cluttonsim.com

CLUTTONS IM

COMMERCIAL PROPERTY EXAMINER

QUARTER TWO | 2019

CLUTTONS IM

We invest in best in class properties for their quality, income security and sustainable growth potential. We believe that a portfolio of properties demonstrating these attributes will produce a consistent, superior investment return over time.

PORTFOLIO
We blend incisive, value-add research with disciplined portfolio construction, selecting those sectors with the best long-term performance prospects.

PERFORMANCE
Our philosophy is perfectly aligned with our clients' objectives as long-term investors in property and best illustrated in our track record of benchmark outperformance over one, three or five year or longer-term time horizons.

ASSET
Our portfolio management is underpinned by a rigorous approach to individual stock selection, with active asset management to protect and enhance asset value whilst driving investment returns.

EXECUTIVE SUMMARY

The UK economy shrunk by 0.29% in April and although it recovered most of the lost ground in May, July's Markit/CIPS PMI survey signals an easing in the rate of economic growth from 0.4% in Q1 to 0.2% in Q2.

Market interest rate expectations are not indicative of any further rise in base rates until the end of 2021. Indeed Gertjan Vlieghe of the MPC has suggested that rates could be reduced to "near-zero" in the event of a no-deal Brexit.

Gilt yields have hardened by a further 40 bps since the end of Q4 in response to recent reductions in consumer price inflation and the subdued outlook for the economy. The current pricing of UK real estate remains attractive relative to other asset classes.

The forward looking public real estate markets indicate that private direct property investors should be looking to sell down their exposure to retail and buy student accommodation, healthcare and logistics assets.

MSCI data indicates that All Property values contracted in Q2 for the third consecutive quarter. The capital values of all retail segments are falling. Only Industrials are benefitting from an uplift in capital values.

Rental value growth for South East Industrials is weakening but it is still strong by historical standards. However, rental values for Shopping Centres, Retail Warehouses and Shops have decreased sharply.

May's IPF Consensus forecast round continues to indicate that 2019 is expected to represent a cyclical trough.

All Property performance expectations for 2019 weakened from 2.4% to 1.8% and expectations for were reduced to 3.1% from 3.5% in February. Capital values are now expected to shrink by 2% or more in both 2019 and 2020.

In the medium to long-term we continue to expect the UK's exit from the EU to entrench the current slow-down in economic growth that will restrain rental growth and cause yields to soften. Consequently, we expect a gradual weakening in property values over the next three years; with an average annualised total return 4% that is some way below the long-run average in this cycle of 10%.

MICRO-ECONOMIC BACKGROUND

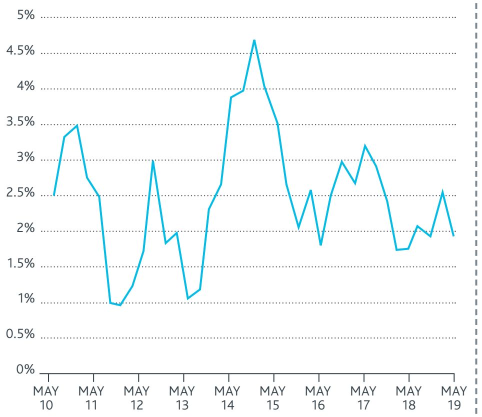
GVA

UK economic output has been disappointing since the Global Financial Crisis (GFC). Since June 2009 the economy has grown at an annualised rate of just 1.8%. Forecaster expectations of the outlook for the next two years are lower still.

The UK economy shrunk by 0.29% in April and although it recovered most of the lost ground in May, July's Markit/CIPS PMI survey signals an easing in the rate of economic growth from 0.4% in Q1 to 0.2% in Q2.

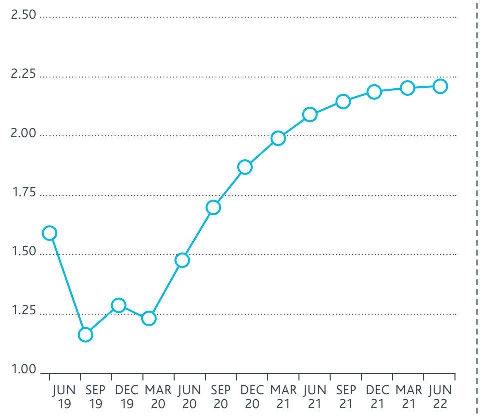
A similar economic shock in 2008 – 09 resulted in the commercial property values declining 40%.

