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UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

June 2021

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JUNE UPDATE

Strength in Industrial drove All Property to the highest rolling quarterly return in three and a half years and all the signs are for a strong economic bounceback in Q2. But the extended eviction moratorium to March 2022 points to more pain for landlords and a more subdued Leisure investment recovery. Read more for the most recent occupier and investment updates, economics data and property forecasts.

Read more.

March 2022	34% ▲	7.7% ▲	1.5% ▲	1.0% ▲	4.8% ▲
extended eviction moratorium	annualised distribution warehouse total return	2021 GDP forecast	2021 CPI forecast	2021 10-yr bond yield forecast	2021 unemployment rate forecast

Extended moratorium points to a more subdued Leisure recovery

All Property quarterly total return continues to trend upwards and in May reached 3.13% - the highest since December 2017. Again, at the aggregate level this was mainly driven by yield impact and income return, while aggregate rental growth remained just above zero.

The key positive driving force for returns is of course from industrial. UK-wide distribution warehouse quarterly total return pushed ahead of even London multi-let to reach 7.59% in May, which is an annualised return of 34%. Occupier demand is strong and varied, availability is at an all-time low and rents are growing strongly. Investor demand is fierce, and the distribution warehouse equivalent yield fell to a record low 5.19% in May. The biggest recent transaction was Blackstone's acquisition of the Albion portfolio of 31 assets for £283m in May.

Retail quarterly total return increased again in May to 1.61% and widened the gap with offices, which again returned only 0.33%. Retail warehouses continued to be the positive driving force, with a quarterly total return of 3.48%, which was its highest since October 2014.

High street quarterly total return was edging closer to zero in May and recorded -1.9%. Rents for the subsector still fell more than 4% over the last three months, making this the worst retail subsegment in this regard. The overall improvement in returns in May was driven by London high street, where yields moved in 10bps between April and May to 4.69%, far below the rest of the UK where they continued to drift slightly.

Shopping centres returns might still be negative, and capital values now 32% below pre-pandemic levels, but there are signs of bottoming out. Rolling quarterly rental growth and total return were -1.4% and -2.23% in May, respectively, which was the least negative month for both since before the pandemic.

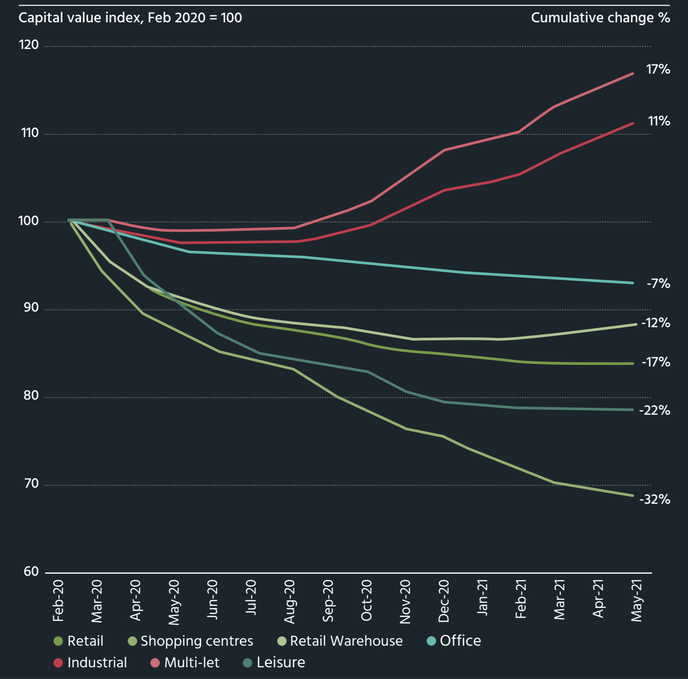
Leisure assets posted a positive but relatively modest quarterly total return of 1.56% in May, despite the economy reopening and given that leisure capital values are 22% cheaper than pre-pandemic. We anticipate a subdued recovery, linked to increased risks around unpaid rent debts made more difficult by the eviction moratorium being recently extended to March 2022. Business rates support will not be extended in parallel, further increasing the likelihood of unactionable rent defaults.

