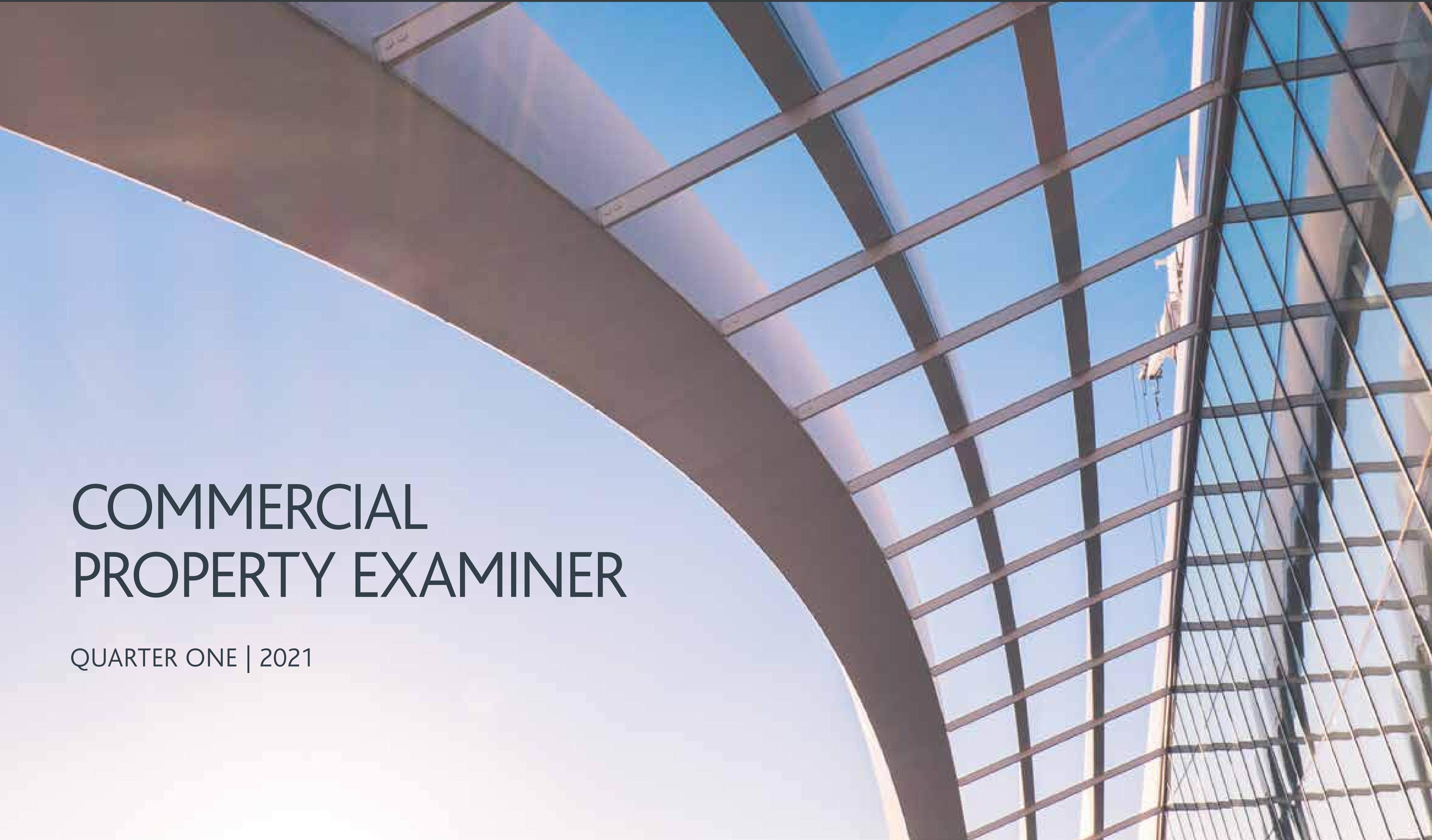

COMMERCIAL PROPERTY EXAMINER

QUARTER ONE | 2021

FORWARD

A number of key issues surrounding the outlook for retail and office property in particular are likely to be prominent for a number of years to come. They include the re-purposing of retail assets, the future demand for offices, the growing importance of ESG issues and the evolving impact of Brexit on the City of London.

The reluctance of consumers to use public transport and visit city centres could work to the benefit of the local high street and out of town retail destinations with ample car parking. Next recently reported that stores located in out of town retail parks continued to perform around 15% better than those in city centres and shopping centres. Moreover, in the most recent lockdown, it was able to service its Click and Collect customers from its Retail Park stores.

British Land sees a value opportunity in out of town retail, driven by affordability and stronger demand from retailers. The REIT has recently acquired the A1 Retail Park in Biggleswade for £49 million on a net initial yield of 8.5%. Occupiers on the park include M&S, Next and Boots.

Like many others, British Land is also looking at urban logistics' opportunities. It has recently exchanged contracts to buy Heritage House a 200,000 sq ft warehouse in Enfield for £87 million. This asset is currently fully let to Waitrose and Crown Records Management but offers significant redevelopment potential given the opportunity to increase density.

JPMorgan announced in April that it anticipated that 10% of staff would work full-time from home, more than 25,000 people. HSBC said 1,200 UK call centre staff would do the same. In March, Daily Mirror publisher Reach announced that three-quarters of employees would work remotely. Such moves represent big savings for Finance Directors and reduced demand for office space. Even allowing for substantial demolitions and office-to-residential conversions this would result in a marked rise in vacancy rates over the medium-term and cause declines in rental values and income returns.

A creeping disillusionment with working from home, however, is detectable elsewhere. The Chief Executive of Barclays had previously suggested its corporate HQ would be a thing of the past—but in early 2020 he remarked that working from home was not sustainable. It will, however, take months or even years for new patterns of work to emerge and the UK's long term leasing structure to allow occupiers to shrink their footprint following expiries.

Institutional investors are threatening stronger action on climate warming. Aviva is prepared to fully divest from 30 oil, gas and mining companies unless they do more to tackle climate change and Blackrock – the world's largest fund manager – will ask the companies it invests in to disclose their plans for net zero emissions.

The built environment accounts for 40% of the UK's CO2 emissions. A momentum is developing towards homogenous measurement reporting and benchmarking. Green leases will require occupiers to share data especially regarding energy consumption.

There are two major sources of carbon in corporate real estate: (1) the operational emissions from energy powering buildings, and (2) the carbon embedded in the materials used for development and refurbishment. The winners of the 2021 Pritzker Architectural Prize, Lacaton & Vassal, show the way forward. Their designs are based on sustainability and the principle of "never demolish".

In April, AXA IM announced that it had raised almost €1 billion to develop offices in Europe, based on occupiers continuing demand for high quality, flexible workspace with low-carbon emissions. AXA said:

> *"Occupiers are far more concerned about how buildings of the future will meet ESG requirements. . . those will be the buildings that investors will want to buy first."*

Lastly, after five years of discussion, Brexit remains an ongoing issue, particularly for financial services. Amsterdam is now Europe's largest share trading centre for European equities and Paris, Frankfurt and Milan have picked up market share at London's expense. The Financial Times has reported on a shift in the $2 trillion market in swaps used to hedge currency movements, shrinking the UK's market share in this trade from 40% to just over 10%.

A Memorandum of Understanding was agreed at the end of March between the UK and the EU establishing a formal platform for discussions regarding further EU market access for banks and financial companies in the City of London. But an agreement on 'Equivalence' seems as far away as ever.