Chart 1.1 Economic growth - rolling 12m



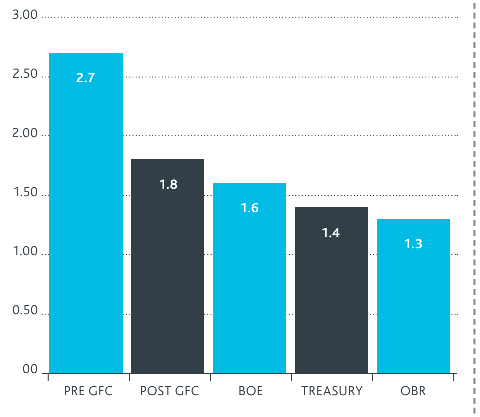
Source: National Statistics (ONS)

Chart 1.2 Bank of England economic forecast (May 2019)



Source: Bank of England (BoE)

Chart 1.3 Historic and forecast economic growth rates



Source: ONS, BoE, HM Treasury & Office of Budget Responsibility (OBR)

MICRO-ECONOMIC BACKGROUND

CPI

Consumer Price Inflation is currently 2.0% year-on-year; right on the MPC's target inflation rate of 2.0%. Weak economic growth forecast for the next 2-years means that inflationary pressures will be relatively subdued.

There is a possibility that a further fall in the value of sterling could provide an inflationary spike through higher prices for imported goods. But when sterling fell 20% after the 2016 referendum result, the MPC was prepared to look through the resulting inflationary spike.

Market interest rate expectations are not indicative of any further rise in base rates until the end of 2021. Indeed Gertjan Vlieghe of the MPC has suggested that rates could be reduced to "near-zero" in the event of a no-deal Brexit.

REGIONAL GVA

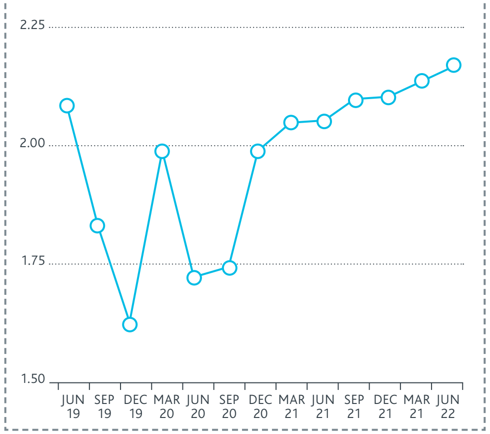
The UK's economy is dominated by London. The UK's capital city is larger than the next ten largest UK cities combined and has experienced the strongest economic growth of any UK city in the last 5 years.

Analysis of City level economic data allows Cluttons IM to closely target their tactical asset allocation decisions.

Chart 1.4 CPI -rolling 12m

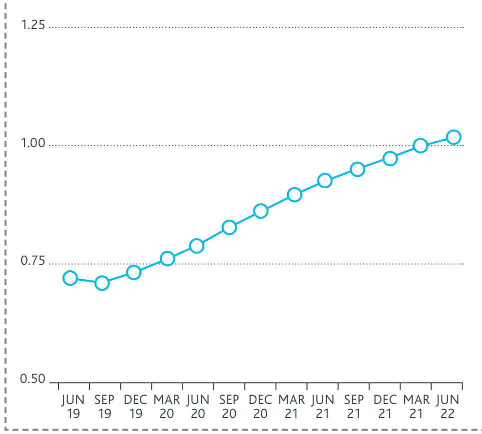
Source: ONS

Chart 1.5 Bank of England CPI forecast (May 2019)



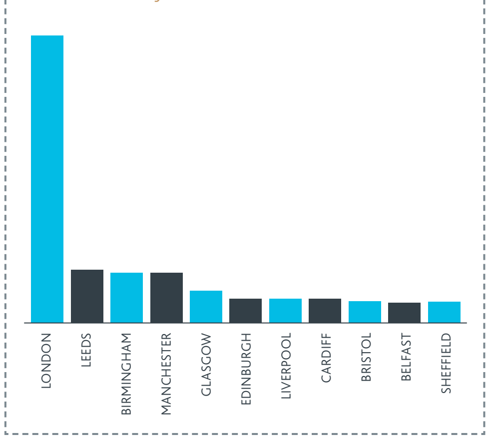
Source: BoE

Chart 1.6 Market interest rate expectation (May 2019)



