CLUTTONS
INVESTMENT MANAGEMENT

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Commercial property examiner

Quarter two | 2021

Contents

Foreword

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. All Property capital values fell just 6.6% between February and October 2020, which marked the bottom of the pandemic cycle. Since October, All Property capital values have recovered 4.2% although values still remain 2.7% below pre-pandemic levels.

Shop and Shopping Centre values have fallen 30% since the start of the pandemic but there are signs that these segments are finally showing signs of stabilising. Supermarkets were the most resilient retail segment. Capital values fell just 1.8% between February and October 2020 but have grown 5% since October.

Office values fell 5% in the first stage of the pandemic and have continued to edge lower ever since. It is likely that occupiers and investors are waiting to see the impact of "Freedom Day" and the end of exhortations to work from home.

The industrial and warehouse sector has been the main real estate beneficiary of the pandemic. The value of London industrials has risen 20% since February 2020; industrial values in the South East are up14% and up 12% in the Rest of the UK.

For the time being the key long-term issues for UK commercial real estate remain the growing importance of Environmental, Social and Governance (ESG) issues and the outlook for retail and office property, the re-purposing of retail assets, the future demand for offices, and the evolving impact of Brexit on the City of London. We will return to consider these in future issues. The big macro issue this quarter has been the return of inflation. The risks threatened by rising inflation have been a persistent topic for

Central Banks in Q2; so inflation has this quarter been added to this litany of issues for real estate investors to worry about.

Why does inflation matter? Firstly, a short piece of economic and social history. Inflation became embedded in the UK economy in the 1960s and by the 1970s double digit inflation was persistent. Inflation peaked in 1975 at 24% and for the 10-years to 1982 averaged 14% per annum. The average house price was £7,800 at the end of 1972. By the end of 1982 it had risen 224% to £25,600. High interest rates were the price of defeating inflation. Interest rates rose to 17% in 1979 and stayed above or near to 10% for the next 13 years. The unemployed numbered 3.25m in 1984; 12% of the work force.

Secondly, inflation has the potential to crash asset markets. Persistently rising prices threaten the low inflation and low interest rate model that has supported markets.

The current pricing levels of stocks, bonds, houses, commercial real estate and even cryptocurrency rests on the assumption that interest rates will stay low for a long time. Interest rates in the UK have been below 1% since March 2009. In March 2020 they were reduced to 0.1% in response to the pandemic lockdown. The market assumes that interest rates will not rise above 0.5% until 2027 and stay below 1.0% until 2033. Previous generations of investors assumed that 5% represented the long-run average interest rate.

In 1974 UK commercial real estate values fell 20% when interest rates rose to 13% and the UK economy entered recession. Again, in 1990 interest rates rose to 15%, the economy entered another recession and for three consecutive years thereafter capital values fell by 10% or more. Rising interest rates eventually make loans secured on property unsustainable or at least put borrowers in breach of loan covenants relating to loan to value and interest cover.

Interest rates have been allowed to stay low for so long, because inflation has been so benign. In the mid-1980s until 2007's financial crisis the USA economy enjoyed the Great Moderation. This was a period of positive economic growth and low inflation that has been attributed to Central Bank independence, a more flexible labour market, the shift away from manufacturing towards a service based economy, and technological innovation improving productivity.

Two further drivers of the Goldilocks economy have been the globalisation of the world economy, which kept commodity prices low and the emergence of China, which kept the price of manufactured goods low. These last two drivers have been threatened by the growth of populist nationalism in reaction to the GFC and immigration, Ex-President Trump's trade war with China and Brexit. The World Trade Organisation reflects that the Covid-19 pandemic represents an unprecedented disruption to the global economy and world trade.

The pandemic has impacted the liquidity of Central London's office market. Far Eastern investors have been deterred from viewing potential investments and in practice completing their due diligence by travel restrictions. Entry into the UK requires 10 days of quarantine, and a return home can require a further 21 days.

For the moment, inflation is being seen as a short run effect rather than a persistent problem. In April 2020, shortly after the imposition of the first pandemic lockdown, retail sales were down 18.1%, goods exports fell by 20.6%, and monthly GDP contracted by a record 18.7%. Spring 2020 saw crude oil prices fall to a 21-year low and this quickly fed through to lower petrol and diesel prices. Average petrol prices fell by 10.4 pence per litre between March and April 2020, the largest monthly fall since the current series began in 1990. At one-point unleaded petrol was retailing at less than £1.00 per litre. Today it is back up to approx. £1.30 per litre.

In July, Michael Saunders of the Monetary Policy Committee (MPC) discussed the outlook for monetary policy in an on-line speech. The main points were that activity had recovered faster than previously expected; price pressures on globally manufactured consumer goods, ICT and plant and machinery may well have persistent effects on UK inflation; and the closing output gap pointed to risks that CPI inflation will remain above the 2% target. The policy prescription was not, however, rising interest rates but ending some of the monetary stimulus through the current £150bn asset purchase program.

For the moment markets are not expecting a rise in interest rates and the early signs of possible trouble to come will be reductions in quantitative easing. Having previously forecast a temporary rise in inflation above the 2% target, the MPC now expects inflation to exceed 3% for a temporary period before falling back. The market path for interest rates, however, which the MPC factors into their forecasts, suggests that interest rates will stay below 0.5% until the end of 2023.

1. Key take aways

As all remaining restrictions on economic activity are lifted, including instructions to work from home, the economy is expected to continue its strong recovery. This outlook could be threatened if the current growing numbers of infections leads to hospitalisations and fatalities.

All Property total returns are improving at both the 3-month and 12-month horizon. In Q2 All Property total returns increased to 3.9% and in the 12-months to the end of March 2021, All Property total returns increased to 9.1%.

Inflationary pressures are building but the latest policy statements from the Bank of England suggest it will continue to look through short term inflationary pressures and maintain its ultra-low interest rate policy. This will support asset values generally and the value of UK commercial real estate in particular.

All Property total returns could recover to 10% or more in 2021 and 8% in 2022 with an annualised average of 9% in the 3-years ending December 2023.

2. Summary

Global output growth is projected to strengthen to 5.6% in 2021— its strongest post-recession pace in 80 years. The recovery is underpinned by steady but highly uneven global vaccination and the associated gradual relaxation of pandemic-control measures in many countries, as well as rising confidence.

The UK economy is estimated to have grown by 0.8% in May 2021, the fourth consecutive month of growth, but remains 3.1% below the pre-coronavirus pandemic levels seen in February 2020.

As the vaccination programme proceeds apace and restrictions on economic activity ease, GDP is expected to rise sharply in 2021 Q2, and recover strongly to pre-Covid levels over the remainder of this year.