JPMorgan foresee that it is inevitable that further work will move from London to European cities. Furthermore,

> *"We may reach a tipping point many years out when it may make sense to move all functions that service Europe out of the United Kingdom and into continental Europe. But London still has the opportunity to adapt and reinvent itself, particularly as the digital landscape continues to revolutionize financial services."*

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This is why many in the City were bitterly disappointed when Deliveroo's shares fell 26% on their first day of trading. The poor performance created an immediate obstacle to the UK's ambitions of attracting more tech companies to list in London and doubts about the wisdom of loosening London listing rules to attract fast-growing but lossmaking tech companies.

Many prominent UK institutional investors, including Legal & General, M&G, Aberdeen and Aviva, declined to subscribe to the flotation citing concerns over the treatment of employees and governance issues. For these potential investors, the problems centred around the "S" and "G" in ESG, particularly the use of gig-economy workers on zero-hours' contracts which failed to provide job security and employment rights; and a dual share class structure that gave enhanced voting rights to the founders of the business.

These are long term issues; office occupiers, investors and property managers will be grappling with their implications for years, not just months.

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1. KEY TAKE AWAYS

The third lockdown has had very little impact on the trajectory of macro-economic forecasts for the UK economy.

The Bank of England will look through short term inflationary pressures and maintain its ultra-low interest rate policy which continues to support the value of UK commercial real estate.

All Property total returns are improving at both the 3-month and 12-month horizon. In Q1 All Property total returns increased to 2.2% and in the 12-months to the end of March 2021, All Property total returns increased to 2.6%.

All Property total returns could recover to 5% or more in 2021 and 8% in 2022 with an annualised average of 7% in the 3-years ending December 2023.

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2. SUMMARY

The global economy is projected to grow at 6% in 2021, moderating to 4.4% in 2022. The projections for 2021 and 2022 are 2.0 percentage points and 0.6 percentage points stronger than those recorded in January's forecasts by the World Bank.

The UK economy shrank by 2.2% in January following the re-imposition of restrictions. Businesses, however, seem to have quickly come to terms with this third lockdown as monthly GDP is estimated to have increased by 0.4% in February.

GDP is projected to recover strongly over 2021 towards pre-COVID levels. Projected activity is also supported by the substantial fiscal and monetary policy actions. Further out, the pace of GDP growth slows as the boost from those factors fades.

Inflation may rise sharply in the next few months. Price pressure, however, will be dampened by the influence of spare capacity and in 2022 and 2023 inflation remains close to the MPC's 2% target.

UK REIT share prices grew by 3.6% in Q1 and outperformed the wider all share market indices.

Concerns surrounding an increase in inflation were behind a rise in the USA's 10-year Treasury bond yield from 0.93% in January to 1.72% at the end of March. In the UK, gilt yields have softened by 69 bps to 0.87% from 0.18% in Q4.

The current property initial / gilt yield gap has decreased to 4.1% from 4.9% in December but remains above the 10-year average.

In Q1 2021, All Property total returns increased very slightly to 2.2% from 2.0% in Q4 2020.

In the 12-months to the end of March 2021, All Property total returns increased to 2.6% from -1.0% in the 12-months ending December 2020.

All Property investment volumes decreased by 58% in Q1 2021 compared to a strong outcome to Q4 2020 and were 38% below their long run average.

Consensus total return forecasts for 2021 have been cut further to 2.2% from 2.5% in November reflecting a fall in capital values of -2.8% and an income return of 5%.

Cluttons HouseView is more optimistic than the consensus view. We expect capital values at the All Property level to stabilise this year. Assuming that the UK successfully moves beyond Lockdown 3.0 and the economy remains open thereafter, All Property total returns could recover to 5% or more in 2021 and 8% in 2022 with an annualised average of 7% in the 3-years ending December 2023.

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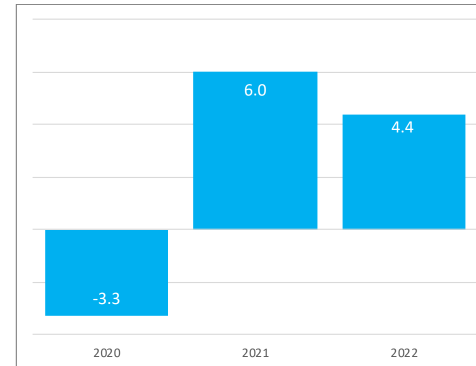
3. THE WORLD ECONOMY

In April's edition of World Economic Outlook (WEO), the IMF estimates that the global economy contracted by 3.3% in 2020. This contraction is 1.1 percentage points smaller than projected in the October 2020 WEO, reflecting the higher-than-expected growth in the second half of the year for most regions after lockdowns were eased and economies adapted to new ways of working (see Chart 1.1).

The global economy is projected to grow at 6% in 2021, moderating to 4.4% in 2022. The projections for 2021 and 2022 are 2.0 percentage points and 0.6 percentage points stronger than those recorded in January's forecasts by the World Bank. This reflects additional fiscal support in a few large economies and the vaccine-powered recovery in the first quarter of this year. Thanks to unprecedented policy response, the COVID-19 recession is likely to leave smaller scars than the 2008 global financial crisis.

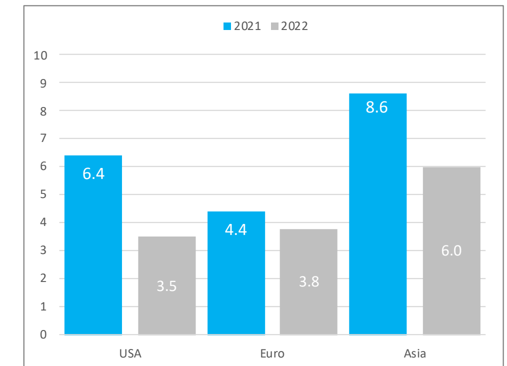
The pace of recovery varies by region (see Chart 1.2). China returned to pre-COVID levels of GDP in 2020, the United States is expected to surpass its pre-COVID GDP level this year, but many other advanced economies will return to their pre-COVID levels only in 2022. High uncertainty surrounds the global outlook. Future developments will depend on the path of the health crisis, particularly whether new COVID-19 strains prove susceptible to vaccines or they prolong the pandemic; the effectiveness of policy actions to limit persistent economic damage or scarring; and the evolution of financial conditions and commodity prices.

1.1 WORLD GROWTH PROJECTIONS (%)



Source: IMF, Apr 2021

1.2 GROWTH PROJECTIONS BY REGION



Source: IMF, Apr 2021

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4. THE UK ECONOMY

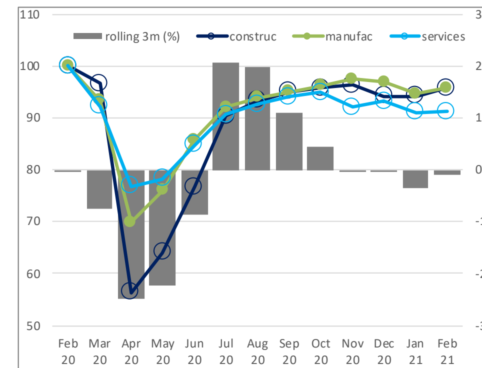
The UK economy shrank by 2.2% in January following the re-imposition of restrictions that closed all shops selling non-essential items, pubs, restaurants and cafes, and gyms and cinemas. Schools were shut to all but the children of essential workers and students with special educational needs. Offices remained empty as workers were instructed once again to work from home. Businesses, however, seem to have quickly come to terms with this third lockdown as monthly GDP is estimated to have increased by 0.4% in February (see Chart 1.3).

Service sector output declined by 2.5% in January. Consumer-facing services such as the motor vehicle and retail trade as well as food and beverage services weakened further. In February, however, wholesale and retail sales improved, growing by 3.3% and contributing to the 0.2% growth in all services. The principal service sectors driving the demand for offices are IT, Finance, Real Estate, Professional Services, Administration and Government. An index made up of these office sectors has fallen 3% since February 2020 but was stable between January and February 2021 (see Chart 1.4).

