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COMMERCIAL PROPERTY EXAMINER

QUARTER ONE | 2020

Key take-aways

The COVID-19 pandemic will result in historic levels of dislocation to the UK's economy.

The prices of publicly traded assets have fallen sharply.

All Property capital values in the UK's direct real estate decreased by -2.7% in Q1.

Cluttons central forecast indicates that capital values could fall by -13% over the whole of 2020 giving a total return in the current year of -8%.

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SUMMARY

The global economy is projected to contract by -3% in 2020. However, the pandemic fades in the second half of 2020 and the global economy is projected to grow by 5.8% in 2021.

In the UK real GDP could fall by up to 35% in Q2 followed by an immediate and sharp recovery in the second half of the year leaving output 13% lower at the end of 2020. The recovery is likely to continue into 2021 resulting in an 18% increase in output.

However, the latest indications are that a measure of "social distancing" could be required to continue for at least the rest of 2020. This will prolong the recession and delay the eventual recovery.

Interest rates have been cut from 0.75% to 0.1% and CPI inflation is expected to decline to 1%.

The pressure on the public finances caused by the need to provide elevated levels of support to businesses, the NHS and the unemployed raises doubts around the government's ability to pursue increased spending on infrastructure health, policing and education.

The Retail sector benefitted from a relatively benign outcome to the Global Financial Crisis (GFC) but there are very real fears for the future of many retail businesses and the physical assets they support. Logistics is expected to perform better than many other sectors of the economy. But industrial property occupiers come from across the whole economy. Industrial assets may not be wholly insulated by on-line retailing.

After heavy falls on the stock market, the FTSE 100 index is now yielding more than the MSCI All Property index. Gilt yields have hardened by 46 bps since the end of Q4 and the current property initial / gilt yield gap has therefore increased to 4.9% more than 1 standard deviation above the 10-year average.

All Property capital values decreased by -2.7% as Retail capital values fell by -6.3%. Office capital values fell by -1.2% and industrial values decreased by just -0.8%. Rental values decreased -0.3% in Q1. Office and industrial rental value growth, however, remains positive. But rental values for Shopping Centres, Retail Warehouses and Shops continue to fall.

Central London office investment volumes were little changed over the whole of Q1. However, the volume of Central London office investments halved in March 2020 compared to March 2019. Residential and Leisure investment volumes declined sharply in March 2020 compared to March 2019, but industrial and retail activity held up well.

A succession of business failures and a collapse in asset prices could put pressure on banking covenants and ultimately the lenders themselves. Although Land Securities recently put out a statement saying that it could withstand a valuation fall of 62% before LTV covenants were breached.

Cluttons HouseView model indicates that capital values could fall by -13% this year. In such a scenario the total return would be -8% and income return 5%. But there is a very large degree of uncertainty surrounding this central forecast.

One element of risk surrounds income returns. Small retail, food & beverage and leisure operators have been released from their rental obligations. Intu received just 29% of rent due on the March 2020 quarter day. A year earlier the collection figure was 77%. At Land Securities 65% of rents had been collected 5 days after the quarter compared to 96% in March 2019.

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THE WORLD ECONOMY

Since 1960 the global economy has only once suffered a world-wide recession (see Chart 1.1). In 2009, the GFC resulted in a decline of -1.7%. However, a second world-wide recession now seems likely. The latest edition of the IMF's World Economic Outlook notes that the measures implemented globally to protect the population from the COVID-19 pandemic are severely impacting economic activity. Consequently, the IMF estimate that the global economy is projected to contract sharply by -3% in 2020, reflecting a deeper recession than resulted from the GFC of 2008–09.

The IMF's baseline scenario assumes that the pandemic fades in the second half of 2020 and containment efforts can be gradually unwound. In which case, the global economy is projected to grow by 5.8% in 2021 as economic activity normalizes, helped by policy support (see Chart 1.2). The risks for even more severe outcomes, however, are substantial.

Chart 1.1 World Economic growth since 1960 (%)

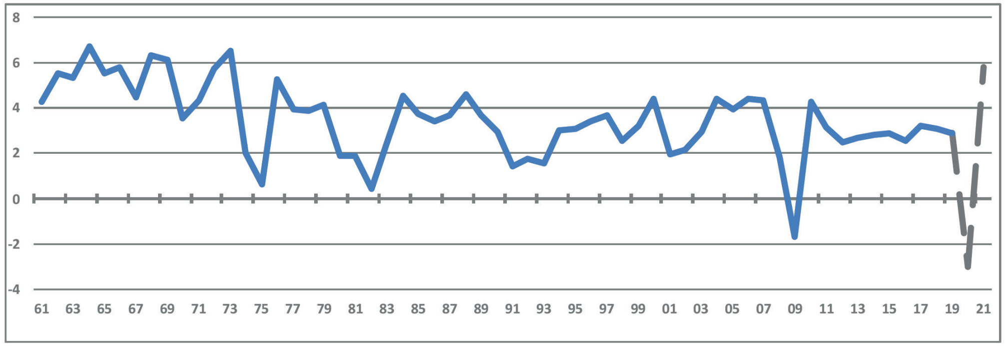
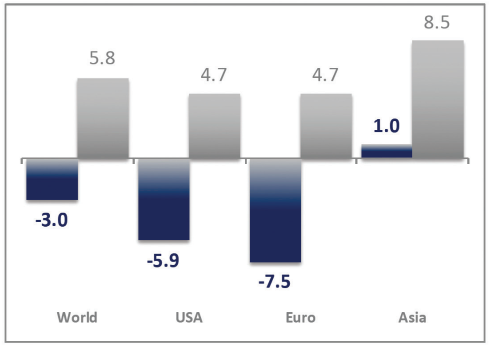