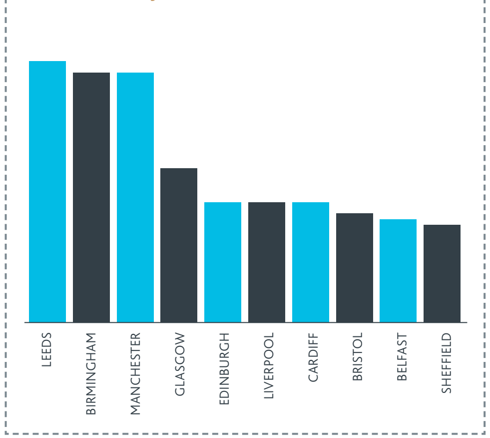
Source: BoE

Chart 1.7 UK city economies



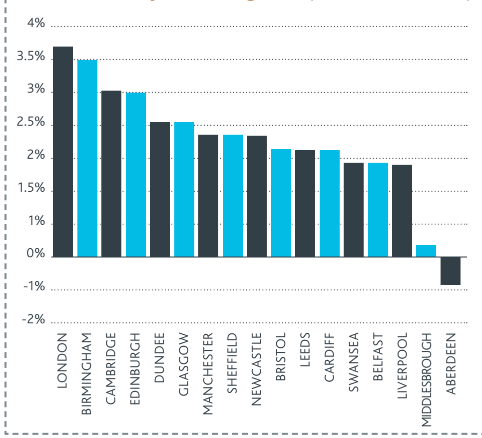
Source: ONS

Chart 1.8 UK city economies excl. London [1]



Source: ONS

Chart 1.9 UK city economic growth (2013-17 annualised)



Source: ONS

INVESTMENT MARKETS

INTEREST RATES & YIELDS

The prevailing low interest rate environment has inflated prices across the asset classes. But at the All Property level capital values are still below the peaks achieved in mid-2007.

Gilt yields have hardened by a further 40 bps since the end of Q4 in response to recent reductions in consumer price inflation and the subdued outlook for the economy. The current property initial / gilt yield gap has therefore increased to 4.23 % which is more than one standard deviation above the 10-year average. The gap has widened by 80 basis points since September last.

The current pricing of UK real estate remains attractive relative to other asset classes.

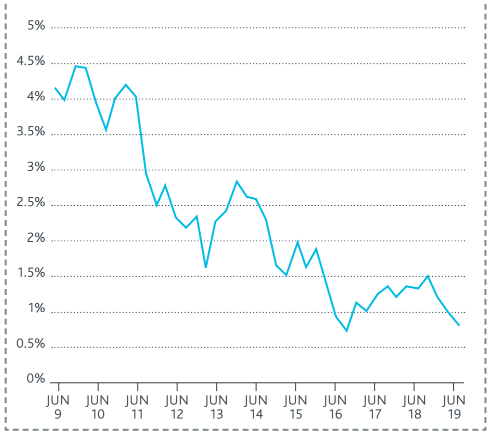
PUBLIC REAL ESTATE PRICING

It is not uncommon for shares in European public real estate companies to trade at a price that reflects a discount to NAV.

In the UK the widening discount to NAV of Reits suggests that investors are wary of current domestic property valuations.

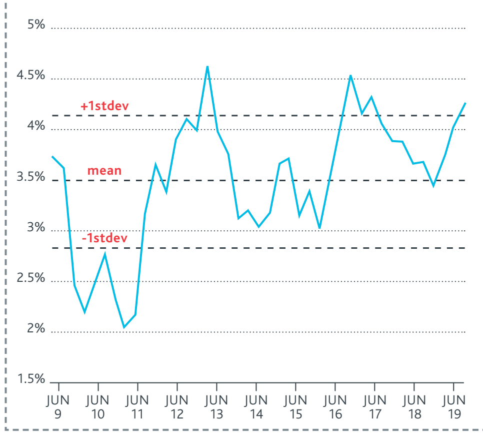
Land Securities and British Land, with portfolios of Central London Offices and Shopping Centres; and specialist Shopping Centre Reits, Hammerson and Intu have a market capitalisation that is at a discount of 40% or more to the net value of assets in their portfolios.