Manufacturing output contracted in December and January but expanded by 1.3% in February (see Chart 1.5). The largest positive contributions coming from the manufacture of transport equipment sector (which grew by 5.4%) and manufacturing of computer, electronic and optical products (which grew by 9.0%).

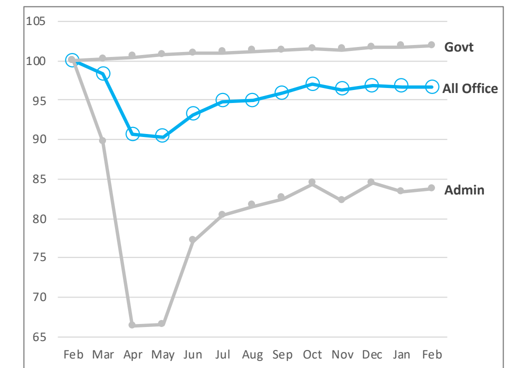
IHS Markit/CIPS survey data suggests that Supply-chain issues remained a constraint on UK manufacturers during March, due to pandemic restrictions, low stocks at suppliers, port disruption, shipping delays, post-Brexit issues and raw material shortages. This month (April), Renault warned that the car industry's chip shortage is worsening and that winter storms in Texas and a fire in Japan last month are just starting to have a serious knock-on effect on its production schedules. With demand outstripping supply, input price inflation accelerated to a 50-month high. Nevertheless, March represented a rebound in domestic and global economic conditions. Business sentiment was at its most elevated for seven years and almost two-thirds of manufacturers expect output to rise over the coming year.

1.3 UK ECONOMIC GROWTH



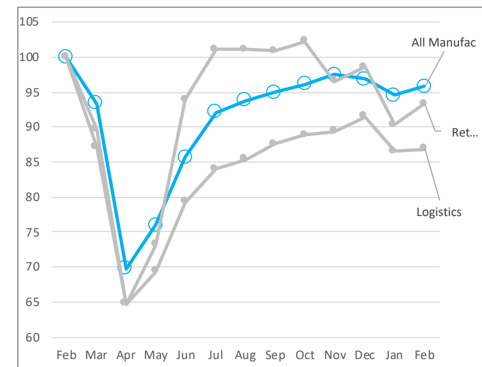
Source: ONS, Apr 2021

1.4 UK SERVICE OUTPUT BY SECTOR



Source: ONS, Apr 2021

1.5 UK INDUSTRIAL SECTOR OUTPUT



Source: ONS, Apr 2021

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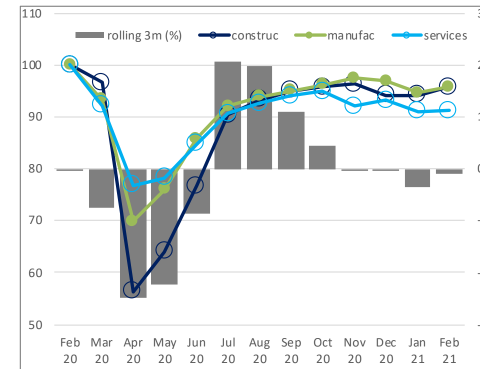
The Monetary Policy Committee's (MPC's) forecasts in the latest Monetary Policy Report assume that COVID-related restrictions and people's health concerns weigh on activity in the near term, but that the vaccination programme leads to those easing, such that GDP is projected to recover strongly over 2021 towards pre-COVID levels. Projected activity is also supported by the substantial fiscal and monetary policy actions. Further out, the pace of GDP growth slows as the boost from those factors fades (see Chart 1.6).

The last year has seen a large drop in consumer expenditure that has been accompanied by an increase in household savings. There is an expectation that as restrictions are eased consumption will increase. But an element of caution from elevated levels of unemployment and health concerns surrounding a return to the high street and hospitality venues may rein in spending. In addition, evidence suggests that much of the recently accumulated savings have accrued to those who are older and with higher incomes. Such households are less likely to spend from savings.

The Trade and Co-operation Agreement will result in barriers to trade. For example, customs, rules of origin and regulatory checks have raised administrative costs for firms engaging in goods trade and some cross-border provision of services is no longer possible. Other trade frictions – such as a divergence in regulatory standards – are likely to emerge over time. As a result of these barriers, trade between the UK and EU in both goods and services is likely to be lower than it would have been.

THE MPC concludes that the risks to its central projections for GDP are skewed to the downside.

1.6 MPC ECONOMIC PROJECTIONS



Source: Bank of England, Feb 2021

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5. OTHER ECONOMIC INDICATORS

So far, the UK's COVID-19 vaccination programme has been extraordinarily successful. Since the start of the programme in January, 33 million people have received a first dose and a further 10 million have received their second dose. Largely as a result of vaccine supply shortages, the pace has slowed to 130,000 daily doses from the peak of the programme in the middle of March when 500,000 vaccinations were administered daily. Nevertheless, 62% of the adult population has received one dose. Such rapid progress allows the government to continue with its policy of lifting restrictions and re-opening the economy.

The substantial fiscal interventions by government required to support employees, businesses and the NHS has caused the total national debt as a percentage of GDP to rise to levels not seen since the early 1960s (see Chart 2.1). There are investor fears especially in the USA that continued fiscal stimulus presents the growing risk of inflation and higher interest rates. But in the UK, there is little evidence that higher national debt on its own leads to higher inflation.

It is widely recognised that inflation will rise sharply in every major economy in the next few months driven by higher energy prices and supply shortages, including semi-conductors. Moreover, the year-on-year comparisons are with the falling prices induced by the first wave of the pandemic.

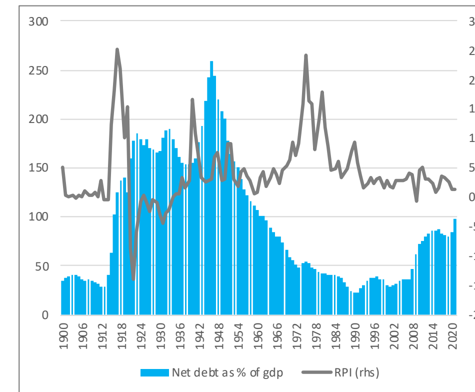
The MPC acknowledges this in February's Monetary Policy Report and expects CPI inflation to rise sharply this year towards its 2% target. Domestic price pressure, however, will be dampened by the influence of spare capacity and in 2022 and 2023 inflation remains close to the target (see Chart 2.2).

Labour market indicators remain difficult to interpret. The latest labour force figures indicate that unemployment decreased by 0.1% to 4.9% in February. This was the first quarterly decrease since December 2019. The employment rate, however, continues to fall. There were an estimated 34.6 million workforce jobs in the UK at the end of December. This is 1.24 million fewer than 12 months earlier and 195,000 fewer than at the end of September.

The possibility of a sharp rise in unemployment following the end of the Coronavirus Job Retention Scheme (CJSS) commonly referred to as furlough, remains. CJSS was originally scheduled to end in November 2020 but has since been extended twice. Initially to the end of April 2021 and subsequently extended in the March Budget to 30 September.

