CLUTTONS
INVESTMENT MANAGEMENT

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Commercial property examiner

Quarter four | 2021

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Contents

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Foreword

In the foreword to Q4's edition of this report we are returning once again to the topic of inflation and specifically considering how it might impact the UK commercial real estate market.

Typically, inflation is caused by economic growth which is one of the key goals of an economic strategy. Growth creates jobs, wealth, and increases wages and standards of living. But too much inflation reduces the value of money and savings and can ultimately result in lower growth and higher unemployment. The Monetary Policy Committee (MPC) of the Bank of England uses monetary policy, essentially adjusting the level of interest rates, to target a 12-month CPI inflation rate of 2%.

Year on year CPI inflation increased to 5.4% in December from 3.0% in September. This is the highest CPI 12-month inflation rate since March 1992, when it stood at 7.1%. In the early 1990's year-on-year inflation peaked at 8.1% and interest rates were increased to 14.875% triggering a 5-quarter recession when the economy declined 2.1%.

There is currently an argument between economists around whether the higher inflation being experienced in the UK, USA and Europe is transitory or permanent. At present the UK authorities think that it is a temporary phenomenon. November's MPC forecasts expected inflation to peak at 5%. However, the upward pressure on CPI inflation was expected to dissipate over time, as supply disruption eases, global demand rebalances, and energy prices stop rising. This view could be partly based on recent experience.

Apart from the current episode, CPI inflation has moved above 5% twice in recent history. In September 2008, inflation unexpectedly rose to 5.2%. The main reason given by the ONS was a sharp rise in utility bills. Electricity prices were 30.3% higher on the previous year

while gas prices soared by 49.9%. As a result, the annual rate of inflation for energy and other household bills hit 15%. Again, in September 2011, consumer price inflation rose to 5.2% in September and the ONS said that gas, electricity and fuel prices were the biggest factors in the rise.

Neither episode triggered an increase in interest rates. In September 2008 interest rates were 5%. By March 2009 they were 0.5% as the MPC sought to support the economy during the GFC. In September 2011 interest rates were still 0.5% and remained so until August 2016 when they were reduced to 0.25% to counter any softening of the economy after the Brexit vote.

In 2008 the need for any decision on interest rates to counter inflation was drowned out by the failure of Lehman Brothers and the UK government's rescue of Northern Rock and Royal Bank of Scotland. In 2011 the MPC was prepared to look through any inflationary episode as base effects from higher oil prices would allow inflation to fall back sharply.

It is not inflation alone but a combination of high inflation and sharply higher interest rates that damage asset prices. Higher interest rates can, of course, increase debt repayments and reduce profitability leading to increased unemployment and lower consumer spending.

Regardless of past experience, if the MPC sees persistent and elevated core inflation, which is defined as CPI excluding energy and food, alcohol and tobacco, together with a tight job market and real terms pay increases, it will tighten policy.

In financial markets higher interest rates lead to an increase in the rate governments must pay to borrow and therefore, an increase in the risk-free rate. Theoretically, risky assets such as equities and real estate are valued by capitalising income steams at a discount rate that reflects an appropriate premium over the risk-free rate. As the yield on Treasuries or Gilts increases the capitalisation rate of these income streams should decrease, potentially resulting in lower valuations if the income streams remain unchanged.

If businesses including landlords can link the price of their goods and rents to inflation, future income streams would increase, and the effect of higher capitalisation rates neutralised. In terms of UK real estate this provides a strong argument for any asset that can be let on long RPI or CPI linked leases or to any sector that is enjoying inflation plus rates of rental growth, such as warehousing and logistics.

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1. Key take aways

The UK economy is estimated to have grown by 0.9% in November 2021 and is now 0.7% above its pre-coronavirus (COVID-19) pandemic level. The Omicron variant has resulted in record numbers of infections across the UK but while hospitalisations have been elevated, mortalities have been mercifully limited due to the effectiveness of the vaccination programme. Staff have once again been asked to work from home wherever possible and it remains to be seen whether quarterly GDP will reach or surpass its pre-coronavirus level.

Year on year CPI inflation increased to 5.4% in December from 3.0% in September. This is the highest CPI 12-month inflation rate since March 1992. Interest rates were increased by 0.15% to 0.25% in December and there are expectations of four 0.25% increases during 2022 to 1.25%. Arguments persist between those who see inflation as transitory and those who perceive that it may be more permanent.

The UK's commercial real estate market enjoyed a spectacularly strong final quarter of 2021 driven by the industrial sector, retail warehousing and unexpectedly West End and Midtown offices. In Q4, All Property total returns, as recorded by the MSCI Monthly Index, increased to 7.9% and in the 12-months to the end of December 2021, All Property total returns increased to 19.9%.

All Property total returns are likely to average 10% or more over the whole of 2022 and could reach 9% in 2023 with an annualised average of 8% in the 3-years ending December 2024.

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2. Summary

The World Bank records that the global economy is set to experience its sharpest slowdown after an initial rebound from a global recession since at least the 1970s reflecting continued COVID-19 flare-ups, diminished policy support, and lingering supply disruptions.

The UK economy is estimated to have grown by 0.9% in November 2021 and is now 0.7% above its pre-pandemic level but not its pre-pandemic trend level. The spread of the Omicron variant across the UK and the "Plan B" instruction to work from home wherever possible may mean that quarterly GDP for Q4 2021 will not reach its pre-coronavirus level.

Year on year CPI inflation increased to 5.4% in December from 3.0% in September. This is the highest CPI 12-month inflation rate since March 1992, when it stood at 7.1%. In the early 1990's year-on-year inflation peaked at 8.1% and interest rates were increased to 14.875% triggering a 5-quarter recession when the economy declined 2.1%.

The minutes of the latest MPC meeting confirmed an increase in interest rates to 0.25% and suggest that inflation is now expected to remain around 5% through the first quarter of 2022, peaking at around 6% in April 2022. It is expected that there will be a further 4 increases of 0.25% in 2022 to 1.25% by year end.

In 2021, stock markets across the world reached record highs as Central Banks maintained their ultra-loose policy stance in support of Covid hit economies and governments continued with pandemic stimulus programmes.

UK REIT share prices grew by 26% in 2021 and outperformed the wider all share market indices. The top performers in the year all focused on logistics and warehousing.

The current property initial / gilt yield gap is 3.5% having decreased by a further 25 bps over the course of Q4 as property yields continue to harden while gilt yields move the other way. At this level, the yield gap is almost one standard deviation below the 10-year average (see Chart 3.5) but remains high by long run historical standards.

The UK's commercial real estate market enjoyed a spectacularly strong final quarter of 2021 driven by the industrial sector, retail warehousing and unexpectedly West End and Midtown offices. In Q4 2021, All Property total returns, as recorded by the MSCI Monthly Index, increased to 7.9% from 4.6% in Q3. This was the highest quarterly return generated at the All-Property level since the end of 2009 when the market was in the early stages of recovery following the GFC.

In the 12-months to the end of December 2021, All Property total returns increased to 19.9% from 13.4% in the 12-months ending September 2021 almost regardless of the arrival of the Omicron variant and the introduction of "Plan B" restrictions.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 9% in 2021 compared to 2020 and were 10% above their long run average.

Open-ended property funds that were once again closed to redemptions in Q1 2020 have mainly re-opened. Data to the end of November suggests firstly, that fund closures stemmed redemptions and that since March 2020 money has begun to flow into the funds again and assets under management have grown. Lending by UK financial institutions to the commercial real estate sector remains muted.