Chart 2.1 FT GILT 5-15 year yield



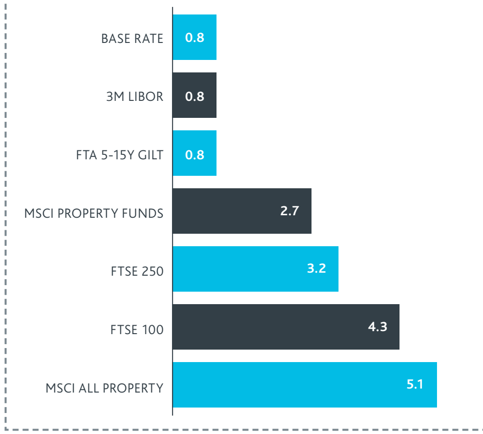
Source: Financial Times (FT)

Chart 2.2 Property IY - GILT yield gap



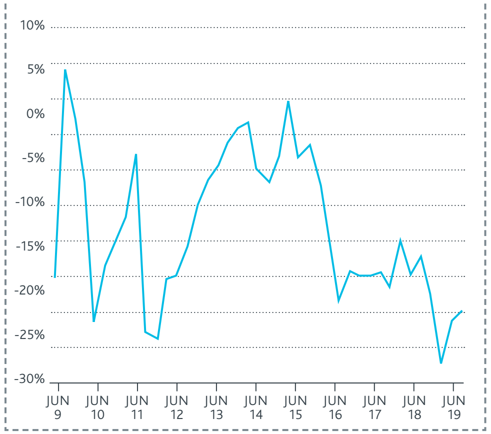
Source: FT, MSCI & APR

Chart 2.3 Asset yields(Jun 2019)



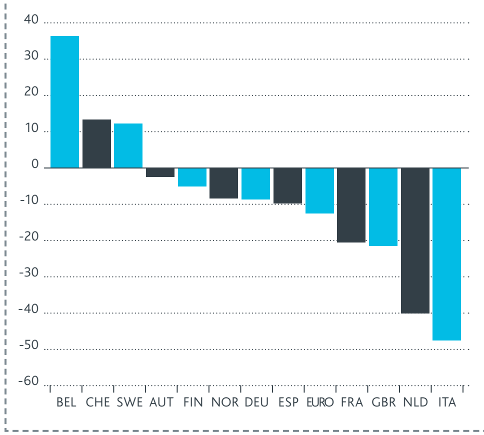
Source: FT & MSCI

Chart 2.4 FTSE Reit Nav discount



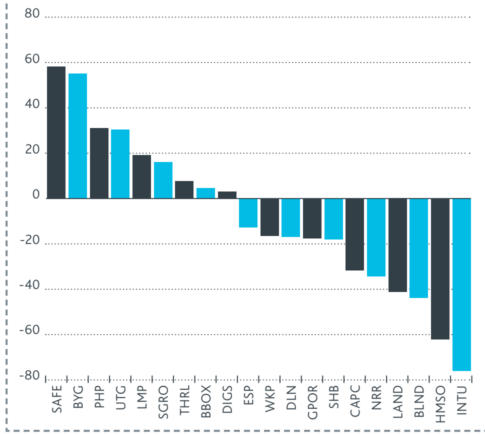
Source: European Public Real Estate Association (EPRA)

Chart 2.5 Discount/Premium to NAV by country (Jul 19)[2]



Source: EPRA

Chart 2.6 Discount/Premium to NAV by country (Jul 19)[3]



Source: EPRA

INVESTMENT MARKETS

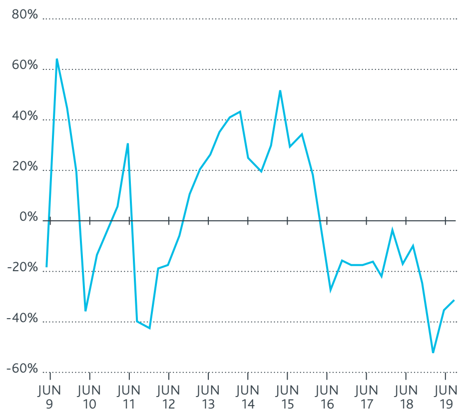
PUBLIC REAL ESTATE PERFORMANCE

UK Reits are currently near the bottom of the EPRA performance tables.

Stronger share price growth has come from those companies specialising in Healthcare, Student Accomodation and Logistics. Those focused on Central London Offices or Shopping Centres have seen their share prices fall in the last 12 months. Hammerson and Intu by more than 50%.

