CLUTTONS
INVESTMENT MANAGEMENT

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Commercial property examiner

Quarter three | 2021

Contents

Foreword

In the Foreword to Q2's edition of this report, we commented on the outlook for inflation and concluded that any rise in year-on-year inflation above the MPC's 2% target would be temporary and that interest rates in all likelihood would stay below 0.5% until the end of 2023.

Inflation has now become the hot macro-economic topic of the moment, so before we move on to discussing the success or otherwise of the return to the office, a few more words on inflation seem appropriate.

Year on year CPI inflation has now risen to 3.1% as at the end of September and the debate as to whether current levels of inflation will be transitory or more permanent is still to be resolved. For the moment the ONS and MPC are continuing to explain the inflationary spike in terms of base effects, that is an increase to normal pricing levels after pandemic related falls. But it has become increasingly clear over the course of the last months that the causes may be more complex.

The current narrative explains growing levels of inflation as the result of supply chain failures. The Delta variant continues to force the closure of manufacturing facilities and ports, notably in Vietnam and China, resulting in a shortage of critical components and sub-components. Responding to the shortage of computer chips, Toyota cut manufacturing at 14 factories and reduced output by 40%. Incidentally, on the day of the announcement, Toyota shares closed 4.4% down.

More problematically for the drive to net zero, is the realisation that part of the problem has been the pressure to move away from the mining of coal and its use in electricity generation. Closures and floods of coal mines in China limited the supply of coke, essential in the manufacture of silicon which is used to produce the silicon wafers used in the manufacture of computer chips.

Natural gas has been used as a greener alternative to coal as nations pivot towards renewable energy such as wind, solar, nuclear or hydro power. A shortage of wind in the UK this autumn has increased the domestic demand for natural gas at a time when stored gas supplies have been run down and demand is increasing across the world, particularly in China.

The world economy could be facing a decade of high energy prices. The consequences will cascade through the economy in some unforeseen ways. High energy prices in the UK have resulted in the closure of fertiliser plants and a reduction in the availability of CO2, a by-product, that is used by the food and drinks industry for canning and packaging, stunning animals for slaughter, carbonating drinks and decaffeinating coffee.

Brexit often seems to be rooted in the nostalgia felt by parts of the UK population for the past. Until recently, the most notable Brexit success had been the return of the navy-blue UK passport. To this can now be added a return to imperial measures as retailers are to be permitted to sell goods measured in pounds and ounces.

A further indication of a possible return to the 1970's was the statement in Parliament by Kwasi Kwarteng, Secretary of State for Business, Energy and Industrial Strategy, referencing the three-day week of January and February 1974 implemented by the then Prime Minister, Edward Heath. Office workers are, of course, already benefitting or suffering from a 3-day week but for the moment, the causes are not a shortage of energy for the generation of electricity.

Monday, 6th September marked the end of the summer holidays, the return to school, the last day of the Oval Test Match and supposedly a mass post-pandemic return to the office that has not so far materialised despite exhortations by some CEO's and politicians. Google search data and TfL passenger transport numbers suggest that activity remains at least 30-40% below pre-pandemic levels.

In a bid to encourage office staff to return to the office, members of the Government have criticised civil servants for working from home and even suggested that employees should follow the example of workers who continued to commute to the City during the Blitz. They seem to have conveniently forgotten about modern day connectivity utilising Wi-Fi and the internet. The problem is to reach a balance between improved lifestyles that result from working from home and the collateral damage to the shops, cafes, bars and dry-cleaners that serve city centre office workers.

Goldman Sachs' CEO is on the record as calling working from home an "aberration" and has pushed for a widespread return. Similarly, the CEO's at JP Morgan and Morgan Stanley have called on staff to return. Goldman Sachs, which had sought to entice staff with free canteen food and ice cream, had 55-60% of its 6,000 UK staff coming into its UK offices by the end of September. The food offer has reportedly been rescinded recently in an attempt to re-vitalise local food and beverage outlets.

Earlier in the year, PwC announced that it was to allow its 22,000 staff greater flexibility for post-pandemic working and embed a hybrid working model which aligns with PwC's Net Zero commitment. Staff may continue working from home but there is an expectation that people will spend an average of 40-60% of their time co-located with colleagues, either in PwC offices or at client sites.

Occupancy levels are slowly increasing. Research from Remit Consulting into the number of office-based staff working from their desks published earlier in October, shows that the average office attendance exceeded 20% for the first time since the UK's lockdown restrictions were lifted. However, it seems likely that central business districts will not witness full occupancy for a long time.

Early indications of post-pandemic office work suggest a hybrid model which allows working from home and where Tuesday, Wednesday and Thursday are the busiest days. One-third of workplace activities in the UK can be carried out remotely without any loss of productivity, which will result in an increase in home/hybrid working and lessen demand for office space in the short to medium term.

The level of home or hybrid working maintained longer term will differ by industry. Finance and insurance have the highest potential, with three-quarters of time spent on activities that can be done remotely. But 'can' does not mean 'should' - organisations will need to understand their value creation models, and work with employees, to identify which activities should be done remotely.

The appeal and advantages of city centre office buildings will be reaffirmed in the coming 24 months as GDP and employment return to pre-pandemic levels. The agglomeration benefits of cities are immeasurable and mass relocation elsewhere is unlikely owing to cost implications and lack of optimal locations. A survey for the BBC by YouGov found that 79% of business leaders say it is likely that people will never return to offices at the same rate as before the pandemic. But in the same survey more than 60% of respondents thought that younger members of staff would struggle to develop their careers without face-to-face meetings and mentoring.

Market developments will be driven by lease events. Lease breaks and expiries will force decisions to be made about the amount of space required, its location and quality. But early indications are that there will be a flight to quality with strong demand for mixed use collaborative space for social and educational purposes. Building owners will be expected to provide flexi space allowing occupiers to expand and contract their footprint at short notice.

1. Key take aways

Growing numbers of Covid-19 infections slowed the economic recovery in Q3 but the success of the vaccination program limited the number of hospitalisations and fatalities. UK GDP is projected to recover further over the remainder of the year, reaching its pre-pandemic level in Q4 2021.

Inflationary pressures are building through higher fuel prices and supply chain failures, but the Bank of England are persisting in the view that this is transitory, and that CPI inflation will fall back to its 2% target by the end of 2023. Markets are now pricing in a rate rise to 0.25% by the end of the year and 0.5% in Q1 2022.

All Property total returns continue to improve at both the 3-month and 12-month horizon. In Q3, All Property total returns increased to 4.6% and in the 12-months to the end of September 2021, All Property total returns increased to 13.4%.

All Property total returns are likely to average 14% or more over the whole of 2021 and could reach 9% in 2022 with an annualised average of 9% in the 3-years ending December 2023.

2. Summary

The IMF's projection for global economic output has been revised very slightly downwards to 5.9% due to supply disruptions being experienced by advanced economies.