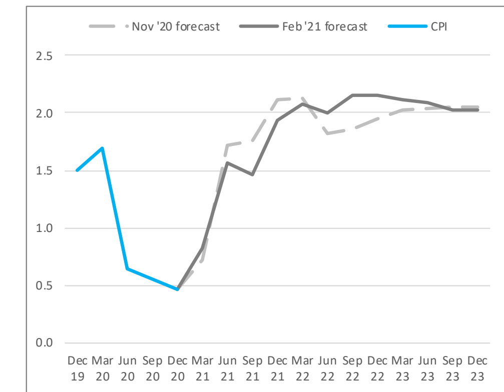
At the end of February, approximately 4.7 million people were on furlough leave. Although some may be at risk of redundancy, the vast majority are expected to return to their regular hours of work. The current

2.1 NATIONAL DEBT & INFLATION



Source: Bank of England, Feb 2021

2.2 MPC INFLATION PROJECTIONS



Source: Bank of England, Feb 2021

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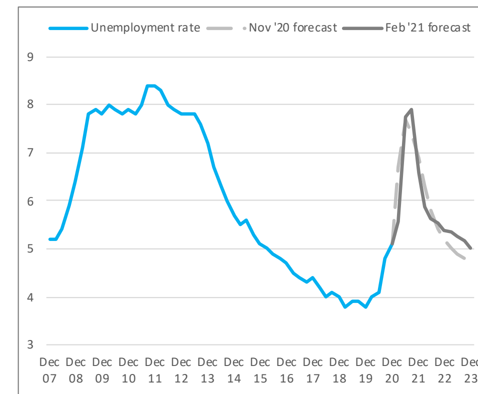
expectation is that unemployment peaks at around 7.5%. Thereafter any improvement in unemployment will lag any increase in economic output (see Chart 2.3).

Trade data for January 2021, the first after the transition period ended, saw significant falls in imports and exports of goods from the EU. In addition to the revised terms of trade this was also attributed to the reimposition of lockdown restrictions and the unwinding of stock piling in November and December. Exports of goods to the EU, recovered in February 2021, increasing by £3.7 billion after a record fall of £5.7 billion in January. Imports of goods from the EU showed a weaker increase of £1.2 billion in February 2021 after a record fall of £6.7 billion in January (see Chart 2.4).

Traditional retailers are continuing to grow their online presence (see Chart 2.5). At John Lewis, online sales have grown to represent more than 60% of sales, from 40% before the pandemic. The retailer is committing £1bn over the next 5 years to accelerate its on-line business and transform its shops. The pre-pandemic delivery capacity at Waitrose was limited to 55,000 customers per week. That has now grown to 250,00 orders per week and the ambition is to grow capacity further. Next sales from its stores in Q4 2020 fell 43% but its online sales grew 38%. Ocado, the online only supermarket, reported that sales rose 40% in Q1 2021. As part of its expansion plans it is searching for 12 "micro" sites as part of ambitions to secure deliveries to Londoners within one hour of ordering. The first "Ocado Zoom" opened in Acton in 2019.

Google's Community Mobility Reports show movement trends by region, across different categories of places such as retail, groceries, transport hubs and workplaces. The data shows how visitors to categorized places change when compared to a baseline day. A baseline day represents a normal value for that day of the week and is the median value from the 5-week period form 3rd January to 6th February. At the end of Q4, the number of searches for workplace destinations in the UK's biggest business centres and conurbations compared to other UK wide destinations suggested that people are avoiding traveling into city centres and continuing to work from home. This quarter there are indications of a gradual return to city centre workplaces (see Chart 2.6).

2.3 UNEMPLOYMENT RATE

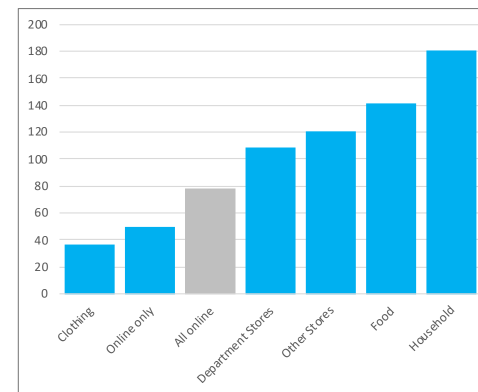


Source: ONS & Bank of England, Feb 2021

2.4 EU & NON-EU EXPORTS FROM UK (£BN)

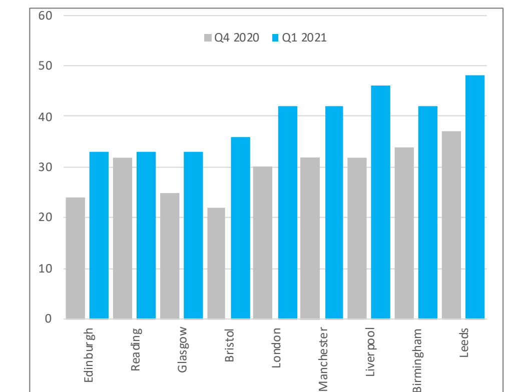
Source: ONS , Feb 2021

2.5 PANDEMIC INTERNET SALES GROWTH (£M/WEEK)



Source: ONS , Mar 2021

2.6 UK CITY WORKPLACE SEARCHES



Source: Google , Apr 2021

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6. INTEREST RATES AND ASSET YIELDS

In Q1, stock markets across the world were once again largely in positive territory as vaccine programmes progressed offering prospects of a return to normality. Despite the slow roll-out of vaccinations in Europe, bourses in Paris and Frankfurt have increased by more than 9% over the course of Q1. The main story in Q1, however, has been the volatility in tech stocks which has caused the under-performance in the NASDAQ and Shanghai indices. Tech has been one of the most favoured sectors through the pandemic but as economic recovery becomes more entrenched, industrial and financial companies are considered to benefit (see Chart 3.1).

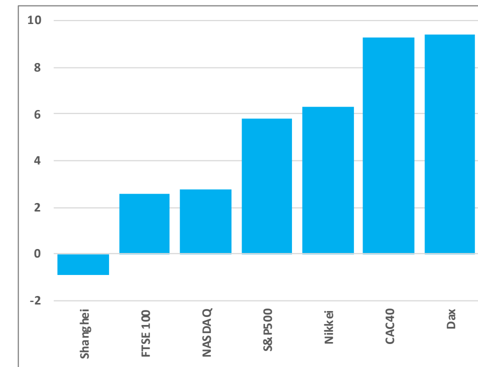
UK REIT share prices grew by 3.6% in Q1 and outperformed the wider all share market indices (see Chart 3.2). Hammerson, a shopping centre specialist that includes Brent Cross, Birmingham's Bullring and Bristol's Cabot Circus in its portfolio, was the outstanding performer of Q1 as its share price rose 41% and is now trading at 164% above its 52-week low. Despite reporting a record loss in the year to December 2020, investors were attracted as the REIT completed a £552 million rights issue and a series of asset disposals, including the sale of its Retail Parks to Brookfield for £350 million. Nevertheless, Hammerson was 70% geared at the end of 2020 and would be under further pressure should the value of its assets fall further.

Shaftesbury with its portfolio of central London village shops has seen its share price increase by 13% in Q1. Although the vacancy rate on the estate has trebled to 10.8% in the past year, the REIT was able to report that offers for space, particularly from restauranteurs, had more than doubled.

Risk free assets continue to yield close to zero. The Bank of England increased its asset purchase programme by a further £450 billion last year. Concerns surrounding an increase in inflation were behind a rise in the USA's 10-year Treasury bond yield from 0.93% in January to 1.72% at the end of March. In the UK, gilt yields have softened by 69 bps to 0.87% from 0.18% in Q4. The yield on the 5-15 year gilt index was 0.87% at the end of March but has since hardened slightly to 0.76% (see Chart 3.3).