June 2021 represented the bottom of the cycle for All Property rental values and rental values should recover their pre-pandemic levels by the end of Q2 2022. Capital values, having surpassed their pre-pandemic levels in Q4 2021, are now expected to follow a more elevated path.

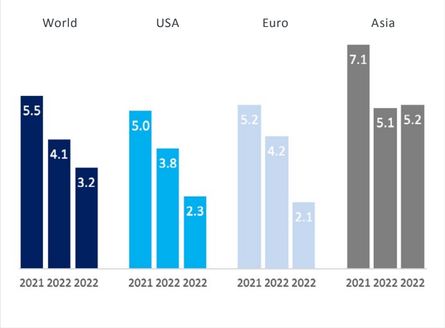
Cluttons' House View model has been revised to reflect the performance of the market in 2021. We continue to be more optimistic than the consensus view. Assuming that the impact of Covid-19 on the UK economy is waning and any further disruptions from new variants of the virus are strictly limited, All Property total returns could now reach 10% or more in 2022.

3. The World economy

In January's edition of Global Economic Prospects, the World Bank records that the global economy is set to experience its sharpest slowdown after an initial rebound from a global recession since at least the 1970s. Global growth is projected to decelerate from 5.5% in 2021 to 4.1% in 2022, reflecting continued COVID-19 flare-ups, diminished policy support, and lingering supply disruptions. Growth is expected to slow further in 2023, to 3.2%, as pent-up demand dwindles and supportive macroeconomic policies are unwound. Despite the slowdown, the projected pace of expansion will be sufficient to return aggregate advanced-economy output to pre- pandemic trend levels in 2023 and thus complete its cyclical recovery. Emerging market and developing economies (EMDEs) are expected to suffer substantial economic scarring preventing the return of output to pre-pandemic trend levels before the end of 2023 (see Chart 1.1).

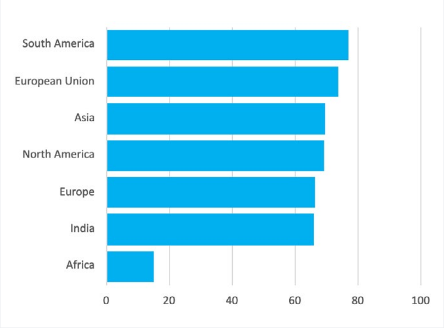
This global outlook is subject to various downside risks which increase the possibility of a hard landing. The unequal distribution of vaccines across countries permits the continued spread of COVID- 19 and the development of new concerning strains. The Omicron variant was first detected in November in South Africa, where just 28% of the population has been fully vaccinated. Omicron infections may cause less severe disease but the variant's ability to spread quickly through vaccinated populations could overwhelm exhausted health systems and force governments to tighten control measures, causing a substantial slowdown in near-term growth (see Chart 1.2).

1.1 Growth projections by region



Source: World Bank, Jan 2022

1.2 Vaccination rates per 100 people



Source: OWiD, Jan 2022

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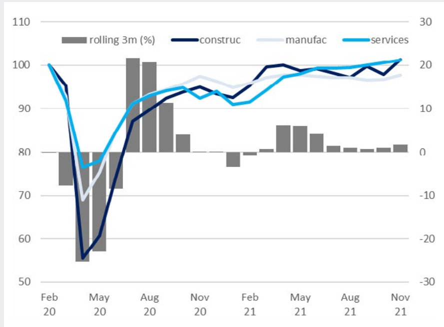
4. The UK economy

The UK economy is estimated to have grown by 0.9% in November 2021 and is now 0.7% above its pre-coronavirus (COVID-19) pandemic level (February 2020) but not its pre-pandemic trend level. If there are no other data revisions, quarterly GDP for Q4 2021 will either reach or surpass its pre-coronavirus level, provided the monthly December 2021 estimate does not fall by more than 0.2%. However, in early December, England moved to “Plan B” as the Omicron variant spread across the UK. Face masks were once again compulsory at most indoor public venues including shops. At large gatherings such as sports matches and concerts the NHS Covid Pass became mandatory confirming the holder’s full vaccination or negative test. And, importantly for office real estate, people were asked to work from home wherever possible (see Chart 1.3).

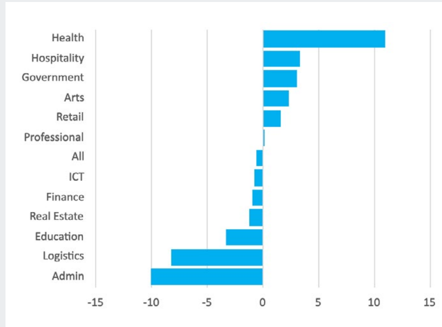
Services output grew by 0.7% in November 2021 and is now 1.3% above its pre-coronavirus (COVID-19) pandemic level in February 2020. Output in consumer-facing services grew by 0.8%, mainly because of a 1.4% increase in retail trade, while all other services rose by 0.6%. Consumer-facing services are still 5.0% below their pre-coronavirus levels, while all other services are 2.9% above. Eight of the fourteen service sub-sectors have now surpassed their pre-coronavirus levels, with the largest contributions from human health and social work activities, wholesale and retail trade, and arts, entertainment and recreation (see Chart 1.4).

1.3 UK economic growth



Source: ONS, Jan 2022

1.4 UK service sector post Covid output

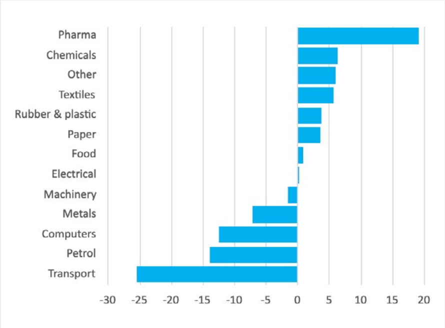


Source: ONS, Jan 2022

Production output increased by 1.0% in November 2021, having previously declined by 0.5% in October and 0.7% in September 2021. The main drivers of this growth were the manufacture of machinery and equipment which expanded by 7.4% and the manufacture of transport equipment which grew 3.6%. After two months of contraction, output in the manufacture of motor vehicles increased by 7.8% with anecdotal evidence suggesting that the sourcing of parts had improved although other businesses in this industry noted a continued supply shortage. Some of the issues sourcing construction products also eased in November as growth in infrastructure and private new housing drove a 3.5% increase in construction output in November (see Chart 1.5).

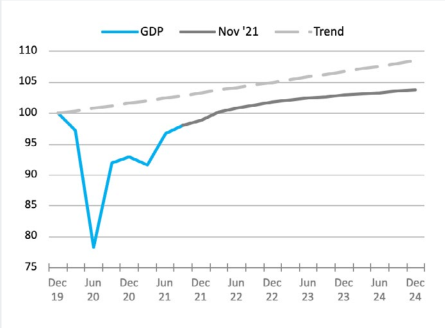
The MPC's UK GDP forecasts published in August expected GDP to grow by around 3% in Q3. In actuality, the economy grew by just 1.3% in the third quarter. This the MPC explains in its November report is the result of the disruption to supply chains. The latest MPC forecasts contained in the November report suggest that growth will amount to 1% in each of Q4 2021 and Q1 2022 before descending further to 0.5% a quarter for the rest of 2022 and approximately 0.25% a quarter thereafter. The post GFC and pre-Covid quarterly average is 0.4%. This subdued rate of growth is caused by higher energy prices and the removal of monetary and fiscal policy support in the form of higher interest rates and taxes and cuts to Government spending. Economic output does return to its trend rate over the forecast period (see Chart 1.6).