Chart 1.2 World growth projections



THE UK ECONOMY

On 14th April, the OBR published an initial assessment of the potential impact of COVID-19 on the economy. The public health restrictions and social distancing required to limit the spread of disease will ultimately mean lower incomes, less spending and weaker asset prices.

The OBR's initial assessment is that real GDP will fall 35% in the second quarter. A collapse that is unprecedented during modern times outside of war (see Chart 1.3) An immediate and sharp recovery in the second half of the year will leave output still 13% lower at the end of the year. It is likely that this recovery continues into 2021 before the economy settles down to more usual levels of growth in 2022 and beyond (see Chart 1.4).

However, the latest indications are that a measure of "social distancing" could be required to continue for at least the rest of 2020. This will prolong the recession and delay the eventual recovery.

IHS Market/CIPS survey data suggests that the decline in economic output has already exceeded that seen at the height of the GFC. City forecasters estimate an average economic decline of 14% in 2020. But the range varies between JP Morgan at -7.5% and Capital Economics at -24%.

Chart 1.3 UK economic growth since 1700 (%)

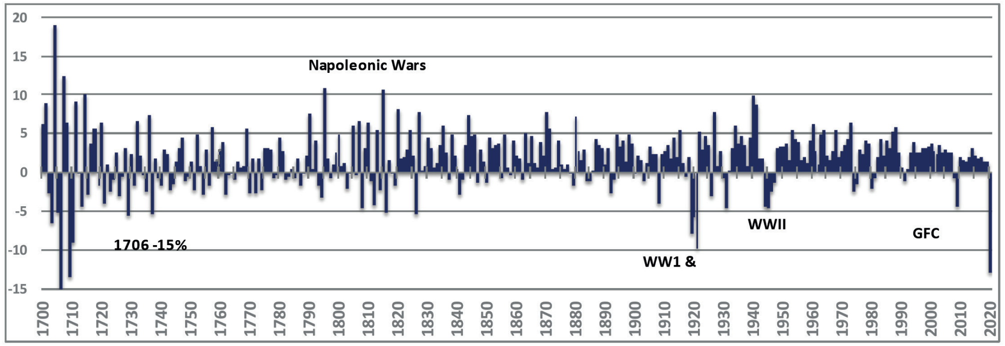
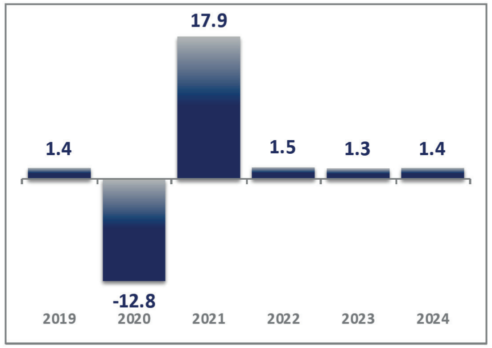


Chart 1.4 UK growth projections



OTHER ECONOMIC INDICATORS

Even before the severity of the impact of COVID-19 was felt the performance of the UK economy was weak (see Chart 2.1). In February economic output declined by -0.1% and year-on-year GDP growth decreased to just 0.4%; the lowest level since June 2012.

CPI inflation was 1.7% in February (see Chart 2.2). The MPC believes that it is now likely to decline to below 1% in Q2, reflecting the recent sharp decline in the oil price. In March to support the economy and employment the MPC reduced the bank rate by 65 basis points from 0.75% to 0.1%. But quite obviously there is no further scope for further cuts in interest rates.

The OBR expects that the measures implemented to protect the economy, jobs and health will drive year on year public sector net borrowing up to 14% of GDP. This surpasses borrowing amounting to 10% of GDP at the height of the GFC and represents the largest single-year deficit since the Second World War. Total public sector net debt increases to 95% of GDP (see Chart 2.3).

This government was initially elected on the back of promises to “level up” regional inequalities and increase spending on infrastructure, health, policing and education. One of its first decisions was to press ahead with HS2. But the Transport Secretary has yet to issue the required formal “Notice to Proceed”.