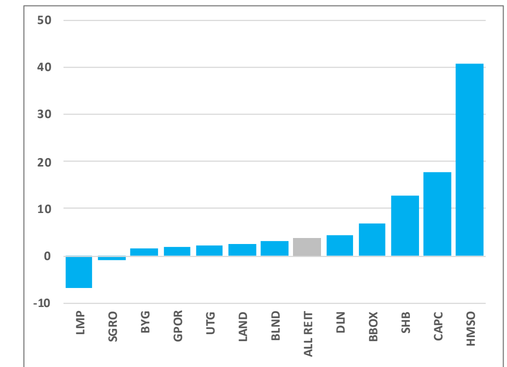
Market expectations of future interest rates have increased by 60-70 bps along all but the very short end of the yield curve. Nevertheless, expectations are that interest rates are set to remain at historic low levels (see Chart 3.4). Annual CPI inflation increased to 1% from 0.8% in December 2020 compared to the MPC's target rate of 2.0%. The MPC projections see inflation rising to 2.2% next year before falling back to 2.0% at the end of 2023.

3.1 WORLD STOCK MARKETS Q1 2021



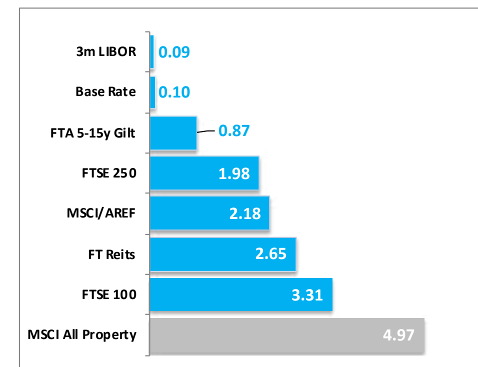
Source: Yahoo Finance , Apr 2021

3.2 UK REIT PRICE MOVEMENT Q1 2021



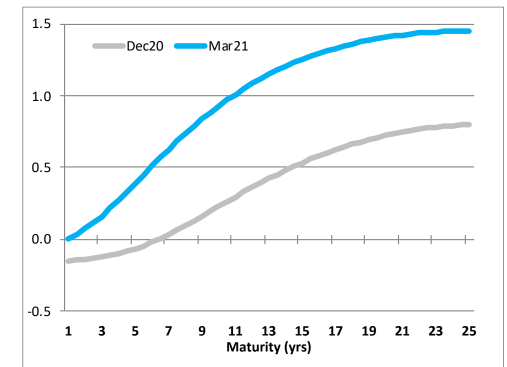
Source: Yahoo Finance , Apr 2021

3.3 UK ASSET YIELDS Q1 2021



Source: Yahoo Finance , Apr 2021

3.4 GILT YIELD CURVE (%)



Source: Bank of England , Apr 2021

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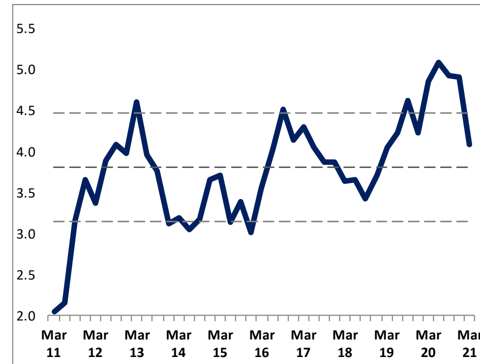
The current property initial / gilt yield gap has decreased to 4.1% from 4.9% in December but remains above the 10-year average (see Chart 3.5). We still continue to believe that the level of property yields relative to the risk free rate has provided protection to UK real estate asset prices and will continue to do so.

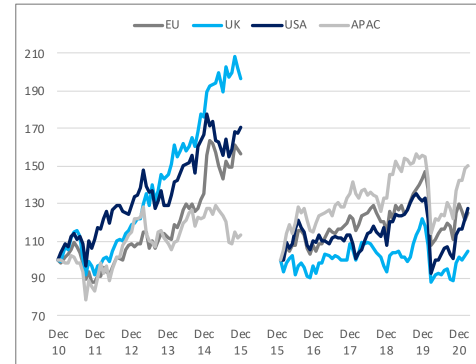
Property investors can benefit from regional diversification. Between 2010 and 2015, the MSCI UK REIT index grew 14% a year whilst MSCI's Asia Pacific index grew by just 2% a year. However, between 2015 and 2021, the UK index grew by just 1% a year whilst the APAC index grew 8% a year (see Chart 3.6).

3.5 PROPERTY IY - GILT YIELD GAP



Source: MSCI & Bank of England , Apr 2021

3.6 REGIONAL PROPERTY ETFS



Source: MSCI, Apr 2021

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7. COMMERCIAL PROPERTY MARKET PERFORMANCE

The UK's commercial real estate market has been far more resilient in the face of the pandemic than was first feared in March/April 2020 after the introduction of Lockdown 1.0.

In Q1 2021, All Property total returns increased very slightly to 2.2% from 2.0% in Q4 2020. Capital growth was 0.7% in Q1 compared to 0.6% in Q4. Property equivalent yields hardened by 9 bps and contributed a 0.9% uplift to valuations. All Property rental values increased by 0.1% having decreased -0.4% in Q4 and income returns amounted to 1.4% (see Charts 4.1 & 4.4).

Over the course of the last quarter, office rental values increased slightly by 0.1% while industrial rental value growth of 1.1% in Q1 remained strongly positive. However, rental values for Shopping Centres, and Shops continue to fall sharply whilst the rate of decline in retail warehouse has diminished (see Charts 4.2 & 4.5).

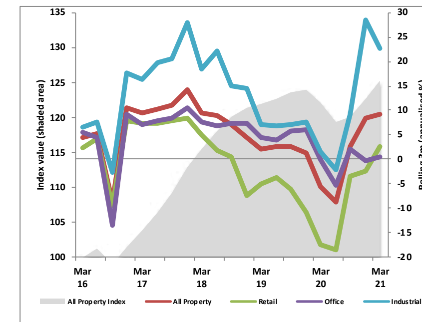
In the 12-months to the end of March 2021, All Property total returns increased to 2.6% from -1.0% in the 12-months ending December 2020. Year-on-year capital growth was -2.9% in March 2021 compared to -6.3% in December 2020. Property equivalent yields hardened by 5 bps in the 12-months ending March 2020 but had a neutral impact on valuations. All Property rental values decreased year-on-year by -2.0% and income returns amounted to 5.6%.

Historically, there has been a strong positive correlation between the performance of UK commercial real estate and the economy. During the Global Financial Crisis, capital values fell by 40%. Since the start of the pandemic in February 2020, the economy has shrunk by 7.9%. Yet All Property values had fallen by just 5.2%. The extremely low interest rate environment and property's continuing premium to gilt yields must be a large contributor to this.

These headline All Property numbers, however, conceal a massive gulf in performance between the three sectors. Retail capital values have fallen by -9.8% since February 2020. Office capital values by -1.8% and industrial values have increased by 13.2%. Entreaties to "stay at home" have driven internet sales from 19% of all retail sales in February 2020 to 35% in February 2021. As High Street footfall has dropped off a cliff, the value of Rest of UK shops has fallen 18% since February 2020 and Shopping Centre values are down 30%.

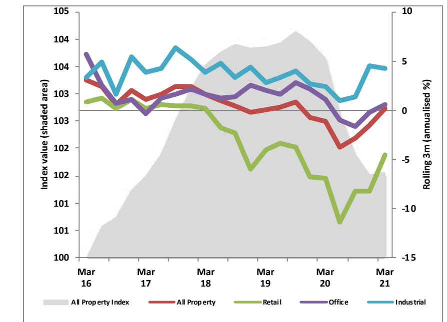
Strong investment demand for industrials has driven yields down to 4.25% and below 4% for last mile logistics in London. Industrial yields are now lower than both retail and office yields (see Charts 4.3 & 4.6). This is an eventuality that was very hard to conceive just 5-years ago. Consequently, capital values for London industrials have grown by 14% since February 2020 and Rest of UK capital values by 4%.

