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COMMERCIAL PROPERTY EXAMINER

QUARTER FOUR | 2020

1. KEY TAKE AWAYS

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

Ultra-low risk free rates and a low outlook for interest rates remain supportive of real estate investment.

In the 12-months to the end of December 2020, All Property total returns decreased to -1.0% from 2.1% in 2019.

All Property total returns could recover to +5% in 2021 and an annualised average of 7% in the 3 years ending December 2023.

2. SUMMARY

The World Bank expects global economic output to expand by 4% in 2021 but at the end of the year will still be more than 5% below its pre-pandemic level. Global growth is projected to moderate to 3.8% in 2022, weighed down by the pandemic's lasting damage to potential growth.

Following six consecutive monthly increases, GDP fell by 2.6% in November 2020 as the UK entered its second national lockdown, leaving the economy 8.5% below the levels seen in February 2020.

Some sectors of the economy had shown signs of a strong recovery from the first lockdown. Real estate benefitted from stamp duty relief and built-up demand created by the first lockdown. Hotels and restaurants, hairdressers and beauty salons and gyms, and arts and entertainment, however, have been afflicted by the biggest loss of jobs.

The UK is now four weeks into its third national lockdown of the pandemic. It is highly likely that economic activity will decline further in Q1 2021.

In September last year, there were 942,000 fewer workforce jobs than in September 2019 and 475,000 fewer than at the end of June 2020.

Unemployment could rise by a further 800,000 at the end of the furlough scheme and peak at 2.6 million or 7.5%.

Stock markets across the world celebrated authorisation of the first vaccines and prospects of a return to normality. The UK equity markets rose 11% in Q4 but still ended the year down 14%. The NASDAQ index ended the year 44% higher as investors continued to aggressively support tech stocks.

The current property initial / gilt yield gap remains 4.9%; more than one standard deviation above the 10-year average.

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

In Q4, All Property total returns increased to 2.0% from 0.7% in Q3. Capital growth was 0.6% compared to a decrease of -0.7% in Q3. Hardening All Property equivalent yields contributed a 1.1% uplift to valuations whilst All Property rental values decreased -0.4%. Income returns amounted to 1.4%

In the 12-months to the end of December 2020, All Property total returns decreased to -1.0% from 2.1% in 2019. Capital growth was -6.3% in 2020 compared to -3.1% in 2019. All Property rental values decreased -2.3% and income returns amounted to 5.6%.

All Property investment volumes increased by 21% in Q4 but nevertheless remained 16% below their long run average. Total investment volumes in 2020 were the lowest since 2012.

For 2021, offices, logistics and residential are the favoured sectors for institutional investors and Germany, France and the UK the preferred destinations in Europe.

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 expect capital values at the All Property level to stabilise this year together with an income return of +5%. All Property total returns could therefore recover to +5% in 2021 and an annualised average of 7% in the 3 years ending December 2023. However, the usual caveats regarding uncertainty surrounding this central forecast remain.

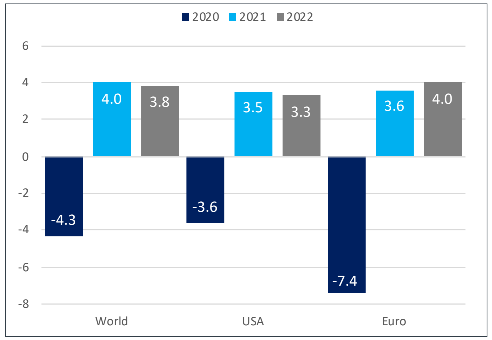
3. THE WORLD ECONOMY

January's edition of Global Economic Prospects produced by the World Bank notes that following a collapse last year caused by the COVID-19 pandemic, global economic output is expected to expand by 4% in 2021 but at the end of the year will still be more than 5% below its pre-pandemic level (see Chart 1.1). Global growth is projected to moderate to 3.8% in 2022, weighed down by the pandemic's lasting damage to potential growth.

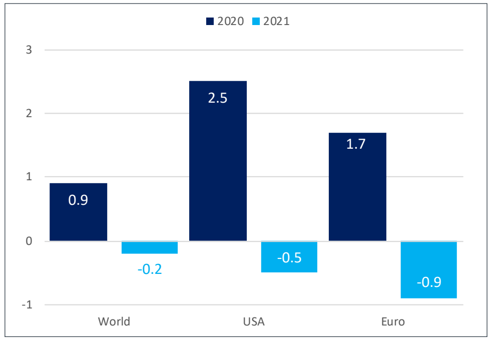
The global recovery in the second half of 2020 has been stronger than expected but has recently been dampened by a resurgence of COVID-19 cases leading to weaker projections for 2021 (see Chart 1.2). Nevertheless, the world economy is expected to strengthen over the Bank's three year forecast horizon as confidence, consumption, and trade gradually improve, supported by ongoing vaccination.

Downside risks to this baseline predominate, including the possibility of a further increase in the spread of the virus, delays in vaccine procurement and distribution, more severe and longer-lasting effects on potential output from the pandemic, and financial stress triggered by high debt levels and weak growth. As the crisis abates, policy makers need to balance the risks from large and growing debt loads with those from slowing the economy through premature fiscal tightening.

1.1 WORLD GROWTH PROJECTIONS (%)



1.2 DIFFERENCE FROM JUN 20 PROJECTIONS



4. THE UK ECONOMY

Following six consecutive monthly increases, GDP fell by 2.6% in November 2020 as the UK entered its second national lockdown, leaving the economy 8.5% below the levels seen in February 2020.

The service sector of the economy grew by 3.7% in the three months to November 2020 driven by increases in education and health which together contributed 1.5%. However, the sector declined by 3.4% in November and is now 9.9% below the level of February 2020. (see Chart 1.3).

There were falls in output in all 14 services sub-sectors between October and November 2020. The largest contributors to this were consumer facing activities damaged by the reimposition of restrictions on interaction with their customers. Accommodation and food service activities including hotels and restaurants, wholesale and retail trade, other service activities represented by hairdressers and beauty salons and gyms, and arts, entertainment and recreation accounted for nearly 80% of the fall in services (see Chart 1.4).

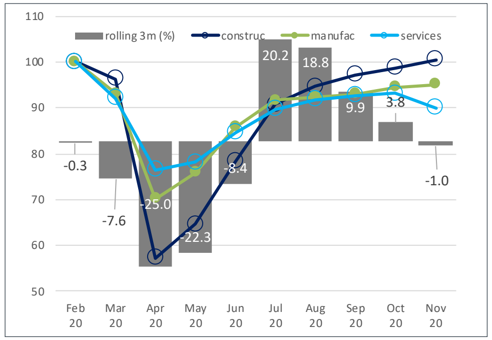
CGA who monitor and research the hospitality sector estimate that nearly 6,000 licensed premises were permanently closed in 2020. In fact, 9,930 sites closed and 3,955 opened for the first time. This represents a 5% contraction in the market and a 175% increase on the number of sites closed since 2019.

