INVESTMENT BRIEF

The definitive guide to
UK commercial property investment

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UK PROPERTY MARKET OUTLOOK

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However, investors are now very much risk-off again until the length and depth of the COVID-19 pandemic becomes clearer. There is increased scrutiny of the risk of tenant default and attendant impact on cashflow. Occupiers linked to discretionary spending are viewed most unfavourably, with food and logistics likely to be most resilient in the short term.

Many planned sales have been postponed, especially by vendors selling through choice rather than necessity. Transactions currently in process as of late March have largely remained on track, although purchasers have allocated enhanced resources for due diligence exercises and deals will take longer to get through the legal process.

The unprecedented closing of certain parts of the UK economy will have a severe impact on Retail property. Around 44% of discretionary spending is at risk of loss or delay in the coming months, particularly in the hospitality industry. Forced closures will impact landlords' ability to collect rent income over the coming months and many occupiers are likely to struggle to meet quarter day rent payments.

Following recent volatility in financial markets, sterling has depreciated by around 9% on a trade-weighted basis compared with two months ago. Multiple overseas funds are raising capital to take advantage of both this adjustment and potentially lower pricing later in 2020. This could be particularly the case for Retail, where there may be forced sales of many distressed assets at greatly reduced prices.

Investment transactions will be severely affected in Q2, with a pickup expected in the second half of the year. All Property annual total return is set to turn negative in 2020 for the first time since 2008. This should rebound in 2021 on the proviso that the "hard stop" in economic output is limited to Q2 and consequent negative impacts do not become entrenched.


TEZENIS

UK PROPERTY MARKET OUTLOOK

Office fundamentals are broadly robust, with low availability and an ability for many occupier employees to work from home. Consequently this is the only property sector likely to post some small positive rental gains by the end of the year, notwithstanding the downside risks of a more protracted period of broader economic inactivity.

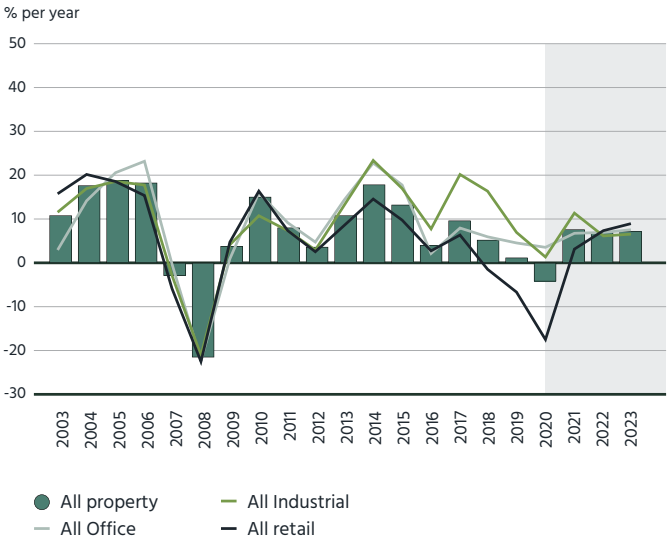
While 2020 will be the year Retail rents and capital values take a big hit (potentially up to 80% in mid-markets outside of the South East) we forecast that Retail rental growth will remain negative into 2021. Consequently, Retail total returns this year are forecast to be of a magnitude similar to the financial crisis, but we expect some rebound from 2022.

Hotels and Leisure are some of the most exposed property sectors to the existing lockdown measures that could remain in place through most of the second quarter. There are, however, some robust fundamentals underlying Alternatives and considerable weight of investment capital targeting them. The extent that hospitality staff can be retained will be critical for the strength of the potential rebound in H2 2020.

Industrial returns will take a hit in the short term along with the global economy and wider UK real estate market. Industrial total returns are forecast to fall below the more shielded Offices segment in 2020 for the first time since 2015, before rebounding in 2021. London and the South East are forecast to continue to outperform other industrial regions.

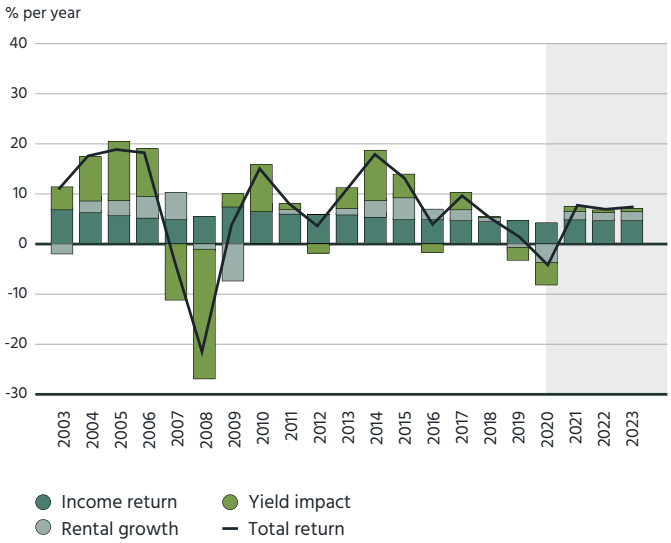
Annual total return by sector

Sources: Gerald Eve, MSCI



All Property total return and components

Sources: Gerald Eve, MSCI



UK ECONOMY

The preliminary GDP estimate suggested essentially no quarterly growth in Q4 2019. This equates to year-on-year GDP growth of 1.4% for 2019, only fractionally higher than 2018's nine-year low.

Business and consumer surveys pointed initially to firmer sentiment early in Q1 following December's decisive election result. However, the CIPS surveys for February evidenced the first domestic impact of COVID-19 in other countries, with manufacturers experiencing a sharp increase in suppliers' delivery times and service operators registering a dramatic reduction in tourism.

The introduction of drastic social distancing measures in late March to try to limit the spread of the virus in the UK will create a major disruption to economic activity that will persist at least into Q2. Oxford Economics forecasts GDP to fall by around 3% in H1 2020, and by 1.4% in 2020 overall.

The key transmission channels are: **lower discretionary spending** given that opportunities in crowded places have been removed and a rise in precautionary saving is likely; **shorter working hours** due to school closures, self-isolators unable to work from home and a higher incidence of sickness; and the **tightening in financial conditions**, such as equity prices, which are down a third from January highs, and bond yields, which have risen sharply in recent weeks.

UK economic activity should rebound strongly in 2021, but the key risk is that many firms could become insolvent and large numbers of workers lose their jobs in the meantime owing to this short but dramatic drop in demand. This would turn a short and deep recession into a depression – hence the significant co-ordinated policy response to avoid this.