As the economy recovers, the negative contributions from last year's price falls drop out of the 12-month CPI growth rate and are replaced by positive contributions from higher prices. CPI inflation has risen to 2.5% in the 12 months to June 2021, the largest year-on-year number since August 2018. For the moment, the MPC consider that these transitory developments should have few direct implications for inflation over the medium term.

UK REIT share prices grew by 5.2% in Q2 but underperformed the wider all share market indices. The top performers in Q2 were Big Yellow Group, the UK's largest self-storage company, and Segro, the UK's largest REIT by market capitalisation with a portfolio of logistics assets across the UK and Europe.

The current property initial / gilt yield gap is 4.1% having decreased by less than 2 bps over the course of Q2 but remains above the 10-year average.

In Q2 2021, All Property total returns increased to 3.9% from 2.2% in Q1.

In the 12-months to the end of June 2021, All Property total returns increased to 9.1% from 2.6% in the 12-months ending March 2020 as the negative returns generated in the first few months of the pandemic fell out of the calculation.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 4% in Q2 compared to Q1. They were, however, 120% higher than Q2 2020 when the original pandemic lockdown shut down most economic activity and were just 4% below their long run average.

The latest consensus forecasts reflect an increasingly positive view on the outlook for UK real estate values as the sector recovers from the effects of pandemic lockdown. Total return forecasts for 2021 have been increased to 4.0% from 2.2% in February.

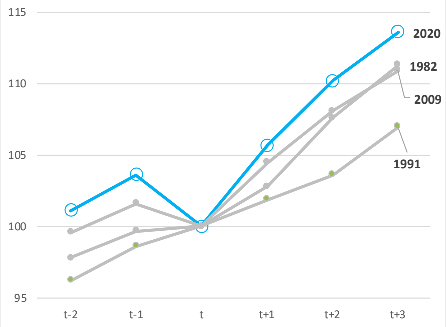
Cluttons' House View has been revised to reflect the performance of the market so far in 2021 and the changing macro-economic forecasts. We continue to be more optimistic than the consensus view and assuming that the UK successfully moves beyond Lockdown 3.0 and the economy remains open thereafter All Property total returns could now recover to 10% or more in 2021.

3. The World economy

In June's edition of Global Economic Prospects, the World Bank records that following a 3.5% contraction caused by the Covid-19 pandemic in 2020, global economic activity has gained significant momentum but remains well below pre-pandemic levels in many countries. Global output growth is projected to strengthen to 5.6% in 2021— its strongest post-recession pace in 80 years (see Chart 1.1). The recovery is underpinned by steady but highly uneven global vaccination and the associated gradual relaxation of pandemic-control measures in many countries, as well as rising confidence.

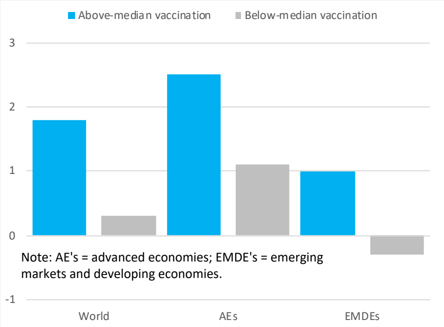
The ongoing pandemic continues to shape the path for global economic activity. A substantial share of the rebound is due to major economies where vaccination has been more prevalent (see Chart 1.2). Severe outbreaks of the virus continue to weigh on growth in many countries. Limited vaccine access and further waves of the pandemic in Emerging Markets and Developing Economies (EMDEs) cause concern for the durability of a truly global recovery. In May, India suffered from 400,000 new cases a day and the more easily transmittable Delta variant has now spread around the world. The result may well be the re-imposition of pandemic control measures.

1.1 Global recoveries after recessions (100 = recession)



Source: World Bank, Jun 2021

1.2 Growth projections by region



Source: World Bank, Jun 2021

4. The UK economy

The UK economy is estimated to have grown by 0.8% in May 2021, the fourth consecutive month of growth, but remains 3.1% below the pre-coronavirus pandemic levels seen in February 2020. From March, the Roadmap out of lockdown began to be implemented. As a first step, children and students returned to attendance on-site at schools and universities. Three weeks later outdoor sports facilities and open-air swimming pools were once again permitted to open to the public (see Chart 1.3).

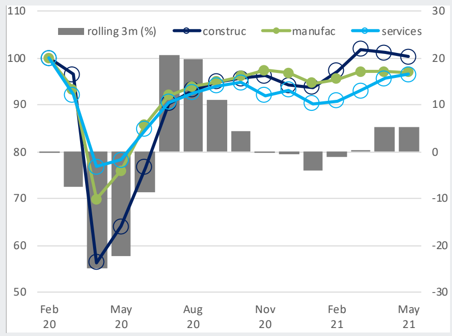
Step 2 in April saw the opening of non-essential retail, hairdressers and gyms. Hospitality venues were allowed to serve customers seated at tables outdoors. In May, under Step 3, indoor hospitality re-opened along with cinemas, adult group sports and exercise classes. Sports venues were permitted to host up to 10,000 spectators. The service sector grew by 0.9% in May 2021. Accommodation and food service activities grew by 37.1% (see Chart 1.4). Step 4 involving the re-opening of night clubs and the lifting of all remaining pandemic restrictions was delayed until 19th July.

Manufacturing output in May, contracted slightly for a second consecutive month, by 0.1%. Production in 6 out of the 13 manufacturing sub-sectors fell in May 2021. The largest contribution to the fall came from the manufacture of transport equipment, falling by 16.5%, as microchip shortages disrupted car production. The fall in the manufacture of transport equipment was partially offset by growth of 25.2% in the manufacture of basic pharmaceutical products and pharmaceutical preparations, which grew following a large fall of 14.5% in April 2021 (see Chart 1.5).

The Monetary Policy Committee's (MPC's) UK GDP forecasts in the latest Monetary Policy Report published in May assume a stronger outcome to the third lockdown in Q1 than was originally expected. As the vaccination programme proceeds apace and restrictions on economic activity ease, GDP is expected to rise sharply in 2021 Q2, and recover strongly to pre-Covid levels over the remainder of this year. There is very little change to May's forecast from the forecasts produced three months earlier (see Chart 1.6).