Offices continue to be relatively uneventful in overall performance terms. Prime yields have broadly held in 2021, but 7% has been eroded from capital values as rents get chipped away outside of the central London markets. However, investor activity is starting to pick up in readiness for the full societal reopening and June investment volumes are on course to achieve the highest monthly level in 2021, with £950m transacted as of the 23rd.

March 2022
extended eviction moratorium

34%
annualised distribution warehouse total return

Capital values over the pandemic by sector
Source: MSCI



Segments

12-month return to May 2021
Source: MSCI

UK economy

UK GDP increased by 2.3% month-on-month in April, pushing economic activity to only 3.7% below the pre-pandemic level. Non-essential retail and outdoor hospitality reopened on 12th April and, unsurprisingly, it was these sectors that contributed most to the extra economic growth. However, hospitality activity was still operating at more than 40% below its previous capacity.

Consumer confidence is on aggregate back up to levels from before the pandemic and surveys of households that have accumulated excess savings suggest an increasingly bullish attitude towards spending them. The proportion of retail spend online fell again to 27.3% in May, but this is still well above the 20% in early 2020.

May and June should see further strong rises in GDP following the reopening of indoor hospitality in England on 17th May. Consequently Oxford Economics expects GDP to rise by 5.5% quarter-on-quarter in Q2. The impact of the four week delay to the final stage of reopening in England should be only moderate and in fact the recent stronger activity and sentiment data has given cause for Oxford Economics to increase its forecast of GDP growth for 2021 to 7.7%, up from 7.5% last month.

The latest ILO unemployment figure ticked down again to 4.7% in April and the risk of a large increase when the Job Retention Scheme is wound down in September looks unlikely. Unemployment has probably already peaked at just over one percentage point above its pre-pandemic level.

CPI inflation increased to 2.1% in May and the recent rises in the UK (and notably in the US) has had much coverage of late over fears that increased price expectations may get entrenched. However, Oxford Economics continues to take the view that UK inflation remains contained. Rising fuel and energy prices, the reversal of the VAT cut for hospitality and strong base effects will fall back out of the figures. The recent strength of sterling, up against both the euro and the US dollar, will also act as a drag.