The key drivers of the rebound will be **very low inflation** from the collapse in the oil price; **loose monetary policy** with the Bank Rate cut by 65bps to 0.1% and £200bn of quantitative easing; and **loose fiscal policy** in the form of unprecedented volumes of public sector loans, wage guarantees and tax breaks.

Services employment growth is likely to be only moderately negative in 2020, given the ability to home-work and the government polices to try to mitigate job losses. However, there was broad weakness in the UK manufacturing sector going into this crisis. Given the manufacturing supply chain links to affected areas abroad and temporary halt to a lot of domestic production already announced, manufacturing output is forecast to contract 5.3% in 2020.

UK GDP forecasts, January and March 2020

Source: Oxford Economics

Key macroeconomic variables: history and forecast

Source: Oxford Economics

	2015	2016	2017	2018	2019	2020	2021	2022
GDP growth	2.4%	1.9%	1.9%	1.3%	1.4%	-1.4%	3.7%	2.2%
Consumer spending growth	2.9%	3.8%	2.3%	1.6%	1.4%	-1.9%	3.7%	2.1%
Manufacturing output growth	-0.1%	0.2%	2.2%	0.9%	-1.5%	-5.3%	3.3%	1.5%
Services employment growth	1.8%	1.7%	0.6%	0.7%	2.1%	-0.4%	1.8%	0.9%
10-year bond yield	2.0%	1.3%	1.3%	1.3%	0.9%	0.7%	1.2%	1.6%
RPI inflation	1.0%	1.7%	3.6%	3.3%	2.6%	1.3%	2.5%	3.9%

INDUSTRIAL

- **Greater risk sensitivity, tenant scrutiny and legal process, and fewer transactions from late Q1.**
- **The best quality assets still being competitively sought for a potential discount in the short term.**
- **Industrial, notably in the South East, will continue to outperform the other property segments.**

Sentiment improved temporarily in late December 2019 and through some of Q1 after the decisive December 2019 general election. The positive market perception was of greater clarity on Brexit and the Conservative government's stance towards the UK business sector.

The volume of transactions increased in Q4 on the back of some significant transactions in London & the South East and an increased number of portfolio deals. The two largest – the £241m Tudor portfolio and the £200m Urban Industrials portfolio were sold to overseas investors.

However, investors are now very much risk-off again until the length and depth of the COVID-19 pandemic becomes clearer. There is increased scrutiny of the risk of tenant default and attendant impact on cashflow. Occupiers linked to discretionary spending are viewed most unfavourably, with food and logistics likely to be most resilient in the short term.

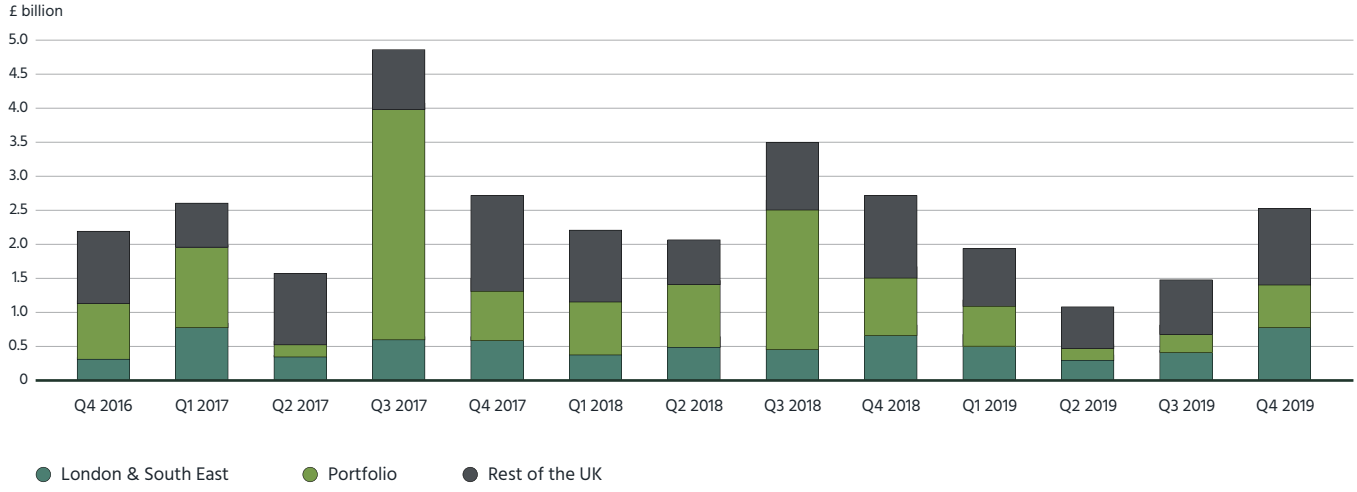
Many planned sales have been postponed, especially by vendors selling through choice rather than necessity. Transactions currently in process as of late March have largely remained on track, although purchasers have allocated enhanced resources for due diligence exercises and deals will take longer to get through the legal process.

The best quality assets, or rare assets with particular attributes, will still be competitively sought as some investors look to capitalise on market uncertainty to secure trophy buildings at a potential discount. Perivale Park in London attracted extremely competitive bidding in the week when most of the social distancing measures were introduced and escalated, but, given difficulties around the practicalities of undertaking a sale and accessing the site in the current circumstances, we understand this sale is now on hold.

The industrial occupational market now is much stronger than during the financial crisis and real estate still provides attractive return fundamentals relative to bonds and equities. Notwithstanding COVID-19 complications, the UK is attractively positioned in terms of exchange rates and relative value for overseas investors, and this group accounted for 59% of industrial transactions in Q4 2019. They have indicated a greater willingness in principle to buy UK industrial in the future also.