Manufacturing grew by 0.7% in November as the sector was relatively unscathed by Lockdown 2.0. Eight of its 13 sub-sectors increased output. The largest contribution came from the motor vehicle industry, which grew 5.7% in November 2020. This industry is now 1.3% above its February 2020 level.

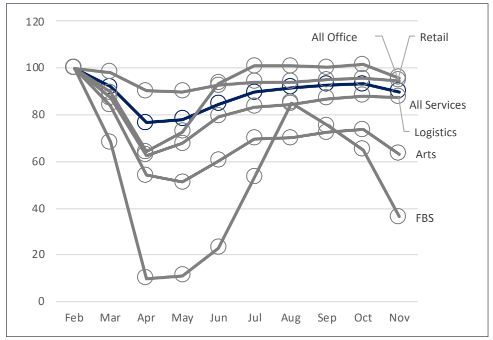
Manufacturing also grew by 4.7% in the three months to November 2020. The manufacture of transport equipment grew by 18.9%, however, it is still 15.3% below its pre-pandemic level. The manufacture of air and spacecraft in this sub-sector has struggled to regain output and remains 35.5% below the February level (see Chart 1.5).

IHS Markit/CIPS January survey data suggests that the UK economy suffered from the steepest fall in private sector output since last May as the government introduced Lockdown 3.0. Services were hard-hit by restrictions on trade and reduced consumer spending. However, manufacturers recorded a small rise in production volumes, but the rate of expansion eased sharply since December.

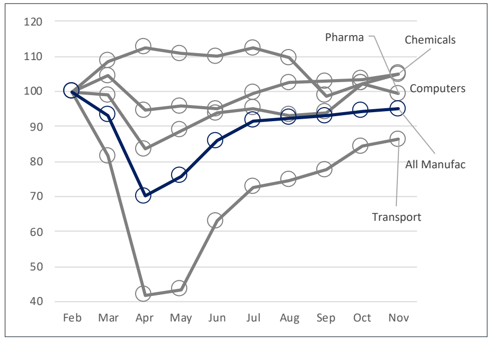
1.3 UK ECONOMIC GROWTH



1.4 UK SERVICE OUTPUT BY SECTOR



1.5 UK MANUFACTURING OUTPUT BY SECTOR

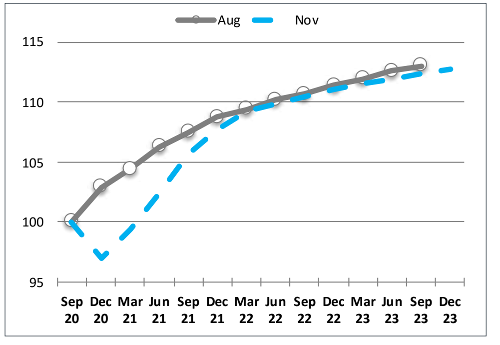


The November 2020 Monetary Policy Report released by the Bank of England's MPC notes that pandemic control measures will weigh on near-term spending to a greater extent than projected in the August 2020 Report, leading to a decline in GDP in 2020 Q4. Household spending and GDP were expected to pick up in 2021 Q1, as restrictions loosened. But the level of activity in the first quarter was expected to remain materially lower than in 2019 Q4 (see Chart 1.6).

In the longer term GDP is not forecast to exceed its level in 2019 Q4 until 2022 Q1. COVID-19 and the UK's withdrawal from the EU are likely to have persistent downward effects on output. Elevated unemployment and lower investment could reduce the supply capacity of the economy by around 1.75% by the end of 2023. The UK's withdrawal from the EU is also likely to have a more persistent effect on supply, as cross-border trade is lower over the forecast period and weighs on productivity growth.

As the UK is now four weeks into its third national lockdown of the pandemic, it is highly likely that economic activity will decline further in Q1 2021. The barriers to trade that have been erected following the agreement reached between the UK and EU at Christmas will also act as a drag. January's PMI report cited above also refers to weaker export orders, short-term supply chain difficulties and the largest increase in suppliers' delivery times since the UK Manufacturing PMI survey began almost 30 years ago.

1.6 MPC ECONOMIC PROJECTIONS



5. OTHER ECONOMIC INDICATORS

A mutation of the virus into a deadlier and more easily transmittable new variant and relaxation of the lockdown over Christmas caused a surge in infection rates. And the UK is now battling a third outbreak of the COVID-19 virus (see Chart 2.1). Lockdown 3.0 has closed all non-essential shops. Hospitality and personal care services including restaurants, pubs and bars, leisure centres and gyms, entertainment venues, hairdressers and beauticians remain closed indefinitely. Schools, colleges and universities are also closed. But the difference compared to Lockdown 1.0 announced last March is that travel to work is permitted if you cannot reasonably do so at home.

The route back to normality is reliant on the efficient roll out of the three vaccines from Pfizer, Moderna and Oxford University / Astra Zeneca that have been approved for use in the UK. The biggest vaccination programme in NHS history aims to have delivered a first vaccine dose to 15 million people across the UK in the top four priority groups by 15 February. The plan is for a further 17 million people in priority cohorts 5 through to 9 to be offered a vaccination opportunity by an as yet indeterminate date in the spring. Phase 2 of the roll-out involving the rest of the adult population numbering 21 million will be planned once vaccinations have been offered to the first 9 cohorts.

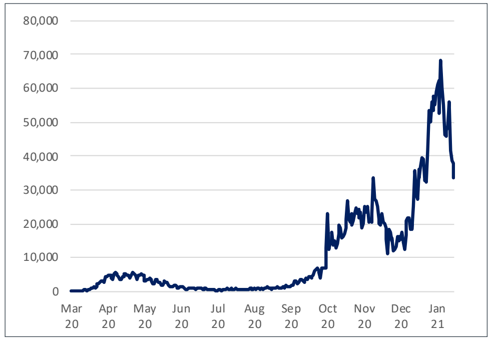
By 24 January, the NHS had administered 6.82 million vaccinations (see Chart 2.2). The latest 7-day rolling average is 362,307 vaccination doses administered meaning that the NHS is on track to vaccinate 14.8 million people by 15 February. Despite this success, there is as yet no indication of when the current restrictions will be lifted. But we do know from the experience in the first half of last year, economic recovery will be rapid once restrictions are lifted.