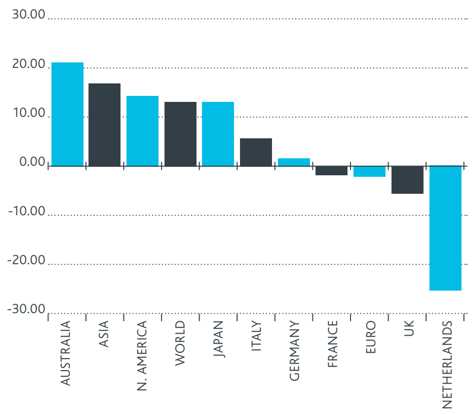
The forward looking public real estate markets indicate that private direct property investors should be looking to sell down their exposure to retail and buy student accommodation, healthcare and logistics assets.

Chart 2.7 FTSE Reit 12m total return



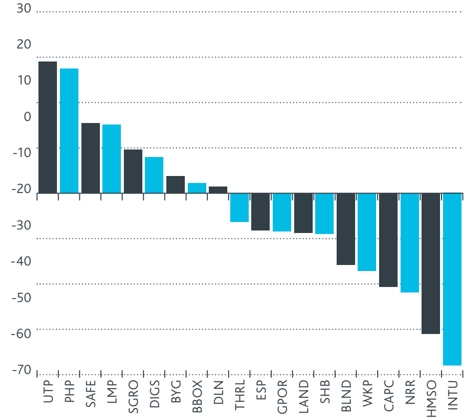
Source: FT

Chart 2.8 EPRA 12m total return (Jun 19)



Source: EPRA

Chart 2.9 UK Reits 12m price change (Jul 19)



Source: FT

COMMERCIAL PROPERTY MARKET PERFORMANCE

MSCI DATA COMMENTARY - PT. 1

The performance of private real estate as monitored by MSCI is weakening across all sectors of the market.

MSCI data indicates that All Property values contracted in Q2 for the third consecutive quarter. However, the rate of capital value growth as measured by the MSCI Monthly index improved slightly from - 0.8% in Q1 to -0.7% in Q2.

The capital values of all retail segments including Central London Shops are falling. Only Industrials are benefitting from an uplift in capital values.

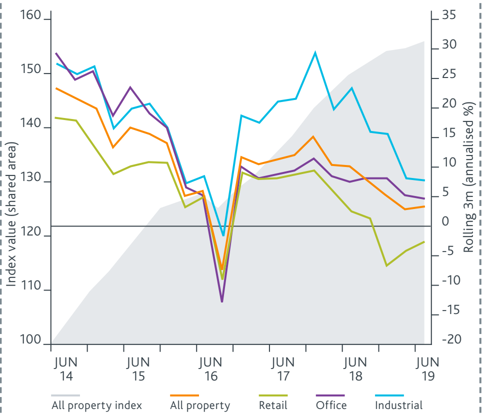
MSCI DATA COMMENTARY - PT. 2

All UK property rental value growth continues to slow. Growth decreased to a barely perceptible 0.2% in the year to June from 0.3% in the year to March.

Rental value growth for South East Industrials is weakening but it is still strong by historical standards.

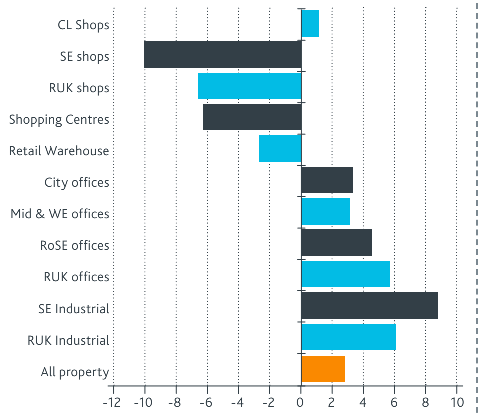
However, rental values for Shopping Centres, Retail Warehouses and Shops have decreased sharply.

Chart 3.1 Total returns by sector



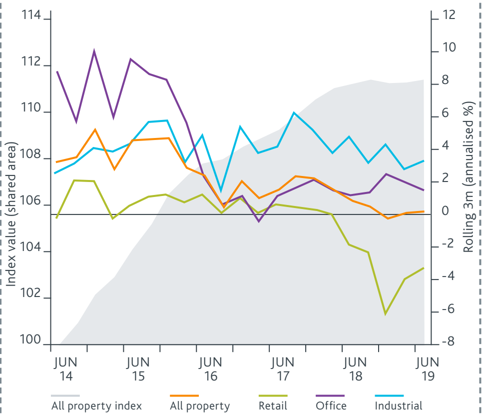
Source: MSCI Jun 19

Chart 3.2 Total returns (Q2 annualised)