Chart 2.1 UK Economic growth - rolling 12m

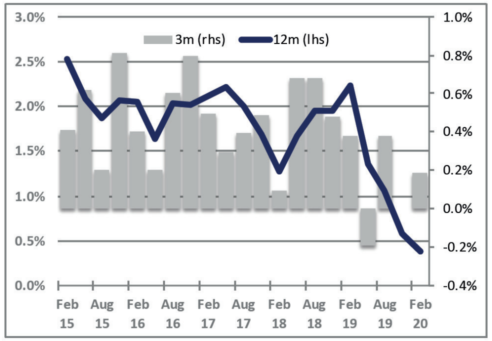


Chart 2.2 CPI - rolling 12m

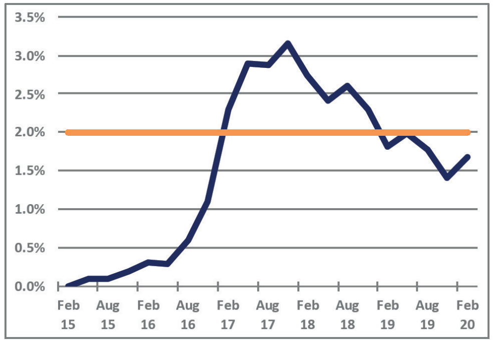
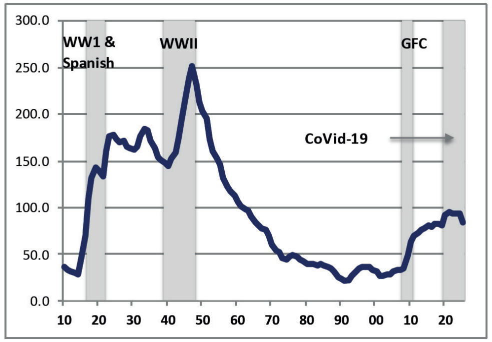


Chart 2.3 Public sector net debt as %'age of gdp



During the GFC, sectors of the economy suffered recessions of varying depths and the pace of recovery was similarly variable. Financial services grew through 2008-09 but contracted during the recovery phase (see Chart 2.4). The Retail sector benefitted from a relatively benign outcome to the GFC (see Chart 2.6) but a similar outcome following the current episode is unlikely.

Forecast losses in output resulting from the Lockdown vary. Not surprisingly Health is expected to grow by 50% but Education, Accommodation Services, Construction, Manufacturing and Retails are all expected to show declines of 50% or more (see Chart 2.5).

Logistics is expected to perform better than many sectors. But industrial property occupiers are drawn from almost every sector of the economy. Industrial assets may not be wholly insulated by on-line retailing. Sectors representing office-based users e.g. Finance and Insurance; Real Estate; Professional and Scientific; and Administration are expected to suffer the smallest declines.

Chart 2.4 Economic sector losses and gains through the GFC (%)

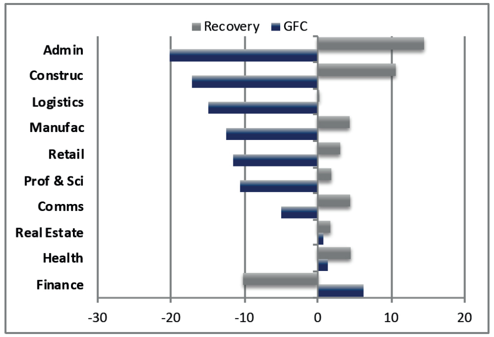


Chart 2.5 Forecast output losses by sector Q2 2020

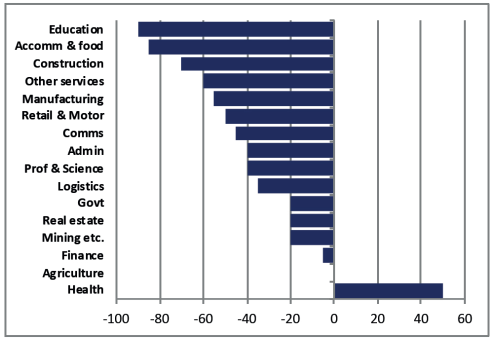
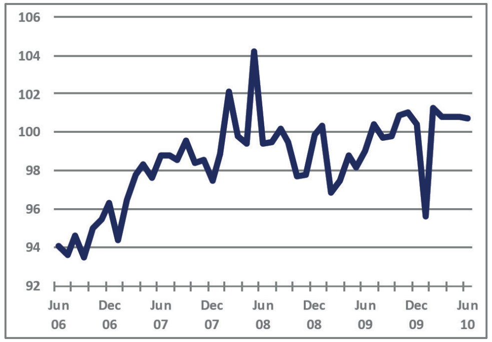


Chart 2.6 Non-food retail sales index 2006-2010



INTEREST RATES AND ASSET YIELDS

The Bank of England has issued firm guidance to banks warning against the payment of dividends. Insurers have also been asked to carefully consider any distributions to shareholders. In fact, almost 40 companies listed on the FTSE 100 index have cancelled or suspended their dividend including ABF, Aviva, Rolls Royce, Land Securities, British Land, WPP, Glencore, Persimmon, Rentokil, Whitbread, ITV and Taylor Wimpey. After the collapse in the oil price it is also likely that the oil majors Shell and BP could join this list.

The FTSE 100 index fell 10.8% on 12th March. This was the largest daily fall since Black Monday in October 1987 and eclipsed the biggest daily fall during the GFC of 8.8% on 10th October 2008. In each case traders took these falls as a prompt to go back into the market. On 21st October 1987 the index rose 7.9%; on 13th October 2008 it was an 8.3% rise; and most recently the market spiked 9.1% on 24th March. (see Charts 3.1 & 3.2)

In Q1 the total return on the FTSE 100 was -24%; total returns on the more domestically focused FTSE 250 were -31%; and the Reit sector performance amounted to -28%. Consequently, the FTSE 100 index is now yielding more than the MSCI All Property index and FT Reits having fallen 29% in Q1 are valued at a premium just 54 bps (see Charts 3.3 & 3.4).