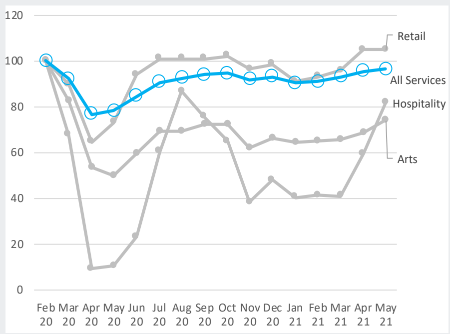
Since the publication of this report by the MPC, we now know that the pandemic risks to the economy have again increased. The emergence of the Delta variant has resulted in a rapidly increasing number of cases. A debate is ongoing regarding the likelihood of a similar increase in hospitalisations and deaths given that, although 87% of the adult population have had a first vaccine dose and 67% a second dose, all pandemic restrictions have now been effectively lifted.

1.3 UK economic growth



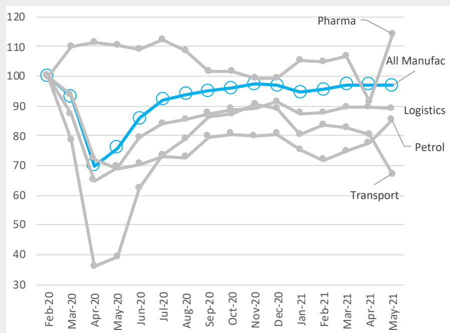
Source: ONS, Jul 2021

1.4 UK service sector output



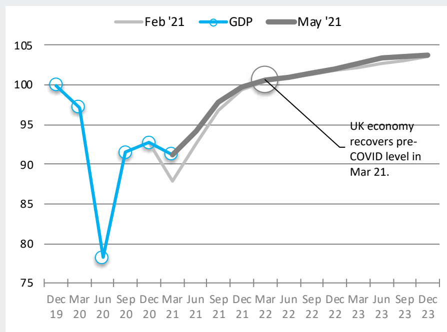
Source: ONS, Jul 2021

1.5 UK industrial sector output



Source: ONS, Jul 2021

1.6 MPC economic projections



Source: Bank of England, May 2021

5. Other economic indicators

At the start of May, the Governor of the Bank of England had written an open letter to the Chancellor of the Exchequer explaining why inflation had fallen by more than 1% below the 2% target. The short answer was that,

> "The effects of the Covid-19 (Covid) pandemic have been associated with a sharp reduction in economic activity in the United Kingdom and globally, reducing UK inflation through a number of channels."

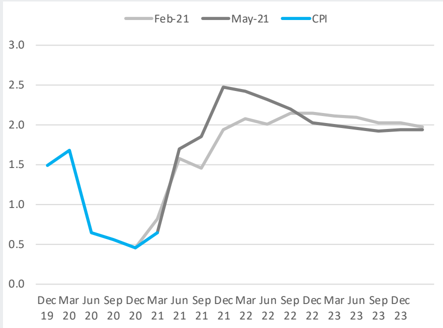
On the same date, the MPC's Monetary Policy Report forecast that CPI inflation would rise temporarily above the 2% target towards the end of 2021, owing mainly to developments in energy prices, a more resilient economy in Q1 and a stronger recovery in the remainder of 2021 than previously anticipated (see Chart 2.1).

As the economy recovers, the negative contributions from last year's price falls drop out of the 12-month CPI growth rate and are replaced by positive contributions from higher prices (see Chart 2.2). This "base effect" can be expected to place upward pressures on headline inflation for the next few months.

In July, it was reported that CPI inflation had risen further to 2.5% in the 12 months to June 2021, the largest year-on-year number since August 2018 (see Chart 2.3). The MPC has now said that it expects inflation to exceed 3% for a temporary period before falling back to around 2% in the medium term. The market path for interest rates, however, which the MPC factors into their forecasts, suggests that interest rates will stay below 0.5% until the end of 2023.

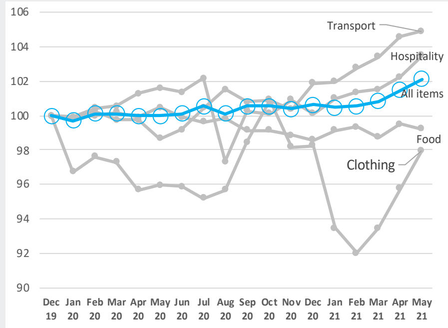
In May, the ONS released annual estimates for 2019 of GDP in UK regions, local areas and city regions. This data was scheduled for release in December 2020 but has been delayed by the pandemic. It provides a more granular view of economic activity across the UK albeit at a distance of twelve months or more.

2.1 MPC inflation projections



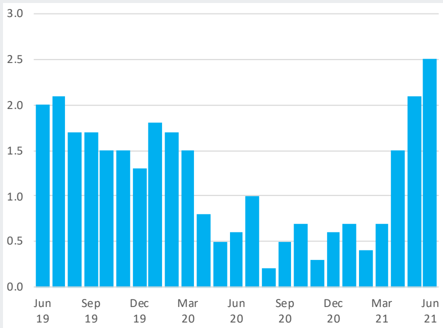
Source: Bank of England, May 2021

2.2 CPI by item



Source: ONS, Jul 2021

2.3 CPI Inflation



Source: ONS, Jul 2021

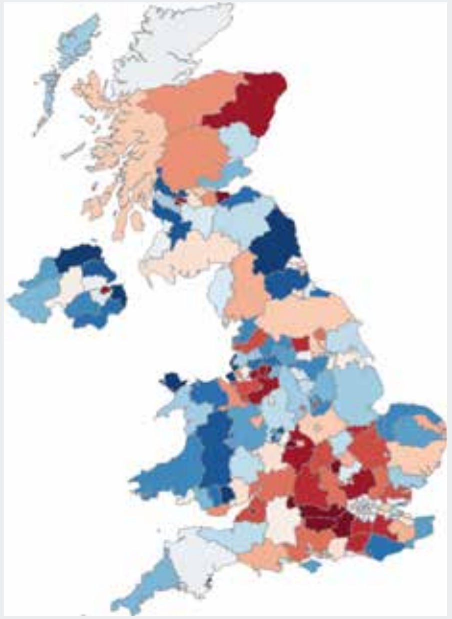
Across a selection of the UK's largest and / or fastest growing city regions, the West End and City of London together with Manchester and Cambridge enjoyed the largest annualised rate of growth in the 10-years following the Global Financial Crisis (GFC). The devolved capitals of Cardiff and Edinburgh also enjoyed stronger growth than the UK average. Birmingham and Glasgow, two of the UK's "Big 6" regional cities, were included in a cluster of northern cities that underperformed the UK average (see Chart 2.5).

