of those on furlough could be made redundant.

The latest ONS data indicates that unemployment has increased to 1.52 million or 4.5% from 1.34 million or 4.0% at the start of the year. The latest Bank of England projections indicate that unemployment will increase to 8% in the second half of 2020 and is likely to decline only gradually after peaking in Q4 this year (see Chart 2.3).

Google's Community Mobility Reports show movement trends by region, across different categories of places such as retail, groceries, transport hubs and workplaces. The data shows how visitors to categorized places change when compared to a baseline day. A baseline day represents a normal value for that day of the week and is the median value from the 5-week period from 3rd January to 6th February. These indicators support the idea of a strong recovery in physical retailing compared to a slow return to the workplace as WFH becomes the new normal, at least for now (see Chart 2.4). Tellingly, those cities that witnessed a quicker return to the workplace are the very same cities that have now been categorised as "Very High Risk" (see Chart 2.5).

Passenger number data from TFL supports the idea of a strictly limited return by employees to their workplace (see Chart 2.6). Anecdotally, road traffic congestion has returned to London's streets and there has been a large growth in the number of cyclists as commuters prefer private transport to the virus risks represented by public transport.

Chart 2.1 Daily COVID-19 cases

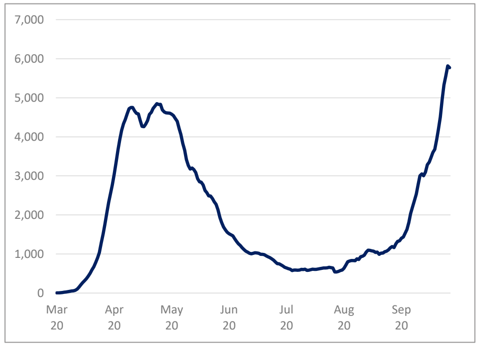


Chart 2.2 Daily COVID tests & cases per test

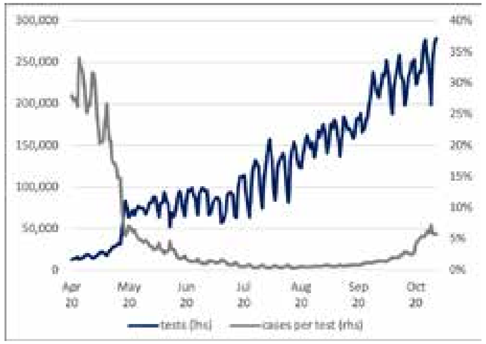


Chart 2.3 MPC unemployment projections

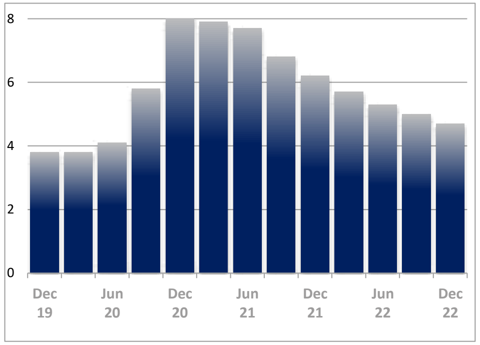


Chart 2.4 Google search data - retail & workplace destinations

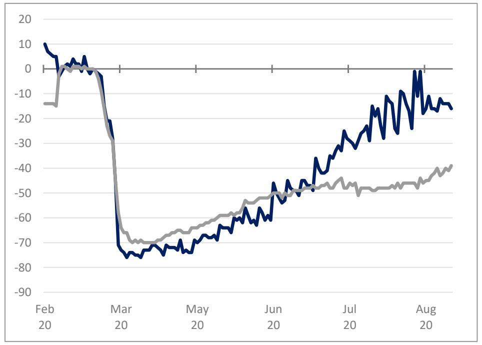


Chart 2.5 UK city workplace searches

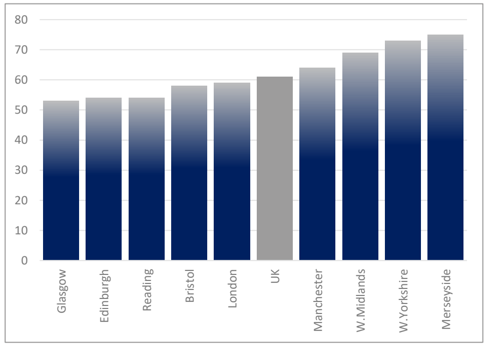
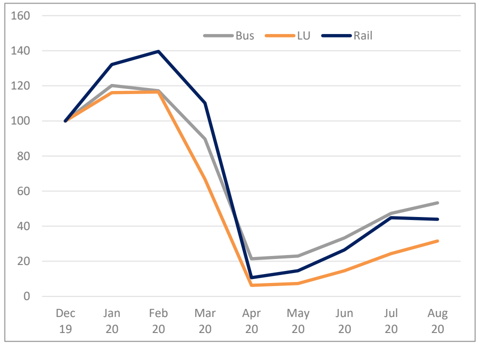


Chart 2.6 Journeys by London Transport



6. INTEREST RATES AND ASSET YIELDS

The FTSE 100 index fell 32% between 21st February and 23rd March but despite a recovery remains down 22% on the year to date (see Chart 3.1). However, the S&P 500, Nasdaq, Dow, Dax, Nikkei and Shanghai Composite have all seen gains on the year's trading so far. (see Chart 3.2). This may be a reflection that the UK's largely service based economy has taken a bigger hit from the lockdown compared to other countries with larger manufacturing sectors.