Chart 3.1 FTSE 100 daily movements

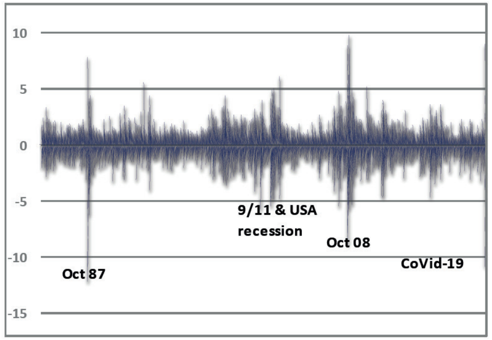


Chart 3.2 FTSE 100 during COVID-19

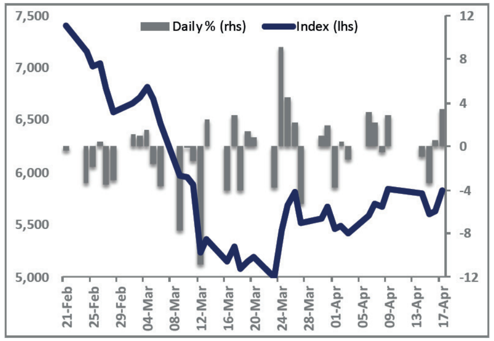
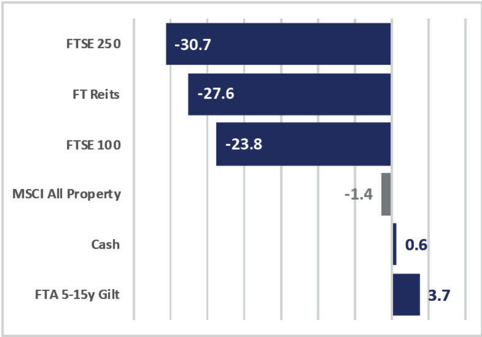


Chart 3.3 UK asset total return Q1 2020



Gilt yields have hardened by 46 bps since the end of Q4 as investors have sought to limit volatility and risk in portfolios (see Chart 3.5). In March the spread on investment grade corporate bonds over 10-year Treasuries increased to 4.3% from 2.0% in February.

The current property initial / gilt yield gap has therefore increased to 4.9% more than 1 standard deviation above the 10-year average (see Chart 3.6). It has never been higher. In June 2007 as UK real estate prices started to slip ahead of the GFC the yield gap was -0.7%. The current level of property yields relative to the risk free rate should provide some level of protection to UK real estate asset prices.

Chart 3.4 UK asset yields Q1 2020 3.5 Gilt

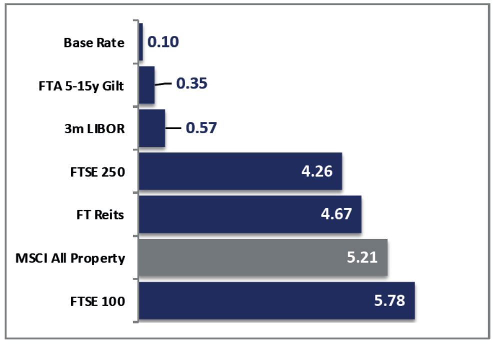


Chart 3.5 Gilt yield curve

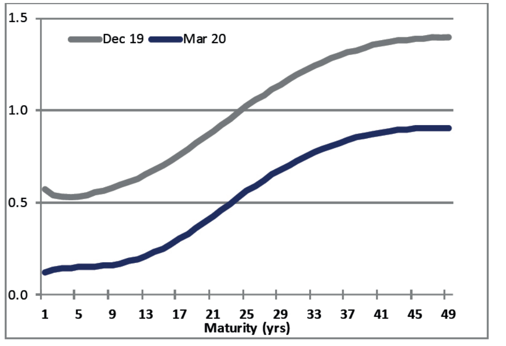
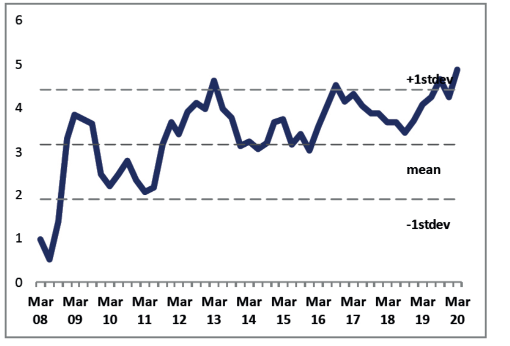


Chart 3.6 Property IY - Gilt yield gap



COMMERCIAL PROPERTY MARKET PERFORMANCE

The performance of private real estate as monitored by MSCI had been weakening since December 2017. MSCI data indicates that at the All Property level total returns continued to fall back in Q1. All sectors of the market suffered from a deterioration in performance but the direction of travel for retail assets on the one hand and office and industrial assets on the other diverged further (see Charts 4.1 & 4.4).