Eurostat established a hierarchy of three geographic levels known as Nomenclature of Territorial Units for Statistics in English or Nomenclature des unités territoriales statistiques (NUTS) in French. The smallest of these is NUTS 3 with a population between 150,000 and 800,000. Since population size can be a major indicator of an area's economic footprint, GDP per head can be a useful way of comparing local areas of different size.

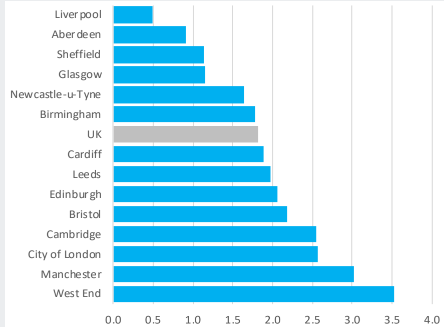
For the UK's NUTS 3 areas, those areas with the highest GDP per head are shaded dark red and the areas with the lowest are shaded dark blue. The red shaded areas are predominantly in south central England below a line drawn between the Bristol Channel in the west and the Wash in the east. However, there are pockets of red north of this line representing some of the UK's major regional cities; in particular, Edinburgh, Glasgow, Belfast, Leeds and Manchester. Birmingham is a notable exception from this list (see Chart 2.4).

The distribution of blue shaded areas with lower levels of GDP per head also extends into parts of the South East i.e. East Sussex, East Kent and Southend-on-Sea. Moreover, London does not have homogenously high levels of GDP per head across all boroughs. Barnet, Redbridge and Waltham Forest, Barking & Dagenham and Havering and Bexley and Greenwich have lower levels of GDP per head than the national average (see Chart 2.6)

2.4 UK gdp per head 2019



2.5 Economic growth by city 2009-2019



Source: ONS , May 2021

2.6 London gdp per head 2019

Source: ONS , May 2021

6. Interest rates and asset yields

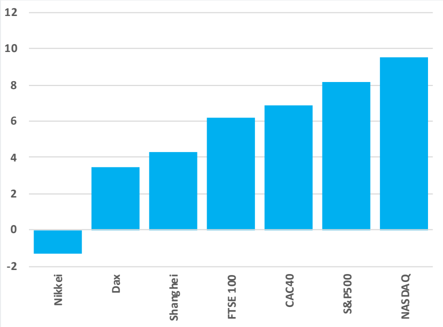
In Q2, stock market across the world advanced further, supported by an accelerating economic recovery and the continued roll-out of Covid-19 vaccines. Although most sectors of the market made gains over the course of the quarter, Growth and Tech stocks recovered ground against Value stocks. The NASDAQ index on which the large tech companies are listed recovered in Q2 and the S&P 500 reached an all-time high in late June. Eurozone and UK markets benefitted as pandemic restrictions were lifted. Japan's Nikkei underperformed other developed markets dragged down by the decision to delay lifting the Covid state of emergency and curtailed car production levels resulting from the global semiconductor shortage (see Chart 3.1)

UK REIT share prices grew by 5.2% in Q2 but underperformed the wider all share market indices. The top performers in Q2 were Big Yellow Group, the UK's largest self-storage company, and Segro, the UK's largest REIT by market capitalisation with a portfolio of logistics assets across the UK and Europe. Shares in Shopping Centre specialist, Hammerson, recovered further in Q2 as it reported completion of the disposal of its seven retail park portfolio to Brookfield for £330 million.

British Land and Land Securities shares fell further as investors continued to fret about the outlook for retail and office space. Shaftesbury with its portfolio of central London village shops announced that it could be another three years until London's West End enjoys a full recovery in international tourism. Its share price fell 11% in Q2 (see Chart 3.2).

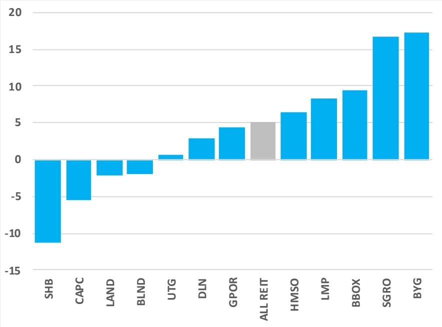
Risk free assets continue to yield close to zero. In May, the Bank of England announced its intention to maintain its asset purchase programme of £875 billion. The latest tranche of £150 billion of purchases is expected to be completed by the end of 2021. The major central banks are expected to be willing to accommodate higher inflation to deliver a more robust recovery. The new framework adopted by the US Federal Reserve in 2020, known as Flexible Average Inflation Targeting, will require them to start raising interest rates only once inflation has been above 2% for a period of time and full employment has been reached. This is expected to be in 2023. In the UK, gilt yields have hardened by 11 bps to 0.76% from 0.87% at the end of Q1. The yield on the 5-15 year gilt index has since hardened further to 0.67% (see Chart 3.3).

3.1 World stock markets Q2 2021



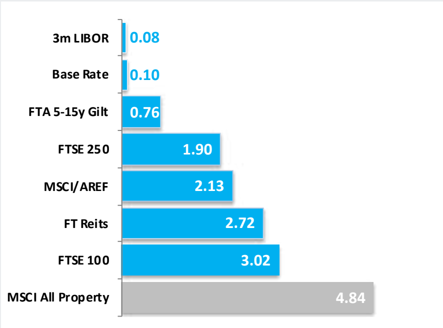
Source: Yahoo Finance, Jul 2021

3.2 UK Reit prices movement Q2 2021



Source: Yahoo Finance, Jul 2021

3.3 UK asset yields Q2 2021



Source: Yahoo Finance, Jul 2021

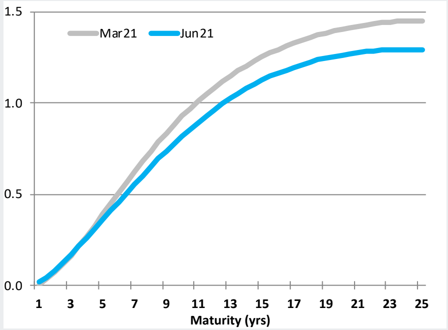
Market expectations of future interest rates have decreased by 10-15 bps along all but the very short end of the yield curve in reaction to this more dovish view on inflation risk. The market view remains that interest rates are set to remain at historic low levels for some time to come (see Chart 3.4).

The current property initial / gilt yield gap is 4.1% having decreased by less than 2 bps over the course of Q2 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.

In May, MCSI published the performance numbers for the world's largest real estate markets in 2020. Total returns ranged from -21.3% for Montreal retail to 30.7% for Gothenburg industrials. The best performing retail market was Munich, where total returns of 16.4% were achieved. And Berlin was the best performing office market with total returns of 21.5%. The median return was 8.6%.