Having slipped back in July, the UK economy is estimated to have grown by 0.4% in August 2021 and is now just 0.8% below the pre-Coronavirus pandemic levels seen in February 2020.

UK GDP is projected to recover further over the remainder of the year, reaching its pre-pandemic level in Q4 2021. Thereafter, the pace of GDP growth is expected to slow towards more normal rates, partly reflecting the gradual tightening of fiscal policy through higher taxes and spending cuts.

CPI inflation has fallen to 3.1% in the 12 months to September from 3.2% in August but inflation is expected to rise further to 4% in Q4. The MPC currently expects that elevated global and domestic cost pressures will prove transitory and that CPI inflation will fall back to close to the 2% target at the end of its forecast period.

Markets are now pricing in a rate rise to 0.25% by the end of the year and 0.5% in Q1 2022.

UK REIT share prices grew by 3.9% in Q3 and outperformed the wider all share market indices. The top performers in Q3 were Segro, the UK's largest REIT by market capitalisation with a portfolio of logistics assets across the UK and Europe, and Big Box, which develops and invests in logistics assets of more than 500,000 sq ft.

The current property initial / gilt yield gap is 3.8% having decreased by less than 27 bps over the course of Q3. It is now below the 10-year average but remains high by long run historical standards.

In Q3 2021, All Property total returns as recorded by the MSCI Monthly Index increased to 4.6% from 3.9% in Q2.

13.4%

All Property total returns increased over the 12 months to September 2021, up from 9.1% over the 12 months to June 2021

14%+

Cluttons House View is showing a strong recovery in All Property total returns for 2021

In the 12-months to the end of September 2021, All Property total returns increased to 13.4% from 9.1% in the 12-months ending June 2020 as the post-pandemic recovery gathers pace.

All Property investment volumes, represented by the current value of investment transactions adjusted for capital growth, increased by 35% in Q2 compared to Q1 and were 10% above their long run average. Preliminary estimates suggest that investment volumes fell sharply in Q3 but the numbers are likely to be revised upwards in the coming months.

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 7.5% from 4.0% in May.

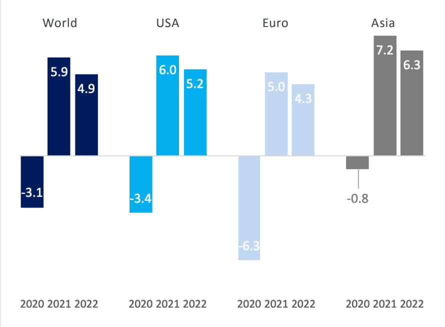
Cluttons' House View has been revised to reflect the performance of the market so far in 2021 and the changing macro-economic forecasts. We continue to be more optimistic than the consensus view. Assuming the impact of Covid-19 on the UK economy is waning and there are no further disruptions from new variants of the virus, All Property total returns could now recover to 14% or more in 2021.

3. The World economy

In October's edition of World Economic Outlook, the IMF records that the global economy is projected to grow by 5.9% in 2021 and 4.9% in 2022. This is 0.1% lower for 2021 than the forecast contained in the July edition. The downward revision for 2021 reflects a downgrade for advanced economies, due to supply disruptions. Low-income developing countries are suffering from worsening pandemic dynamics, partially offset by stronger near-term prospects among some commodity-exporting emerging market and developing economies. Rapid spread of Delta and the threat of new variants have increased uncertainty about how quickly the pandemic can be overcome (see Chart 1.1).

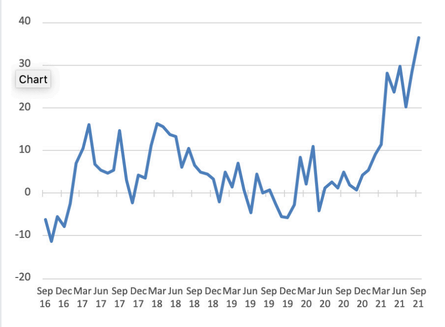
Pandemic outbreaks in critical links of global supply chains have resulted in longer than expected supply disruptions, feeding inflation in many countries. China's determination to stamp out Covid has meant even a small number of cases can cause major disruptions to trade. Part of the world's third-busiest container port at Ningbo was closed for two weeks after a single dockworker was found to have the Delta variant. Earlier this year, wharves in Shenzhen were idled after the discovery of a handful of coronavirus cases. The cost of sending a container from Asia to Europe is about 10 times higher than in May, while the cost from Shanghai to Los Angeles has grown more than sixfold. Increasing delivery times are illustrated by data captured by the Federal Reserve Bank of New York in its Empire State Manufacturing Survey (see Chart 1.2)

1.1 Growth projections by region



Source: Source: IMF, Jul 2021

1.2 New York delivery time index



Source: FRED, Sep 2021

4. The UK economy

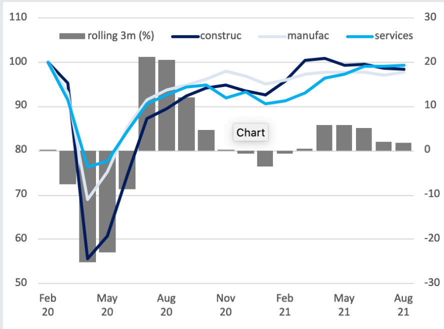
All pandemic restrictions on economic activity were finally lifted in July but the pace of the recovery is slowing. Having slipped back in July, the UK economy is estimated to have grown by 0.4% in August 2021 and by 1.7% in the three months to August. Output remains 0.8% below the pre-Coronavirus pandemic levels seen in February 2020. Shortages of materials including steel, concrete, timber and glass and higher prices hit the construction sector, with output falling by 0.2% in August after a 1% drop in July (see Chart 1.3).

Services grew by 0.3% in August 2021, but activity remains 0.6% below pre-pandemic levels. Output in consumer-facing services increased by 1.2% in August 2021. Post-lockdown consumers once again returned to bars and restaurants, festivals, and 'staycation' holidays. Accommodation and food service activities were the main contributors to services' growth in August 2021, growing by 10.3%. There was particularly strong growth in accommodation, which grew by 22.9% boosted by hotels and campsites, and growth of 5.9% in food and beverage service activities. Travel agency, tour operator and other related reservation services grew by 47.9%. Overall, consumer-facing services are 4.7% below their pre-pandemic levels, while all other services are now 0.4% above them (see Chart 1.4).

The manufacturing sector grew by 0.5% in August 2021, following a 0.6% fall in July 2021 with output in 9 out of the 13 manufacturing sub-sectors increasing. Most of the contribution to manufacturing growth came from a 6.6% increase in the manufacture of motor vehicles, as the car industry recovers from the global microchip shortage which disrupted production. However, output in the manufacture of motor vehicles remains 14.5% below its February 2021 peak. Prospective purchasers unable to secure a new model off the forecourt have been turning to nearly new and used vehicles. Sales and repairs of motor vehicles are now close to their pre-pandemic levels (see Chart 1.5).