There were an estimated 34.7 million workforce jobs in the UK at the end of September. This is 942,000 fewer than 12 months earlier and 475,000 fewer than at the end of June.

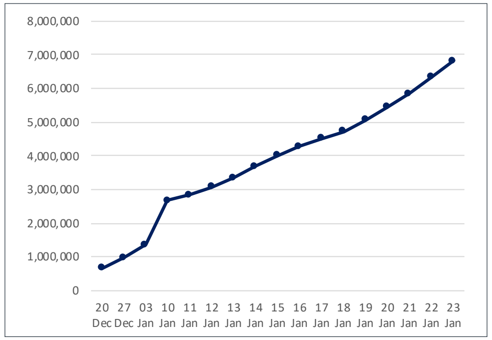
Some sectors of the economy had shown signs of a strong recovery from the first lockdown. Real Estate benefitted from stamp duty relief and built up demand created by the first lockdown. Hotels and restaurants, hairdressers and beauty salons and gyms, and arts and entertainment, however, have been afflicted by the biggest loss of jobs (see Chart 2.3).

In the 12 months to the end of September workforce jobs have decreased across all the UK's regions with the exception of Wales (see Chart 2.4). London and the South East suffered from the biggest proportionate loss of jobs. In London, 92% of jobs are in the broad services sector. Nationally, the service sector accounts for 84% of jobs.

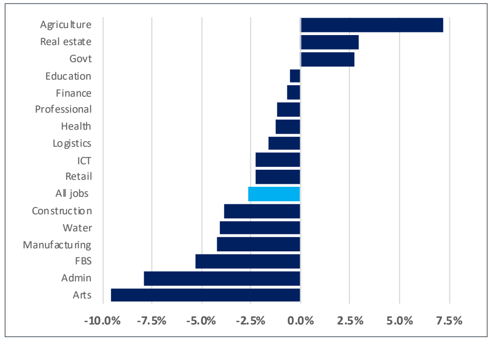
2.1 DAILY COVID-19 CASES



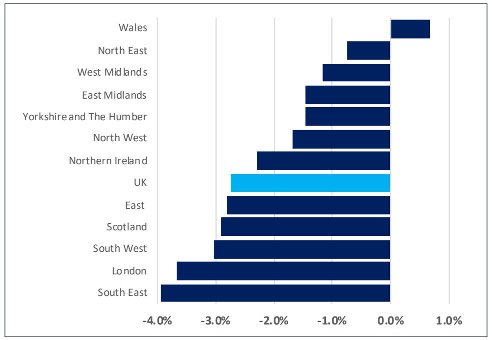
2.2 CUMULATIVE COVID-19 VACCINATIONS



2.3 12M CHANGE IN WORKFORCE JOBS BY INDUSTRY



2.4 12M CHANGE IN WORKFORCE JOBS BY REGION



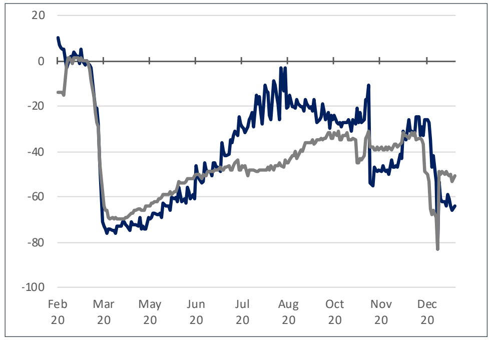
Last quarter, we considered the possibility of a sharp rise in unemployment following the end of the Coronavirus Job Retention Scheme (CJRS) commonly referred to as furlough, which was originally scheduled in November. On 5 November, England entered Lockdown 2.0 and the Treasury has now extended CJRS until the end of April 2021.

At the end of December approximately 4.6 million people were on furlough leave. Following the scheduled end of the CJRS at the end of April, the OBR expects unemployment to rise by a further 800,000 and peak at 2.6 million or 7.5%.

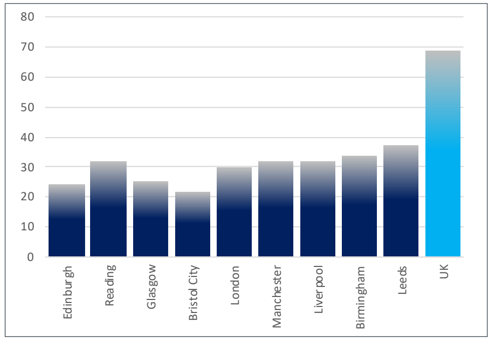
Google's Community Mobility Reports show movement trends by region, across different categories of places such as retail, groceries, transport hubs and workplaces. The data shows how visitors to categorized places change when compared to a baseline day. A baseline day represents a normal value for that day of the week and is the median value from the 5-week period from 3 January to 6 February. These indicators support the idea of an initial strong recovery in physical retailing and a gradual return to the workplace. In recent weeks these trends have been put into reverse by the re-introduction of restrictions on movement (see Chart 2.5).

The number of searches for workplace destinations in the UK's biggest business centres and conurbations compared to other UK wide destinations suggests that people are avoiding traveling into city centres and continue to work from home in growing numbers, as requested by Government (see Chart 2.6).

2.5 GOOGLE SEARCH DATA - RETAIL & WORKPLACE DESTINATIONS



2.6 UK CITY WORKPLACE SEARCHES



6. INTEREST RATES AND ASSET YIELDS

In Q4 stock markets across the world celebrated authorisation of the first vaccines and prospects of a return to normality. The UK equity markets rose 11% in Q4 having previously fallen 32% between 21 February and 23 March but still ended the year down 14%. However, the S&P 500, Nasdaq, Dax, Nikkei and Shanghai Composite have all recorded gains on the year's trading (see Chart 3.1).

The NASDAQ index ended the year 44% higher as investors continued to aggressively support tech stocks. Tesla rose 696% and has become the most valuable car manufacturer in the world despite only making a fraction of the cars produced by its competitors. Bitcoin, showing all the signs of a classic bubble, rose 440%.

UK equity markets have systematically under-performed developed world markets since the middle of the last decade. It has been argued that this is a commentary on the result of the Brexit referendum and the years of uncertainty as the UK struggled to reach an agreement with the EU. Now an agreement of sorts has been reached, so the argument continues, the UK should benefit from a much needed boost to its equity markets (see Chart 3.2).