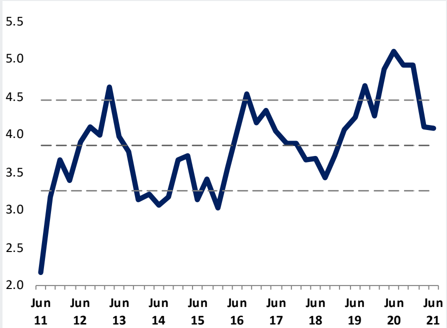
The relative performance of the three principle commercial real estate sectors in 2020 was very similar across all global cities. Retail centres dominate the underperformers in the left-hand tail of the distribution. Whilst industrial centres made up 55% of the top quartile centres and office centres 34% (see Chart 3.6).

3.4 Gilt yield curve (%)



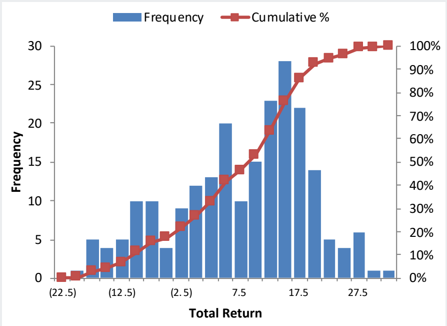
Source: Bank of England, Jul 2021

3.5 Property IY - Gilt yield gap



Source: MSCI & Bank of England, Jul 2021

3.6 Distribution of global CRE performance in 2020



Source: MSCI, May 2021

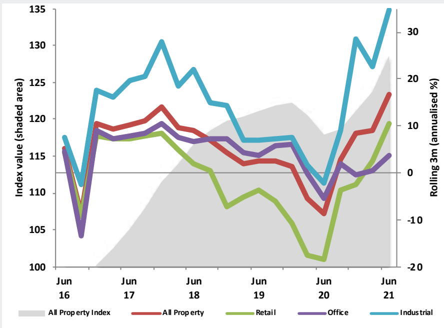
7. Commercial property market performance

In Q2 2021, All Property total returns increased to 3.9% from 2.2% in Q1. This was the highest quarterly return generated at the All Property level since December 2014. Capital growth was 2.6% in Q2 compared to 0.8% in Q1. Property equivalent yields hardened by 17 bps and contributed a 2.6% uplift to valuations. All Property rental value growth increased to 0.4% in Q2 from zero growth in Q1. Q2 income returns amounted to 1.3% (see Charts 4.1 & 4.4).

Over the course of the second quarter, office rental values increased slightly by 0.1% while industrial rental value growth of 1.8% remained strongly positive. However, rental values for Shopping Centres, and Shops continue to fall sharply whilst the decline in retail warehouse rental values has paused (see Charts 4.2 & 4.5).

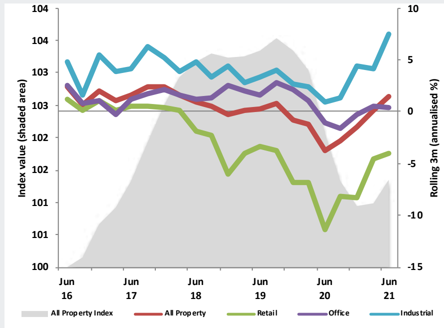
In the 12-months to the end of June 2021, All Property total returns increased to 9.1% from 2.6% in the 12-months ending March 2020 as the negative returns generated in the first few months of the pandemic fell out of the calculation. Year-on-year capital growth was 3.4% in June compared to -2.9% in March. Property equivalent yields hardened by 34 bps in the 12-months to June and contributed a 4.7% uplift to valuations. All Property rental values decreased year-on-year by -0.7% and income return amounted to 5.6%.

4.1 Total returns by sector



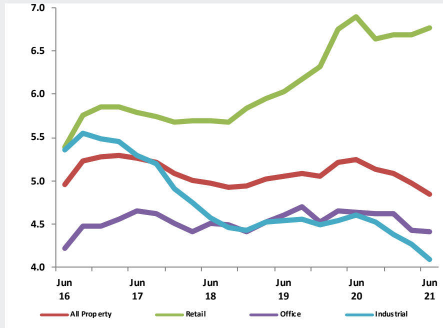
Source: MSCI, Jul 2021

4.2 MRV growth by sector



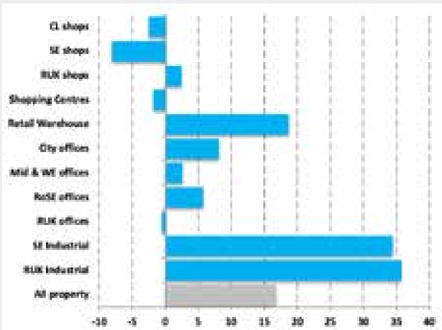
Source: MSCI, Jul 2021

4.3 Initial yield by sector



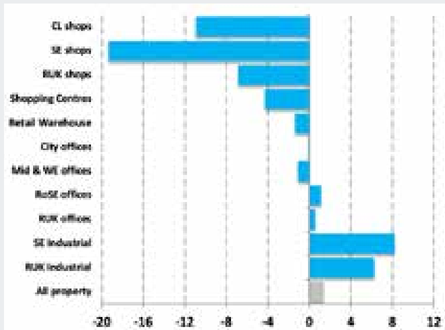
Source: MSCI, Jul 2021

4.4 Total returns by segment (Q2 annualised)



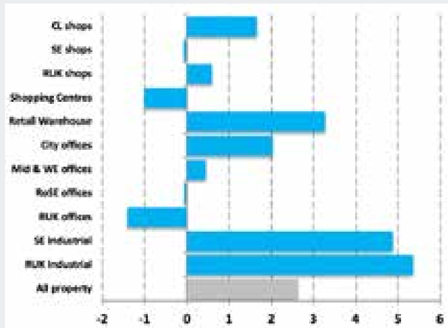
Source: MSCI, Jul 2021

4.5 MRV growth by segment (Q2 annualised)



Source: MSCI, Jul 2021

4.6 Yield impact (Q2)



Source: MSCI, Jul 2021

Strong investment and occupier demand for industrials has pushed up rental values and driven yields down to 4.0% and nearer 3% for last mile logistics in London. The yield gap between industrials and retail and office assets continues to expand to the point where the sector could be considered over valued (see Charts 4.3 & 4.6).

Occupier demand, however, is driving rental growth of 5% year-on-year and 7% at a quarterly annualised rate in Q2. For the moment, after adding back the income investors can reasonably anticipate total returns of 10% or more. This suggests that the re-rating of industrial assets may have further to run.