UK REITS fell -28% in Q1 and by the end of Q3 had lost any ground they recovered in Q2. Industrial and logistics specialists Segro and Big Box are the only two companies from the index to have a higher price than at the start of the year. Land Securities price has fallen 47% since the start of the year and has just announced its intention to sell a third of its portfolio over the next six years. British Land's price is also down -47%. Intu is in the course of being wound up and shares in Hammerson, another shopping centre specialist, have lost 88% of their value since the start of the year (see Chart 3.3).

Shaftesbury with its portfolio of central London village shops had seen its share price increase by 353% between February 2009 and December 2019. In 2020 its market value has dropped 47%. Low footfall, as many of London's businesses continue to WFH and tourists stay away will not have helped investor sentiment. Moreover, 38% of the portfolio by MRV is in the Food and Beverage sector.

Risk free assets are now yielding close to zero and UK short term rates remain negative. The Bank of England has increased its asset purchase programme by a further £300 billion so far this year and has just asked the UK's clearing banks if they are prepared for negative rates. There is evidence from the ECB and the Euro Zone that negative deposit rates discourage corporations from running large cash balances and encourage investment.

Gilt yields have softened by 6 bps in Q3 but are nevertheless 60 bps lower than at the start of the year of the year partly driven by the quantitative easing noted above and investors attempts to limit volatility and risk in portfolios (see Charts 3.4 & 3.5).

Although UK commercial real estate values are continuing to fall, the current property initial / gilt yield gap has decreased to 4.9% as vacancy rates increase. Nevertheless, the yield gap remains more than 1 standard deviation above the 10-year average (see Chart 3.6). In June 2009, as UK real estate prices reached the trough of the slump caused by the GFC, the yield gap stood at 3.7%. The current level of property yields relative to the risk free rate should provide some level of protection to UK real estate asset prices. But it is also a continuing comment on the liquidity premium required as a result of the collapse in the number of real estate transactions.

Ten open-ended property funds including those managed by M&G, Standard Life, Columbia Threadneedle and Legal & General closed to redemptions in March. These are now gradually re-opening following the RICS decision to lift the declaration of material valuation uncertainty on all UK real estate with some minor exceptions. To date Columbia Threadneedle, St James's Place and L&G have re-opened their funds. Aberdeen and Standard Life will do likewise in November. So far, the managers seem to have sufficient cash buffers to manage the demand for redemptions.

Chart 3.1 FTSE 100 index & daily movements

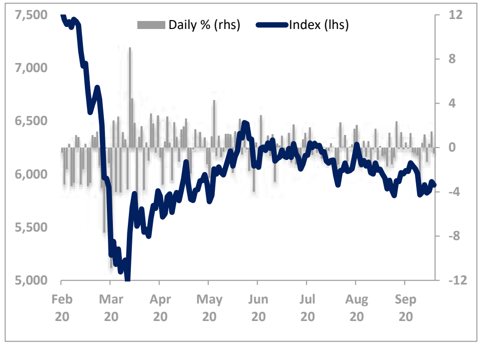


Chart 3.2 World stock markets in 2020 (ytd)

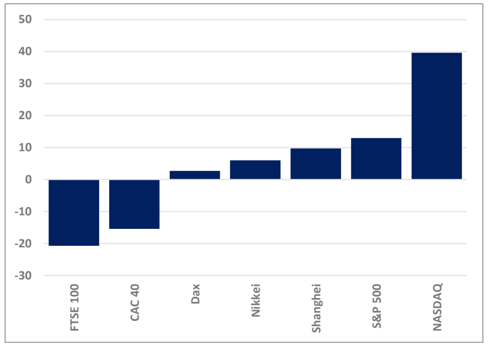


Chart 3.3 UK Reit prices (y-t-d)