All Property capital values decreased by -2.7% in Q1 as Retail capital values fell by -6.3%. Office capital values fell by -1.2% and Industrial values decreased by just -0.8%. Clearly, valuers have had problems in making judgements on March end valuations. The lockdown was announced just 8 days before the quarter end and there has been the usual absence of evidence in a recessionary market. It is likely that most if not all valuations will have been qualified by "Material Uncertainty".

All UK property rental value growth continues to be weak. Rental values decreased -0.3% in Q1. Office and industrial rental value growth, however, remains positive. But rental values for Shopping Centres, Retail Warehouses and Shops continue to fall (see Charts 4.2 & 4.5).

Chart 4.1 Total returns by sector

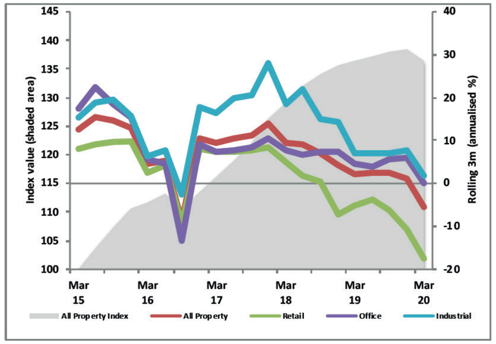


Chart 4.2 MRV growth by sector

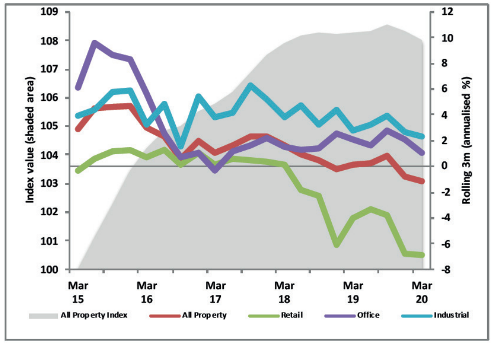


Chart 4.3 Initial yield by sector

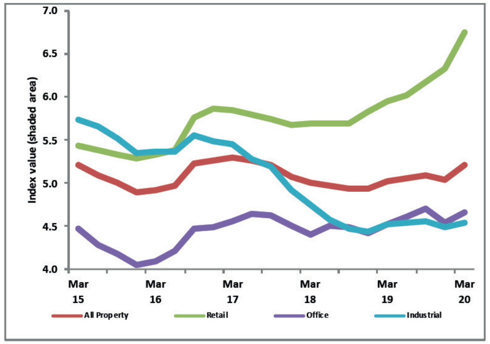


Chart 4.4 Total returns by segment (Q1 annualised)

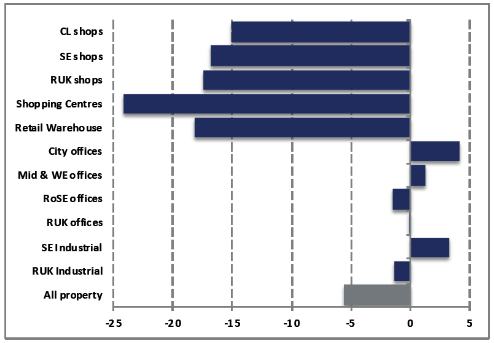


Chart 4.5 MRV growth by segment (Q1 annualised)

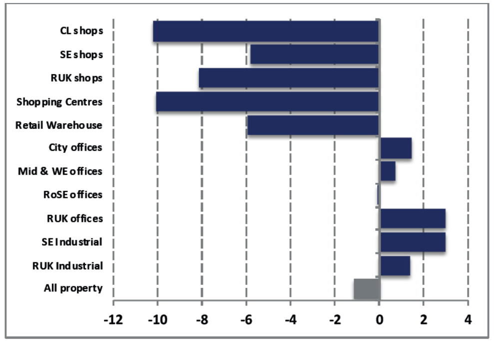
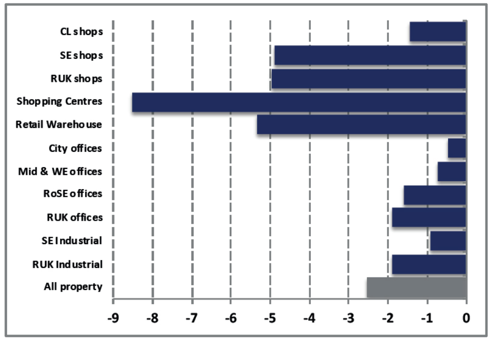


Chart 4.6 Yield impact (Q1)



The relatively slow and lagged reaction of rents to falling markets is a typical response. In 1989-90, rents continued to grow for more than a year after values started to decline; and during the GFC values started to fall in June 2007 whilst rents continued to grow until March 2008. Consequently, softening yields were responsible for almost all the fall in capital values in Q1 (see Charts 4.3 & 4.6).