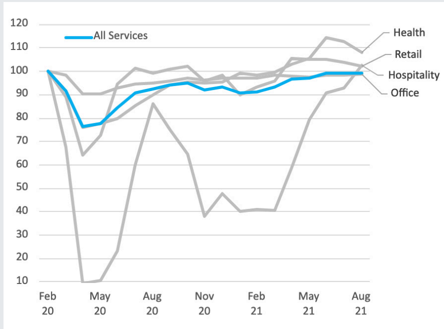
The Monetary Policy Committee's (MPC's) UK GDP forecasts contained in the latest Monetary Policy Report published in August expect GDP to grow by around 3% in Q3. This is somewhat weaker than expected in the May Report as the economy experienced a small negative impact coming from recent developments in the pandemic. Covid cases rose after all activity restrictions were lifted and there was a sharp rise in the number of people being asked to temporarily self-isolate. UK GDP is projected to recover further over the remainder of the year, reaching its pre-pandemic level in Q4 2021, with demand growth boosted by a waning impact from Covid. Further out, the pace of GDP growth is expected to slow towards more normal rates, partly reflecting the gradual tightening of fiscal policy through higher taxes and spending cuts (see Chart 1.6).

1.3 UK economic growth



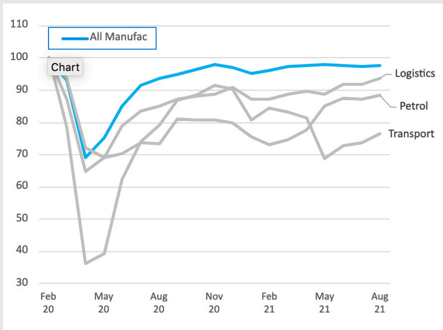
Source: ONS, Oct 2021

1.4 UK service sector output



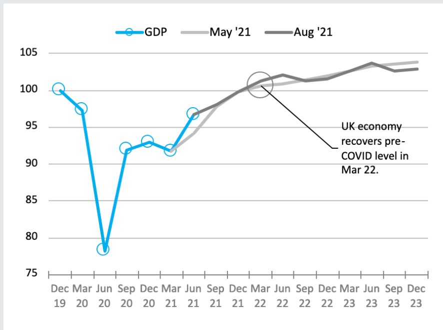
Source: ONS, Oct 2021

1.5 UK industrial sector output



Source: ONS, Oct 2021

1.6 MPC economic projections



Source: Bank of England, Aug 2021

5. Other economic indicators

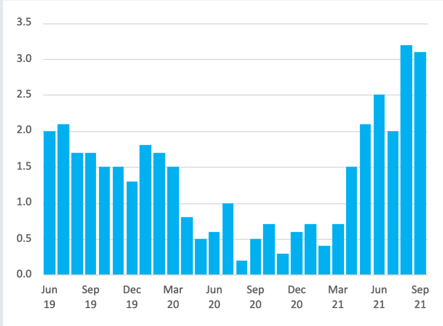
Year on year CPI inflation decreased to 3.1% in September from 3.2% in August. The largest upward contribution to the rise in prices came from transport costs. The effect of negative contributions from last year's price falls dropping out of the 12-month CPI growth rate and being replaced by positive contributions from higher prices continues. This "base effect" can be expected to place continued upward pressures on headline inflation for the next few months. Added to this will be further upward price pressures arising from the global supply chain problem (see Chart 2.1).

> "A shortage of new cars and a pandemic preference for private over public transport have increased used car prices by 2.9% in September and by 21.8% since April 2021."

Transport cost inflation has been driven by increases in the price of motor fuels. Average petrol prices of 134.9p per litre compare with 113.3p per litre a year earlier. A shortage of new cars and a pandemic preference for private over public transport have increased used car prices by 2.9% in September and by 21.8% since April 2021. In August last year the governments "Eat Out to Help Out" scheme offered diners a 50% discount every Monday, Tuesday, and Wednesday. Also, VAT rates for the hospitality sector were reduced to 5%. The scheme ended in September last year but some outlets continued to offer discounts (see Chart 2.2).

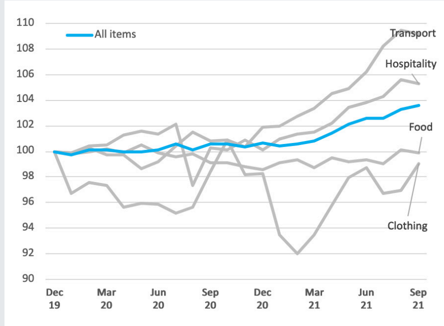
The MPC forecasts that the UK economy will experience a more pronounced period of above-target inflation in the near term than hitherto expected. August's Monetary Policy Report projected that CPI inflation would rise to 4% in Q4 2021, owing largely to developments in energy and other goods prices. The report's central expectation was that current elevated global and domestic cost pressures would prove transitory and that CPI inflation would fall back to close to the 2% target at the end of the forecast period (see Chart 2.3).

2.1 CPI inflation



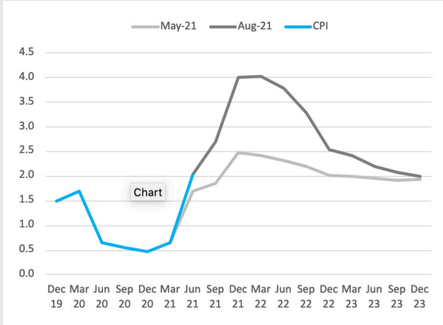
Source: ONS, Sep 2021

2.2 CPI by item



Source: ONS, Sep 2021

2.3 MPC inflation projections



Source: Bank of England, Aug 2021

Speaking at the end of September, Andrew Bailey, Governor of the Bank of England, again confirmed the view that price pressures will be transient. Although recent evidence appears to have strengthened the case for a tightening of policy, substantial uncertainties remain and the MPC is monitoring the situation closely..

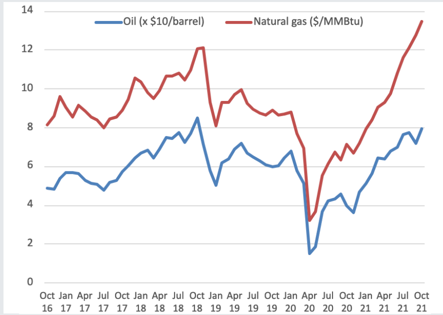
A subsequent speech by the Governor to the G30 group of central bankers in October saying that he is concerned about a rise in medium term inflation expectations, has been interpreted as a signal that rates could rise to 0.25% by the end of the year and 0.5% in Q1 2022.

The current bout of raised levels of inflation has been caused partly by supply chain constraints. The price of oil and natural gas has risen sharply in recent months (see Chart 2.4). During the pandemic, businesses across many sectors reduced inventories. When economies opened again a rapid expansion in demand created shortages.

This was compounded in the UK by a shortage of workers, particularly HGV drivers, which has left KFC without chicken, McDonald's without milkshakes and filling stations without petrol.