1.5 UK industrial sector post Covid output



Source: ONS, Jan 2022

1.6 MPC economic projections



Source: Bank of England, Nov 2021

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5. Other economic indicators

Year on year CPI inflation increased to 5.4% in December from 3.0% in September. This is the highest CPI 12-month inflation rate since March 1992, when it stood at 7.1%. (see Chart 2.1).

The elevated contribution from Housing and household services (Utilities) was a result of price rises for gas and electricity following the increase in the energy price cap on 1st October. The energy regulator, OFGEM updates the energy price caps twice a year, in April and October, to ensure that they reflect changes in the cost of supplying energy. In October the price cap increased by 12%. In April 2022 it is estimated that it will increase by 51%, adding £600 to the typical household bill.

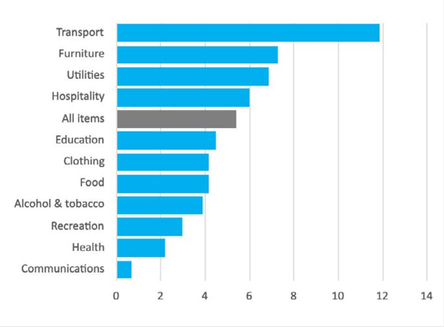
Transport cost inflation has been driven by increases in the price of motor fuels and second-hand cars. Average petrol prices of 145.8p per litre compare with 114.1p per litre a year earlier. A shortage of new cars and a pandemic preference for private over public transport have increased used car prices by 28% since January 2021. Fewer one-year old cars are now coming to the market because of a fall in new car registrations 12-months earlier, leases are being extended and fewer cars offered in part exchange (see Chart 2.2).

November's MPC forecasts expected inflation to peak at 5%. However, the upward pressure on CPI inflation is expected to dissipate over time, as supply disruption eases, global demand rebalances, and energy prices stop rising. The minutes of the latest MPC meeting confirmed an increase in interest rates to 0.25% and suggest that inflation is now expected to remain around 5% through the first quarter of 2022, peaking at around 6% in April 2022, with that further increase being accounted for predominantly by the lagged impact on utility bills of wholesale gas prices (see Chart 2.3).

2.1 CPI inflation

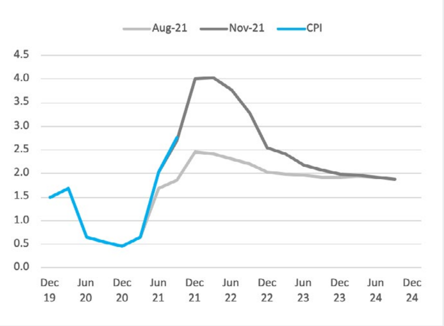
Source: ONS, Jan 2022

2.2 CPI by item



Source: ONS, Jan 2022

2.3 MPC inflation projections

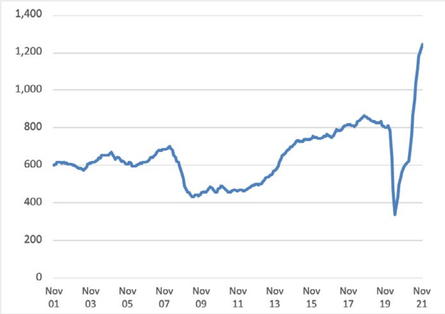


Source: Bank of England, Nov 2021

Despite the shortage of HGV drivers, the UK's major supermarkets and other food retailers managed to save Christmas. However, a shortage of workers remains, caused by homeward-bound migrants and retirements prompted by Covid. Those who see inflation as being more permanent argue that high job vacancy levels could see employers competing for staff by driving up wages. These higher staff costs are then passed on to consumers in the form of higher prices, while the higher wages paid increase consumer demand. This is the classic wage-price spiral of the 1970s and 1980s. The Bank of England and those arguing for more transitory inflation argue that higher wages will be spent on the increased costs of living in the form of higher utility bills and the relatively low membership of trade unions will weaken collective bargaining (see Charts 2.4 & 2.5).

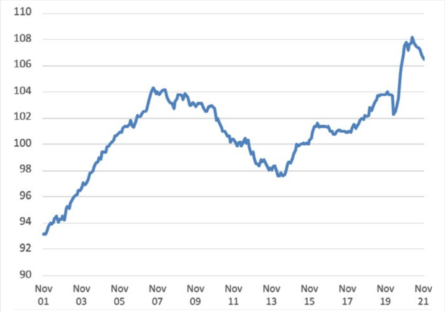
Google's Community Mobility Reports indicate the likely impact of "Plan B" instructions to work from home on office occupancy rates and the profitability of hospitality and retail businesses serving office centres. At the end of 2021, the number of searches for workplace destinations in the UK's biggest business centres and conurbations across the UK had decreased to 40% of pre-pandemic levels from 70% at the end of September. In Central London, activity levels were nearer 30% of pre-pandemic levels (see Chart 2.6).

2.4 Job vacancies



Source: ONS, Jan 2022

2.5 Real terms regular pay index SA



Source: ONS, Jan 2022

2.6 West End workplace searches

Source: Google , Jan 2022

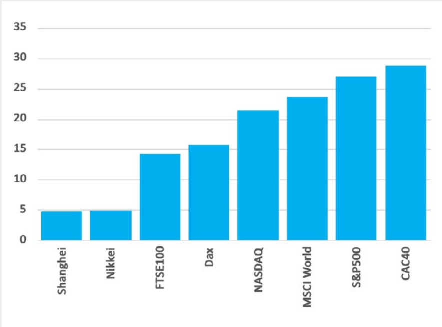
6. Interest rates and asset yields

In 2021, stock markets across the world reached record highs as Central Banks maintained their ultra-loose policy stance in support of Covid hit economies and governments continued with pandemic stimulus programmes. In the USA, the Federal Reserve bought $120bn of bonds each month and only started to taper the programme in November. In the UK, purchases by the Bank of England of investment grade corporate bonds and UK gilts financed by the issuance of central bank reserves amounted to £895bn by November. The MSCI World Index with large and mid-cap representation across 23 developed markets gained 23.6% in 2021. In China, markets suffered from regulatory crackdowns on the tech sector; fears over the fallout from the real estate giant, Evergrande; and energy rationing and power cuts (see Chart 3.1).

More than a third of stock market performance in the USA was attributable to "Big Tech". The valuation of "Fangman" hit an all-time high of $11.2 trillion driven by Apple which briefly became the first $3 trillion company. But smaller tech stocks tumbled. Zoom fell by 45% and Peloton lost 75% of its value. Warren Buffett's business partner Charlie Munger of Berkshire Hathaway, told a conference that the markets are wildly overvalued in places, warning that "I consider this era an even crazier era than the dotcom era." Since the start of 2022 the price of some of the best performing assets last year has fallen back (see Chart 3.2).

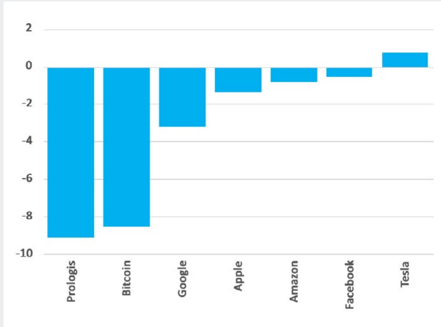
UK REIT share prices grew by 26% in 2021 and outperformed the wider all share market indices. The top performers in the year all focused on logistics and warehousing. Segro, the UK's largest REIT by market capitalisation with a portfolio of logistics assets across the UK and Europe, and Big Box, which develops and invests in logistics assets of more than 500,000 sq ft. were out-performed by Big Yellow Group, a provider of self-storage units. The surprise performance of the year came from Shopping Centre specialist, Hammerson, as it reported the successful disposal of six non-core assets for £92m in line with the Company's strategy of reducing debt, simplifying the portfolio and generating capital for redeployment. (see Chart 3.3).