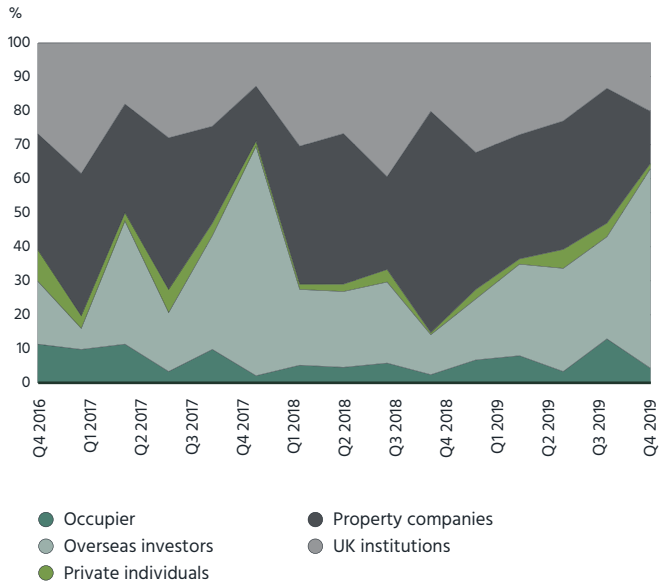
Industrial quarterly investment

Sources: Gerald Eve, Property Data



Industrial investment by investor type

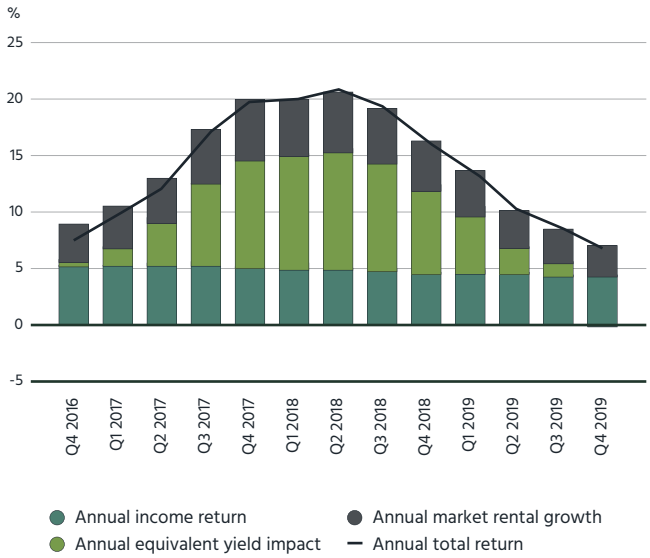
Sources: Gerald Eve, Property Data



The strong outperformance of Industrial over the other property sectors has largely fallen out of the figures now that industrial yields have stabilised at their new lower position in Q4 and yield impact was again minimal.

Industrial annual total return and components

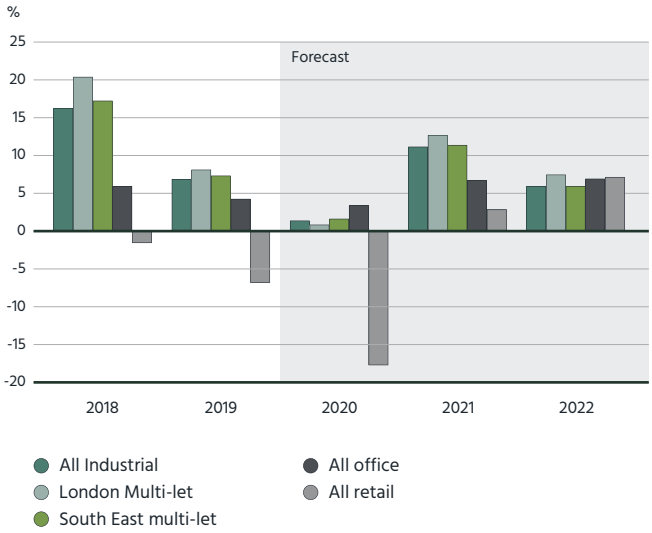
Sources: Gerald Eve, MSCI



Industrial returns will take a hit in the short term along with the global economy and UK real estate market. Industrial total returns are forecast to fall below the more shielded Offices segment in 2020 for the first time since 2015 before rebounding strongly in 2021. London and the South East are forecast to continue to outperform other regions.

Annual total return forecasts by major property segment

Sources: Gerald Eve, MSCI



Access arrangements will make inspections and surveys very challenging for now, but some investors are taking advantage of this period to prepare assets for sale when signs of normalisation return. Sterling's depreciation will bring global capital to the UK, which was already looking very strong, so we expect this to continue once the impacts of COVID-19 start to fade.

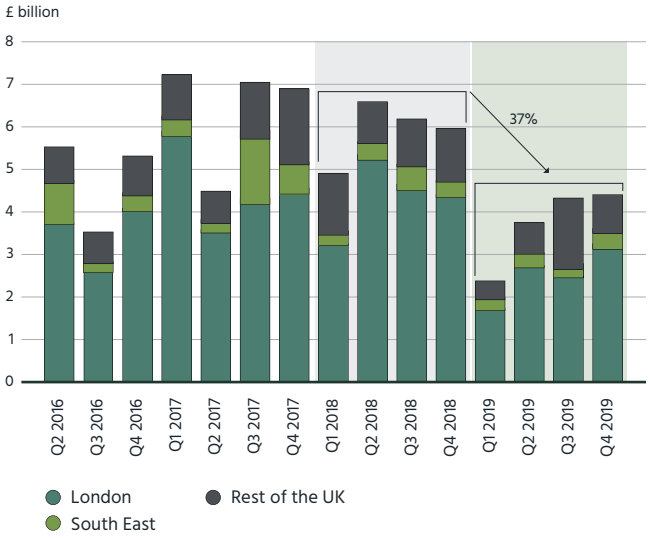
John Rodgers
Partner, Capital Markets

OFFICE

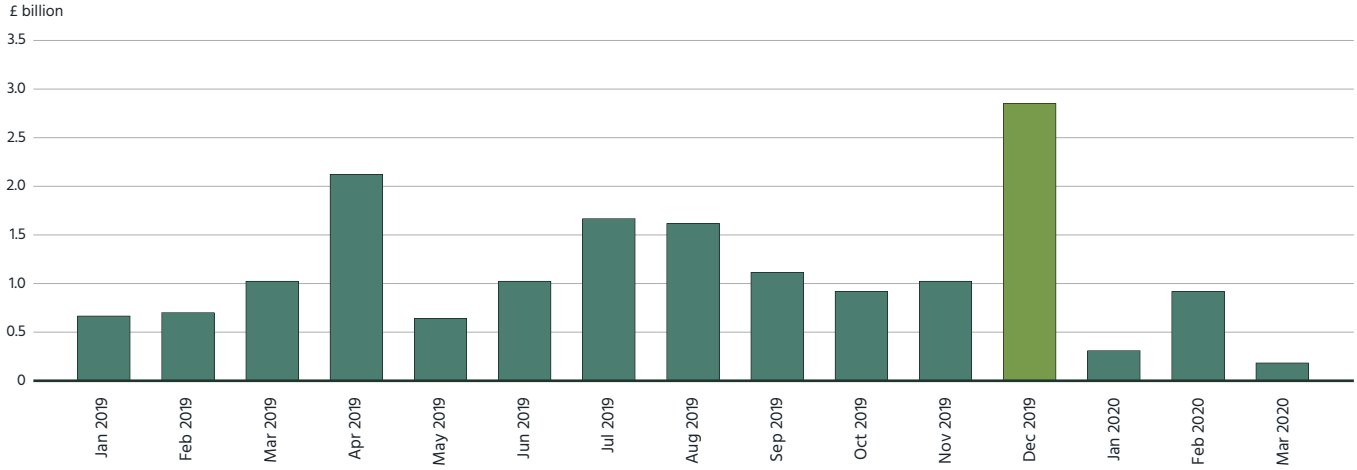
- **Social distancing and major economic disruption to significantly cut office investment in Q2.**
- **Far Eastern investors will look to take advantage of the fall in currency once restrictions are eased.**
- **Office fundamentals remain strong which will lead to a return to positive rental growth once the spread of the Coronavirus is contained.**