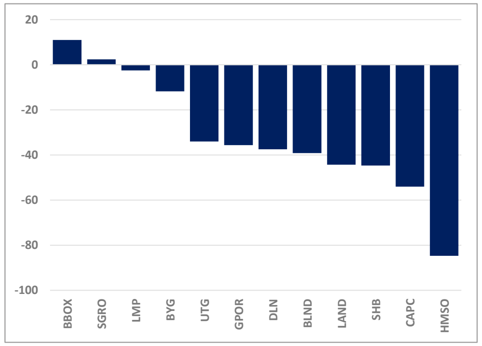


Chart 3.4 UK asset yields Q3 2020

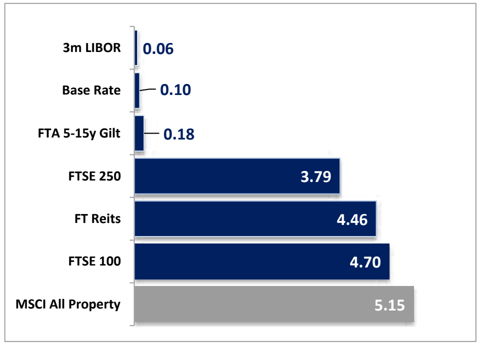


Chart 3.5 Gilt yield curve (%)

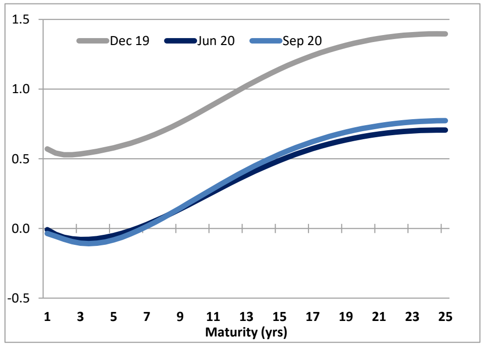
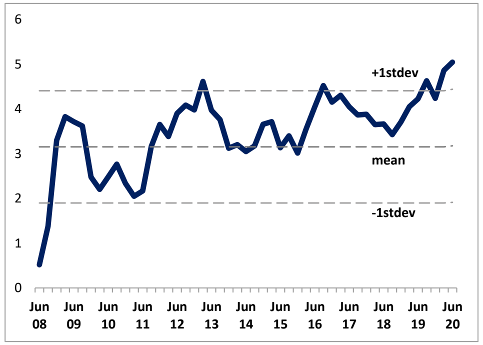


Chart 3.6 Property IY - Gilt yield gap



7. COMMERCIAL PROPERTY MARKET PERFORMANCE

MSCI data indicates that at the All Property level capital values continued to drift down in Q3 by a further -0.7%. However, the UK commercial real estate sector must be surprised and not a little relieved that the fall out so far from the pandemic and associated lockdown has been so limited. All Property values had fallen by 16% nine months into the GFC and yet so far this year capital values have fallen by just 7%.

All Property total returns returned to positive territory in Q3 at 0.7% as an income return of 1.4% offset a capital loss of -0.7%. The gap between retail assets on the one hand and office and industrial assets on the other continues to grow (see Charts 4.1 & 4.4).

The retail capital values fell by -2.7%. Office capital values fell by -0.7% and Industrial values increased by 1.0%. As we noted above, the RICS has decided that there is sufficient market transparency to no longer require a "material uncertainty" qualification to be applied to valuations of all types of assets except those valued with reference to trading potential, particularly leisure and hospitality assets.

In Q3 All Property equivalent yields were largely stable and had a neutral effect on valuations (see Charts 4.3 & 4.6). The overall decrease of -0.7% was therefore the result of falls in market rental value and assumptions on voids and rent collection.

The impact of softening yields and falling market rental values continued to be larger for retail assets than they were for the industrial and office sectors. All Property rental values decreased -0.7% in Q3. Office rental values fell just -0.4% while industrial rental value growth remained positive. However, rental values for shopping centres, retail warehouses and shops continue to fall (see Charts 4.2 & 4.5).

Data from Remit Consulting, a management consultancy specialising in real estate, shows that 62% of rents had been collected 7 days after the September quarter day. Whereas 7 days after the June and March quarter day 46% and 47% of rents had been collected. There is evidence of growing confidence from some commercial occupiers and that landlords and tenants are working together to meet the challenges caused by the pandemic.

Leisure and hospitality assets have the lowest collection rates with just 38% collected 7 days after the September quarter. The retail collection rate was 55%. Offices and industrials have been more resilient with collection rates of 77% and 74% respectively.

In their 2020 half yearly results presentation Shaftesbury Plc said that they were in discussion with approximately 800 commercial tenants to agree tailored solutions with the aim of collecting 50% of the rents due in Q2 and Q3 2020 over time. In October they plan to move permanently to monthly rents for all commercial tenants.

Factor investing or "smart beta" involves targeting quantifiable characteristics or "factors" that can explain differences in asset returns. This smart beta approach can be used to identify characteristics of real estate that drive out-performance and identify new asset allocation strategies based on factors. Such an approach offers real estate investors new tools to segment the market in addition to traditional approaches that dissect assets by sector and geography.

In Table 5.6 we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e. yield, rent or lease length. The numbers presented are the 3-month total return relative to the MSCI All Property average for Q2 2020. A heat map has been used as a visual aid to pick out the under-performing segments in dark orange and out-performing segments in green.