4.1 TOTAL RETURNS BY SECTOR



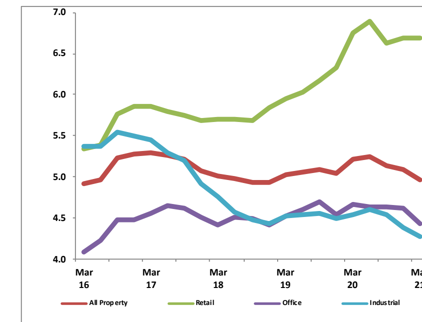
Source: MSCI, Apr 2021

4.2 MRV GROWTH BY SECTOR



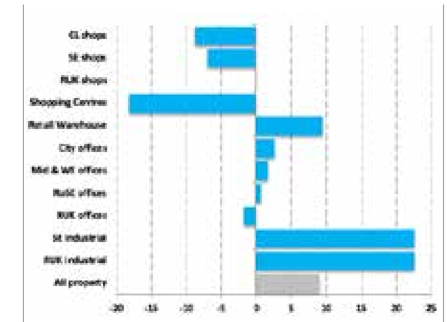
Source: MSCI, Apr 2021

4.3 INITIAL YIELD BY SECTOR



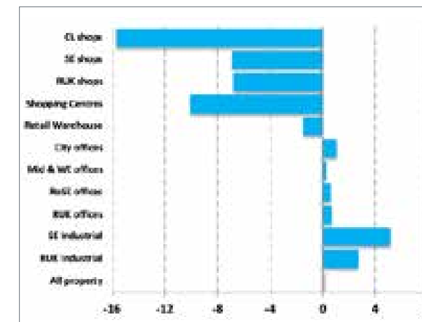
Source: MSCI, Apr 2021

4.4 TOTAL RETURNS BY SEGMENT (Q1 ANNUALISED)



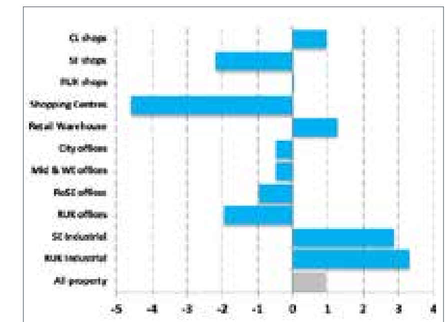
Source: MSCI, Apr 2021

4.5 MRV GROWTH BY SEGMENT (Q1 ANNUALISED)



Source: MSCI, Apr 2021

4.6 YIELD IMPACT (Q1)



Source: MSCI, Apr 2021

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Tables 5.1 – 5.5 contain further performance details for UK commercial real estate in Q4 2020.

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.

5.1 TOTAL RETURNS

	Mar	3m	6m	12m
All Property	1.1	2.2	4.3	2.6
Retail	0.4	0.6	0.0	-5.8
Office	0.0	0.1	0.1	-0.8
Industrial	2.6	5.2	12.0	13.9
ANNUALISED				
All Property	14.1	9.1	8.7	2.6
Retail	4.9	2.5	0.0	-5.8
Office	-0.2	0.6	0.1	-0.8
Industrial	36.3	22.6	25.5	13.9

5.2 CAPITAL GROWTH

	Mar	3m	6m	12m
All Property	0.7	0.8	1.5	-2.9
Retail	-0.2	-1.2	-3.6	-12.4
Office	-0.4	-1.1	-2.4	-5.6
Industrial	2.2	4.0	9.5	8.7
ANNUALISED				
All Property	8.2	3.4	2.9	-2.9
Retail	-2.5	-4.7	-7.0	-12.4
Office	-4.8	-4.3	-4.7	-5.6
Industrial	30.3	17.2	19.9	8.7

5.3 INCOME RETURN

	Mar	3m	6m	12m
All Property	0.4	1.4	2.8	5.6
Retail	0.6	1.8	3.7	7.4
Office	0.4	1.3	2.5	5.1
Industrial	0.4	1.1	2.4	4.8
ANNUALISED				
All Property	5.5	5.5	5.6	5.6
Retail	7.6	7.5	7.5	7.4
Office	4.9	5.1	5.1	5.1
Industrial	4.7	4.6	4.8	4.8

5.4 ERV GROWTH

	Mar	3m	6m	12m
All Property	0.1	0.0	-0.3	-2.0
Retail	-0.4	-1.1	-3.3	-8.1
Office	0.1	0.1	0.1	-0.6
Industrial	0.6	1.0	2.1	2.7
ANNUALISED				
All Property	1.3	0.2	-0.7	-2.0
Retail	-5.0	-4.5	-6.4	-8.1
Office	1.6	0.6	0.2	-0.6
Industrial	7.2	4.2	4.3	2.7

5.5 NET INITIAL YIELD

	Mar	3m	6m	12m
All Property	5.0	5.1	5.1	5.2
Retail	6.7	6.7	6.6	6.8
Office	4.4	4.6	4.6	4.7
Industrial	4.3	4.4	4.5	4.5

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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 Q1 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, the majority of the retail segments are coloured red and the Industrial segments are universally out-performing. Long lease shops continue to be in positive territory, as they have been for the last two quarters. They are joined this quarter by parts of the Retail Warehouse segment. Rest of UK offices has also shown better performance than Central London and South East offices.

5.6 PERFORMANCE BY STRATEGY RELATIVE TO ALL PROPERTY AVERAGE Q3 2020

	Low Yield	High Yield	High Rent	Low Rent	Long Lease	Short Lease
Shops	-3.6	-4.2	-7.8	-3.6	0.2	-7.6
Shopping Centres	-8.4	-5.8	-9.3	-8.4	-5.6	-5.4
Retail Warehouses	0.4	-1.8	-1.3	0.4	0.0	-1.4
Central London offices	-4.9	-1.6	-6.1	-4.9	-0.5	-2.1
RoSe offices	-1.3	-2.3	-2.8	-1.3	-0.4	-2.8
RUK offices	0.3	-1.9	-0.7	0.3	0.7	-2.8
Industrials	6.3	4.0	6.1	6.3	5.5	4.9

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8. INVESTMENT IN PROPERTY

A search for yield in the current hyper-low interest rate environment is driving allocations to real estate. But this is tempered by high levels of uncertainty surrounding the short to medium term outlook and limited liquidity.

All Property investment volumes decreased by 58% in Q1 2021 compared to a strong outcome to Q4 2020 and were 38% below their long run average. (see Chart 6.1). Leaving the second quarter of last year during the first lockdown, this is the lowest quarterly investment total since the GFC. This is, however, an early view of Q1's transaction levels and may subsequently be revised upwards.

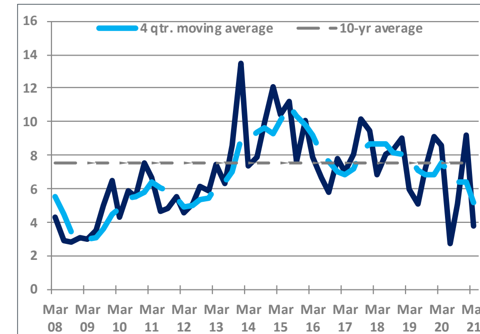
Industrials and Alternatives made up 60% of investment transactions in Q1. But across all sectors of the market, investment volumes continued to be lower than in Q4 (see Chart 6.2).

Central London offices traditionally dominate UK real estate investment representing 28% of the market over the last 20 years. In Q1, its share of the market fell to 18%. Accordingly, transaction numbers across Central London represented a reduction from the levels achieved in Q4 2020 with Midtown standing out as the most resilient (see Chart 6.3).