Office transactions in 2019 were 37% down on 2018. However, the decisive general election result in December brought with it a surge of investor activity. Over 18% of 2019 office transactions completed in December.

Quarterly office transaction volumes
Sources: Property Data, Gerald Eve



Office investment transactions by month
Sources: Property Data, Gerald Eve



However, the post-election bounce in optimism experienced across much of January and February was cut short in March as the global economy experienced immense pressure from the impact of the spread of the Coronavirus.

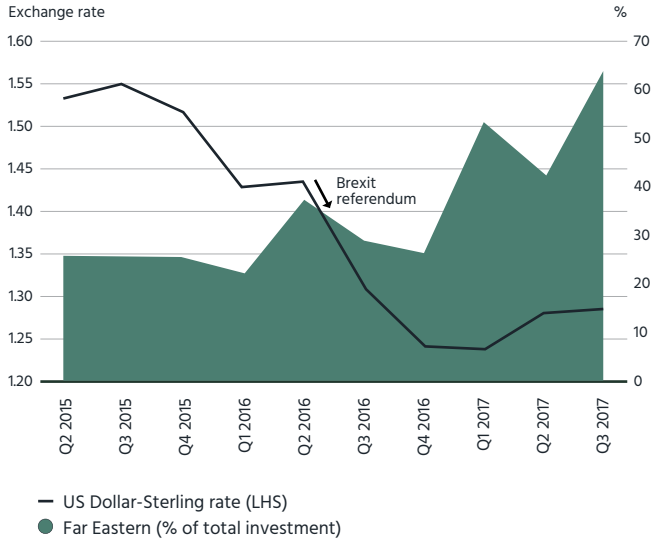
The subsequent lock-down late in Q1 will have significantly impacted office investment volumes in Q1, which will continue into Q2. Cash buyers are best placed currently, but restrictions on movement will limit this advantage. Similarly, the numbers of sellers are set to be drastically reduced. Extended transaction timelines and delayed launches are already in evidence, though technology will be used where possible to connect separate parties.

Investors are now risk-off until the length and depth of the pandemic becomes clearer. We have seen a doubling-down on covenant risk and investors are closely analysing the potential of tenant default and attendant impact on cashflow. In general investors are taking a more cautious approach to transactions, with deals being double-checked by investment committees.

Overseas investors are similarly risk-off at present. However, these buyers will ultimately look to take advantage of the fall in sterling to buy London offices at a discount, similar to the period 12 months following the EU referendum. When the situation with the virus is more under control, we expect a significant amount of demand to return from the Far East.

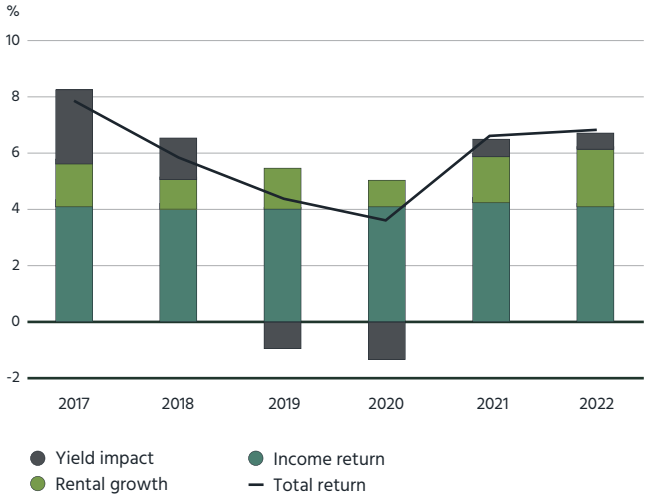
Increase in Far Eastern investment in London offices after the Brexit referendum

Sources: Property Data, Gerald Eve



UK Office investment performance and forecast

Sources: MSCI, Gerald Eve



Rental growth will be impacted in the short term. Other property segments are much more exposed, but a large temporary drop in output will increase the risk of tenant failures. Landlords with exposure to short-term leases, in particular serviced offices, will be the most at risk. The impact on WeWork could also be crucial. Other than the government, the serviced office provider is the largest individual occupier of office space in London, and should the company fail, it could lead to a sharp rise in the vacancy rate.

An evolving impact from the lockdown has been that tenants with the ability to work from home have been able to maintain business continuity where possible, notwithstanding the broader impacts of on each individual business. Landlords negotiating new leasing deals are considering more flexible leasing models, including more rent frees, in order to secure occupancy and maintain headline rents in their schemes. Institutional landlords, REITs, insurance companies, pension and sovereign wealth funds are particularly keen on maintaining face rents to preserve capital values.

The underlying real estate fundamentals remain robust. Good quality office space is in short supply and should be supportive of a return to positive rental growth towards the end of the year.

Notwithstanding a protracted crisis, an investment bounce-back is anticipated later in the year. A significant amount of pent-up capital is targeting London offices in particular. Office annual total return is forecast to fall to 3.7% in 2020, with stronger rental growth and positive yield movement boosting returns from 2021.

Outside of central London, we anticipate any deployment of capital to be focused on secure and well positioned assets providing long-dated income streams, as investors move to de-risk their portfolio and limit exposure to market volatility. We expect property companies and private equity investors with large cash weightings to take advantage of potential price adjustments and decreased competition for assets, given difficulties with market valuations for debt-backed buyers.