Consistent with our analysis in this report, the majority of retail segments are coloured dark orange. The two exceptions are low yielding or prime shops and shops with long leases.

Chart 4.1 Total returns by sector

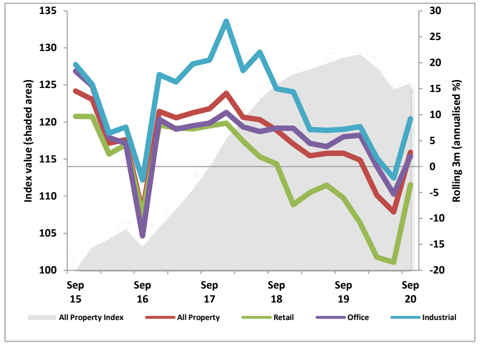


Chart 4.2 MRV growth by sector

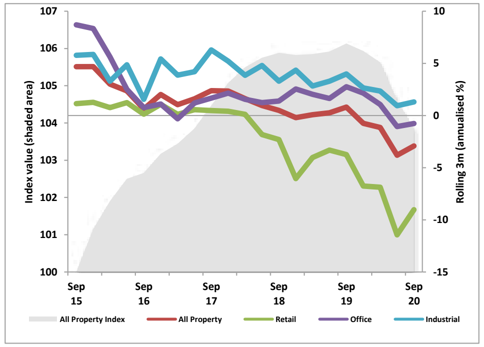


Chart 4.3 Initial yield by sector

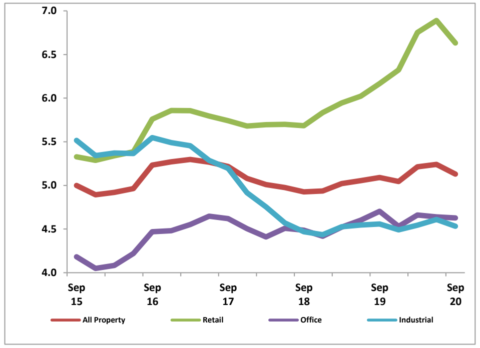


Chart 4.4 Total returns by segment (Q2 annualised)

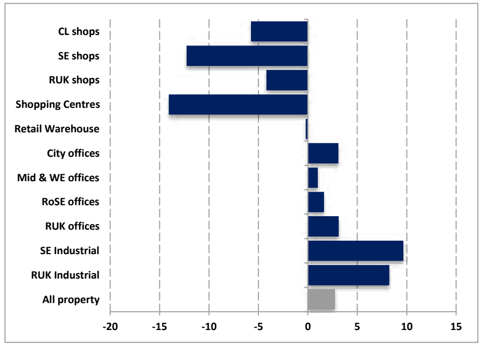


Chart 4.5 MRV growth by segment (Q2 annualised)

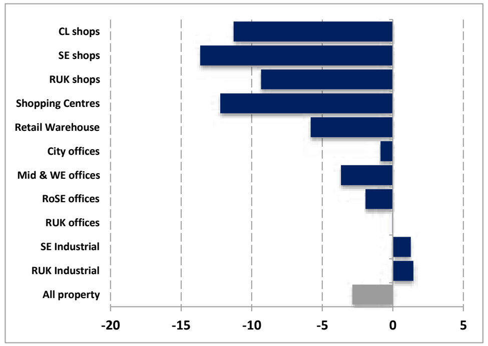
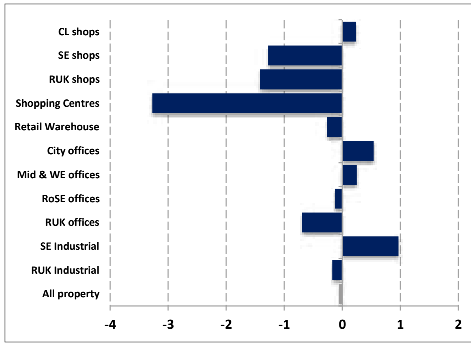


Chart 4.6 Yield impact (Q2)



5.1 TOTAL RETURNS

	Sep	3m	6m	12m
All Property	0.3	0.7	-1.6	-2.7
Retail	-0.3	-0.9	-5.8	-12.8
Office	0.1	0.5	-0.9	0.6
Industrial	1.1	2.2	1.7	4.0
ANNUALISED				
All Property	4.0	2.7	-3.2	-2.7
Retail	-3.6	-3.5	-11.3	-12.8
Office	0.7	2.0	-1.7	0.6
Industrial	14.3	9.2	3.3	4.0

5.2 CAPITAL GROWTH

	Sep	3m	6m	12m
All Property	-0.1	0.7	-4.3	-7.8
Retail	-0.9	-2.7	-9.1	-18.6
Office	-0.4	-0.7	-3.3	-4.1
Industrial	0.7	1.0	-0.8	-0.8
ANNUALISED				
All Property	-1.5	-2.7	-8.3	-7.8
Retail	-10.3	-10.2	-17.4	-18.6
Office	-4.1	-2.9	-6.4	-4.1
Industrial	9.0	4.1	-1.5	-0.8