Since the start of the real estate market's post GFC recovery in mid-2009, overseas investors have represented 44% of the investment market. Their participation fell to 31% in Q2 2020 but recovered in Q4 2020 when overseas investors represented 49% of the market in money terms. In Q1 2021, the weight of money attributable to overseas investment grew further to 54%. In Q1, investment in retail and Central London offices by both domestic and overseas' investors has fallen a long way short of their historic levels. However, overseas' investors matched their quarterly average allocation to Rest of UK offices and domestic investors matched their average allocation to industrials (see Chart 6.4).

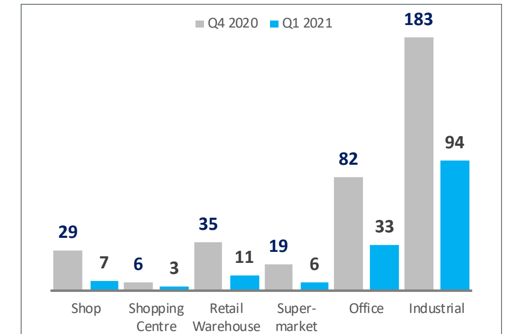
In the last five years, property funds have regularly faced demands for redemptions from retail investors. In 2016, the Brexit referendum resulted in the closure of open ended funds. And in the last two years, the lethargic performance of the UK economy and the continued uncertainties surrounding Brexit have resulted in an almost continuous outflow of money from open-ended property funds. Open-ended property funds were once again closed to redemptions in Q1 2020. This trend of net disinvestment continued into Q4 2020 with £382 million being redeemed as some of the open ended funds cautiously re-opened. In January and February of 2021, net investment by retail investors amounts to just £18 million (see Chart 6.5). Finally, 17 months after its latest suspension, the £2.1 billion M&G Property Portfolio is set to re-open in May 2021 having built up a 33% cash buffer against future redemptions.

6.1 ALL PROPERTY INVESTMENT VOLUMES (£BN)



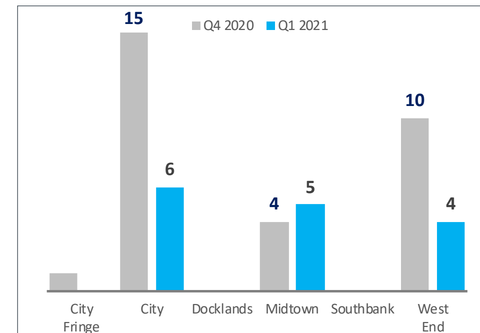
Source: Property Data, Apr 2021

6.2 INVESTMENT TRANSACTION NOS. (Q4 2020 V Q1 2021)



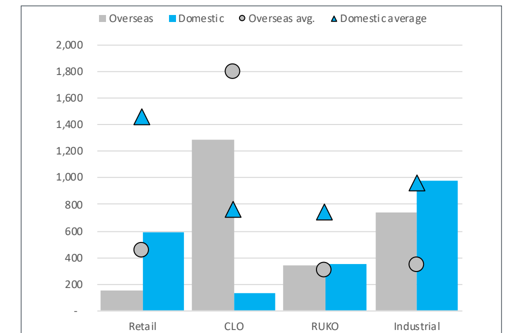
Source: Property Data, Apr 2021

6.3 CENTRAL LONDON OFFICE INVESTMENT TRANSACTION NOS. (Q4 2020 V Q1 2021)



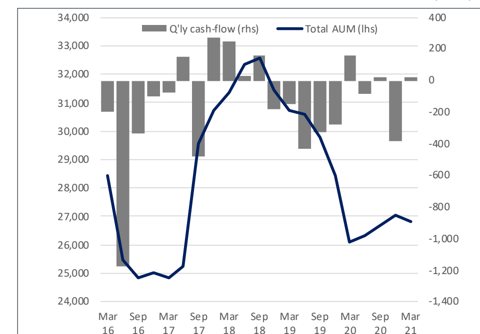
Source: Property Data, Apr 2021

6.4 DOMESTIC & OVERSEAS INVESTORS BY PROPERTY TYPE (Q1 2021)



Source: Property Data, Apr 2021

6.5 PROPERTY FUNDS AUM & CASH-FLOW (£M)



Source: Investment Association, Apr 2021

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9. OUTLOOK

February 2021's IPF consensus forecasts reflect the view that UK real estate values will not mount a strong recovery from the Pandemic. Total return forecasts for 2021 have been cut further to 2.2% from 2.5% in November 2020 reflecting a fall in capital values of -2.8% and an income return of 5% (see Chart 7.1). Total return forecasts of between 6.2% and 6.6% from 2022 onwards indicate that capital value growth is expected to be restricted to between 1 and 1.5%. (see Chart 7.2).

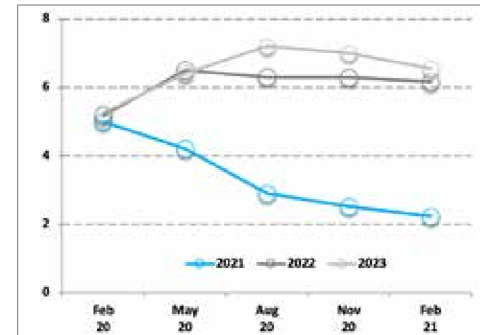
There continue to be a wide range of forecasts. Total return forecasts for 2021 range between +9.4% and -8.5%. The forecast range for 2022 is 15.3% with a maximum of 16.6% and a minimum of 1.3% (see Chart 7.3).

The MPC's economic forecasts noted above indicate that the third lockdown will postpone the start of any recovery from December 2020 to March 2021. Thereafter, the growth path of the economy is very similar to November's outlook. Consequently, there is little difference in the outlook for commercial property between Q4 2020 and Q1 2021.

All Property rental values are expected to follow a gently declining trend until the end of 2021 with a slow recovery thereafter. Rental values are unlikely to recover their previous cyclical peak by the end of the forecast horizon.

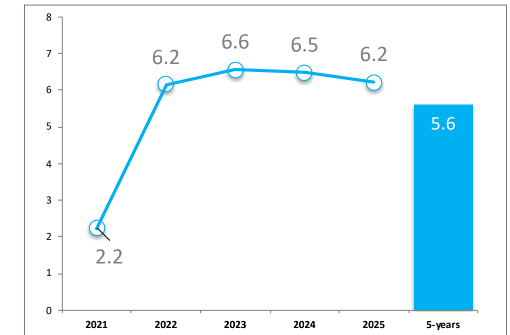
The support offered by continued low risk free rates and the larger than average gilt – property yield gap suggests there is scope for some yield compression especially if rental growth surprises on the up-side. Although capital values should gradually improve from Q1, they are also unlikely to recover their previous cyclical peak by the end of the forecast horizon (see Charts 7.4 & 7.5).