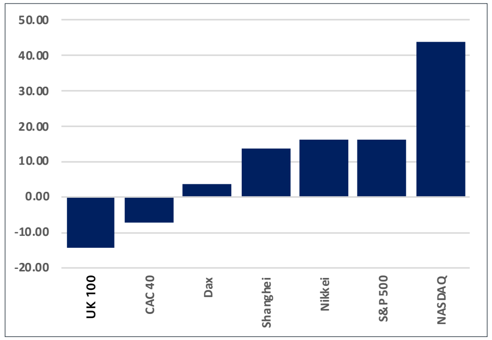
The constituents of the respective indices, however, are revealing. The top holdings in the UK index include AstraZeneca, HSBC and Glaxo Smith Kline alongside Royal Dutch Shell, BP, British American Tobacco and Diageo. The top holdings in the world index are Apple, Microsoft, Amazon, Facebook, Alphabet and Tesla.

UK REITS fell -19% in 2020. Industrial and logistics specialists Segro and Big Box are the only two companies from the index to have a higher price than at the start of the year. Land Securities price ended the year down 32% and is planning to sell its hotels, leisure and retail parks, valued at a combined £1.4 billion and representing 12% of the portfolio. British Land was able to sell £456 million of retail assets in the 6 months to end-September but its price was down -24% at the end of the year.

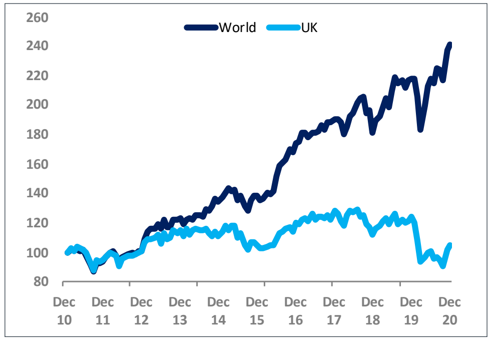
Intu's administrators failed to sell the Trafford Centre and the asset was eventually transferred to the Canada Pension Plan Investment Board who had an outstanding loan secured against the centre. Shares in Hammerson, another shopping centre specialist, had lost 82% of their value by the end of the year (see Chart 3.3).

Shaftesbury with its portfolio of central London village shops had seen its share price increase by 353% between February 2009 and December 2019. In 2020 its market value fell 40%. Low footfall, as many of London's businesses continue to work from home and tourists stay away, will not have helped investor sentiment. Moreover, 38% of the portfolio by market rental value is in the Food and Beverage sector.

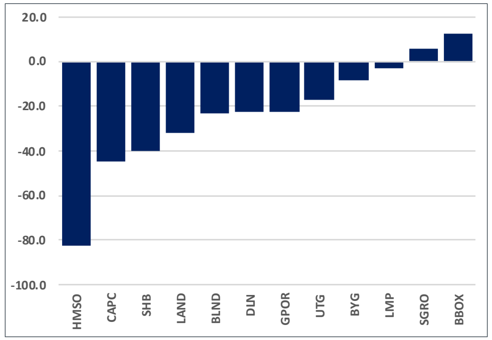
3.1 WORLD STOCK MARKETS IN 2020



3.2 UK v. WORLD EQUITY MARKETS



3.3 UK REIT PRICES IN 2020

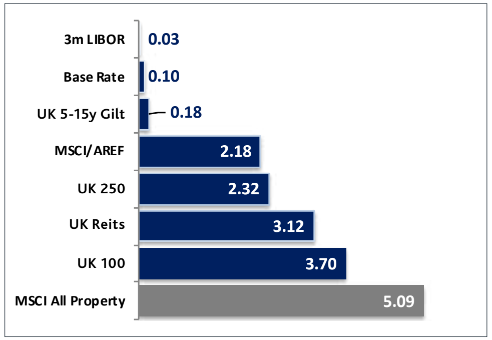


Risk free assets continue to yield close to zero. The Bank of England increased its asset purchase programme by a further £300 billion earlier in the year and in November announced a further £150 billion of quantitative easing. Gilt yields have hardened by 3 bps in Q4 and are 63 bps lower than at the start of the year. The yield on the 5-15 year UK gilt index is 0.18% partly driven by quantitative easing and investors attempts to limit volatility and risk in portfolios (see Charts 3.4).

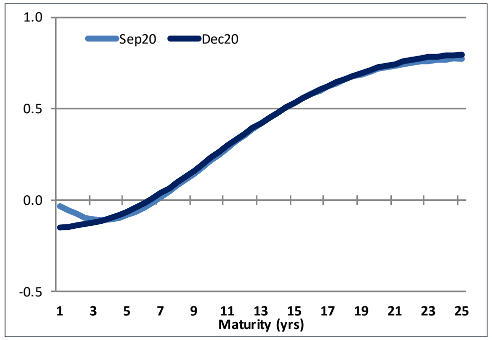
Interest rates are set to remain low for some time (see Chart 3.5). CPI inflation amounted to just 0.8% in the year to December 2020 compared to the MPC's target rate of 2.0%. The MPC projections see inflation rising to 2.1% at the end of 2023 based on forward market interest rates that do not rise above 0%. Should the economy require further monetary policy loosening, the MPC has suggested that negative interest rates remain under consideration.

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

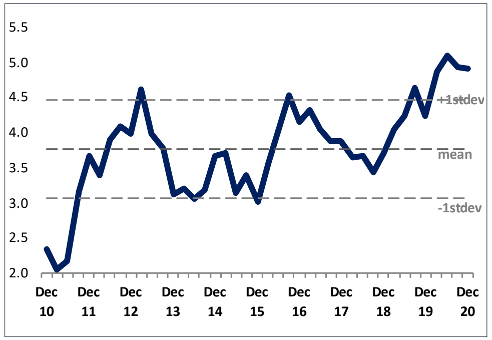
3.4 ASSET YIELD Q4 2020



3.5 GILT YIELD CURVE (%)



3.6 PROPERTY IY - GILT YIELD GAP



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 and April after the introduction of Lockdown 1.0.

In Q4 All Property total returns increased to 2.0% in Q4 from 0.7% in Q3. Capital growth was 0.6% in Q4 compared to a decrease of -0.7% in Q3. Property equivalent yields hardened by 7 bps and contributed a 1.1% uplift to valuations. All Property rental values decreased -0.4% and income returns amounted to 1.4% (see Charts 4.1 & 4.4).

Over the course of the last quarter, office rental values fell just -0.1% while industrial rental value growth of 1.1% in Q4 remained strongly positive. However, rental values for Shopping Centres, Retail Warehouses and Shops continue to fall (see Charts 4.2 & 4.5).