5.3 INCOME RETURN

	Sep	3m	6m	12m
All Property	0.5	1.4	2.8	5.5
Retail	0.6	1.8	3.6	7.0
Office	0.4	1.2	2.5	4.9
Industrial	0.4	1.2	2.4	4.9
ANNUALISED				
All Property	5.6	5.6	5.6	5.5
Retail	7.4	7.4	7.3	7.0
Office	5.0	5.0	5.0	4.9
Industrial	4.9	4.9	4.9	4.9

5.4 ERV GROWTH

	Sep	3m	6m	12m
All Property	-0.3	-0.7	-1.7	-2.1
Retail	-0.8	-2.1	-5.0	-8.3
Office	-0.4	-0.4	-0.7	0.1
Industrial	0.1	0.3	0.6	1.8
ANNUALISED				
All Property	-4.0	-2.9	-3.3	-2.1
Retail	-9.5	-8.2	-9.8	-8.3
Office	-4.3	-1.6	-1.3	0.1
Industrial	1.8	1.3	1.1	1.8

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5.5 NET INITIAL YIELD

	Sep	3m	6m	12m
All Property	5.1	5.2	5.2	5.1
Retail	6.6	6.9	6.8	6.2
Office	4.6	4.6	4.7	4.7
Industrial	4.5	4.6	4.5	4.6

5.6 PERFORMANCE BY STRATEGY RELATIVE TO ALL PROPERTY AVERAGE Q2 2020

	Low Yield	High Yield	High Rent	Low Rent	Long Lease	Short Lease
Shops	0.5	-5.6	-2.5	-1.7	1.9	-4.7
Shopping Centres	-5.0	-6.7	-6.4	-7.9	-3.7	-5.4
Retail Warehouses	-1.2	-2.8	-2.9	-1.9	-0.7	-2.4
Central London Offices	0.5	0.4	0.2	1.3	2.2	0.3
Rose Offices	1.4	-0.9	0.9	0.0	1.3	0.2
RUK Office	1.7	0.7	0.5	1.5	2.4	0.8
Industrials	2.1	1.6	2.1	2.0	2.2	1.6

8. INVESTMENT IN PROPERTY

All Property investment volumes increased by 35% in Q3 off a very low base in the previous quarter (see Chart 6.1) but nevertheless remained 56% below their long run average. Across all sectors of the market, investment volumes continued to be sharply lower than in the same quarter of 2019 (see Chart 6.2). Last quarter we commented that "without certainty over values investors do not have the confidence to transact". The removal of the "material uncertainty" qualification in September could now lead to a rebound in the number of transactions.

Offices and industrials again made up the majority of investment transactions in Q2. Unsurprisingly, Central London offices traditionally dominate UK real estate investment, representing 29% of the market over the last 20 years. In Q3 its share of the market fell to 18% as transaction numbers declined in each of the core sub-markets with the West End standing out as the most resilient (see Chart 6.3).

According to Reuters, Sovereign Wealth Funds invested $4.4 billion in worldwide real estate in the first seven months of 2020, 65% down from the same period in 2019. These funds are increasingly investing in logistics space and retreating from allocations to retail and offices.

Since the start of the real estate market's post GFC recovery in mid-2009, overseas investors have represented 44% of the investment market. Their participation fell to 33% in Q2 but in Q3 overseas investors again represented 45% of the market in money terms. However, in Q2 and Q3 across all broad segments of the market both domestic and overseas investors participation in the market has fallen a long way short of their historic levels (see Chart 6.4).

Liquidity and uncertainty are the main factors driving the reduction in investment activity. The post GFC reform of the banking system, involving stricter regulation and capital adequacy requirements, has limited the availability of bank lending to the UK real estate sector (see Chart 6.5).

Since 2015 property funds have faced demands for redemptions from retail investors quarter after quarter. In 2016, the Brexit referendum resulted in the closure of open ended funds. And in the last two years the lethargic performance of the UK economy and the continued uncertainties surrounding Brexit have resulted in a continuous outflow of money from open-ended property funds (see Chart 6.6).

Those investors who have funds available are still willing to acquire the right assets. Having raised £673m of new equity in June, Segro successfully acquired Schroder's Electra Business Park in Canning Town with a winning bid of £133 million at a yield of 2.6%.

There is an expectation that post-lockdown insolvencies will increase in number. So far though there is little evidence of forced sales by delinquent borrowers at distressed prices even though there is a strong likelihood that lost rental income will pass through to missed mortgage payments.