3.13 Total returns	Mar	3m	6m	12m
All Property	-2.0	-1.4	-1.1	0.1
Retail	-4.2	-4.7	-7.4	-9.7
Office	-1.0	0.0	1.5	3.9
Industrial	-0.6	0.4	2.3	5.8
Annualised				
All Property	-21.0	-5.6	-2.2	0.1
Retail	-40.3	-17.5	-14.2	-9.7
Office	-11.1	0.0	3.0	3.9
Industrial	-6.9	1.7	4.6	5.8

3.14 Capital growth	Mar	3m	6m	12m
All Property	-2.4	-2.7	-3.7	-5.0
Retail	-4.8	-6.3	-10.4	-15.3
Office	-1.4	-1.2	-0.9	-0.9
Industrial	-1.0	-0.8	-0.1	1.0
Annualised				
All Property	-25.2	-10.5	-7.2	-5.0
Retail	-44.3	-22.8	-19.7	-15.3
Office	-15.3	-4.7	-1.8	-0.9
Industrial	-11.3	-3.0	-0.2	1.0

3.15 Income return	Mar	3m	6m	12m
All Property	0.4	1.3	2.7	5.4
Retail	0.6	1.7	3.3	6.6
Office	0.4	1.2	2.4	4.8
Industrial	0.4	1.2	2.4	4.8
Annualised				
All Property	5.5	5.4	5.4	5.4
Retail	6.9	6.8	6.7	6.6
Office	5.0	4.9	4.9	4.8
Industrial	4.8	4.8	4.8	4.8

3.16 ERV growth	Mar	3m	6m	12m
All Property	-0.2	-0.3	-0.5	-0.2
Retail	-0.8	-1.8	-3.5	-5.2
Office	0.0	0.3	0.8	1.9
Industrial	0.2	0.6	1.2	3.1
Annualised				
All Property	-2.1	-1.1	-1.0	-0.2
Retail	-9.2	-6.9	-6.8	-5.2
Office	0.0	1.1	1.6	1.9
Industrial	2.9	2.3	2.5	3.1

3.17 Net initial yield	Mar	3m	6m	12m
All Property	5.2	5.0	5.1	5.0
Retail	6.8	6.3	6.2	5.9
Office	4.7	4.5	4.7	4.5
Industrial	4.5	4.5	4.6	4.5

INVESTMENT IN PROPERTY

Central London office investment transactions are a key sector of the UK market accounting for on average 30% by value of all transactions. The value of rolling 12-m Central London office investment transactions increased in Q1 by 1% to £11.9bn but there has been a reduction in the value of transactions of 24% between the year ending March 2020 and the year ending March 2019 (see Chart 6.1).

Central London office investment volumes were little changed over the whole of Q1. However, the volume of Central London office investments halved in March 2020 compared to March 2019 (see Chart 6.3).

Although, Residential and Leisure investment volumes declined sharply in March 2020 compared to March 2019, industrial and retail activity held up well. It was a similar story looking at the whole of Q1 but with a large drop in the number of hotel transactions (see Charts 6.2, 6.3, 6.4 & 6.5).

It is likely that the level of gearing in the market drove much of the fall in values in 2007-09. Forced sales by borrowers who had or were close to breaching their banking covenants provided evidence of sales at distressed prices to vulture funds. As a result of investors collective memory of the hazards of gearing or stricter lending practices, the level of debt in the market has now stabilised. And, the absence of excessive gearing should provide a degree of protection to capital values (see Chart 6.6).

Chart 6.1 Rolling 12m investment by sector (£bn)