3.1 World stock markets 2021



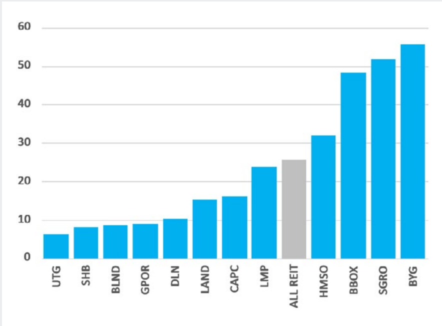
Source: Yahoo Finance , Jan 2022

3.2 Tech stocks year to date



Source: Yahoo Finance , Jan 2022

3.3 UK Reit price movement in 2021



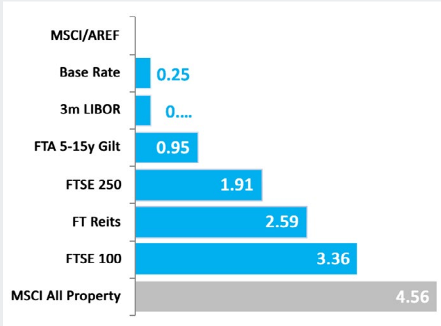
Source: Yahoo Finance , Jan 2022

Risk-free assets remain at historic low yields. However, recent inflationary pressures on the economy and the strength of the labour market caused the MPC to raise the UK's base rate from 0.1% to 0.25% in December and maintain QE at £895bn. In the UK, gilt yields hardened by 4 bps to 0.95% from 0.99% over the course of Q4 reflecting the difficult balance between limiting inflation expectations and supporting the economy in the face of the Omicron wave of the pandemic. The yield on the 5-15 year gilt index has since softened to 1.16% (see Chart 3.4).

Market expectations of future interest rates have increased by 25 bps at the shorter end of the yield curve in reaction to a more hawkish view on inflation risks. But at longer durations yields have decreased by 20 bps or more. The difference between the yield on 1 year and 5-year gilts is 35 bp. Context remains important. In the 10-years before the GFC, the Bank Rate averaged 5%; today, markets and commentators are now commenting on the possibility of four 25 bp increases this year, leaving Base Rate at 1.25% by year-end (see Chart 3.5).

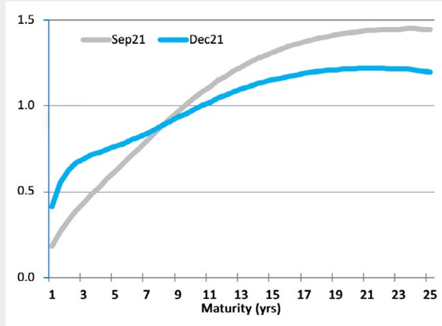
The current property initial / gilt yield gap is 3.5% having decreased by a further 25 bps over the course of Q4 as property yields continue to harden while gilt yields move the other way. At this level, the yield gap is almost one standard deviation below the 10-year average but remains high by long run historical standards. QE by central banks and the prevailing low cost of debt has resulted in unprecedented levels of liquidity in global markets. This liquidity and the level of property yields relative to the risk-free rate and the yield on other risky assets will continue to provide protection to UK real estate asset prices. Lower yielding industrial and logistics assets, however, will need to benefit from continued growth in rental values. Generally, for the retail and office sectors the yield gap is much higher (see Chart 3.6).

3.4 UK asset yields Q4 2021



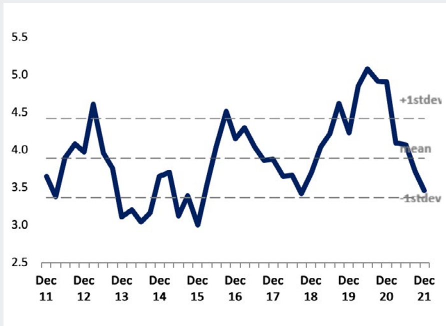
Source: Yahoo Finance & MSCI , Jan 2022

3.5 Gilt yield curve (%)



Source: Bank of England , Jan 2022

3.6 Property IY - Gilt yield gap



Source: MSCI & Bank of England , Jan 2022

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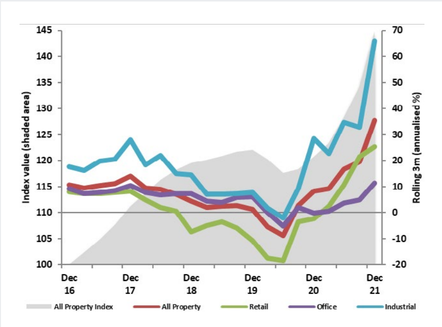
7. Commercial property market performance

The UK's commercial real estate market enjoyed a spectacularly strong final quarter of 2021 driven by the industrial sector and retail warehousing. Unexpectedly strong performance from West End and Midtown offices in Q4 is likely to prove a one-off correction given the uncertain post-Covid outlook for offices.

In Q4 2021, All Property total returns, as recorded by the MSCI Monthly Index, increased to 7.9% from 4.6% in Q3. This was the highest quarterly return generated at the All-Property level since the end of 2009 when the market was in the early stages of recovery following the GFC. Capital growth was 6.6% in Q4 compared to 3.3% in Q3. Property equivalent yields hardened by 31 bps and contributed a 5.4% uplift to valuations. All Property rental value growth increased to 1.5% in Q4 from 0.6% in Q3. Q4 income returns amounted to 1.2% (see Charts 4.1 & 4.4).

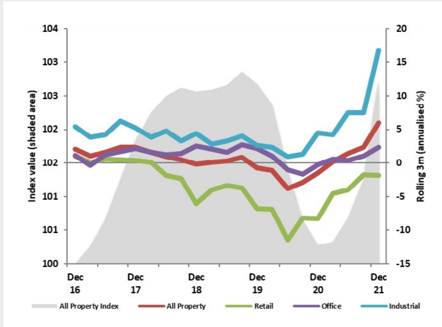
Over the course of the fourth quarter, office rental values increased by 0.6% while industrial rental value growth increased to 4.0% from 1.8% in Q3. However, with the exception of retail warehousing, rental values in all retail segments fell further (see Charts 4.2 & 4.5).