Chart 6.1 All property investment volumes (£bn)

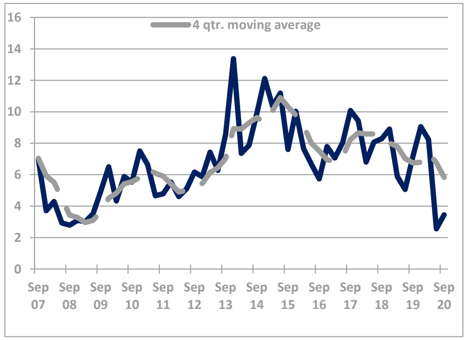


Chart 6.2 Investment transaction nos. (Q2 & Q3)

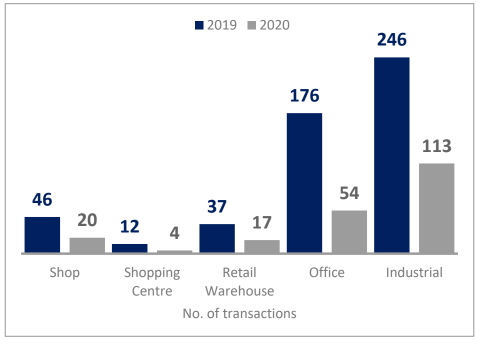


Chart 6.3 Central London office Investment transaction nos. (Q2 & Q3)

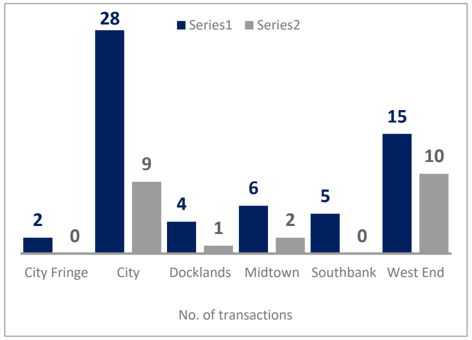


Chart 6.4 Domestic & overseas investors by property type Q2 and Q3 2020

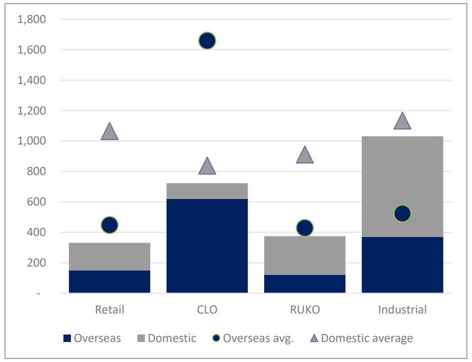


Chart 6.5 Bank lending to UK real estate (£m)

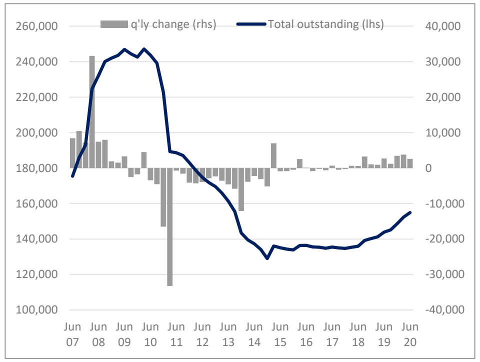
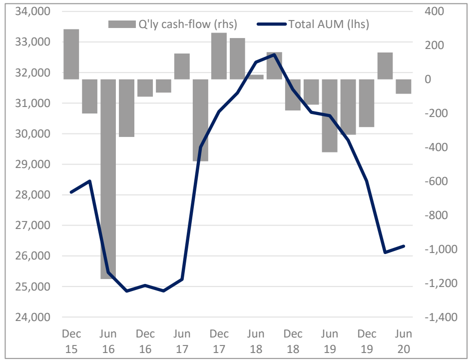


Chart 6.6 Property funds AUM & cash-flow (£m)



9. OUTLOOK

August's IPF forecasts reflect the view that UK real estate values will not fall as far nor as fast as initially expected at the outset of the pandemic lockdown. But the recovery stage of the crisis is likely to be more prolonged.

The consensus forecasts continue to show capital values falling in 2020 and 2021 (see Chart 7.1). The median total return of -7.7% in 2020 reflects a fall in capital values of -11.8% and an income return of 4.1%. A total return of 2.9% in 2021 includes a fall in capital values of -2.0%. Previously in May, expectations were that capital values would decline -12.6% in 2020 and -1.0% in 2021.

Total return expectations represent an annualised average of 3% over the next 5 years. But over the last three years of the forecast horizon, after the current levels of turbulence have passed, the consensus view on the 3-year annualised average has increased to 6.8% from 6.4% in May (see Charts 7.1 & 7.2).

There continue to be a wide range of forecasts, especially for the next two years. Total return forecasts for 2020 range between +1.2% and -12.0%. The forecast range for 2021 is 9.4% with a maximum of 9.1% and a minimum of -0.3% (see Chart 7.3).

The rate of decline in All Property capital values continues to be slower than the pace set during the GFC (see Chart 7.4).

Nevertheless, values are forecast to decline until the end of 2021. The recovery thereafter is expected to be weak and values are unlikely to recover their previous cyclical peak over the forecast horizon (see Chart 7.5).