> Despite the uncertainty, strong investor interest in the capital remains, particularly from those less dependent on debt and more typically comfortable with opportunistic investment. The more robust investors see the lack of competition as an opportunity.
>
> **Lloyd Davies**
> **Partner, Capital Markets**

RETAIL

- **Impact of COVID-19 means many occupiers are likely to have missed the March quarter day rent payment.**
- **Overseas funds are raising capital to take advantage of dramatically lower capital values later in 2020.**
- **Negative total returns in 2020 similar to the financial crisis, but we forecast some rebound from 2022 as the rebasing of values kick-starts activity.**

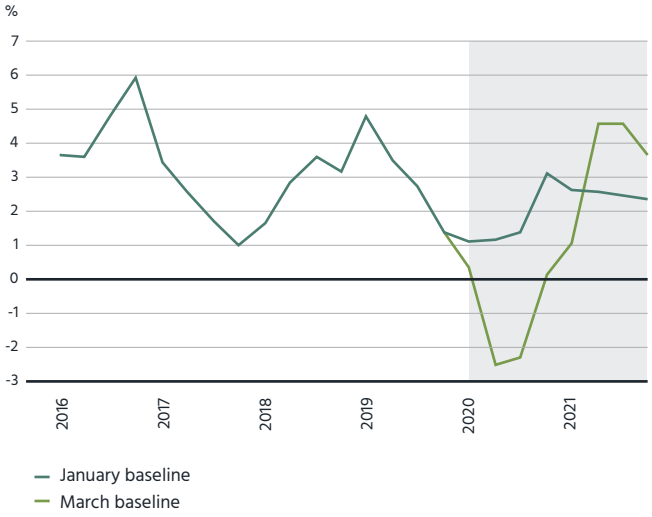
The unprecedented closing of certain parts of the UK economy to combat COVID-19 will have a severe impact on Retail property. Around 44% of discretionary spending is at risk of loss or delay in the coming months, particularly in the hospitality industry.

The business rates 'holiday' for the next 12 months may alleviate some pressure for retailers but may not do enough for weaker firms already nearing insolvency. The appointment of administrators by Laura Ashley is a sign of things to come.

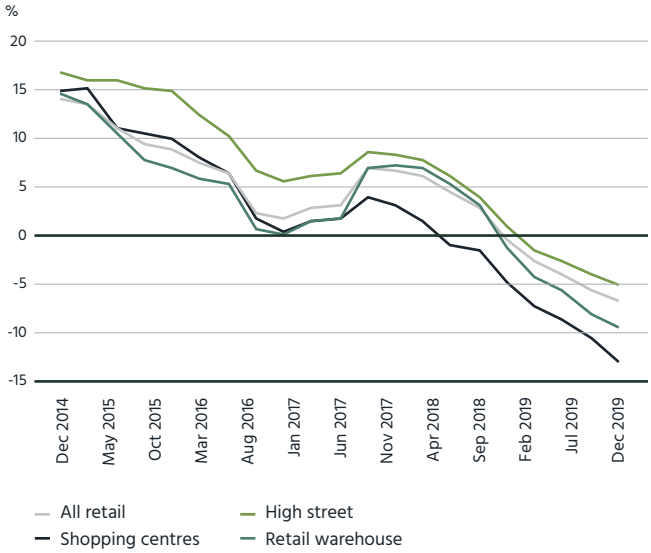
Hard data to show the impact of COVID-19 is not yet available, but annual retail rental growth had already fallen further to -5.0% in Q4 2019, in an occupier market characterised by thinning retailer margins and locked-in high rents for many tenants. Retail yields continued to move out precipitously at the year-end and the annual yield impact of -7.6% pushed total returns to a more deeply negative -6.9%.

Shopping centres were the worst performing retail sub-sector in 2019, with annual total return of -13.2%. High street has been the most resilient though total return nevertheless fell to -5.2% by the year-end.

Updated forecasts for UK consumption
Source: Oxford Economics



UK retail total returns by segment
Source: MSCI



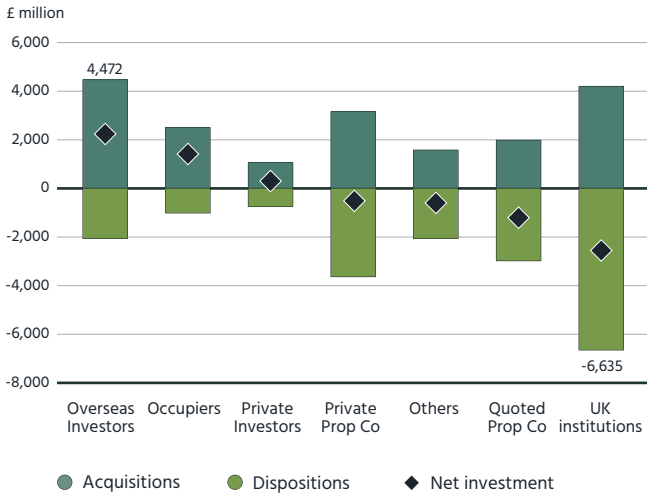
> Market disruption caused by widespread forced retail closures will accelerate a re-basing of rents and the fall in capital values, taking some to below post-GFC levels. This could provide an attractive investment entry point earlier than previously expected and offer positive returns over a 3 to 5-year horizon.
>
> **Robert Wingrave**
> **CEO, Time Retail Partners**

Forced closures will impact landlords' ability to collect rental income over the coming months and many occupiers are likely to have missed the March quarter day rent payment. Consequently income return will be down by as much as a quarter in 2020. Only supermarkets and other essential stores will offer defensive income during the lockdown of wider retail assets.

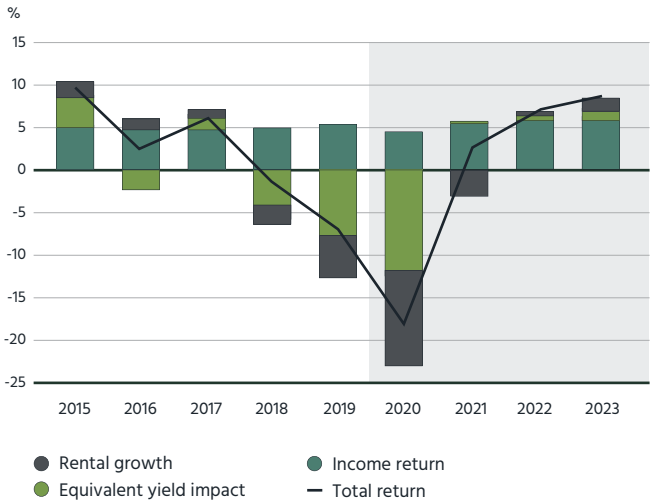
2020 will face the big hit on rents and capital values (potentially up to 80% in mid-markets outside of the South East) and we forecast that retail rental growth will remain negative into 2021. Consequently, forecast total returns this year are of a magnitude similar to the financial crisis, but we expect some rebound from 2022 for retail investors able to capitalise on further repricing.