Industrial assets now represent 39% of the index and many traditional balanced funds will still be over-weight in retail and office and under-weight in industrial. The drive to re-balance will add further liquidity to the sector.

Tables 5.1 – 5.5 contain further performance data for UK commercial real estate in Q2 2021.

5.1 Total returns

	June	3m	6m	12m
All Property	1.9	3.9	6.2	9.1
Retail	1.3	2.5	3.2	1.6
Office	0.6	0.9	1.1	1.5
Industrial	3.5	7.8	13.4	23.4
Annualised				
All Property	25.5	16.7	12.8	9.1
Retail	17.2	10.6	6.5	1.6
Office	7.3	3.8	2.1	1.5
Industrial	51.9	34.8	28.6	23.4

Source: MSCI

5.2 Capital growth

	June	3m	6m	12m
All Property	1.5	2.6	3.5	3.4
Retail	0.7	0.7	-0.5	-5.4
Office	0.2	-0.3	-1.4	-3.4
Industrial	3.2	6.6	10.9	17.9
Annualised				
All Property	19.2	10.8	7.0	3.4
Retail	9.1	3.0	-0.9	-5.4
Office	2.2	-1.1	-2.8	-3.4
Industrial	45.7	29.1	23.0	17.9

Source: MSCI

5.3 Income return

	June	3m	6m	12m
All Property	0.4	1.3	2.7	5.6
Retail	0.6	1.8	3.7	7.4
Office	0.4	1.2	2.5	5.0
Industrial	0.4	1.1	2.3	4.8
Annualised				
All Property	5.4	5.4	5.5	5.6
Retail	7.5	7.4	7.5	7.4
Office	4.9	5.0	5.0	5.0
Industrial	4.4	4.5	4.6	4.8

Source: MSCI

5.4 ERV growth

	June	3m	6m	12m
All Property	0.3	0.4	0.4	-0.7
Retail	-0.2	-1.0	-2.2	-6.3
Office	0.2	0.1	0.3	-0.2
Industrial	0.8	1.8	2.9	4.3
Annualised				
All Property	3.3	1.4	0.8	-0.7
Retail	-1.8	-4.0	-4.3	-6.3
Office	2.1	0.4	0.5	-0.2
Industrial	9.6	7.4	5.8	4.3

Source: MSCI

5.5 Net initial yield

	June	3m	6m	12m
All Property	4.8	5.0	5.1	5.2
Retail	6.8	6.7	6.7	6.9
Office	4.4	4.4	4.6	4.6
Industrial	4.1	4.3	4.4	4.6

Source: MSCI

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

In Table 5.6, we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e. yield, rent or lease length. The numbers presented are the 3-month total return relative to the MSCI All Property average for 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 Shop and Shopping Centre segments are coloured red and the Industrial segments are universally out-performing. Prime low yield and long lease shops continue to be in positive territory, as they have been for at least the last three quarters. And the relative performance of the Retail Warehouse market continues to improve. Secondary high yielding offices with short lease expiries have under-performed in the last quarter. Questions surrounding the future demand for office space in a post-Covid business environment suggest that this trend will continue.

5.6 Performance by strategy relative to All Property average Q1 2021

	Low yield	High yield	High rent	Low rent	Long lease	Short lease
Shops	-0.1	-3.6	-2.4	-0.1	0.6	-3.3
Shopping Centres	-7.6	-6.9	-9.8	-7.6	-5.4	-6.6
Retail Warehouses	0.6	-0.6	-0.9	0.6	0.0	-0.2
Central London offices	-0.3	-2.3	-1.4	-0.3	-0.4	-1.9
RoSe offices	-0.1	-2.4	0.9	-0.1	-0.1	-2.5
RUK offices	-0.5	-2.5	-0.7	-0.5	-0.2	-3.1
Industrials	3.1	3.4	3.4	3.1	2.8	3.3

8. Investment in property

A search for yield in the current hyper-low interest rate environment is driving allocations to real estate. A re-surgent economy following the easing of lockdown restrictions and a strong performance by commercial real estate in Q2 should encourage higher levels of investment activity. On a relative basis, the UK remains highly attractive from a return perspective compared to many other global real estate markets.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, decreased by 4% in Q2 compared to Q1. They were, however, 120% higher than Q2 2020 when the original pandemic lockdown shut down most economic activity and were just 4% below their long run average (see Chart 6.1).

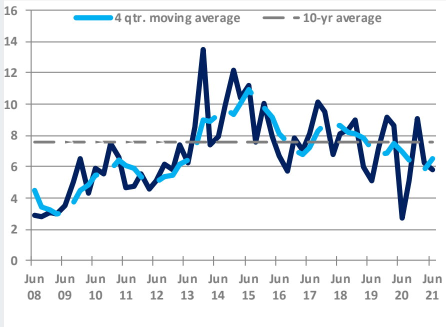
Industrials made up 46% of investment transactions in Q2 while all retail segments represented 15% of market activity in Q2. But across all sectors of the market, investment volumes continued to be lower than in Q1 (see Chart 6.2). This is an early view of Q2's transaction levels, however, and will subsequently be revised upwards in later data releases.

Central London offices traditionally dominate UK real estate investment representing 28% of the UK's real estate investment market over the last 20 years. Investment volumes, however, have been on a declining trend since December 2013 (see Chart 6.3). In Q1, its share of the UK's CRE investment market was 20%.

Transaction numbers across Central London represented a reduction from the levels achieved in Q1. Since the end of Q4 2020 the City of London has accounted for 50% of all Central London office transactions (see Chart 6.4). City yields have hardened even as rental values are drifting and vacancy rates increasing, as investors make a bet on the continued importance of the square mile in a post Brexit / post Covid world.