4.1 Total returns by sector



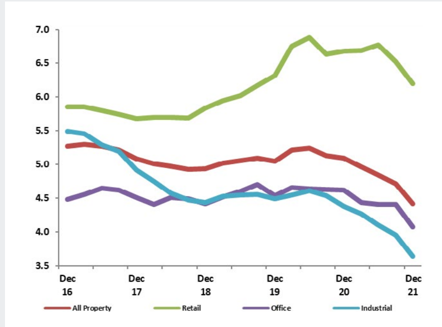
Source: MSCI, Jan 2022

4.2 MRV growth by sector



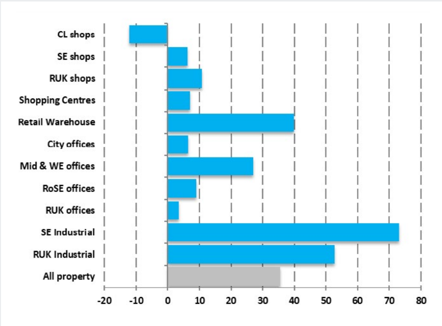
Source: MSCI, Jan 2022

4.3 Initial yield by sector



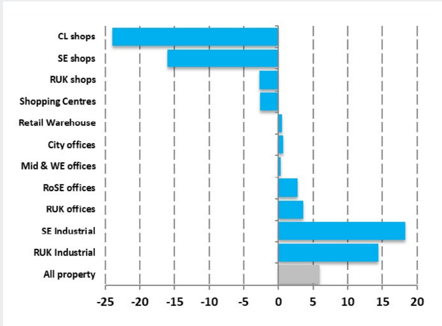
Source: MSCI, Jan 2022

4.4 Total returns by segment (Q3 annualised)



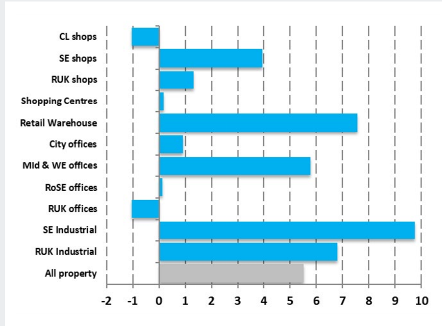
Source: MSCI, Jan 2022

4.5 MRV growth by segment (Q3 annualised)



Source: MSCI, Jan 2022

4.6 Yield impact (Q3)



Source: MSCI, Jan 2022

In the 12-months to the end of December 2021, All Property total returns increased to 19.9% from 13.4% in the 12-months ending September 2021 almost regardless of the arrival of the Omicron variant and the introduction of “Plan B”. Year-on-year capital growth was 13.9% in December compared to 7.5% in September. Property equivalent yields hardened by 78 bps in the 12-months to December and contributed an 11.9% uplift to valuations. All Property rental values increased year-on-year by 2.4% and income return amounted to 5.3%.

Strong investment and occupier demand for industrials has pushed up rental values and driven yields down to 3.5% and sub 3% for last mile logistics in London. The yield gap between industrials and retail and office assets continues to expand to the point where investors might be tempted to look for value in the latter two sectors (see Charts 4.3 & 4.6).

Occupier demand for industrials, however, is driving rental growth of 9% year-on-year and 17% at a quarterly annualised rate in Q4. For the moment, after adding back the income, investors can reasonably anticipate total returns of 12% or more. This suggests that the re-rating of industrial assets may have further to run.

5.1 Total returns

	Dec	3m	6m	12m
All Property	3.9	7.9	12.9	19.9
Retail	2.5	5.8	11.1	14.6
Office	0.7	2.7	4.0	5.1
Industrial	7.1	13.5	21.9	38.2
Annualised				
All Property	58.8	35.6	27.4	19.9
Retail	35.2	25.2	23.4	14.6
Office	9.4	11.5	8.1	5.1
Industrial	127.8	66.1	48.5	38.2

Source: MSCI

5.2 Capital growth

	Dec	3m	6m	12m
All Property	3.5	6.6	10.1	13.9
Retail	2.0	4.1	7.4	6.9
Office	0.4	1.6	1.6	0.1
Industrial	6.8	12.4	19.4	32.5
Annualised				
All Property	51.5	29.2	21.2	13.9
Retail	26.7	17.2	15.3	6.9
Office	4.5	6.4	3.1	0.1
Industrial	119.3	59.7	42.7	32.5

Source: MSCI

5.3 Income return

	Dec	3m	6m	12m
All Property	0.4	1.2	2.5	5.3
Retail	0.6	1.7	3.5	7.3
Office	0.4	1.2	2.4	4.9
Industrial	0.3	1.0	2.1	4.4
Annualised				
All Property	5.0	5.1	5.1	5.3
Retail	6.9	6.9	7.0	7.3
Office	4.7	4.8	4.8	4.9
Industrial	4.1	4.2	4.2	4.4

Source: MSCI

5.4 ERV growth

	Dec	3m	6m	12m
All Property	0.7	1.5	2.0	2.4
Retail	-0.2	-0.5	-0.9	-3.1
Office	0.1	0.6	0.8	1.1
Industrial	1.9	4.0	5.8	8.9
Annualised				
All Property	8.5	6.0	4.1	2.4
Retail	-1.8	-1.9	-1.8	-3.1
Office	1.4	2.3	1.7	1.1
Industrial	25.4	16.8	12.0	8.9

Source: MSCI

5.5 Net initial yield

	Dec	3m	6m	12m
All Property	4.4	4.7	4.8	5.1
Retail	6.2	6.5	6.8	6.7
Office	4.1	4.4	4.4	4.6
Industrial	3.6	4.0	4.1	4.4

Source: MSCI

Industrial assets now represent 43% of the monthly index and many traditional balanced funds will still be over-weight in retail and office and under-weight in industrial. The drive to re-balance will add further liquidity to the sector.

Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q4 2021.

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 with new tools to segment the market in addition to traditional approaches that dissect assets by sector and geography as noted above.

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 Q3 2021. A heat map has been used as a visual aid to pick out the under-performing segments in red and out-performing segments in green.

Consistent with our analysis in this report, each of the retail, warehouse and industrial segments are out-performing. Prime low yield and long lease shops are the best retail strategies but their performance relative to the whole market remains negative. All office strategies across the Central London, South East and Rest of UK markets are also negative as questions surrounding the future demand for space in a post-Covid business environment hang over the future for offices.

5.6 Performance by strategy relative to All Property average Q3 2021

	Low yield	High yield	High rent	Low rent	Long lease	Short lease
Shops	-1.8	-3.9	-3.7	-1.8	-1.2	-4.1
Shopping Centres	-4.0	-3.8	-3.4	-4.0	-2.8	-3.5
Retail Warehouses	1.5	2.6	2.9	1.5	2.0	2.8
Central London offices	-1.8	-3.8	-2.6	-1.8	-2.2	-3.5
RoSe offices	-1.2	-4.8	-2.1	-1.2	-2.0	-3.8
RUK offices	-2.7	-3.9	-1.5	-2.7	-2.6	-4.2
Industrials	3.9	2.4	4.1	3.9	2.2	3.8

Source; MSCI Quarterly Digest Q3 2021

8. Investment in property

High levels of investor liquidity and a search for yield in the continuing hyper-low interest rate environment is driving allocations to real estate. A re-surgent economy following the easing of lockdown restrictions earlier in the year and a strong performance by commercial real estate has encouraged higher levels of investment activity. On a relative basis, the UK remains highly attractive from a yield perspective compared to many other global real estate markets.

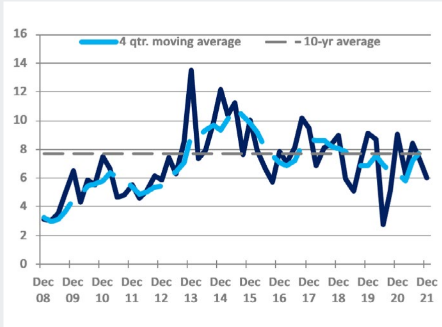
All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 9% in 2021 compared to 2020 and were 10% above their long run average. Preliminary estimates suggest that investment volumes fell sharply in Q4 and surprisingly the second half of the year, when the UK was largely out of lockdown, only accounts for 55% of all transactions. But the numbers are likely to be revised upwards in the coming months (see Chart 6.1).