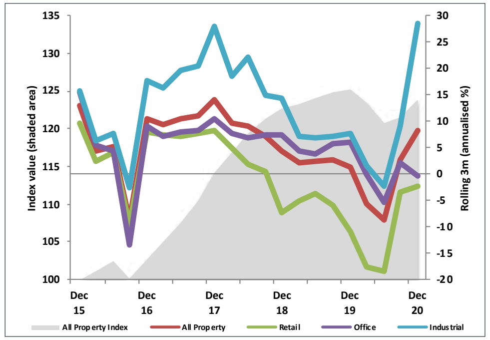
In the 12-months to the end of December 2020, All Property total returns decreased to -1.0% from 2.1% in 2019. Capital growth was -6.3% in 2020 compared to -3.1% in 2019. Property equivalent yields softened by 24 bps in 2020 and contributed a -4.5% decrease to valuations. All Property rental values decreased -2.3% and income returns amounted to 5.6%.

Given the strong positive correlation between the performance of UK commercial real estate and the economy, it continues to be a source of surprise that the fall out so far from the pandemic and associated lockdown has been so limited. GDP fell by 5.9% during the GFC and All Property capital values declined by 44%. In the first three quarters of 2020 the economy has shrunk by 9.7% and it is likely that the economy will have fallen further in Q4 and Q1 2021. Yet All Property values had fallen by just 6.3% in 2020. The extremely low interest rate environment and property's large premium to gilt yields must be a large contributor to this.

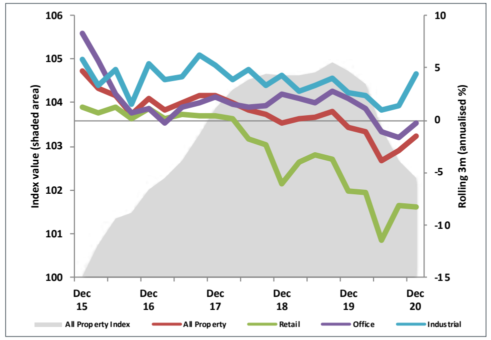
These headline numbers, however, conceal a massive gulf in performance between retail and industrials. Retail capital values fell by -2.4%. Office capital values fell by -1.3% and Industrial values increased by 5.2%. Entreaties to "stay at home" have driven internet sales from 21% of all retail sales in December 2019 to 31% in December 2020. As High Street footfall has dropped off a cliff, the value of Rest of UK shops has fallen 25% over the course of the year and Shopping Centre values are down 27%.

Strong investment demand for industrials has driven yields down to 4.5% 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 grew by 8% in 2020 although Rest of UK capital values fell back by 1% over the same period.

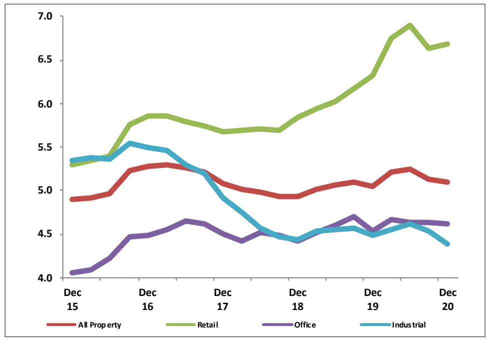
4.1 TOTAL RETURNS BY SECTOR



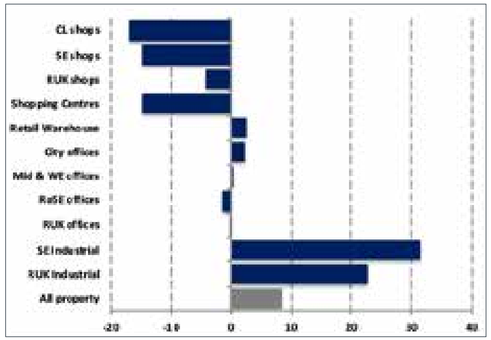
4.2 MRV GROWTH BY SECTOR



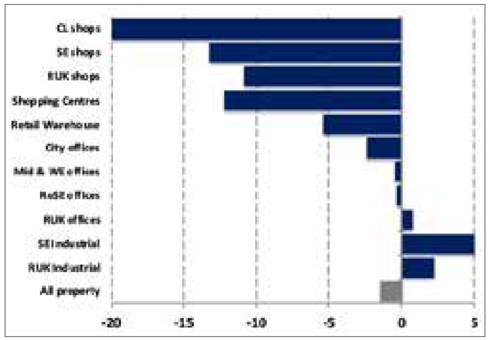
4.3 INITIAL YIELD BY SECTOR



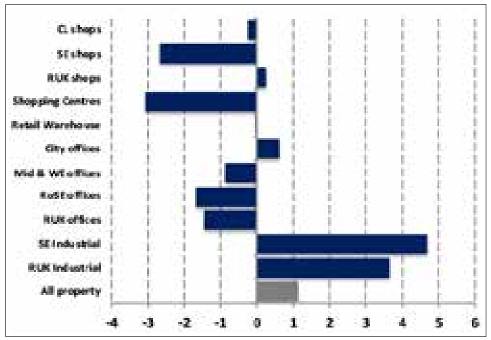
4.4 TOTAL RETURNS BY SEGMENT (Q4 ANNUALISED)



4.5 MRV GROWTH BY SEGMENT (Q4 ANNUALISED)



4.6 YIELD IMPACT (Q4)



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

Data from Remit Consulting, a management consultancy specialising in real estate, shows that in December, at the end of the September Quarter, there was an overall shortfall in rent collection from tenants of commercial properties of 20.9%. When combined with similar shortfalls from the March and June quarters, Remit calculate that the collective loss to investors between the start of the pandemic and the end of the year totalled over £4.2 billion.

Leisure and Hospitality assets have the lowest collection rates with just 48% collected 35 days after the September quarter. The retail collection rate was 68%. Offices and industrials have been more resilient with collection rates of 88% and 85% respectively.

The moratorium on forfeiting leases is due to end in March. At that point landlords will need to make a decision whether to evict and manage a vacancy in a poor letting market; or negotiate with occupiers on rent holidays, concessions and monthly payments.