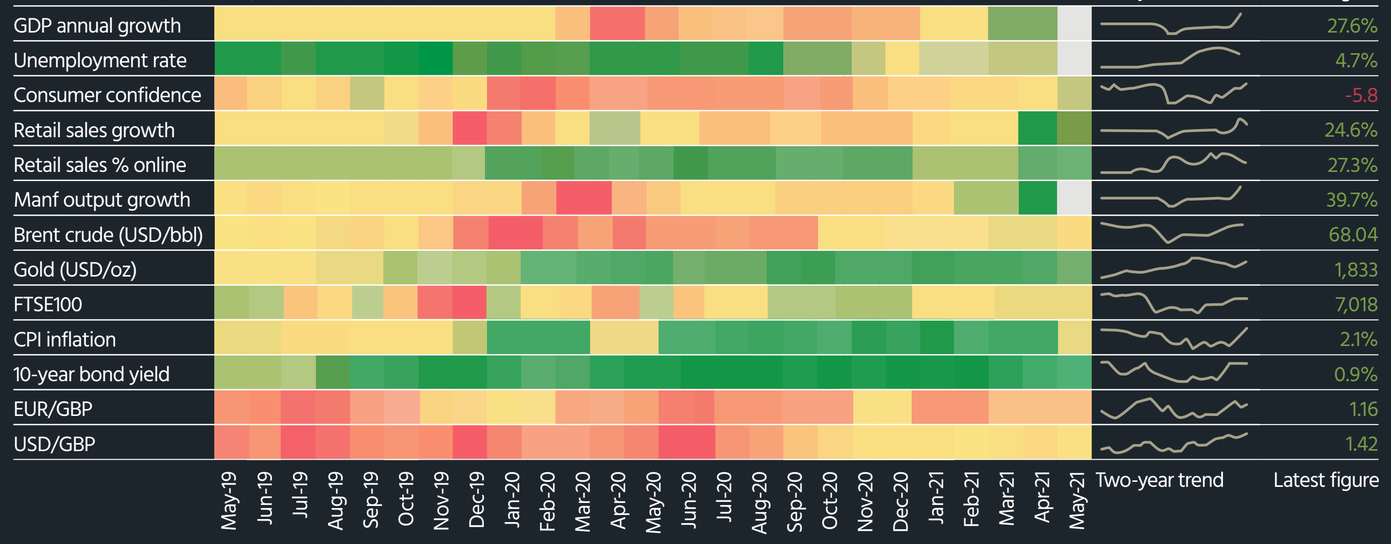
7.7% ▲
2021 GDP forecast

1.0% ▲
2021 10-yr bond yield forecast

1.5% ▲
2021 CPI forecast

4.8% ▲
2021 unemployment rate forecast

The monthly monitor
Source: Bank of England, European Commission, IMF, ONS

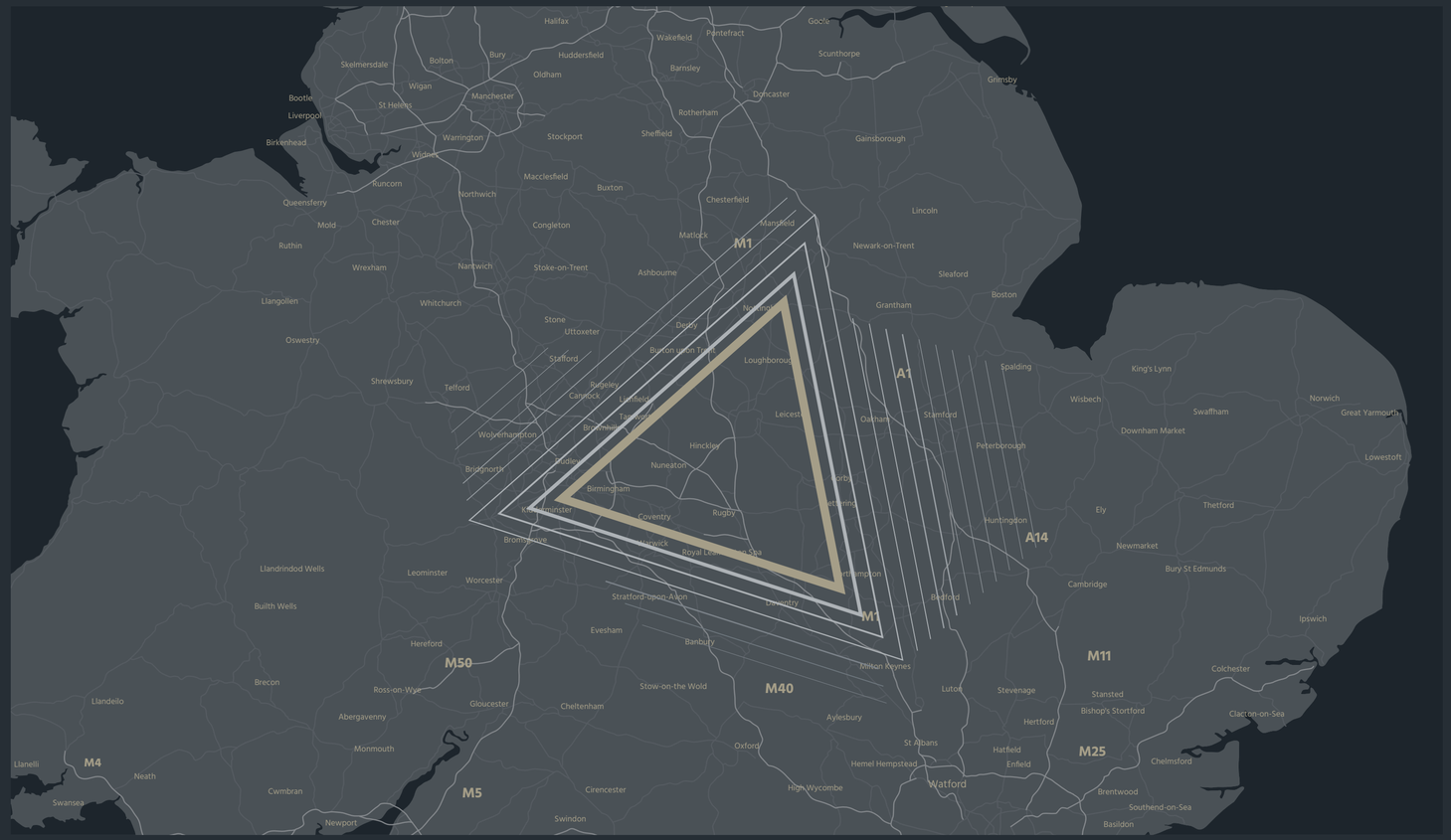


Spotlight on…
Modern requirements and the reshaped ‘prime’ logistics

Occupier demand for UK logistics property is at an all-time high and stems from a range of sectors. Accelerated shifts in online shopping patterns have put pressure on logistics and retailer supply chains; manufacturer demand has increased in response to new Brexit trading arrangements; and data centres along with emerging sectors – such as sustainable energy production and even film and TV production companies – are all vying for industrial space. The most in-demand buildings in Q2 were let following rental best bids from a variety of would-be tenants. As a result, void periods are short, availability is at an all-time low and prime rents are growing strongly.

Developers have responded with speculative schemes and land is being readied through planning permission and infrastructure works. However, appropriate serviced land is typically both expensive and in short supply, especially in the traditional ‘prime’ locations. Consequently the most acquisitive occupiers have widened their search to less established logistics markets. These sites can still often meet key modern occupational requirements, such as sufficient power for sophisticated automated facilities, access to a diverse and skilled workforce and the best-in-class ESG building credentials.