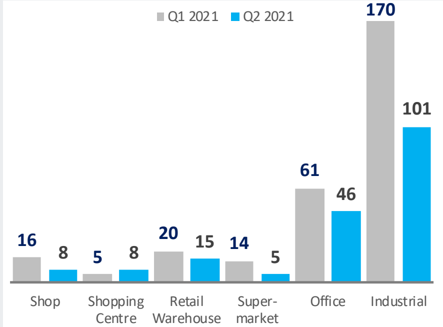
Investment in alternative real estate comprising Medical and Motor Trade facilities, Residential and Student accommodation, peaked at £16bn in the rolling 12-months to the end of March 2020. The pandemic has caused a reversal in this near 5-year trend of increased transaction levels. As the economy opens again, we expect real estate alternatives to become once again more popular (see Chart 6.5). Cluttons' is currently

6.1 All property investment volumes (£bn)



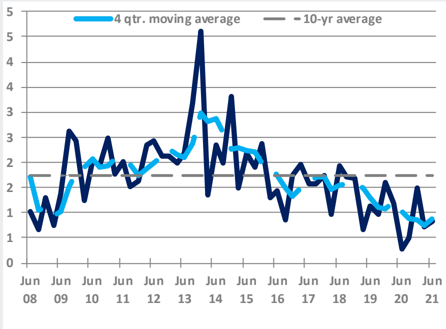
Source: Property Data, MSCI & APR, Jul 2021

6.2 2021 Investment transaction nos. (Q1 v. Q2)



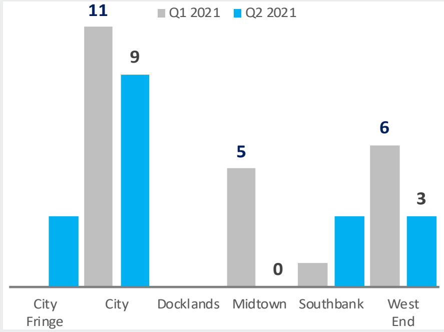
Source: Property Data, Jul 2021

6.3 Central London office investment volumes (£bn)



Source: Property Data, MSCI & APR, Jul 2021

6.4 Central London office Investment transaction nos. (Q1 v. Q2)



Source: Property Data, Jul 2021

involved in the sale of the York Biotech Campus, benefitting from a weighted average unexpired lease term of 25 years and RPI-linked rent reviews, at an asking price of £42.175m and a yield of 6.25%.

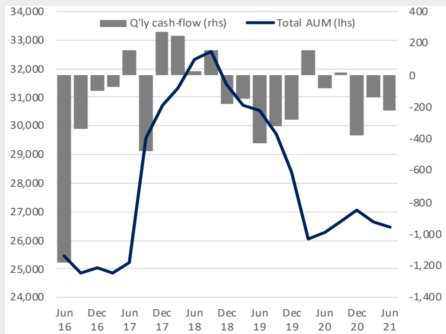
In the last five years, property funds have regularly faced demands for redemptions from retail investors. In 2016, the Brexit referendum resulted in the closure of open ended funds. And in the last two years, the lethargic performance of the UK economy and the continued uncertainties surrounding Brexit 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 has continued since Q4 last year (see Chart 6.6).

Finally, 17 months after its latest suspension, the £2.1 billion M&G Property Portfolio re-opened on 10th May 2021. Estimates are that investors had withdrawn £806m by the end of the month. Aviva Investors has recently announced the closure of its UK Property Fund, 14 months after dealing was suspended but warned that investors may have to wait up to two years before they receive the proceeds from the winding up.

6.5 Investment in alternatives (£bn)

Source: Property Data, Jul 2021

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



Source: Investment Association, Jul 2021

9. Outlook

May 2021's IPF consensus forecasts reflect an increasingly positive view on the outlook for UK real estate values as the sector recovers from the effects of pandemic lockdown. Total return forecasts for 2021 have been increased to 4.0% from 2.2% in February (see Chart 7.1). From 2022 onwards year-on-year total return forecasts range from 6.2% to 5.6% (see Chart 7.2). It would seem, however, that these forecasts were compiled before MSCI reported a strong outcome to Q2.

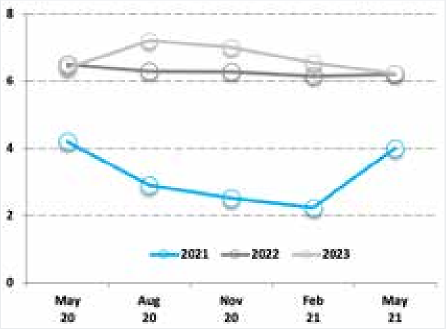
Respondents to the IPF Consensus forecasts continue to favour Industrials at the expense of Shops and Shopping Centres. There has, however, been a strong improvement in the prospects for Retail Warehouses (see Chart 7.3). This has been driven by the outperformance of retail parks in retailers' portfolios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

There continue to be a wide range of forecasts. Total return forecasts for 2021 range between +12.7% and -1.8%. The forecast range for 2022 is 17.9% with a maximum of 21.3% and a minimum of 3.4% (see Chart 7.4).

The MPC's economic forecasts noted above indicate that the reaction to the end of the third lockdown should be stronger than previously anticipated. Thereafter, the growth path of the economy is stronger in the short term but similar to May's outlook from the end of 2021. Consequently, the outlook for commercial property in 2021 has now strengthened.

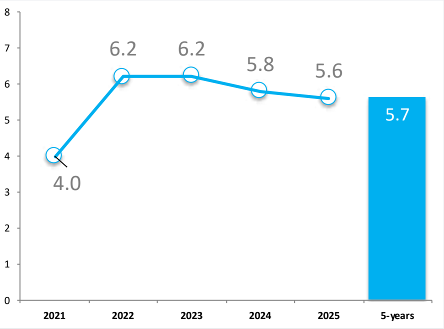
June 2021 is now expected to represent the bottom of the cycle for All Property rental values. Rental values should recover their pre-pandemic levels by the end of the 3-year forecast horizon.

7.1 IPF forecast evolution (May 20)



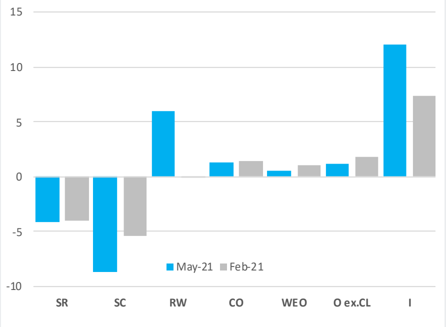
Source: IPF, May 2021

7.2 IPF All Property forecasts y-by-y (May 20)



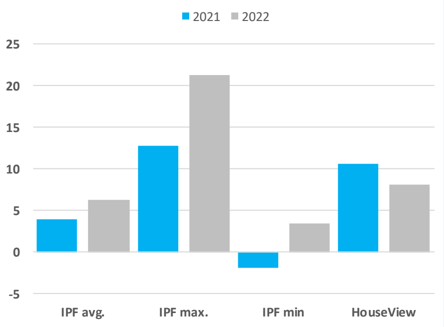
Source: IPF, May 2021

7.3 IPF sector forecasts May 21 v Feb 21



Source: IPF, May 2021

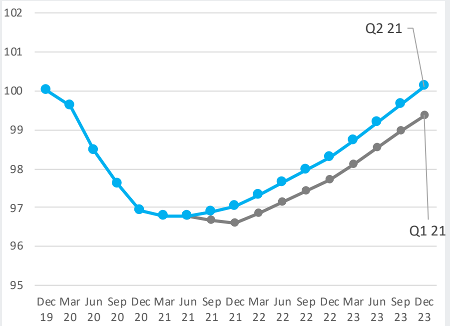
7.4 UK commercial total return forecasts