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

5.1 TOTAL RETURNS

	Dec	3m	6m	12m
All Property	1.0	2.0	2.7	-1.0
Retail	0.1	-0.6	-1.5	-10.8
Office	0.0	-0.1	0.4	-0.9
Industrial	2.5	6.5	8.8	8.7
ANNUALISED				
All Property	12.1	8.4	5.5	-1.0
Retail	1.5	-2.4	-3.0	-10.8
Office	-0.3	-0.3	0.9	-0.9
Industrial	35.0	28.5	18.5	8.7

5.2 CAPITAL GROWTH

	Dec	3m	6m	12m
All Property	0.5	0.6	-0.1	-6.3
Retail	-0.5	-2.4	-5.0	-16.9
Office	-0.4	-1.3	-2.0	-5.7
Industrial	2.1	5.2	6.3	3.6
ANNUALISED				
All Property	5.8	2.5	-0.2	-6.3
Retail	-5.5	-9.3	-9.7	-16.9
Office	-5.3	-5.1	-4.0	-5.7
Industrial	28.8	22.6	13.0	3.6

5.3 INCOME RETURN

	Dec	3m	6m	12m
All Property	0.5	1.4	2.8	5.6
Retail	0.6	1.8	3.6	7.2
Office	0.4	1.3	2.5	5.0
Industrial	0.4	1.2	2.4	4.9
ANNUALISED				
All Property	6.0	5.8	5.7	5.6
Retail	7.4	7.5	7.4	7.2
Office	5.2	5.1	5.1	5.0
Industrial	4.9	4.9	4.9	4.9

5.4 ERV GROWTH

	Dec	3m	6m	12m
All Property	0.1	-0.4	-1.1	-2.3
Retail	-0.5	-2.1	-4.2	-8.7
Office	0.1	-0.1	-0.5	-0.5
Industrial	0.6	1.1	1.4	2.3
ANNUALISED				
All Property	1.0	-1.5	-2.2	-2.3
Retail	-6.0	-8.3	-8.2	-8.7
Office	1.0	-0.3	-1.0	-0.5
Industrial	7.7	4.5	2.9	2.3

5.5 NET INITIAL YIELD

	Dec	3m	6m	12m
All Property	5.1	5.1	5.2	5.0
Retail	6.7	6.6	6.9	6.3
Office	4.6	4.6	4.6	4.5
Industrial	4.4	4.5	4.6	4.5

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 2020. 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. Since Q2 low yielding shops have tipped into negative territory meaning that the only remaining positive strategy for retail investment is shops with long leases.

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	-0.5	-2.9	-2.5	-0.9	1.1	-2.9
Shopping Centres	-5.1	-7.8	-6.5	-5.1	-4.0	-3.3
Retail Warehouses	0.0	-1.7	-2.5	0.2	-0.5	-1.2
Central London offices	-0.2	-0.2	-0.9	0.1	0.4	-0.9
RoSe offices	0.6	-1.1	0.1	0.2	0.6	0.0
RUK offices	0.6	-0.2	1.2	0.6	0.9	0.0
Industrials	1.9	1.5	2.0	1.8	1.9	2.0

8. INVESTMENT IN PROPERTY

All Property investment volumes increased by 21% in Q4 but nevertheless remained 16% below their long run average. Total investment volumes in 2020 were the lowest since 2012 (see Chart 6.1).

Offices and industrials again made up the majority of investment transactions in Q4. But across all sectors of the market, investment volumes continued to be lower than in the same quarter of 2019 (see Chart 6.2). Nevertheless, the RICS has decided that there is sufficient market transparency despite the introduction of Lockdown 3.0 to not require the return of "Material Uncertainty" qualifications to be applied to valuations of most types of assets. However, those valued with reference to trading potential, particularly Leisure and Hospitality assets, remain subject to the use of the declaration.

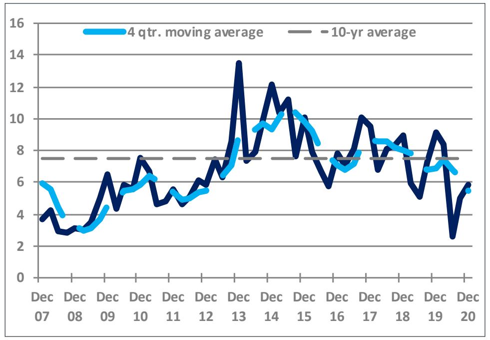
Central London offices traditionally dominate UK real estate investment representing 29% of the market over the last 20 years. In Q4 its share of the market rose to 33%. Nevertheless, transaction numbers represented a reduction from the levels achieved in 2019 with the West End standing out as the most 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 38% in Q3 but in Q4 overseas investors represented 59% of the market in money terms. In Q2, Q3 and Q4 investment in retail and Central London offices by both domestic and overseas investors has fallen a long way short of their historic levels. However, both sets of investors have more than matched their average allocations to industrials (see Chart 6.4).

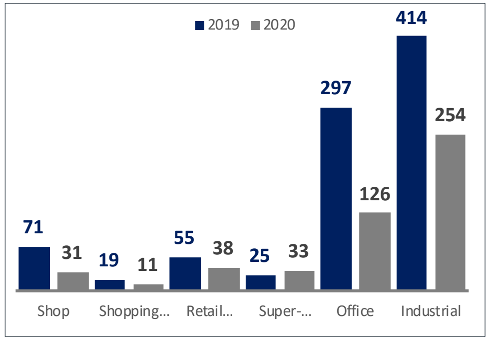
According to the 2021 ANREV / INREV / PREA Investment Intentions Survey the COVID-19 pandemic has had little impact on global real estate investment plans. Very few respondents indicated that it had led to an increase or decrease in investment plans. A minimum of €64.6 billion is expected to be allocated with the majority originating from European institutions. Offices, logistics and residential are the favoured sectors and Germany, France and the UK the preferred destinations in Europe.

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. The post GFC reforms of the banking system, involving stricter regulation and capital adequacy requirements, have reduced liquidity through limiting the availability of bank lending to the UK real estate sector (see Chart 6.5). In Q3 £706 million was actually withdrawn from the lending market after 10 consecutive quarters of expansion.

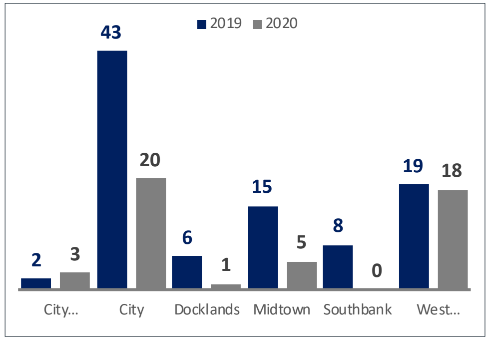
6.1 ALL PROPERTY INVESTMENT VOLUMES (£BN)



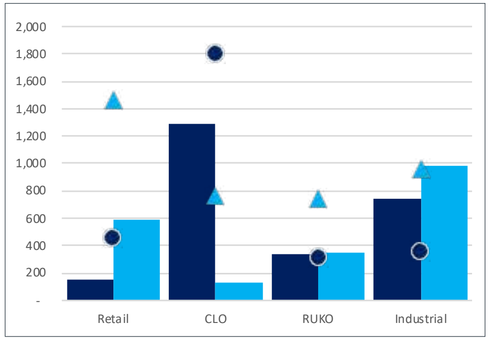
6.2 INVESTMENT TRANSACTION NOS. (Q2, Q3 & Q4)