Industrials made up 28% of investment transactions in 2021; Central London offices represented a further 20% and Alternatives including Medical Facilities, Car Showrooms, Residential and Student Accommodation made up another 19%. Across all sectors of the market, investment volumes were higher than in 2020 with the exception of shops and Alternatives (see Chart 6.2).

Central London offices traditionally dominate UK real estate investment representing 28% of the UK's real estate investment market over the last 20 years. Investment volumes, however, have been on a declining trend since December 2013. In 2021, its share of the UK's CRE investment market was 20% (see Chart 6.3).

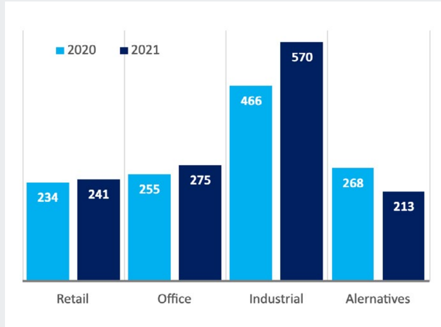
Transaction numbers across Central London increased in 2021 but the City Fringe, Docklands and Southbank markets were thinly traded. In 2021 the City of London accounted for 50% of all Central London office transactions while the West End represents 38% of such transactions (see Chart 6.4). Since the start of the pandemic £7.49bn has been invested in City offices, more than twice £3.38bn invested in West End offices. However, in Q4 West End yields hardened by 74 bps and City yields softened by 8 bps.

6.1 All property investment volumes (£bn)



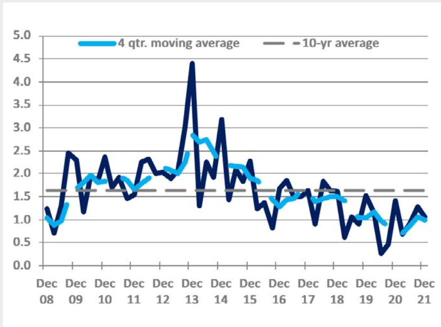
Source: Property Data, MSCI & APR, Jan 2022

6.2 Investment transactions 2020 v. 2021



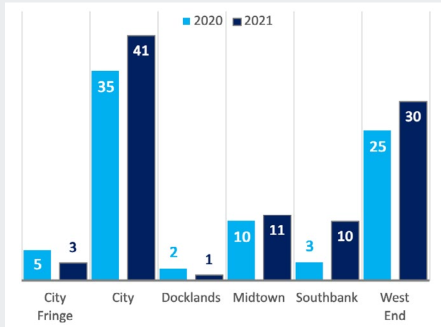
Source: Property Data, Jan 2022

6.3 Central London office investment volumes (£bn)



Source: Property Data, MSCI & APR, Jan 2022

6.4 Central London office investment transactions 2020 v. 2021



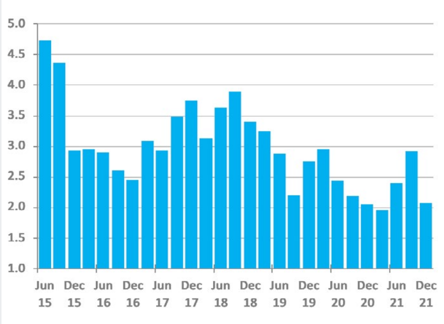
Source: Property Data, Jan 2022

Continued talk of a large amount of overseas capital targeting Central London offices may well be accurate but this capital has yet to be deployed (see Chart 6.5). This may be through a lack of suitable assets for sale or residual concerns surrounding the medium-term risks.

In the last six years, property funds have regularly faced demands for redemptions from retail investors. 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 an almost continuous outflow of money from Property funds. Open-ended property funds that were once again closed to redemptions in Q1 2020 have mainly re-opened. Data to the end of November suggests firstly, that fund closures stemmed redemptions and that since March 2020 money has begun to flow into the funds again and assets under management have grown (see Chart 6.6).

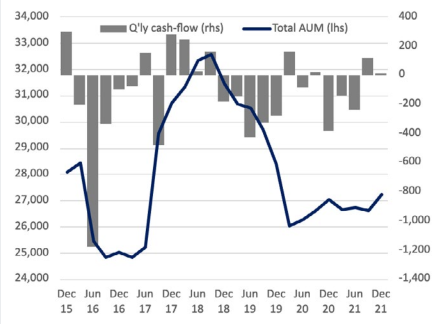
Since the GFC total lending by UK resident financial institutions to the UK real estate market fell by 48% from £247bn to £129bn. The shock of the Brexit vote briefly subdued demand for debt finance but in 2018 financial institutions resumed lending only for the pandemic to choke off demand. To-date lending remains muted (see Chart 6.7).

6.5 Rolling 12m overseas investment in Central London offices (£bn)



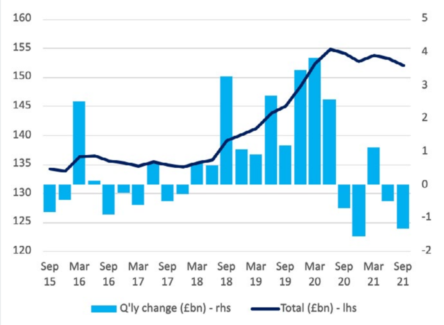
Source: Property Data, Jan 2022

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



Source: Investment Association, Jan 2022

6.7 Bank lending to UK property



Source: Bank of England, Dec 2021

9. Outlook

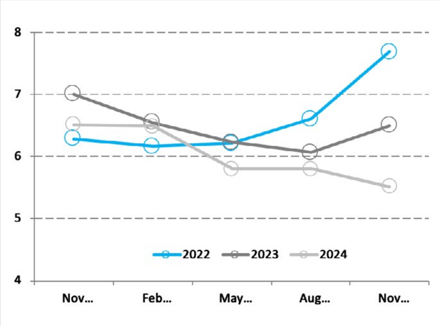
November's IPF consensus forecasts reflect an increasingly positive view on the outlook for UK real estate values as the sector recovers from the effects of pandemic lockdown. Total return forecasts for 2022 have been increased to 7.7% from 6.6% in August (see Chart 7.1). From 2022 onwards, year-on-year total return forecasts decrease from 7.7% to 5.4% in 2025 with an annualised average over the next 4-years of 6.3% (see Chart 7.2).

Respondents to the IPF Consensus forecasts continue to strongly favour Industrials at the expense of Shops and Shopping Centres. There has, however, been a strong improvement in the prospects for Retail Warehouses (see Chart 7.3). This has been driven by the outperformance of retail parks in retailers' portfolios servicing 'click and collect' orders and redevelopment potential to either increase density or re-purpose for last mile logistic or residential use.

As the effects of Covid on the economy recede and we move into a post pandemic environment, the range of forecasts has narrowed, reflecting a reduction in risk. Total return forecasts for 2022 range between 11.4% and 3.7%. The forecast range for 2023 is 7.2% with a maximum of 9.8% and a minimum of 2.6%. Last quarter the forecast range for 2023 was 15.2% (see Chart 7.4).

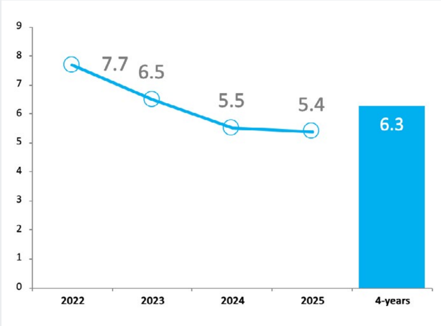
The MPC's latest economic forecasts noted above are very similar in outcome to those produced three months earlier. However, the strength of the commercial property market's post-pandemic recovery has surprised on the upside and the forecast path for rental and capital values reflects the strong numbers posted in Q3 and Q4.