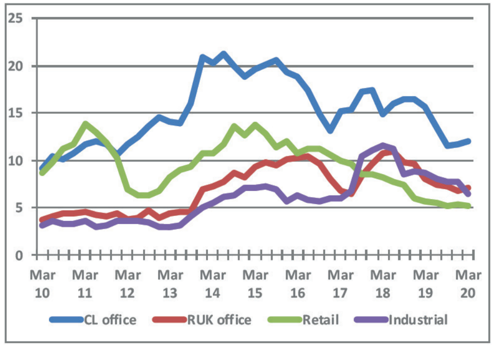


Chart 6.2 Investment volumes %'age change - Mar 20 v Mar 19

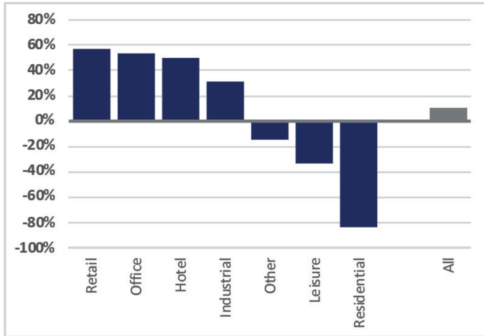


Chart 6.3 Investment volumes - Mar 20 v Mar 19

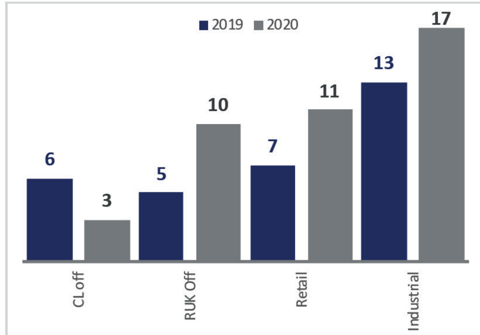


Chart 6.4 Investment volumes %'age change - Q1 20 v Q1 19

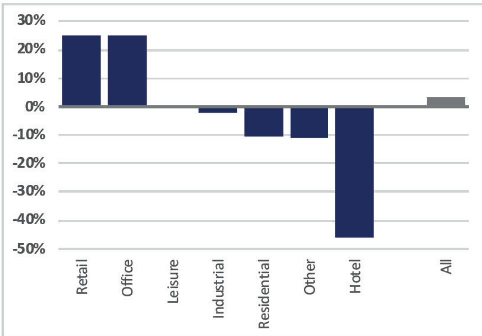


Chart 6.5 Investment volumes - Q1 20 v Q1 19

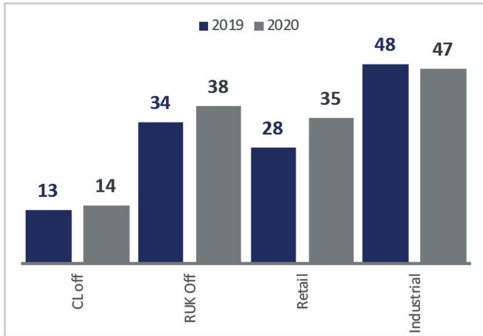
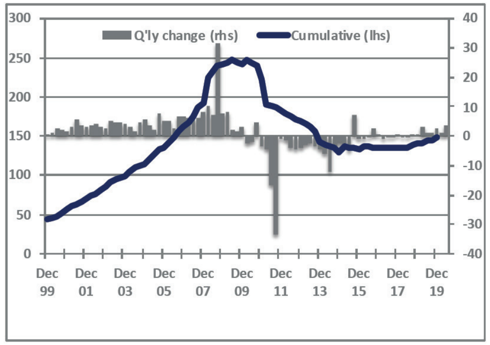


Chart 6.6 Bank lending to real estate (£bn)



Nevertheless, it is not inconceivable that a succession of business failures and a collapse in asset prices could put pressure on banking covenants and ultimately the lenders themselves. Although Land Securities recently put out a statement saying that it could withstand a valuation fall of 62% before LTV covenants were breached.

APRIL 2020 OUTLOOK

Although February's IPF forecast round indicated that 2020 was expected to represent a cyclical trough (see Chart 7.1). The outlook for 2020 strengthened for the first time in six quarters (see Chart 7.2). These forecasts are now historic but serve as an indication of how much conditions have changed in the last 3-months.

Total return expectations of 5% or more a year in 2021-24 and an annualised 5-year average of 4.9% are indicative of a stable market with low levels of rental value growth. They are perhaps representative of what the future might hold after the current levels of turbulence have passed.

It is unlikely that all segments of the market will suffer from the same decline in value. During the GFC, central London Shops were not only the most resilient segment but also one of the strongest in the recovery period (see Charts 7.3 & 7.4). It is highly likely that international travel will be restricted for some time after countries come out of their pandemic lockdown. The tourist trade is an important driver of occupational demand for Central London retail and it is therefore difficult to see the segment recovering in the same way this time.

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

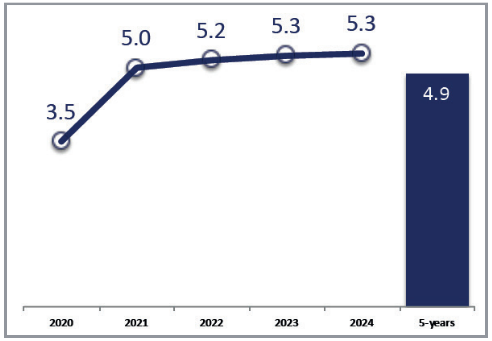


Chart 7.2 IPF forecast evolution (Feb 20)

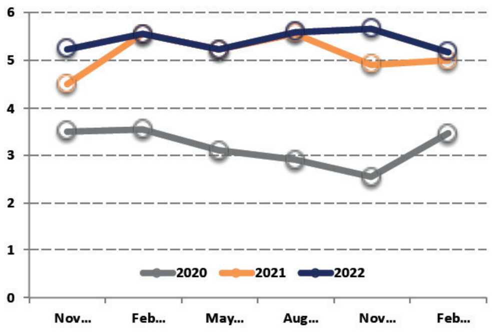
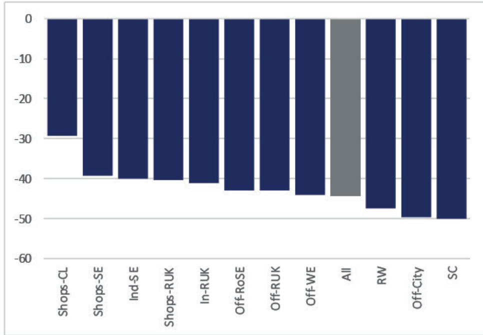


Chart 7.3 MSCI capital values during GFC



Central London offices although suffering from some of the largest valuation falls in the GFC also recovered strongly in the immediate post-GFC years (see Chart 7.4). A sharp fall in Central London office values may seem to offer buying opportunities especially for overseas investors after the recent further falls in the value of sterling. But London's future trading relationship with the rest of Europe remains to be settled.

Some segments of the market have never recovered from the GFC. Twelve years on, only Central London shops and offices and UK wide Industrials have recovered their peak June 2007 valuations. All segments of the retail market as well as Offices outside Central London are valued at less than they were in 2007. Shopping Centres are down 64%, Rest of UK shops down 51% and Retail Warehouses, which led the market out of the last recession are now 43% down on 2007 values (see Chart 7.5).