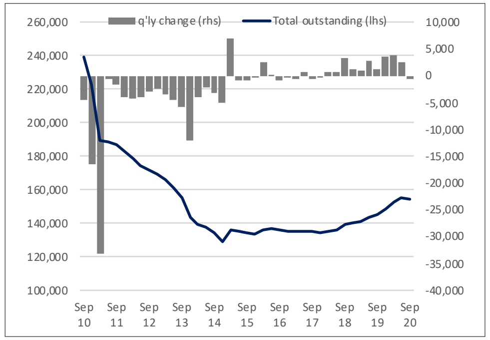
6.3 CENTRAL LONDON OFFICE INVESTMENT TRANSACTION NOS. (Q2, Q3 & Q4)



6.4 DOMESTIC & OVERSEAS INVESTORS BY PROPERTY TYPE Q2, Q3 & Q4 (£M)

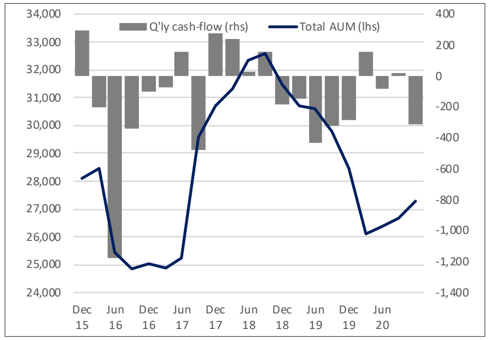


6.5 BANK LENDING TO UK REAL ESTATE (£M)



Since 2015 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 this year. This trend of net disinvestment continued into Q4 with £310 million being redeemed in October and November. (see Chart 6.6).

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



9. OUTLOOK

November's IPF consensus forecasts reflect the view that UK real estate values will not fall as far nor as fast as initially expected at the outset of the pandemic lockdown. But the recovery stage of the crisis is likely to be more prolonged. Forecasts for 2021 have been reducing each quarter since February 2020 (see Chart 7.1).

The consensus forecasts continue to show capital values falling in 2021. The median total return of 2.5% in 2021 reflects a fall in capital values of -2.6% and an income return of 5.1%. A total return of 7.1% in 2022 is the result of an increase in capital values of 0.6% (see Chart 7.2).

Total return expectations represent an annualised average of 3% over the next 5-years. But over the last three years of the forecast horizon, after the current levels of turbulence have passed, the consensus view on the 3-year annualised average has decreased slightly to 6.6% from 6.8% in August.

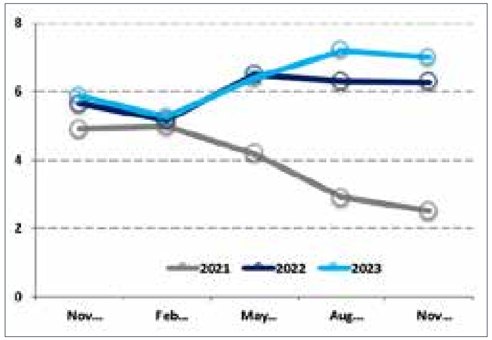
There continue to be a wide range of forecasts. Total return forecasts for 2021 range between +7.5% and -6.0%. The forecast range for 2022 is 21.5% with a maximum of 18.7% and a minimum of -2.8% (see Chart 7.3).

The rate of decline in All Property capital values continues to be slower than the pace set during the GFC (see Chart 7.4). Market resilience during 2020 and the support offered by ultra-low risk free rates and the gilt – property yield gap have caused forecasts to be revised upwards from the bigger falls reflected in Q2 and Q3. Nevertheless, values are forecast to decline until the end of 2021 albeit slightly. The recovery thereafter is expected to be weak and values are unlikely to recover their previous cyclical peak until the end of the forecast horizon (see Charts 7.5 & 7.6).

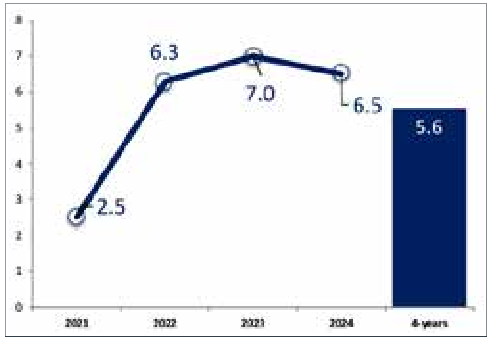
It is unlikely that all segments of the market will suffer from the same decline in value. The pandemic has accelerated the rise of on-line shopping and the decline in capital and rental values achievable for all types of retail assets. Current estimates suggest that retail space is between 30% and 50% over supplied.

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. Current trends include the re-purposing of retail parks as logistic space. Ocado have taken over a Homebase unit in Merton and Amazon are redeveloping a Toys R Us unit in Croydon. Tesco are using retail warehouse space as dark stores to service their on-line deliveries.

7.1 IPF FORECAST EVOLUTION (NOV 20)

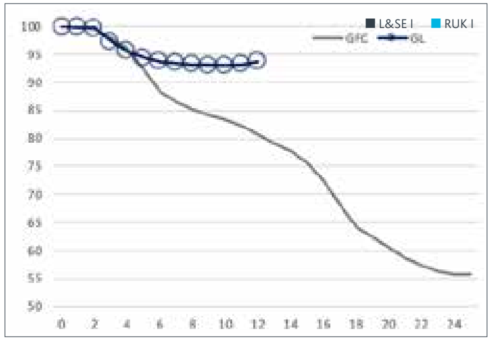


7.2 IPF ALL PROPERTY FORECASTS Y-BY-Y (NOV 20)

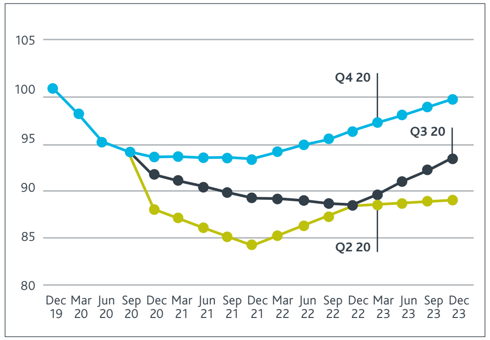


7.3 UK COMMERCIAL TOTAL RETURN FORECASTS

7.4 MSCI CAPITAL GROWTH GFC v LOCKDOWND



7.5 CAPITAL VALUE FORECASTS



7.6 RENTAL VALUE FORECASTS

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

Capital Economics have offered an extreme view that the enforced remote-working experiment of recent months will cause a dramatic demand shift in the office sector. In the future as many as 50% of office-based employees could be working from home at least once a week. Even allowing for substantial demolitions and office to residential conversions, vacancy rates can be expected to rise markedly in the next five years causing a decline in rental values and income returns.