Source: MSCI Jun 19

Chart 3.3 MRV growth by sector



Source: MSCI Jun 19

Chart 3.4 MRV growth (Q2 annualised)

Source: MSCI Jun 19

COMMERCIAL PROPERTY MARKET PERFORMANCE

MSCI DATA COMMENTARY - PT. 3

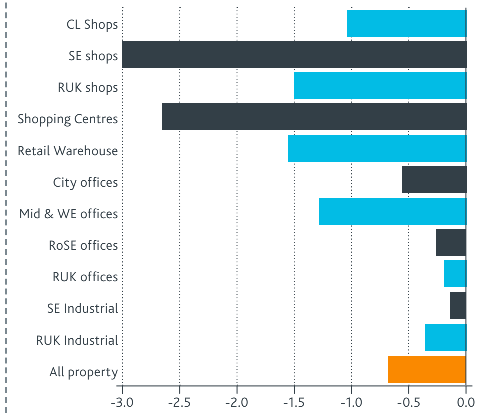
The Q2 market decline is wholly attributable to yield impact of -0.6% as there was no Rental Value Growth to speak of at the All Property level.

The initial yield on MSCI's monthly index has increased from 5.02% in Q1 to 5.06% at the end of Q2.

Chart 3.5 Initial yield by sector

Source: MSCI Jun 19

Chart 3.6 Yield impact (Q2)



Source: MSCI Jun 19

3.7 TOTAL RETURNS

	June	3m	6m	12m
All property	0.2	0.6	1.1	4.0
Retail	-0.5	-0.9	-2.2	-3.9
Office	0.3	0.9	2.1	5.8
Industrial	0.6	1.7	3.5	10.8
ANNUALISED				
All property	2.0	2.5	2.3	4.0
Retail	-5.8	-3.6	-4.3	-3.9
Office	3.4	3.8	4.2	5.8
Industrial	7.7	7.0	7.0	10.8

Source: MSCI Apr19

3.8 CAPITAL GROWTH

	June	3m	6m	12m
All property	-0.3	-0.7	-1.4	-1.2
Retail	-1.0	-2.4	-5.1	-9.5
Office	-0.1	-0.2	-0.3	1.0
Industrial	0.2	0.5	1.1	5.8
ANNUALISED				
All property	-3.2	-2.6	-2.8	-1.2
Retail	-11.5	-9.4	-10.0	-9.5
Office	-1.2	-0.9	-0.5	1.0
Industrial	2.9	2.1	2.2	5.8

Source: MSCI Apr19

3.9 INCOME RETURN

	June	3m	6m	12m
All property	0.4	1.3	2.6	5.2
Retail	0.5	1.6	3.1	6.1
Office	0.4	1.2	2.3	4.7
Industrial	0.4	1.2	2.4	4.8
ANNUALISED				
All property	5.3	5.3	5.3	5.2
Retail	6.4	6.4	6.3	6.1
Office	4.7	4.8	4.7	4.7
Industrial	4.8	4.8	4.8	4.8

Source: MSCI Apr19

3.10 ERV GROWTH

	June	3m	6m	12m
All property	0.0	0.1	0.1	0.2
Retail	-0.3	-0.8	-1.9	-3.9
Office	0.1	0.4	0.9	1.9
Industrial	0.3	0.8	1.5	3.4
ANNUALISED				
All property	0.4	0.3	0.2	0.2
Retail	-3.1	-3.3	-3.7	-3.9
Office	0.7	1.6	1.8	1.9
Industrial	4.1	3.3	3.1	3.4

Source: MSCI Apr19

3.11 NET INITIAL YIELD

	June	3m	6m	12m
All property	5.1	5.0	4.9	5.0
Retail	6.0	5.9	5.8	5.7
Office	4.6	4.5	4.4	4.5
Industrial	4.5	4.5	4.4	4.6

Source: MSCI Apr19

COMMERCIAL PROPERTY MARKET OUTLOOK

IPF CONSENSUS FORECASTS MAY 2019

May's forecast round continues to indicate that 2019 is expected to represent a cyclical trough.

All Property performance expectations for 2019 weakened from 2.4% to1.8% and expectations for 2020 were reduced to 3.1% from 3.5% in February. Capital values are now expected to shrink by 3% in 2019 and 2% in 2020.