It is unlikely that all segments of the market will suffer from the same decline in value. The pandemic has accelerated the rise of on-line shopping and the decline in capital and rental values achievable for all types of retail assets. We continue to believe that the visible reluctance of consumers to use public transport and visit city centres could work to the benefit of the local high street and out of town retail destinations with ample car parking.

Many column inches continue to be devoted to the future of offices. Fewer employees working from city centre offices may reduce the demand for space. But social distancing requirements will pull in the opposite direction and may oblige businesses to take on more space.

A British Council of Offices survey concluded that in the future employees at all levels will divide their time between working from home and visiting their workplace. The Institute of Directors agrees but highlighted the problem of managing teams remotely and believes that offices will remain valuable places for interaction and collaboration.

Again, we continue to believe that out-of-town business parks could see a resurgence in demand as city centre offices remain largely empty and private transport is preferred to public transport. City centre vacancy rates will not rise sharply but there will be an increase in the amount of unoccupied or under-utilised grey space. However, any structural change to the office market will play out over many years.

The huge growth in online shopping and home working may damage some segments of the real estate market. But it will increase the demand from investors and occupiers for large warehouses or fulfilment centres and last mile logistics units such as Electra Business Park in Canning Town (see above). It is also possible to argue the case for suburban co-working space and data centres to support home workers.

Chart 7.1 IPF All Property forecasts y-by-y (Aug 20)

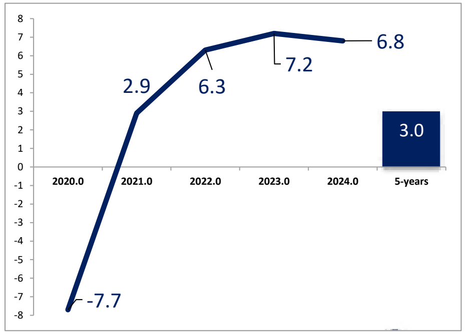


Chart 7.2 IPF forecast evolution (Aug 20)

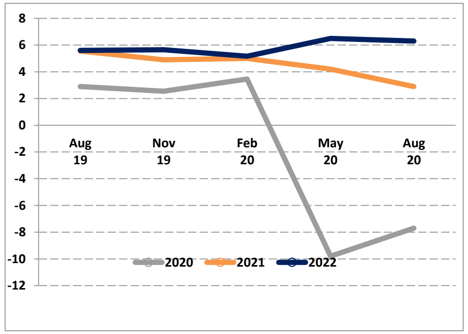


Chart 7.3 UK commercial total return forecasts

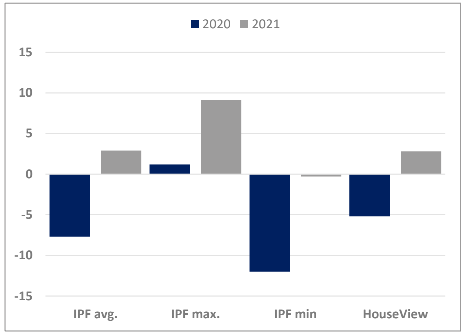


Chart 7.4 MSCI capital growth Jun 2007 to Dec 2019

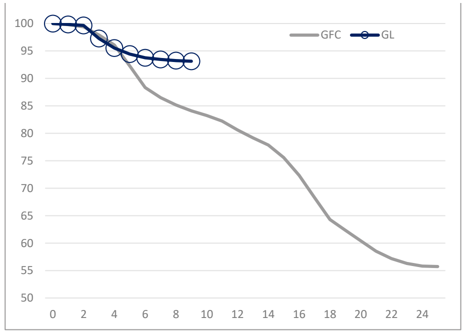
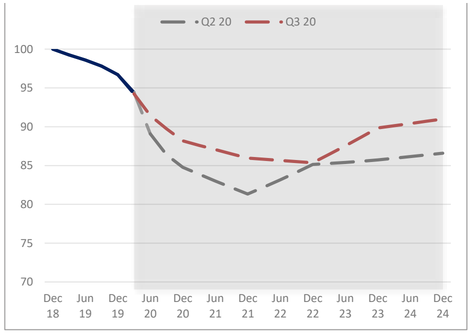


Chart 7.5 Capital value forecasts



10. HOUSEVIEW

The central forecast from Cluttons HouseView model has been amended to reflect the performance of the market in the year to date and the revised macro-economic forecasts. Capital values could fall by -9% this year. After allowing for an element of tenant delinquency which reduces income return to +4% total return is likely to be -5%.

However, there remains a very large degree of uncertainty surrounding this central forecast. On the current trajectory, the decline this year could be limited to capital value falls of -7% and a relatively benign total return outcome of -3%. However, the second wave of regional lockdowns and a disruptive collapse of the Brexit trade talks could yet see the market fall further.

We expect the decline in capital values to run beyond the end of the year and into 2021. But the current year will witness the largest proportion of the falls. From the second half of 2021 market conditions should improve for all market sectors (see Charts 8.1 – 8.4).