A British Council of Offices survey lends support to this argument, finding that in the future employees at all levels will divide their time between working from home and visiting their workplace. The counterpoint is offered by the Institute of Directors who highlight the problem of managing teams remotely and believes that offices will remain valuable places for interaction and collaboration.

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

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

10. HOUSEVIEW

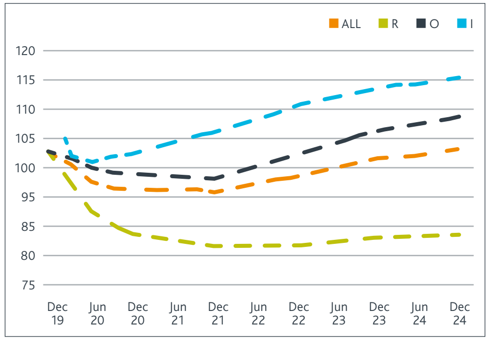
The central forecast from Cluttons HouseView model has been amended to reflect the performance of the market in 2020 and the revised macro-economic forecasts. On balance, we expect capital values at the All Property level to stabilise this year. Assuming that the UK escapes from Lockdown 3.0 at the end of Q1 and the economy remains open thereafter we have removed any allowance for an element of tenant delinquency. Consequently, we expect an improved income return of +5%. All Property total returns could therefore recover to 5% 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 GFC (see Charts 8.5 & 8.6). Industrials will provide some upside protection from the downside risks inherent in holding offices and particularly retail.

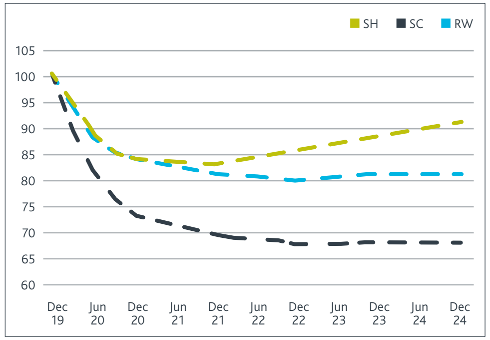
Brexit and December's thin trade agreement with the EU continue to act as a drag on the UK economy and therefore its real estate market. Trade in both goods and services is likely to be lower. This reduction in trade with the EU is expected to weigh on productivity and GDP over the next three years. The agreement does, however, end uncertainty surrounding the eventual outcome. As such it could improve sentiment and encourage investors to commit resources to UK real estate.

On the one side is the disappointing news about increased transport costs and delays and Scottish shell-fish rotting in quayside lorries. HGV's now need a Kent Access Permit certifying that they have the correct documentation to travel onward to France before they can approach Dover. Consequently, the M20 Euro-Tunnel terminal and Port of Dover have avoided a repeat of the traffic jams seen before Christmas, when France closed its borders. On the other side, Nissan have this month committed to maintain production at its Sunderland car plant where the Qashqai and electric Leaf are assembled.

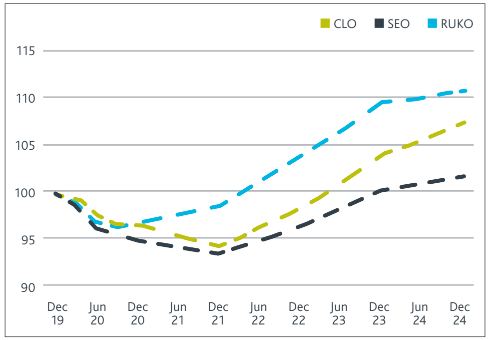
8.1 3-SECTOR CAPITAL VALUE FORECASTS



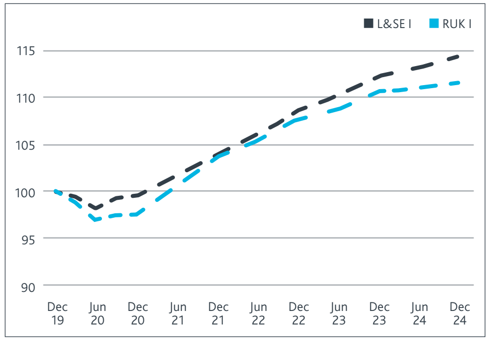
8.2 RETAIL SEGMENTS CAPITAL VALUE FORECASTS



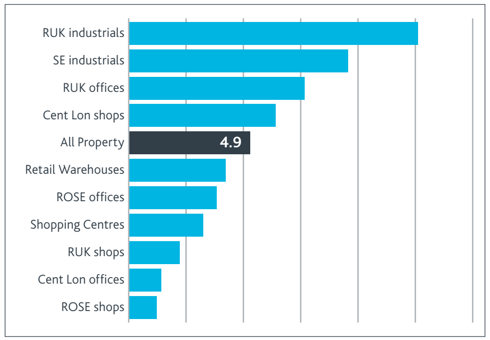
8. 3 OFFICE SEGMENTS CAPITAL VALUE FORECASTS



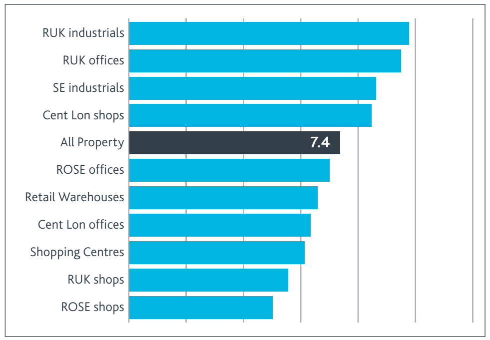
8.4 INDUSTRIAL SEGMENTS CAPITAL VALUE FORECASTS



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



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



We have previously highlighted the risks to Central London offices as investment banks and their advisors gradually move manpower and resources to mainland Europe. On the first day of trading in 2021, €6 billion of trading in European equities such as Santander, Deutsche Bank and Total switched from London to exchanges in Paris, Madrid and Frankfurt. The FT has also reported on a shift in derivative trading to New York and Amsterdam. Pre-Brexit the market in swaps used to hedge currency movements was valued at $2 trillion.

The High Street's loss continues to be Industrials gain. The main driver for UK industrials will continue to be the growth of supply chains to support on-line shopping. At the margins, however, industrials may face some downside risks as manufacturers and logistic operators could foreseeably re-locate to mainland Europe to avoid tariffs and the accompanying paperwork.

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