The GFC resulted in a 40% decline in UK All Property Values. Only three quarters into the latest downturn the market is tracking this downward direction of travel (see Chart 7.6).

Chart 7.4 MSCI capital growth GFC +3-years

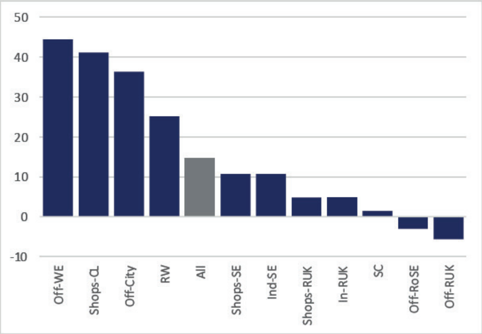


Chart 7.5 MSCI capital growth Jun 2007 to Dec 2019

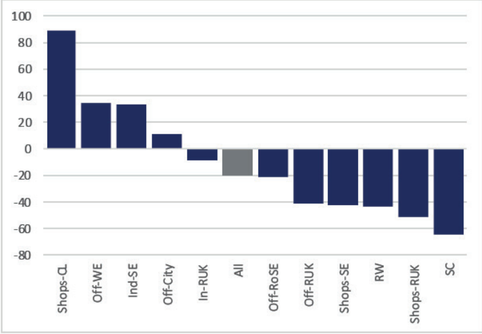
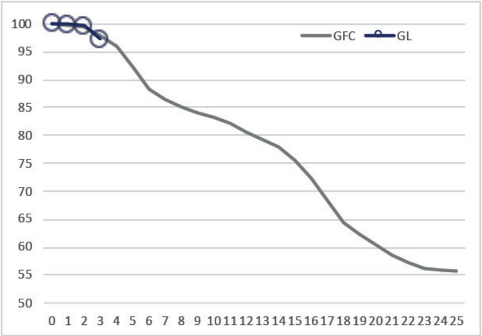


Chart 7.6 Monthly capital value index GFC v GL



CLUTTONS IM HOUSEVIEW

Cluttons HouseView model suggests that capital values could fall by -13% this year. In such a scenario the total return would be -8% and income return 5%. However, there is a very large degree of uncertainty surrounding this central forecast such that there is a 30% probability that capital values could fall by more than 13% and a 25% probability that they could fall by more than 19%.

One element of risk surrounds income returns. Small retail, food & beverage and leisure operators have been released from their rental obligations. Intu received just 29% of rent due on the March 2020 quarter day. A year earlier the collection figure was 77%. At Land Securities 65% of rents had been collected 5 days after the quarter compared to 96% in March 2019.

We expect capital values to decline in the next two calendar years with the largest proportion of the falls in 2020. From the second half of 2021 market conditions should improve.

Industrials and Central London offices provide some protection from the large downside risks inherent in the current market conditions. But there is a further risk in multi-let assets from smaller tenants withholding rental payments or large-scale occupier failures.

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. Central London shops could be particularly vulnerable. They are currently valued off record high multiples that reflect yields that are 100 bps below those prevailing at the top of the market in June 2007. They do not benefit from the defensive characteristics of higher yielding assets; and are vulnerable without rental value growth and the return of large numbers of tourists to Central London.

Chart 8.1 Cluttons House View - 2020 relative total returns (%)

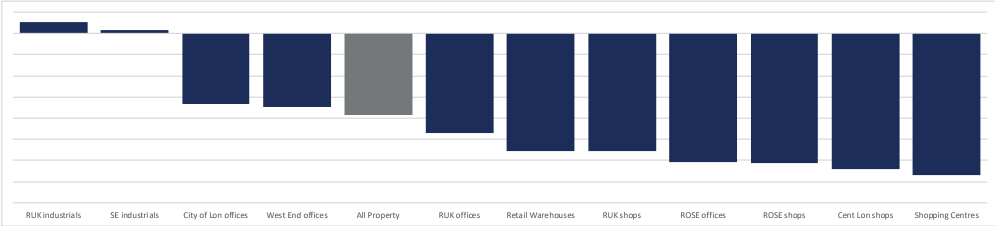
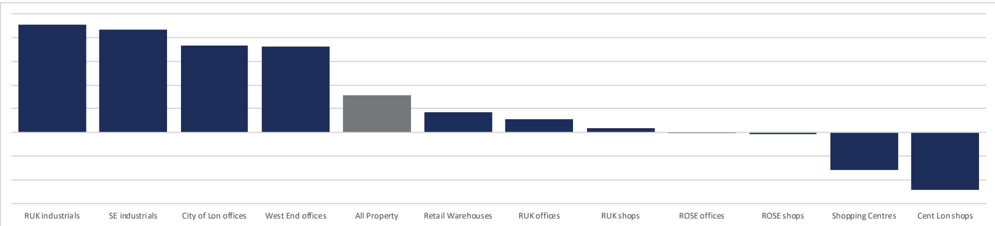


Chart 8.2 Cluttons House View - 2020-2022 relative total returns (%)



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