Suitable land is more readily available (and cheaper) in locations on the outskirts of traditional prime locations, and thus development appraisals can be more palatable. This outward overspill has been evident for several years but certain regions in the South East have been given a significant boost since the pandemic, including Suffolk and Oxfordshire. Several markets around the traditionally recognised Golden Triangle in the Midlands have had a marked increase in demand.



● Golden triangle ● Demand ripple effect

Outlook

All Property total return is forecast to return to a positive and be 10.4% in 2021, slipping back to 6.8% in 2022. This will be driven in the short term by a surge in industrial rents and yield tightening, and as retail and leisure pricing stabilise and contribute positively again in some cases in H2 2021.

There will be sustained underlying strength in the industrial market, not only in London and the South East multi-let, but also wider UK distribution warehouses. The current late cycle surge in investment activity and pricing will boost total return in 2021. However, this very keen pricing going into more uncertain economic conditions in 2022 suggest this rate of return will not be maintained.

Headline office rents in the regions are expected to deteriorate more rapidly in 2021 as tenant-controlled space continues to increase. Thus some further yield softening in the short term is expected – particularly for secondary assets with short income that pose greater operational and ESG issues.

Retail should experience some further but smaller fall in rents and more moderate outward yield shift in 2021. A non-negative annual total return in 2021 driven by retail warehouses will be the first since 2017. By 2022 total return should increase to be relatively competitive against other sectors, boosted by a large income return component.

Total return and components by sector
Source: Gerald Eve, MSCI

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