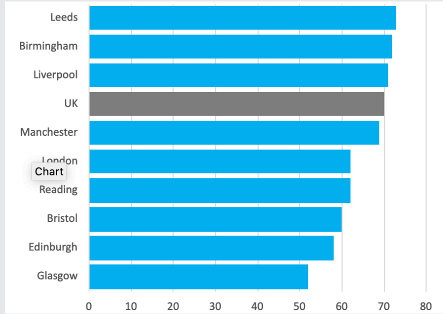
Google's Community Mobility Reports show movement trends by region, across different categories of places such as retail, groceries, transport hubs and workplaces. The data shows how visitors to categorized places change when compared to a baseline day. A baseline day represents a normal value for that day of the week and is the median value from the 5-week period form 3rd January to 6th February. At the end of Q3 2021, the number of searches for workplace destinations in the UK's biggest business centres and conurbations reached 70% of pre-pandemic levels across the UK (see Chart 2.5). The Google data does show a sharp decline in City of London workplace searches on Monday but attendance on Friday is more widespread than other data suggests (see Chart 2.6).

2.4 Energy prices



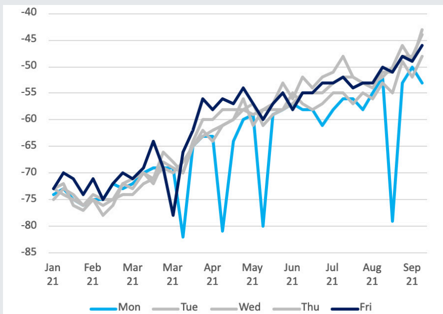
Source: indexmundi.com

2.5 Workplace searches at end Sep 2021



Source: Google , Sep 2021

2.6 City of London workplace searches by day



Source: Google , Sep 2021

6. Interest rates and asset yields

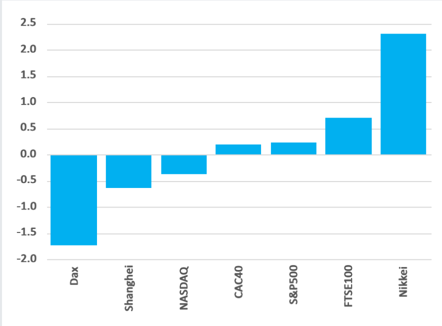
In Q3, stock markets across the world stalled amid concerns regarding inflation and the easing of central bank support. The MSCI World Index with large and mid-cap representation across 23 developed markets gained 0.1% in Q3 but is 13.7% ahead in the year to date and up 29.4% in the last 12 months. There was little change in the levels of US and Euro markets over Q3. In the US, utilities benefitted from the sharp increase in energy prices. However, in Europe and the UK, the relationship between the share price of energy stocks and underlying prices is complicated by price caps. In the UK, nine of the smaller energy suppliers ceased trading as the price cap prevented them from passing on higher gas prices to consumers. In China, markets suffered a sell off driven by regulatory crackdowns on the tech sector; fears over the fall out from the real estate giant, Evergrande; and energy rationing and power cuts (see Chart 3.1).

UK REIT share prices grew by 3.9% in Q3 and outperformed the wider all share market indices. The top performers in Q3 were Segro, the UK's largest REIT by market capitalisation with a portfolio of logistics assets across the UK and Europe, and Big Box, which develops and invests in logistics assets of more than 500,000 sq ft. Shaftesbury, with its portfolio of central London village shops, announced that West End footfall had increased to 50-60% of pre-pandemic levels footfall. Its share price rose 7% in Q3. Shares in Shopping Centre specialist, Hammerson, fell 13% in Q3 as it reported a pre-tax loss of £354m in the six months to June and a 6.4% fall in the value of its portfolio (see Chart 3.2).

Risk free assets continue to yield close to zero. However, recent inflationary pressures on the economy and the forthcoming expiry of the current programme of asset purchases in December, have caused the Bank of England to indicate that the appropriate response, if needed, would involve a rise in the Bank Rate. In the UK, gilt yields softened by 23 bps to 0.99% from 0.76% over the course of Q3. The yield on the 5-15 year gilt index has since softened further to 1.13% (see Chart 3.3).

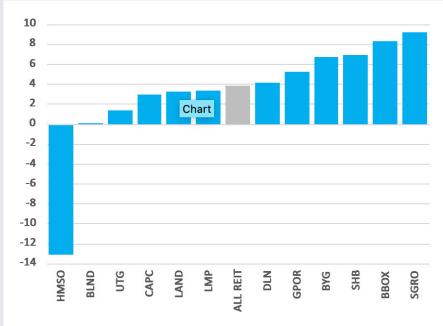
Market expectations of future interest rates have increased by 20-25 bps along the length of the yield curve in reaction to a more hawkish view on inflation risks. The difference between the yield on 1 year and 5 year gilts has risen to 44 bp, a level last seen in early 2014 (see Chart 3.4). Context is important here. In the 10-years before the GFC, the Bank Rate averaged

3.1 World stock markets Q3 2021



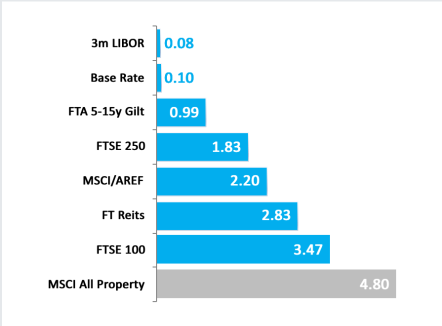
Source: Yahoo Finance, Sep 2021

3.2 UK Reit prices movement Q3 2021



Source: Yahoo Finance, Sep 2021

3.3 UK asset yields Q3 2021



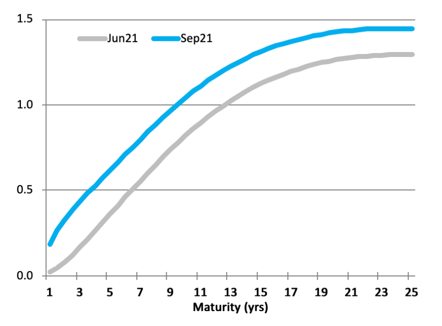
Source: Yahoo Finance, Sep 2021

5%; today, markets and commentators are excitedly predicting a rate of 0.5% by the end of the first quarter of 2022.

> "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."

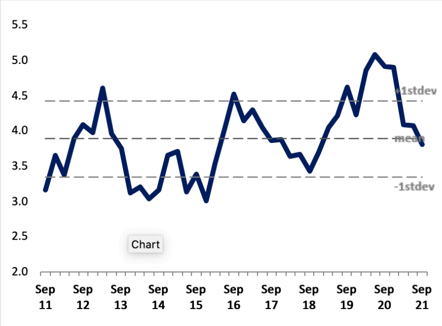
The current property initial / gilt yield gap is 3.8% having decreased by 27 bps over the course of Q3 as property yields hardened while gilt yields moved the other way. At this level, the yield gap is now below the 10-year average (see Chart 3.5) but remains high by long run historical standards. We 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. Lower yielding industrial and logistics assets need to benefit from continued growth in rental values. Generally for the retail and office sectors the yield gap is much higher.