At the segment level the outlook for retail property in the next 12 months has weakened further. The outlook for Offices and Industrials is stronger.

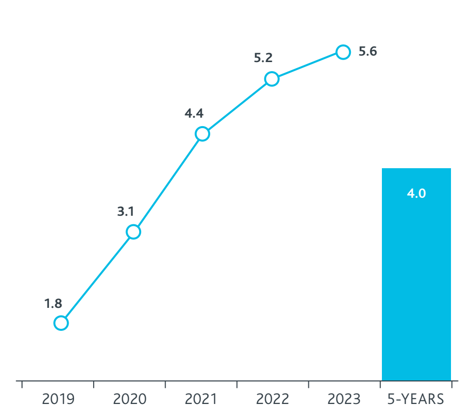
The 5-year outlook has weakened to an annualised average forecast of 4.0% in May from 4.4% in February.

CLUTTONS IM HOUSEVIEW FORECASTS

In the medium to long-term we continue to expect the UK's exit from the EU to entrench the current slow-down in economic growth that will restrain rental growth and cause yields to soften.

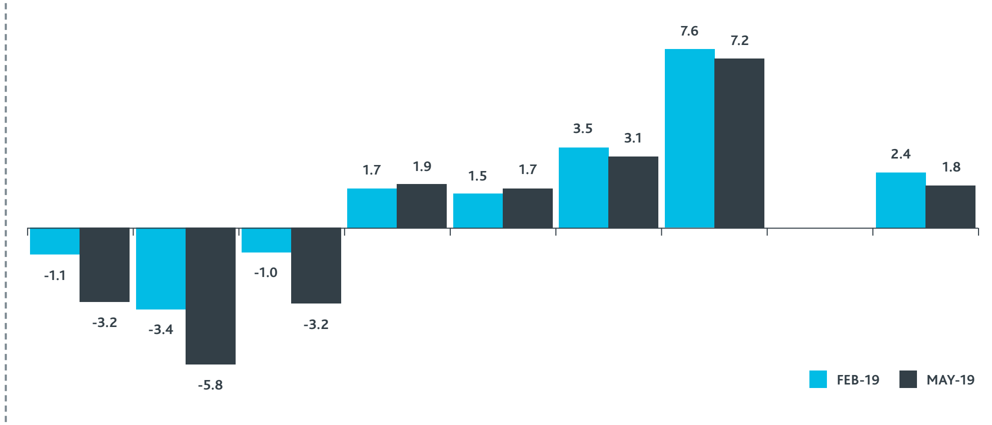
Consequently, we expect a gradual weakening in property values over the next three years; with an average annualised total return of 4% that is some way below the long run of average in this cycle of 10%.

Chart 4.1 IPF All Property forecasts y-by-y (May 19)



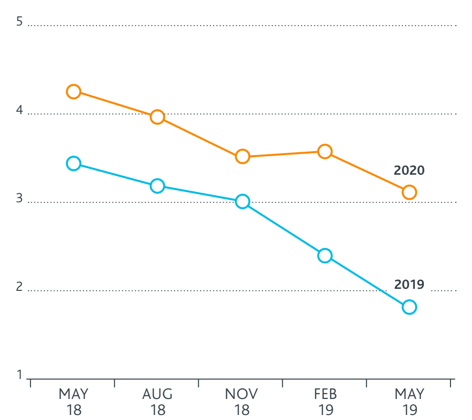
Source: IPF May19

Chart 4.3 IPF 2019 forecasts by sectors (May 19)



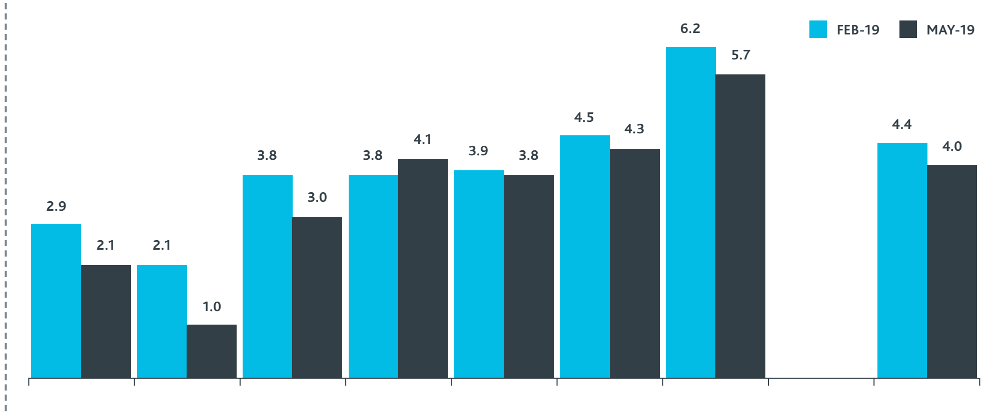
Source: IPF May19

Chart 4.2 IPF forecast evolution (May 19)