7.1 IPF forecast evolution (Nov 2021)



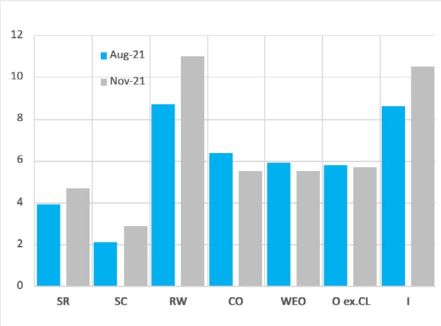
Source: IPF, Nov 2021

7.2 IPF All Property forecasts y-by-y (Nov 21)



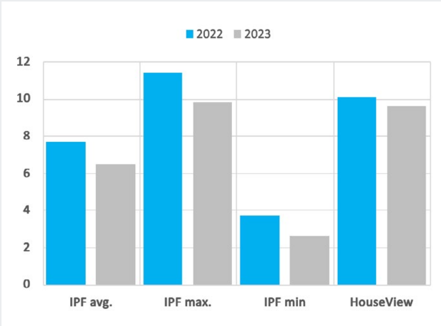
Source: IPF, Nov 2021

7.3 IPF 2021 forecasts by sector Nov 21 v. Aug 21



Source: IPF, Nov 2021

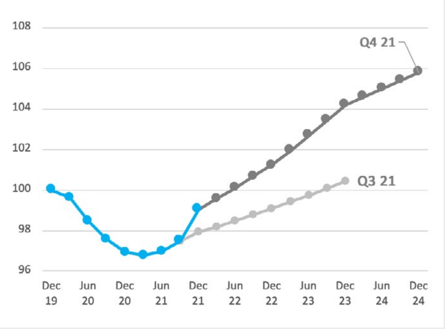
7.4 UK commercial total return forecasts



Source: IPF, Nov 2021

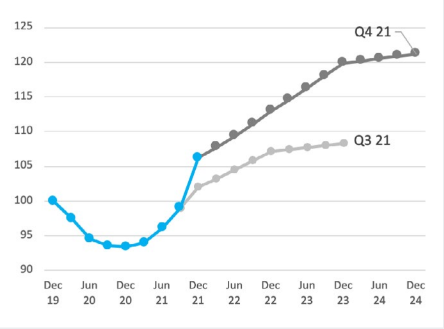
June 2021 represented the bottom of the cycle for All Property rental values and rental values should recover their pre-pandemic levels by the end of Q2 2022. Capital values, having surpassed their pre-pandemic levels in Q4 2021, are now expected to follow a more elevated path (see Charts 7.5 & 7.6).

7.5 Rental value forecasts

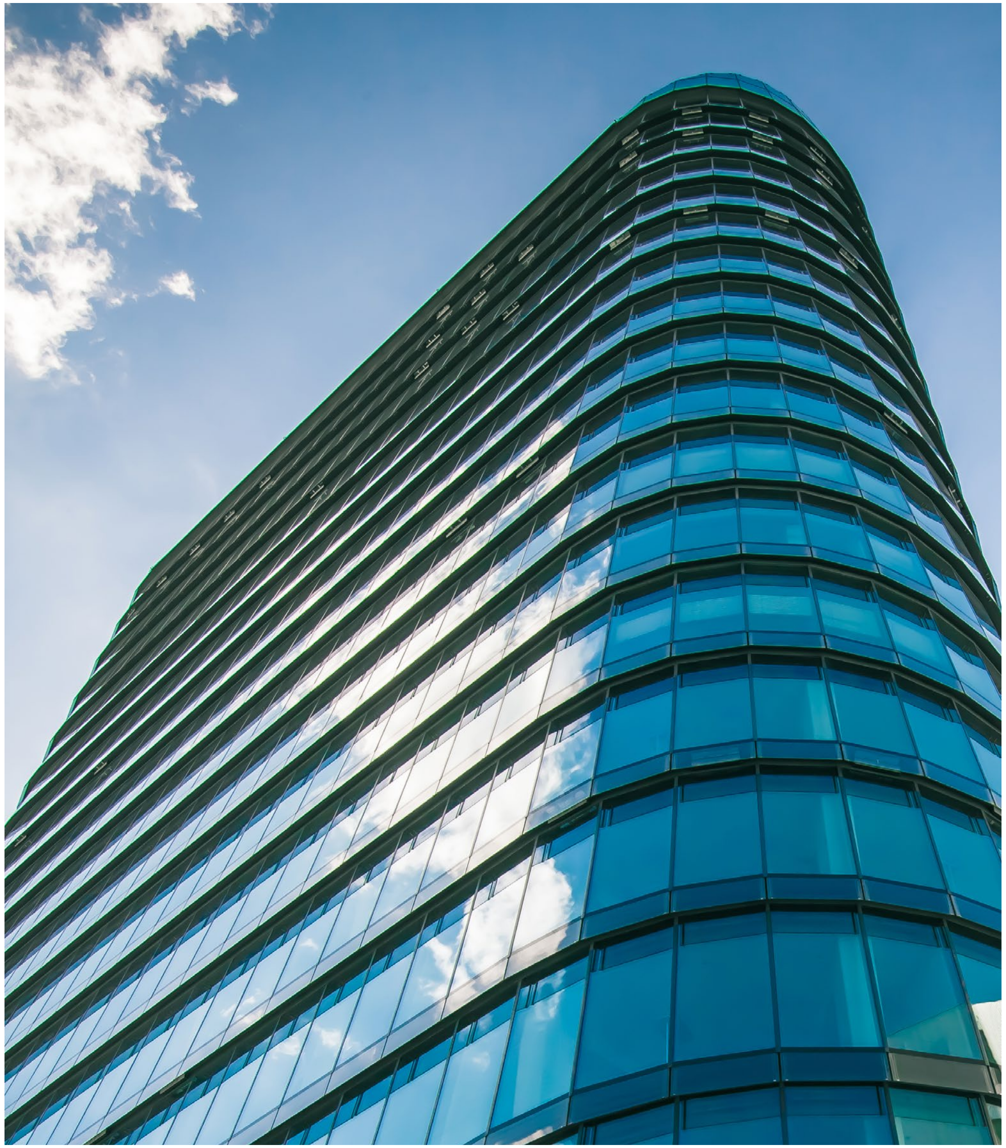


Source: IPF, APR & Cluttons, Jan 2022

7.6 Capital value forecasts



Source: IPF, APR & Cluttons, Jan 2022

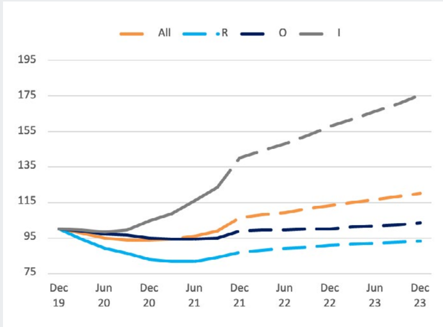


10. Houseview

The central forecast from Cluttons' House View model has been revised to reflect the performance of the market in 2021. We continue to be more optimistic than the consensus view and expect capital values at the All Property level to improve for the remainder of the forecast period. Assuming that the impact of COVID-19 on the UK economy is waning and any further disruptions from new variants of the virus are strictly limited, All Property total returns could now reach 10% or more in 2022 and 9% in 2023 with an annualised average of 8% in the 3-years ending December 2024. However, the usual caveats regarding uncertainty surrounding this central forecast remain.