3.4 Gilt yield curve (%)



Source: Bank of England, Sep 2021

3.5 Property IY - Gilt yield gap



Source: MSCI & Bank of England, Sep 2021

7. Commercial property market performance

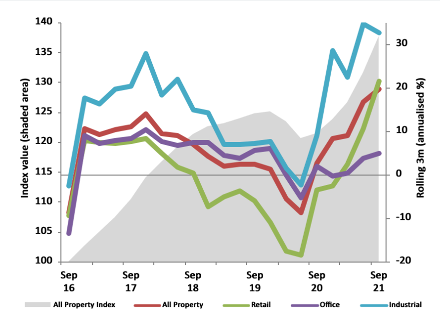
The UK's commercial real estate market continues to be driven exclusively by the performance of industrials.

In Q3 2021, All Property total returns increased to 4.6% from 3.9% in Q2. This was the highest quarterly return generated at the All-Property level since September 2014. Capital growth was 3.3% in Q3 compared to 2.6% in Q2. Property equivalent yields hardened by 22 bps and contributed a 3.0% uplift to valuations. All Property rental value growth increased to 0.6% in Q3 from 0.4% in Q2. Q3 income returns amounted to 1.3% (see Charts 4.1 & 4.4).

Over the course of the third quarter, office rental values increased by 0.3% while industrial rental value growth of 1.8% remained strongly positive. However, rental values in all retail segments fell further (see Charts 4.2 & 4.5).

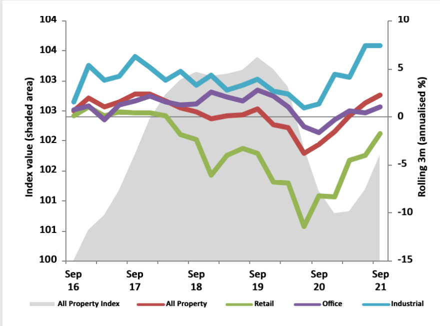
In the 12-months to the end of September 2021, All Property total returns increased to 13.4% from 9.1% in the 12-months ending June 2020 as the post-pandemic recovery gathers pace. Year-on-year capital growth was 7.5% in September compared to 3.4% in June. Property equivalent yields hardened by 55 bps in the 12-months to September and contributed a 7.6% uplift to valuations. All Property rental values increased year-on-year by 0.6% and income return amounted to 5.5%.

4.1 Total returns by sector



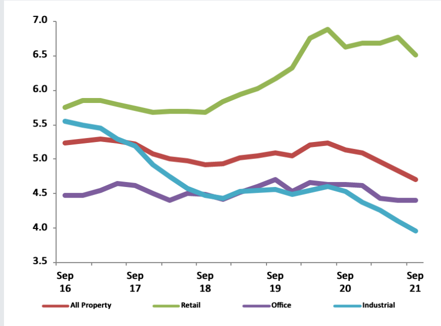
Source: MSCI, Oct 2021

4.2 MRV growth by sector



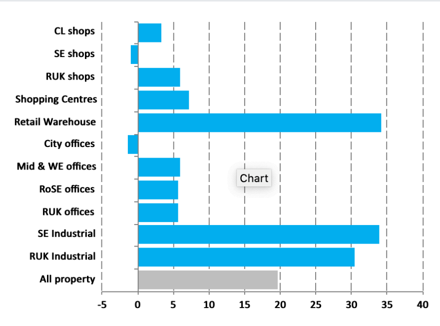
Source: MSCI, Oct 2021

4.3 Initial yield by sector



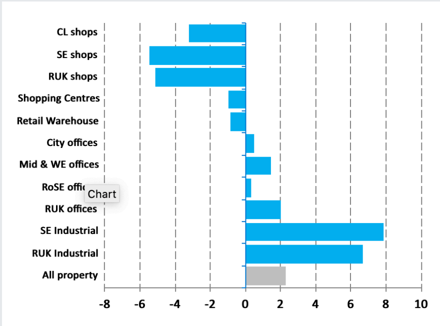
Source: MSCI, Oct 2021

4.4 Total returns by segment (Q3 annualised)



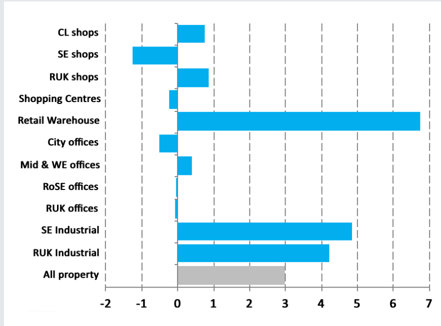
Source: MSCI, Oct 2021

4.5 MRV growth by segment (Q3 annualised)



Source: MSCI, Oct 2021

4.6 Yield impact (Q3)



Source: MSCI, Oct 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 for industrials, however, is driving rental growth of 6% year-on-year and 7% at a quarterly annualised rate in Q3. 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 Q3 2021.

Factor investing or "smart beta" involves targeting quantifiable characteristics or "factors" that can explain differences in asset returns. This smart beta approach can be used to identify characteristics of real estate that drive out-performance and identify new asset allocation

5.1 Total returns

	Sep	3m	6m	12m
All Property	1.9	4.6	8.7	13.4
Retail	2.1	5.0	7.7	7.7
Office	0.5	1.2	2.1	2.2
Industrial	3.1	7.3	15.7	29.6
Annualised				
All Property	25.7	19.7	18.2	13.4
Retail	28.6	21.5	15.9	7.7
Office	5.9	4.9	4.3	2.2
Industrial	43.5	32.8	33.8	29.6

Source: MSCI

5.2 Capital growth

	Sep	3m	6m	12m
All Property	1.5	3.3	6.0	7.5
Retail	1.6	3.2	4.0	0.3
Office	0.1	0.0	-0.3	-2.7
Industrial	2.7	6.2	13.3	24.0
Annualised				
All Property	19.6	13.8	12.3	7.5
Retail	20.3	13.5	8.1	0.3
Office	1.0	0.0	-0.6	-2.7
Industrial	37.8	27.4	28.3	24.0

Source: MSCI

5.3 Income return

	Sep	3m	6m	12m
All Property	0.4	1.3	2.6	5.5
Retail	0.6	1.7	3.6	7.4
Office	0.4	1.2	2.5	5.0
Industrial	0.3	1.1	2.2	4.6
Annualised				
All Property	5.2	5.2	5.3	5.5
Retail	7.0	7.2	7.2	7.4
Office	4.9	4.9	4.9	5.0
Industrial	4.3	4.3	4.4	4.6

Source: MSCI

5.4 ERV growth

	Sep	3m	6m	12m
All Property	0.3	0.6	0.9	0.6
Retail	-0.2	-0.4	-1.5	-4.7
Office	0.2	0.3	0.4	0.4
Industrial	0.8	1.8	3.7	5.9
Annualised				
All Property	3.1	2.3	1.9	0.6
Retail	-2.9	-1.8	-2.9	-4.7
Office	2.1	1.0	0.7	0.4
Industrial	10.2	7.5	7.5	5.9

Source: MSCI

5.5 Net initial yield

	Sep	3m	6m	12m
All Property	4.7	4.8	5.0	5.1
Retail	6.5	6.8	6.7	6.6
Office	4.4	4.4	4.4	4.6
Industrial	4.0	4.1	4.3	4.5

Source: MSCI

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.