Retail assets will bear the brunt of the downturn although we currently think it is unlikely that they will suffer the size of capital value falls seen in the GFC (see Charts 8.5 & 8.6). Subject to the comments regarding Brexit related risks below, industrials will provide some immediate protection from the large downside risks inherent in the current market conditions. But there is a continued risk in multi-let assets from smaller tenants withholding rental payments or large-scale occupier failures.

Brexit continues to pose a threat to the UK economy and therefore its real estate market. The transitional arrangements under the Withdrawal Agreement end on 31st December and so far no new agreement with the EU has been negotiated. In the absence of an agreement the UK will be forced to trade with its closest and largest export market on WTO terms; or an Australia style agreement according to the euphemism used by the government.

We have previously highlighted the risks to Central London offices as investment banks and their advisors gradually move manpower and resources to mainland Europe. Industrials are another sector at risk as manufacturers and logistic operators could foreseeably re-locate to the mainland to avoid tariffs, the accompanying paperwork and 7,000 HGV's parked on the M20 in Kent.

Chart 8.1 Values 3-sector capital value forecasts

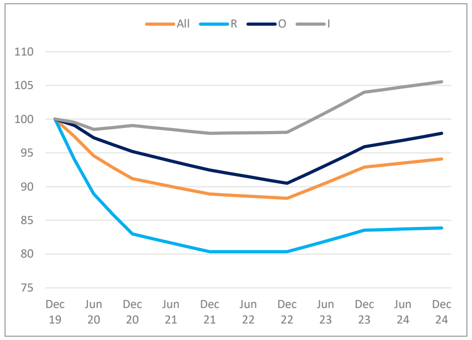


Chart 8.2 Retail segments capital value forecasts

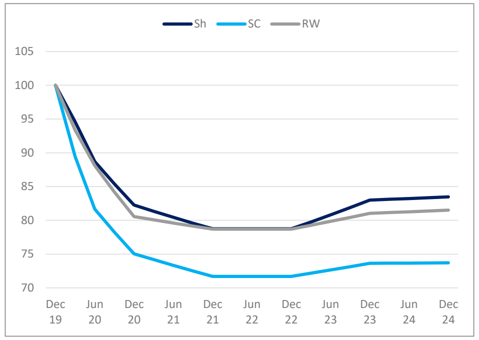


Chart 8.3 Office segments capital value forecasts

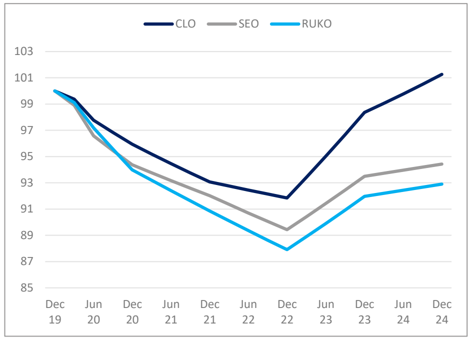


Chart 8.4 Industrial segments capital value forecasts

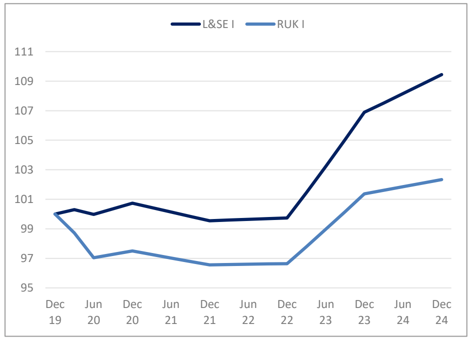


Chart 8.5 Cluttons House View - 2020 relative total returns (%)

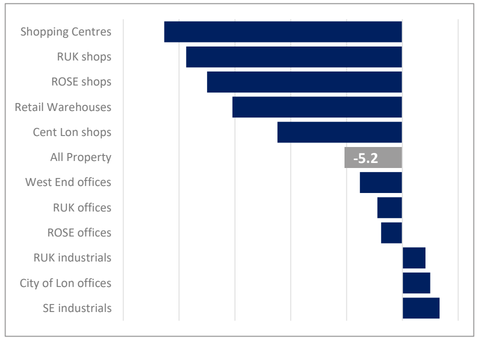
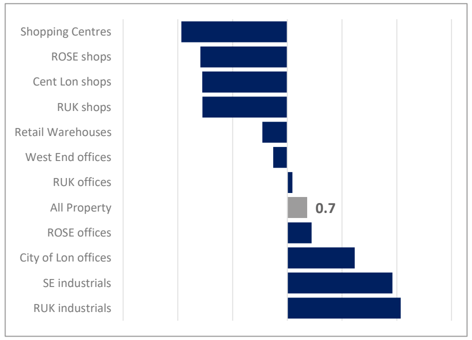


Chart 8.6 Cluttons House View - 2020-2022 relative total returns (%)



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