Source: IPF, May 2021

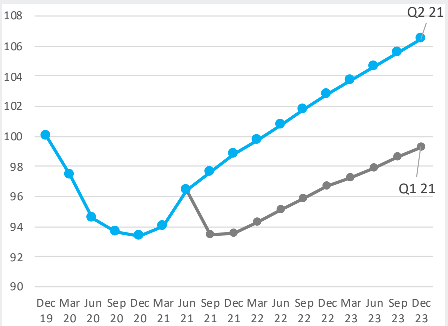
The support offered by continued low risk-free rates and the larger than average gilt – property yield gap suggests there is scope for some yield compression especially if rental growth surprises on the up-side. Capital values outperformed expectations in Q2 and are now expected to follow a more elevated path, recovering their pre-pandemic levels by the end of Q1 2022 (see Charts 7.4 & 7.5).

7.5 Rental value forecasts



Source: IPF, APR & Cluttons, Jul 2021

7.6 Capital value forecasts



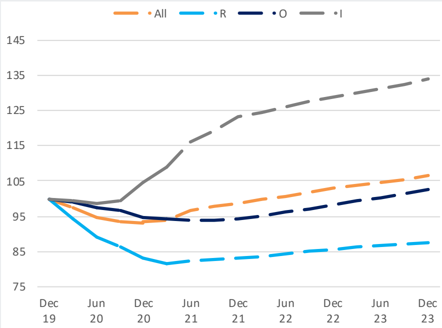
Source: IPF, APR & Cluttons, Jul 2021

10. Houseview

The central forecast from Cluttons' House View model has been revised to reflect the performance of the market so far in 2021 and the changing macro-economic forecasts. We continue to be more optimistic than the consensus view and expect capital values at the All Property level to improve for the remainder of the forecast period. Assuming that the UK successfully moves beyond Lockdown 3.0 and the economy remains open thereafter All Property total returns could now recover to 10% or more in 2021 and 8% in 2022 with an annualised average of 9% in the 3-years ending December 2023. However, the usual caveats regarding uncertainty surrounding this central forecast remain.

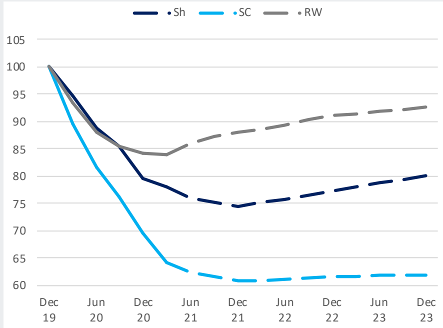
At the All Property level, we expect capital value growth to be positive. Market conditions have been improving throughout the first half of the year and we expect this trend to continue (see Charts 8.1 – 8.4). Retail assets have borne the brunt of the downturn, but we expect them to show some signs of stability in the remainder of the year. Industrials will provide upside protection from the downside risks inherent in holding offices and particularly retail (see Charts 8.5 & 8.6). If, however, affordability becomes an issue for logistic occupiers, especially in the most expensive locations, they will not be prepared to chase rents higher, and yields may de-rate.

8.1 3-sector capital value forecasts



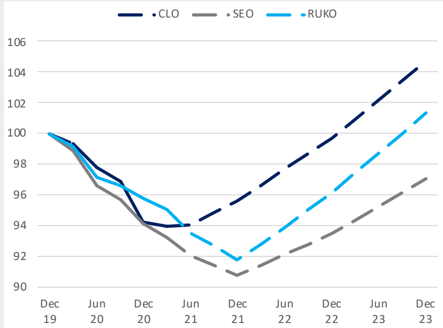
Source: IPF, APR & Cluttons, Jul 2021

8.2 Retail segments capital value forecasts



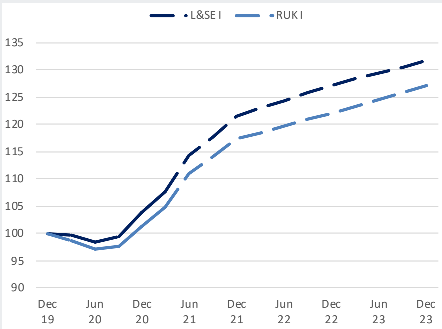
Source: IPF, APR & Cluttons, Jul 2021

8.3 Office segments capital value forecasts



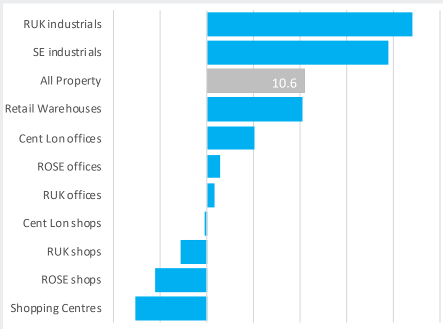
Source: IPF, APR & Cluttons, Jul 2021

8.4 Industrial segments capital value forecasts



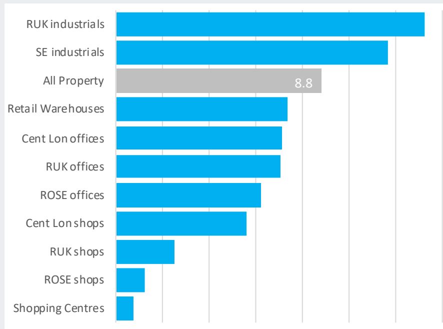
Source: IPF, APR & Cluttons, Jul 2021

8.5 Cluttons House View - 2021 relative total returns (%)



Source: IPF, APR & Cluttons, Jul 2021

8.6 Cluttons House View - 2021-2023 relative total returns (%)



Source: IPF, APR & Cluttons, Jul 2021

Despite the increasing popularity of investment in alternative CRE, performance monitoring is not as transparent as it could be. It is, however, possible to draw some inferences from appropriate real estate funds. The net asset value (NAV) of the Unite Student Accommodation Fund, which declined by 5% in the 12-months to the end of December 2020 has recovered 2% in the first half of 2021; and the NAV of Kames Target Healthcare Property Limited Partnership has risen 2% in 2021 have fallen by 1% in 2020.

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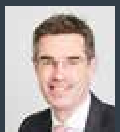
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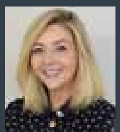
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