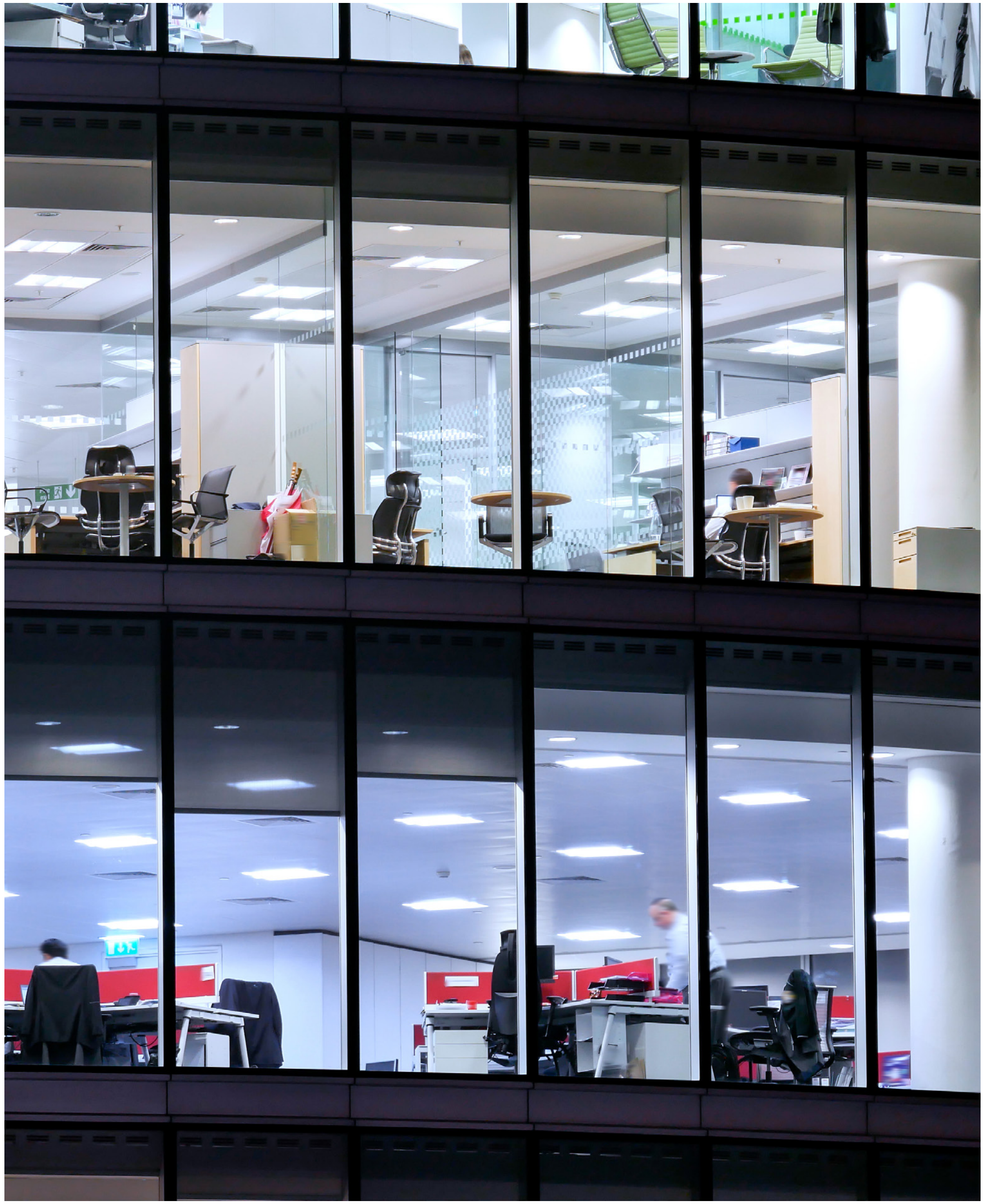
In Table 5.6, we have adopted the factor approach to real estate by segmenting the market firstly by use and secondly by a key characteristic i.e. yield, rent or lease length. The numbers presented are the 3-month total return relative to the MSCI All Property average for Q2 2021. A heat map has been 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, all of the Shop and Shopping Centre segments are in negative territory and the Industrial segments are universally out-performing. Prime low yield and long lease shops are the best retail strategies but their performance relative to the whole market has now turned negative. And the relative performance of the Retail Warehouse market continues to improve. All office strategies across the Central London, South East and Rest of UK markets have now turned negative. Questions surrounding the future demand for space in a post-Covid business environment hang over the office market.

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	-1.8	-4.4	-3.6	-1.8	-0.9	-4.7
Shopping Centres	-3.9	-4.4	-4.8	-3.9	-3.4	-6.0
Retail Warehouses	0.0	0.3	-0.4	0.0	0.7	-0.6
Central London offices	-1.4	-2.9	-1.6	-1.4	-0.3	-2.8
RoSe offices	-1.5	-3.4	-2.5	-1.5	-1.3	-3.3
RUK offices	-1.7	-4.6	-3.0	-1.7	-1.4	-3.8
Industrials	3.8	4.4	4.4	3.8	3.3	4.5

Source: MSCI, Jul 2021



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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. A re-surgent economy following the easing of lockdown restrictions and a strong performance by commercial real estate in the year to date 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, increased by 35% in Q2 compared to Q1 and were 10% above their long run average. Preliminary estimates suggest that investment volumes fell sharply in Q3 but the numbers are likely to be revised upwards in the coming months. Nevertheless, Q3's numbers are 5% higher than Q3 2020 when the investment market started to wake up from its pandemic hibernation (see Chart 6.1).

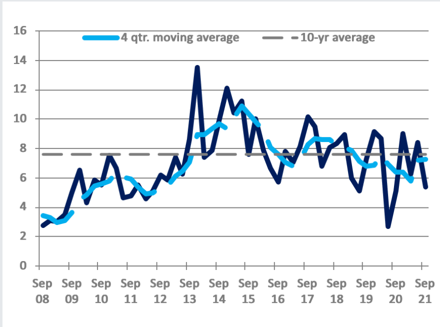
Industrials made up 39% of investment transactions in Q3 while all retail segments represented 19% of market activity. But across all sectors of the market, investment volumes continued to be lower than in Q2 (see Chart 6.2). As noted above, this is an early view of Q3's transaction levels, however, and will subsequently be revised upwards in later data releases.