Overseas investors increased their net exposure to the UK retail sector by £2.4bn over 2017 to 2019. Meanwhile, relatively overexposed UK-based funds and investors have been divesting out of the segment. Following recent volatility in financial markets, sterling has depreciated by around 9% on a trade-weighted basis compared with two months ago. Multiple overseas distressed funds are raising capital to take advantage of lower pricing. This is set to attract further international purchasing activity in Retail later in 2020.

Net retail investment by investor type, 2017-2019
Sources: Property Data, Gerald Eve



UK retail annual forecast total returns and components
Sources: MSCI, Gerald Eve



> Despite government measures to help, the impact of forced retail closures is still likely to result in a number of retailer insolvencies and rent deferrals that will have serious knock-on effects to current landlords.
>
> **Richard Lines**
> **Partner, Capital Markets**

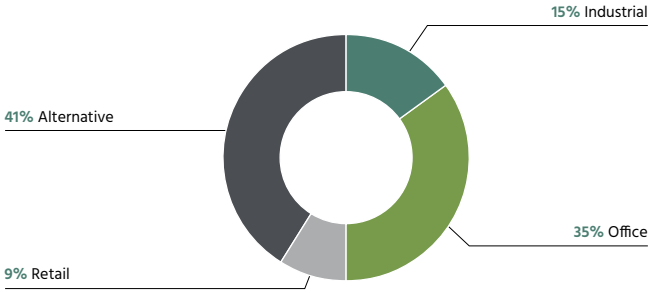
ALTERNATIVES

- **The hotels and leisure sector is the most exposed property sectors to the economic impact of COVID-19.**
- **The potential loss in staff is a critical risk.**
- **Underlying fundamentals points to a rebound in H2 2020 as economic activity returns.**

Alternatives accounted for 41% of total UK investment in 2019 – a record high. Investors were attracted to the typically long-term income, and rents that are a proportion of profitability and defensively index-linked.

2019 investment volume by sector

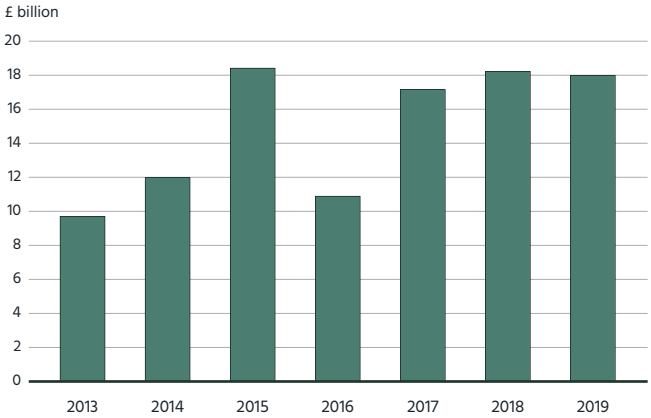
Source: Property Data, Gerald Eve



There was a significant drop off in activity across the main commercial sectors in 2019. In contrast, Alternatives was more stable, with a similar level of activity as 2018.