7.1 IPF FORECAST EVOLUTION FEB 2021



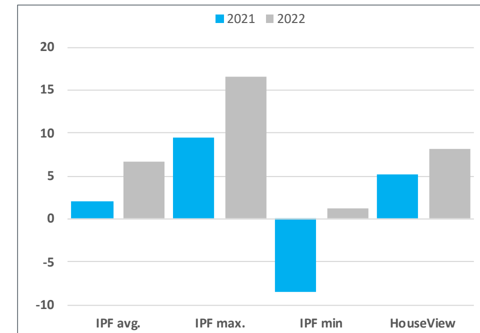
Source: IPF, Apr 2021

7.2 IPF ALL PROPERTY FORECASTS Y-BY-Y FEB 2021



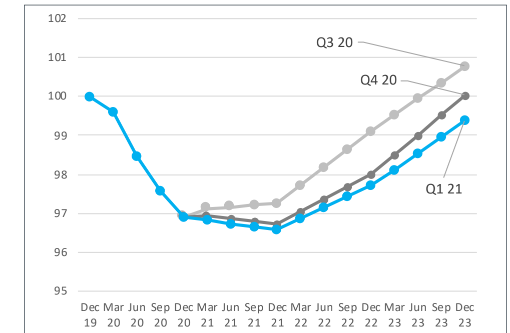
Source: IPF, Apr 2021

7.3 UK COMMERCIAL TOTAL RETURN FORECASTS



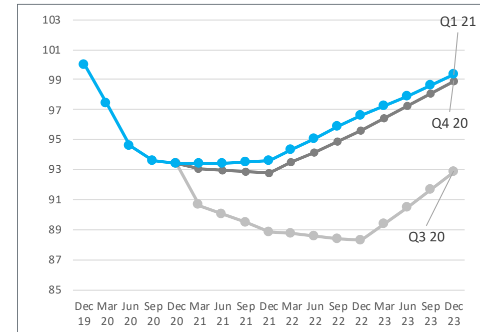
Source: IPF, Apr 2021

7.4 RENTAL VALUE FORECASTS



Source: APR & Cluttons, Apr 2021

7.5 CAPITAL VALUE FORECASTS



Source: APR & Cluttons, Apr 2021

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10. HOUSEVIEW

The central forecast from Cluttons HouseView model has been amended to reflect the performance of the market in 2020 and the revised macro-economic forecasts. On balance, we are more optimistic than the consensus view and expect capital values at the All Property level to stabilise this year. Assuming that the UK successfully moves beyond Lockdown 3.0 and the economy remains open thereafter All Property total returns could recover to 5% or more in 2021 and 8% in 2022 with an annualised average of 7% in the 3-years ending December 2023. However, the usual caveats regarding uncertainty surrounding this central forecast remain.

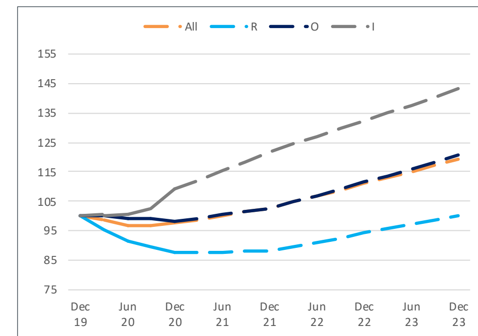
At the All Property level, we expect capital value growth to be weakly positive. From the second half of 2021, market conditions should improve (see Charts 8.1 – 8.4). Retail assets will continue to bear the brunt of the downturn although we continue to think it is unlikely that they will suffer the size of capital value falls seen in the last 12-months. Industrials will provide some upside protection from the downside risks inherent in holding offices and particularly retail (see Charts 8.5 & 8.6).

Comments accompanying SEGRO's December 2020 year-end results explain the expected out-performance of industrials. The UK's largest REIT by market capitalisation believes that market rental growth will continue to be driven by increased occupier demand and a shortage of modern warehouse space, in urban markets located inside or on the edges of cities. Furthermore, e-commerce levels would not retreat markedly post-pandemic because:

> *"… there has been a step-change in consumer behaviour. Some of the factors that were considered as barriers to increased levels of online sales penetration (for example concerns about the quality of food bought online and reluctance to share financial information over the internet) have been overcome and habits have potentially changed irrevocably."*

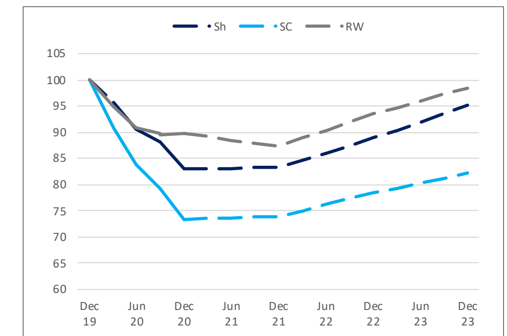
Underlining another theme of this quarter's report, SEGRO also sought to burnish its ESG credentials by committing to be net-carbon neutral by 2030 driven by changes in development activity and the operation of existing buildings.

8.1 3-SECTOR CAPITAL VALUE FORECASTS



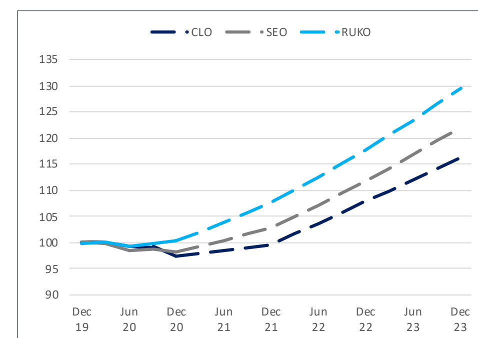
Source: APR & Cluttons, Apr 2021

8.2 RETAIL SEGMENTS CAPITAL VALUE FORECASTS



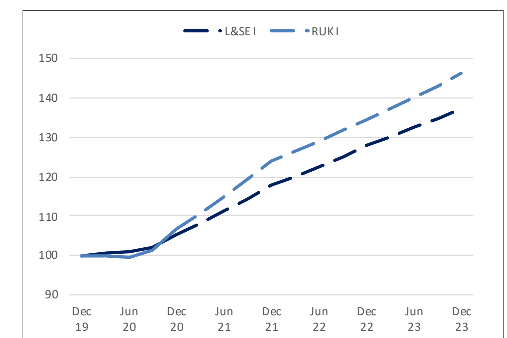
Source: APR & Cluttons, Apr 2021

8. 3 OFFICE SEGMENTS CAPITAL VALUE FORECASTS



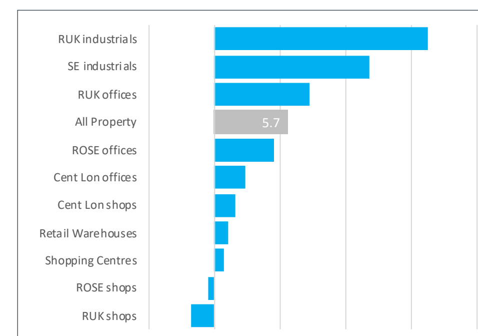
Source: APR & Cluttons, Apr 2021

8.4 INDUSTRIAL SEGMENTS CAPITAL VALUE FORECASTS



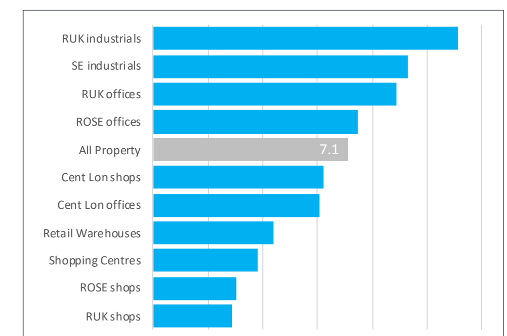
Source: APR & Cluttons, Apr 2021

8.5 CLUTTONS HOUSE VIEW - 2021 RELATIVE TOTAL RETURNS (%)



Source: APR & Cluttons, Apr 2021

8.6 CLUTTONS HOUSE VIEW - 2021-2023 RELATIVE TOTAL RETURNS (%)



Source: APR & Cluttons, Apr 2021

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For further details contact:

JAMIE McCOMBE
Head of investment management
+44 (0) 20 7647 7234
jamie.mccombe@cluttonsim.com

MATTHEW PEAKE
Head of commercial and strategic asset management
+44 (0) 20 7647 7067
matthew.peake@cluttonsim.com

Researched on behalf of Cluttons Investment Management by Alexander Property Research.

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