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 caused a reversal in this near 5-year trend of increased transaction levels but as the economy opens up again, we expect real estate alternatives to become once again more popular In 2021. Alternatives are trading at the same level as the retail sector, with both sectors representing 17% of all transactions. (see Chart 6.2).

Central London offices traditionally dominate UK real estate investment representing 28% of the UK's real estate investment market over the last 20 years. Investment volumes, however, have been on a declining trend since December 2013 (see Chart 6.3). In Q3, its share of the UK's CRE investment market was 22%.

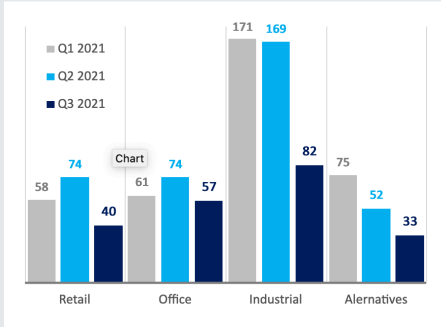
Transaction numbers across Central London maintained the levels achieved in Q2. Since the end of Q4 2020 the City of London has accounted for 42% of all Central London office transactions while the West End represents 29% of such transactions (see Chart 6.4). Since the start of the year, the yield on the MSCI index for City offices has hardened by 12 bps although rental values are drifting and vacancy rates increasing.

6.1 All property investment volumes (£bn)



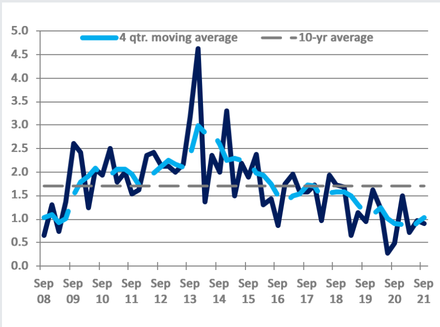
Source: Property Data, MSCI & APR, Sep 2021

6.2 2021 Investment transaction nos. by quarter



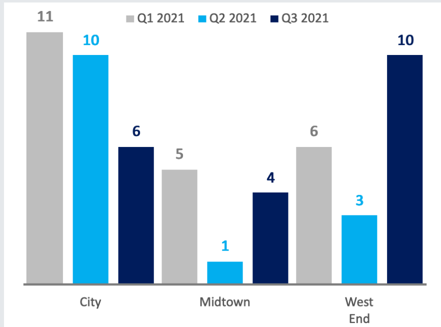
Source: Property Data, Sep 2021

6.3 Central London office investment volumes (£bn)



Source: Property Data, MSCI & APR, Sep 2021

6.4 Central London office Investment transaction nos. by quarter



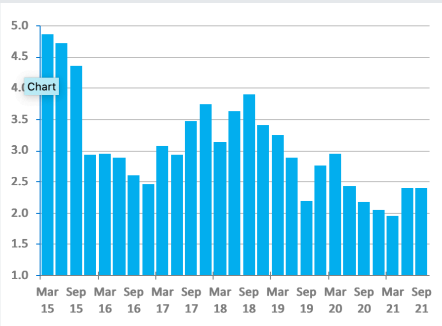
Source: Property Data, Sep 2021

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

The fundamentals underpinning the office investment market are occupier demand and the letting market. Lettings of both Central London offices and UK regional offices are at substantially lower levels than those prevailing before the pandemic. Central London office letting markets are showing signs of recovery; 60% more space was let in Q3 2021 than in Q3 2020. But lettings remain 20% below their quarterly average. Regional office lettings in Q3 were 62% below their long run average (see Chart 6.6). Annecdotally, demand remains firm for prime space whilst secondary accommodation is proving harder to let.

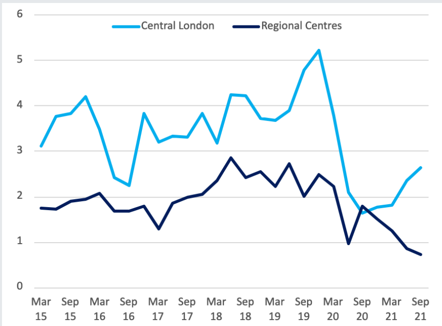
In the last five years, property funds have regularly faced demands for redemptions from retail investors. In 2016, the Brexit referendum resulted in the closure of open ended funds. And in the last two years, the lethargic performance of the UK economy and the continued uncertainties surrounding Brexit have resulted in an almost continuous outflow of money from open-ended property funds. Open-ended property funds that were once again closed to redemptions in Q1 2020 have mainly re-opened. Data to the end of August hints that the heavy demand for redemptions since October last year may be changing (see Chart 6.7).

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



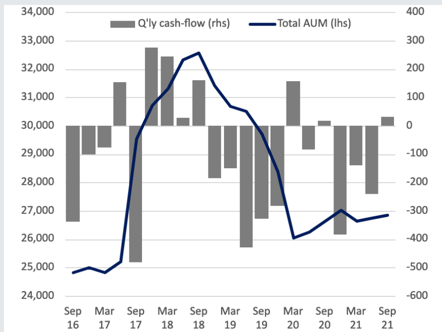
Source: Property Data, Sep 2021

6.6 Office lettings (m sf.)



Source: EGi, Sep 2021

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



Source: Investment Association, Sep 2021

9. Outlook

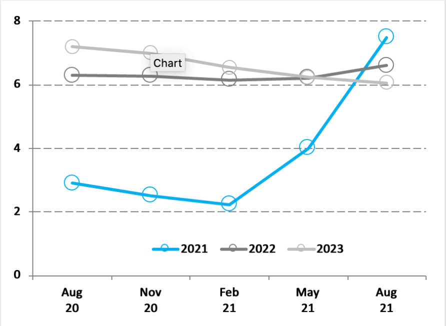
August's IPF consensus forecasts reflect an increasingly positive view on the outlook for UK real estate values as the sector recovers from the effects of pandemic lockdown. Total return forecasts for 2021 have been increased to 7.5% from 4.0% in May (see Chart 7.1). From 2022 onwards, year-on-year total return forecasts range from 6.6% to 6.1% (see Chart 7.2). Nevertheless, it would seem that these forecasts do not adequately reflect the momentum driving the market where total returns are 11.1% in the year to date and 13.4% in the 12ms to the end of September.

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

There continues to be a wide range of forecasts. Total return forecasts for 2021 range between +12.5% and +1.2%. The forecast range for 2022 is 15.2% with a maximum of 18.6% and a minimum of 3.4% (see Chart 7.4).