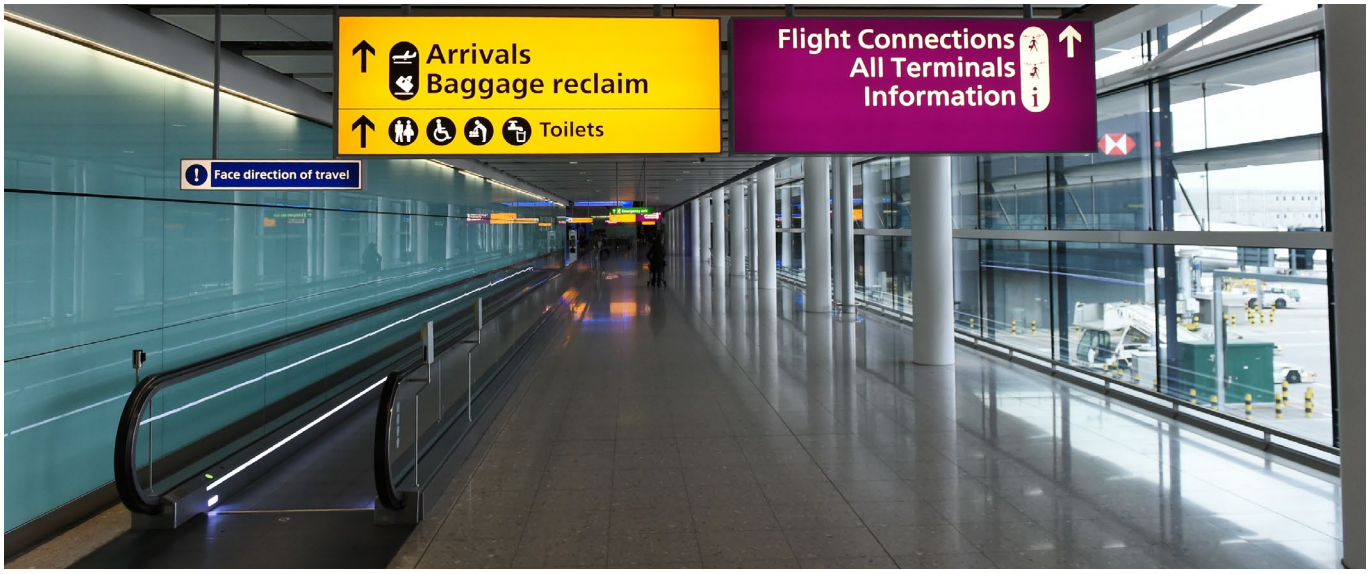
Alternative annual investment volumes

Sources: Property Data, Gerald Eve



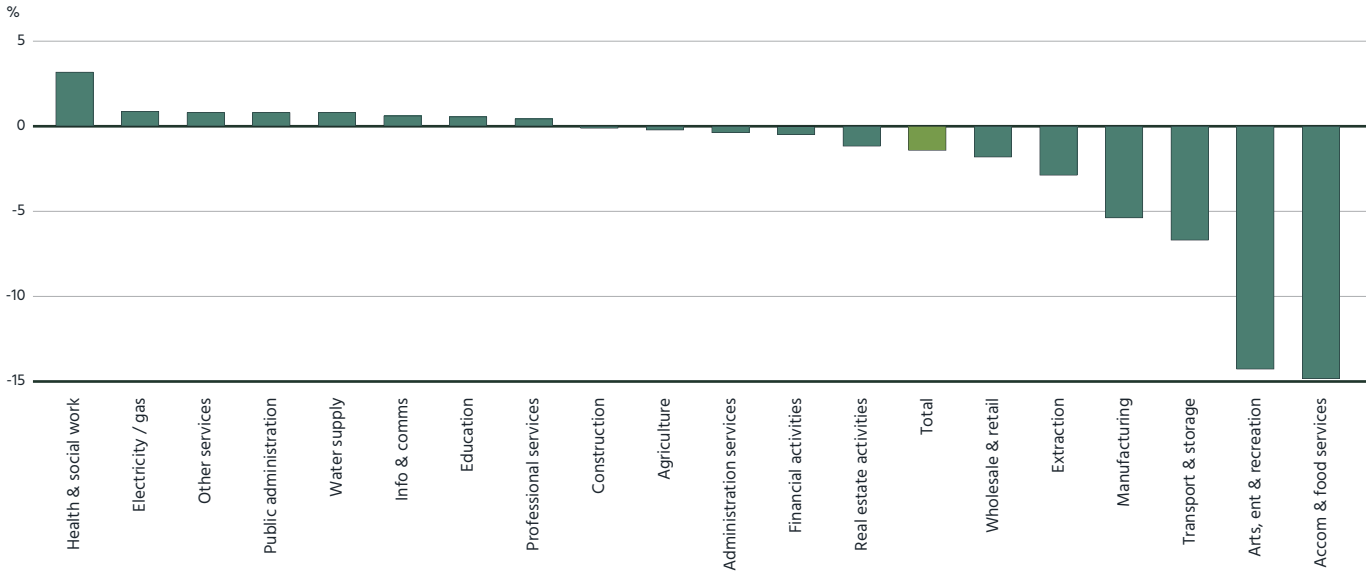
However, Hotels and Leisure are the most exposed property sectors to the economic impact of COVID-19, along with Retail. Tourism has fallen significantly, and holidays and business trips have been cancelled or postponed, whilst the Leisure sector has been forced to close.

Oxford Economics forecasts that the arts, entertainment and recreation, and accommodation and food services will be the most severely hit UK segments in terms of GVA growth this year at -14.2% and -15% respectively.



2020 sector output forecasts

Source: Oxford Economics



London hotels have been particularly affected since it is ordinarily the most visited city in Europe with over 19 million business and leisure travellers a year. International travellers to the UK regions tend to arrive via London also so the initial impact will be greater in the capital than in the regional markets. STR reported that the occupancy rate for hotels in London for the first eight days of March dropped 21% to 65.5% and RevPar plummeted 27.7%.

Whilst all hotels have seen a sharp drop in occupancy, some investors are taking a positive longer term view on London, especially in the ultra-prime hotel market. The recent purchase of the Ritz Hotel in London by a Qatari investor from the Barclay Brothers was concluded in the week when a lot of the restrictive measures were being escalated.

Many landlords will be looking at the situation in China for confidence. Hotels have started to reopen and occupancy is returning, although this will likely all be domestic demand. China's experience suggests that existing lockdown measures in Europe could remain in place through most of the second quarter. And they may have to last longer than in China as European governments have less of a tight control over individuals' movements.

The government has responded robustly with a series of loans, grants and other help, however the retainment of staff is one critical issue facing the industry. There are potentially more than one million jobs in the UK's hotel and hospitality industry that are in danger of disappearing.

More broadly, however, with the weight of investment capital targeting the UK, and the long income and covenant strength of some of the Alternatives segments, particularly healthcare, there is potential in H2 2020 for a rebound in activity.

> Companies are having to make difficult decisions with many hospitality and leisure businesses now having to close or massively reduce their operations. Although the government is willing to cover a large portion of the wages, the remainder will need to be paid with no revenue coming in, placing a significant number of jobs at risk.
>
> **Will Kirkpatrick**
> **Partner, Alternative Markets**

CORPORATE FINANCE

Overall the cost of property debt is low and traditional clearing and international banks account for the majority of lending. Since 2010, as real capital values have risen there has been no corresponding increase in banks and building societies relative exposure to property debt. They have been less willing to lend post-crisis, not least because they are subject to more restrictive regulation.

Challenger banks and debt funds have sought to take market share, especially in the smaller (sub-£25 million) market. Loan-to-value ratios offered by debt funds and challenger banks have risen over last few years and their facilities currently linked to retail or operational assets such as hospitality and leisure, hotels and restaurants are exposed.

We are likely to see lenders with higher retail exposure retreat from the market in 2020. If market conditions worsen or government guarantees are not effective, we could see a raft of borrowers in this sector failing and defaulting on their bank liabilities around the June quarter date.

Most lenders are re-deploying staff from real estate to work on the new debt products which will be supported by the recently announced government guarantees. This is a large-scale government initiative which is likely to continue to channel resources away from real estate lending in order to help with the practical interpretation of the schemes.

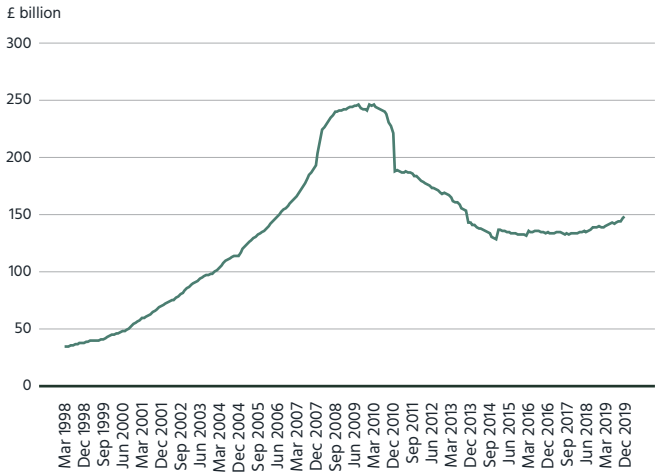
Lending for existing developments continues, although construction drawdowns have been delayed by the impact of social distancing on site access for monitoring surveyors. Lenders are more sceptical of new development opportunities as current market conditions mean build terms are extended and sales take longer, which will impact development returns. Some lenders have stated they are stress testing new enquiries by adding between 3-6 months to the build programme.

Capital value falls as well as the ongoing uncertainty surrounding trade relations with the EU is likely to keep lending to property subdued this year and this may impact already-challenged sectors such as retail where a large number of lenders have already materially reduced their exposure.