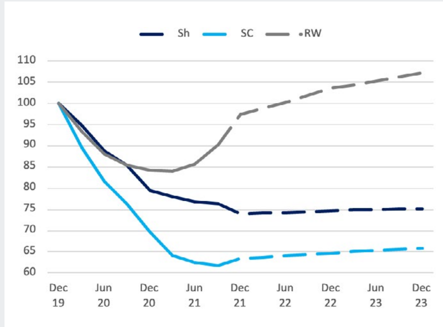
At the All Property level, we expect capital value growth to be positive. Market conditions have been improving throughout 2021 and we expect this trend to continue (see Charts 8.1 – 8.4) albeit at a slower pace than exhibited in the fourth quarter of 2021. The main risk to this outlook is now represented by persistently high inflation and increasing interest rates.

8.1 3-sector capital value forecasts



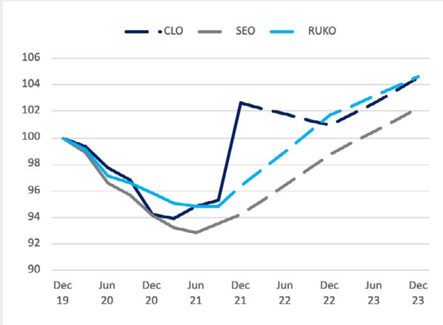
Source: IPF, APR & Cluttons, Jan 2022

8.2 Retail segments capital value forecasts



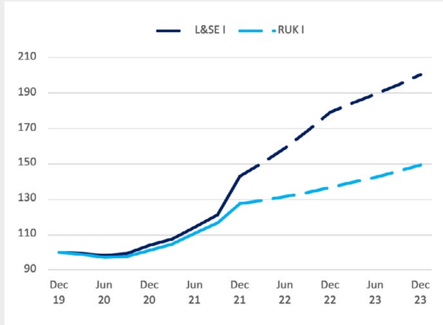
Source: IPF, APR & Cluttons, Jan 2022

8.3 Office segments capital value forecasts



Source: IPF, APR & Cluttons, Jan 2022

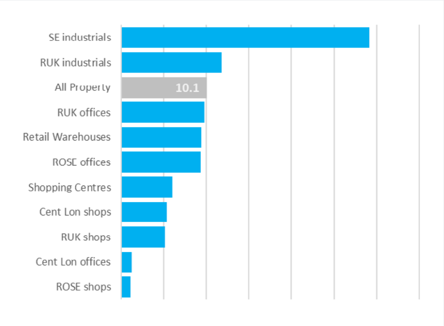
8.4 Industrial segments capital value forecasts



Source: IPF, APR & Cluttons, Jan 2022

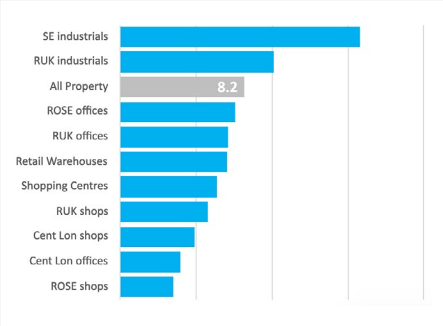
Retail assets have borne the brunt of the downturn, but we expect them to show some signs of stability in 2022. Industrials will provide upside protection from the downside risks inherent in holding offices and particularly retail (see Charts 8.5 & 8.6). If, however, affordability becomes an issue for logistic occupiers, especially in the most expensive locations, they will not be prepared to chase rents higher, and yields may de-rate.

8.5 Cluttons House View - 2022 relative total returns (%)

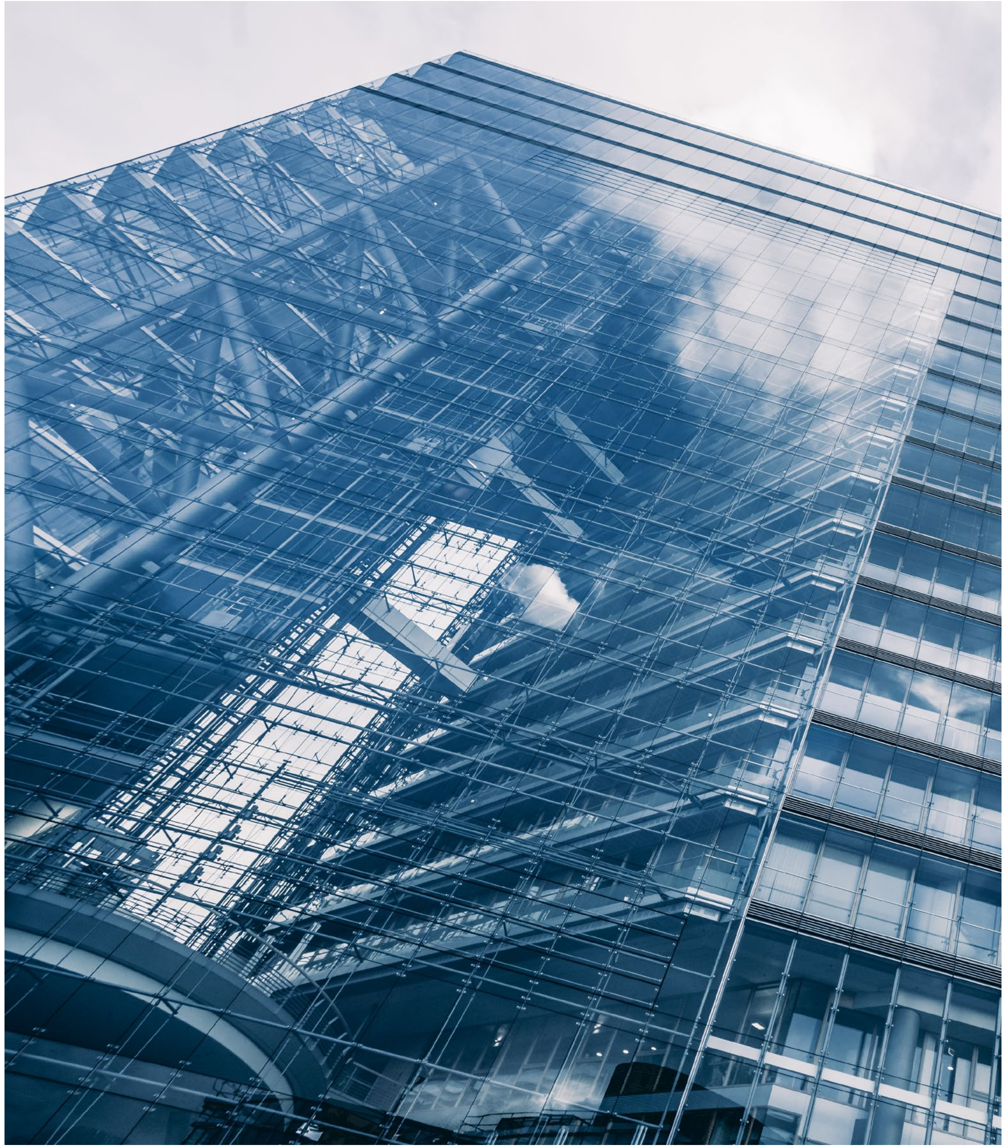


Source: IPF, APR & Cluttons, Jan 2022

8.6 Cluttons House View - 2022-2024 relative total returns (%)



Source: IPF, APR & Cluttons, Jan 2022



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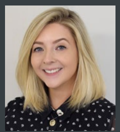

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