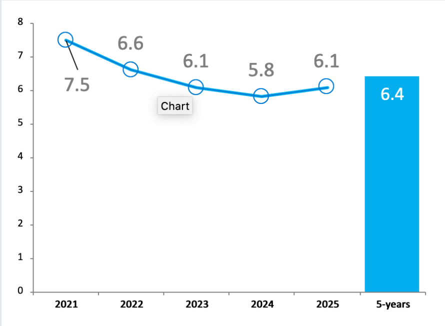
The MPC's latest economic forecasts noted above are very similar in outcome to those produced three months earlier. However, the strength of the commercial property market's post-pandemic recovery has surprised on the upside and the forecast path for rental and capital values reflects the strong numbers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

7.1 IPF forecast evolution (Aug 20)



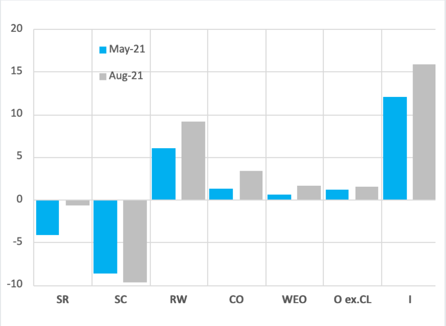
Source: IPF, May 2021

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



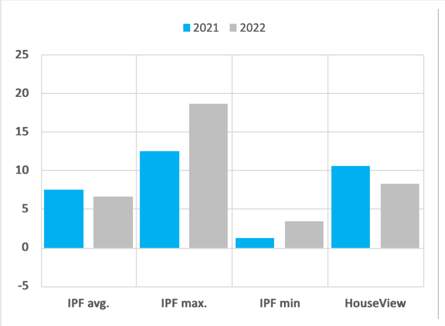
Source: IPF, May 2021

7.3 IPF 2021 forecasts by sector Aug 21 v May 21



Source: IPF, May 2021

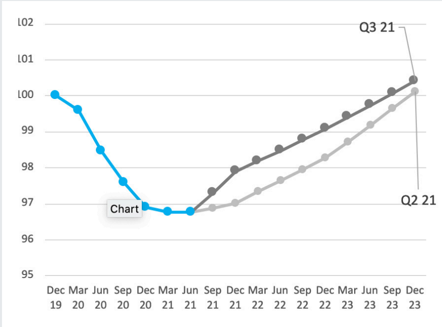
7.4 UK commercial total return forecasts



Source: IPF, Aug 2021

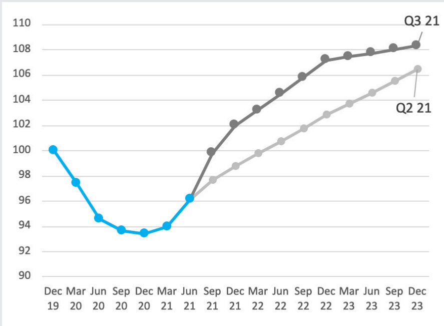
June 2021 is likely to represent the bottom of the cycle for All Property rental values and rental values should recover their pre-pandemic levels a quarter earlier than previously anticipated. Capital values outperformed expectations in Q3 and are now expected to follow a more elevated path, surpassing their pre-pandemic levels by the end of Q4 2021 (see Charts 7.5 & 7.6).

7.5 Rental value forecasts



Source: IPF, APR & Cluttons, Oct 2021

7.6 Capital value forecasts



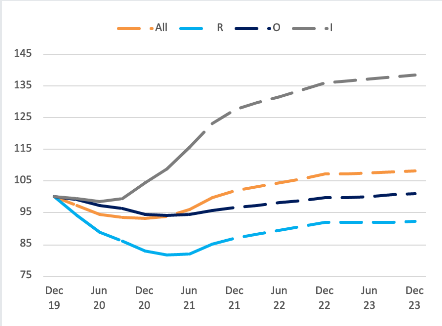
Source: IPF, APR & Cluttons, Oct 2021

10. Houseview

The central forecast from Cluttons' House View model has been revised to reflect the performance of the market so far in 2021. We continue to be more optimistic than the consensus view and expect capital values at the All Property level to improve for the remainder of the forecast period. Assuming that the impact of Covid-19 on the UK economy is waning and there are no further disruptions from new variants of the virus, All Property total returns could now recover to 14% or more in 2021 and 9% 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.

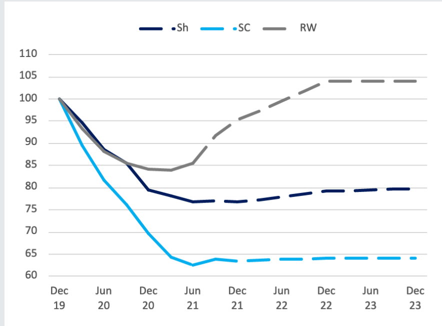
At the All Property level, we expect capital value growth to be positive. Market conditions have been improving throughout the year and we expect this trend to continue (see Charts 8.1 – 8.4). The main risk to this outlook is now represented by persistently high inflation and increasing interest rates.

8.1 3-sector capital value forecasts



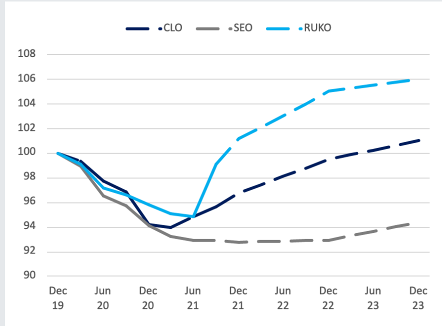
Source: IPF, APR & Cluttons, Oct 2021

8.2 Retail segments capital value forecasts



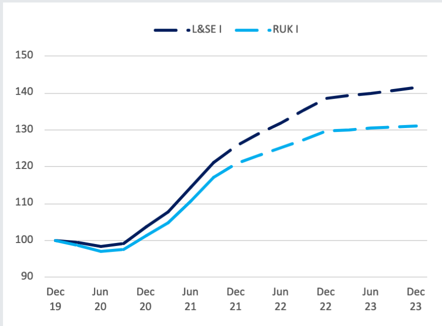
Source: IPF, APR & Cluttons, Oct 2021

8.3 Office segments capital value forecasts



Source: IPF, APR & Cluttons, Oct 2021

8.4 Industrial segments capital value forecasts

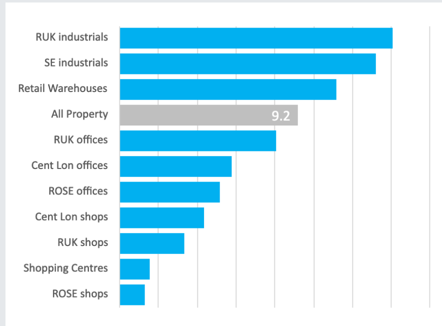


Source: IPF, APR & Cluttons, Oct 2021

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

Source: IPF, APR & Cluttons, Oct 2021

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



Source: IPF, APR & Cluttons, Oct 2021

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.

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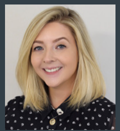
cluttonsim.com

For further details contact:

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

Matthew Peake
Head of commercial & strategic asset management
+44 (0) 20 7647 7067
matthew.peake@cluttons.com



Sophy Moffat
Head of research
+44 (0) 20 7647 7032
sophy.moffat@cluttons.com

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

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