Transaction volumes are also expected to slow considerably in 2020, despite the low cost of debt. Real estate investors are likely to price in diminished future income expectations, which will limit the volume of transactions, and lenders are struggling to price assets against a backdrop of interest rate volatility.

Total outstanding CRE loans

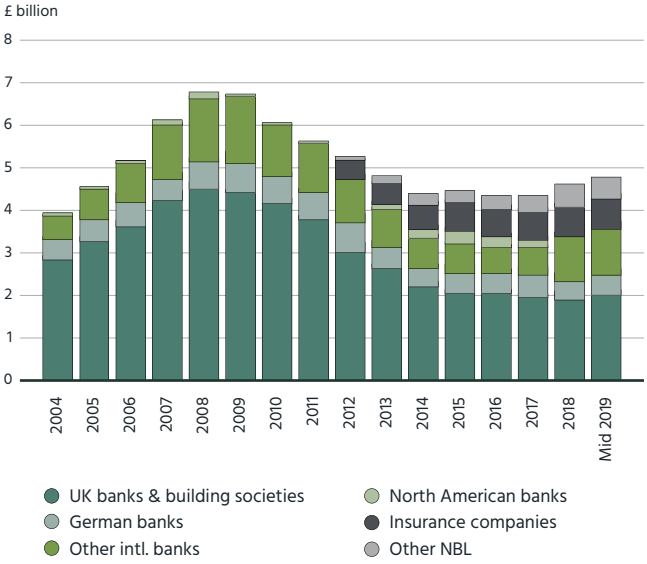
Sources:



Because traditional lending has been subdued, a greater share of property debt has been financed by insurance companies and other non-banks, who are generally more conservative and like to match gilt terms rather than LIBOR and tend to offer higher LTV ratios. Although non-banks' share of lending has risen, banks and building societies still account for the majority (around 80%) of all lending.

Outstanding loans by lender type

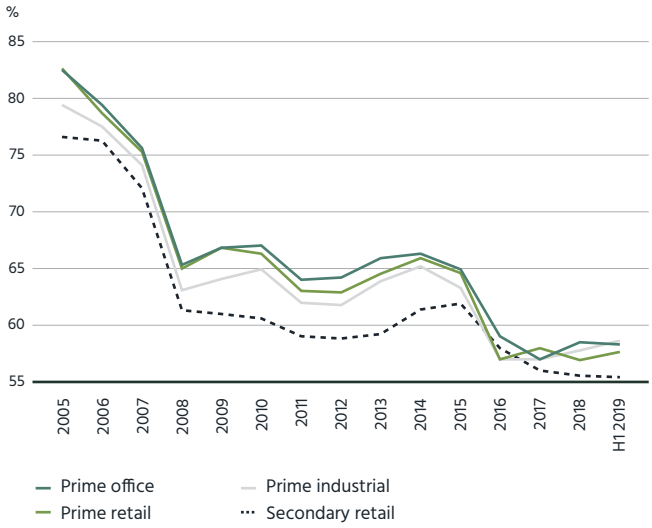
Source: Cass CRE lending survey



Lending margins remain under pressure and pricing for loans against secondary properties and locations remains 80-100bps wider than prime, especially loan pricing against secondary retail property, which remains above those of other asset classes. Primary lenders generally won't consider retail and as such they are forced to challenger or secondary lenders, which creates a pricing gap. Retail is also seen as a material risk and often loans are underwritten off a VP basis (for short leases) which drives the LTV (based on an investment value) and also drives pricing.

Average LTV ratios by sector

Sources: Cass Commercial Real Estate Lending Survey



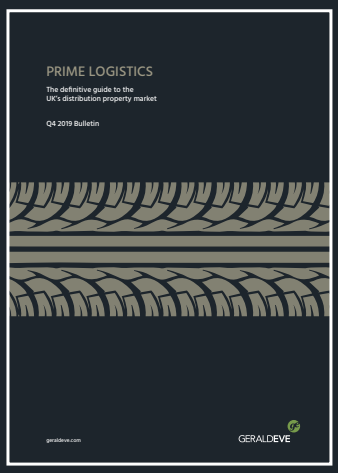
> Investor caution, together with the prospect of falling capital values will restrict lending for the rest of the year.
>
> **Stephen Oliver**
> **Gerald Eve Corporate Finance**

FURTHER INSIGHT

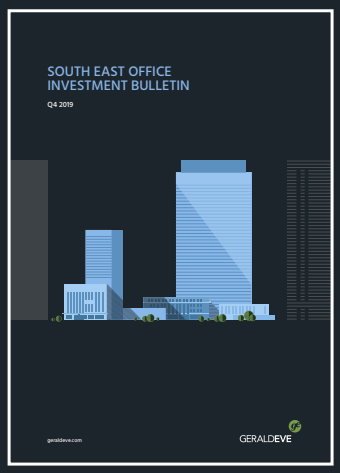
For more information on individual sectors, please see the following publications:

Multi-Let
Summer 2019

London Markets
Winter 2019



Prime Logistics Bulletin
Q4 2019



South East Office Investment Bulletin
Q4 2019

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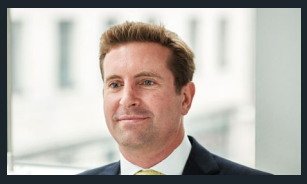

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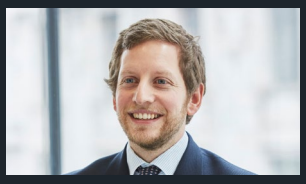

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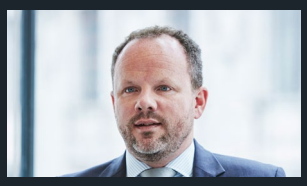

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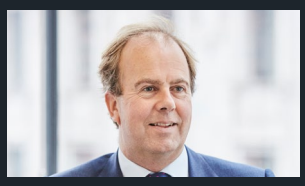

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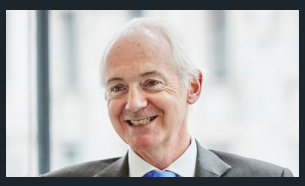

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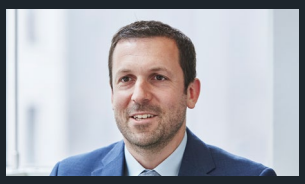

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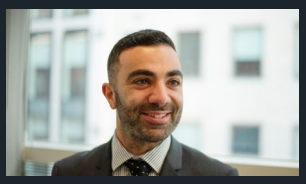

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