Source: IPF May19

Chart 4.4 IPF 5-year forecasts by sectors (May 19)



Source: IPF May19

COMMERCIAL PROPERTY MARKET OUTLOOK

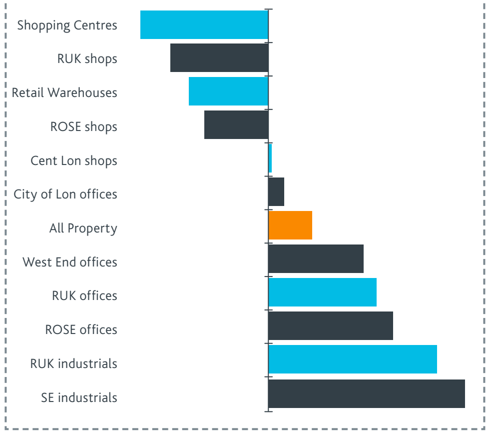
CLUTTONS IM OPINION

Political and economic indicators suggest the prospects of a no-deal Brexit are greater now than they were 3 months ago, a recession and decline in capital values cannot therefore be discounted.

Whilst some way below this cycle's average, an annualised total return of 4% p.a. over the next three years will compare favourably to both UK equities and gilts on a relative basis.

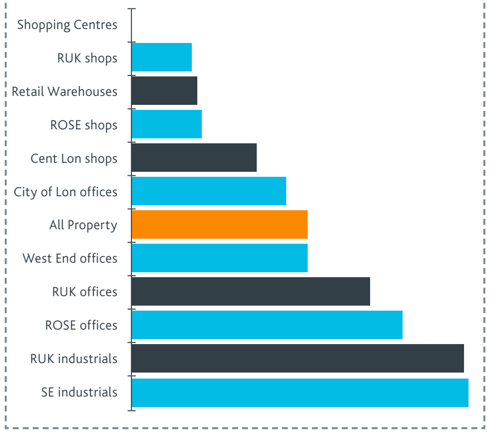
Defensively positioned portfolios holding high quality stock on durable income profiles and with limited exposure to retail will perform best.

Chart 4.5 Cluttons house view - 2019 relative total returns (%)



Source: Alexander Property Research (APR)

Chart 4.6 Cluttons house view - 2019-21 relative total returns (%)



Source: APR Q219

GLOSSARY

1. **LEEDS CITY REGION**
Barnsley
Bradford
Calderdale
Craven
Harrogate
Kirklees
Leeds
Selby
Wakefield
York

WEST MIDLANDS COMBINED AUTHORITY
Birmingham
Coventry
Dudley
Sandwell
Solihull
Walsall
Wolverhampton

GREATER MANCHESTER COMBINED AUTHORITY
Bolton
Bury
Manchester
Oldham
Rochdale
Salford
Stockport
Tameside
Trafford
Wigan

2\.

BEL	Belgium
CHE	Switzerland
SWE	Sweden
AUT	Austria
FIN	Finland
NOR	Norway
DEU	Germany
ESP	Spain
EURO	Europe
FRA	France
GBR	United Kingdom
NLD	Netherlands
ITA	Italy

3\.

SAFE	Safestore Ltd.
BYG	Big Yellow Group plc
PHP	Primary Health Properties
UTG	Unite Group Plc
LMP	LondonMetric Property Plc
SGRO	SEGRO
THRL	Target Healthcare REIT Limited
BBOX	Tritax Big Box REIT
DIGS	GCP Student Living plc
ESP	ESP Empiric Student Property
WKP	Workspace Group Plc
DLN	Derwent London Plc
GPOR	Great Portland Estates Plc
SHB	Shaftesbury Plc
CAPC	Capital & Counties Properties PLC
NRR	NewRiver REIT plc
LAND	Land Securities Group PLC
BLND	British land company
HMSO	Hammerson Plc
INTU	INTU Properties Plc

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CLUTTONS IM

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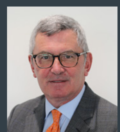

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