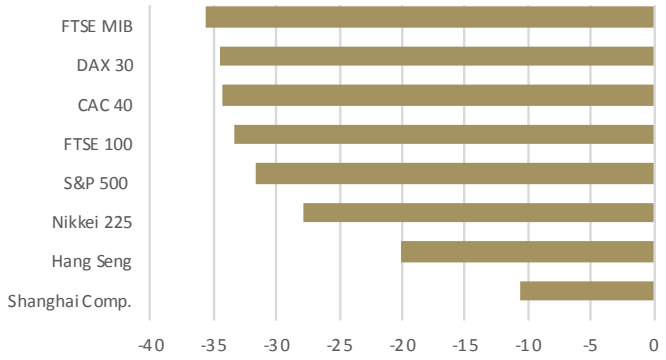
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update March 2020

Economic Overview

Equity markets have taken a significant hit over the past month or so as the COVID-19 virus has spread (see Chart 1).

1.0 Change in Selected Major Equity Market Indices over 40 Trading Days to 24/03/20 (%)



Source: Refinitiv

Having had one of the most severe outbreaks outside of China, it is unsurprising the Italian index (FTSE MIB) suffered some of the steepest price falls. In response to concerns over the potential economic impact of the virus, central banks and governments have announced significant support for their economies through a combination of monetary and fiscal policy loosening. With economic conditions evolving rapidly, much of the backward-looking data released during the past month offers little insight into current developments in the world economy. What follows in this section therefore outlines only the most relevant data, as well as policy announcements.

The US has seen an exponential rise in new confirmed cases, which has meant a shift in the response from Federal, State and local governments.

Top 5

- Equity markets have taken a significant hit over the past month as the COVID-19 virus has spread;
- Interest rates have hit almost crisis-era lows of near 0%;
- Major European governments have pledged significant packages of between €100bn and €500bn, to support their respective economies;
- Increasing concern over what the virus will mean for property prices has led to the suspension of several open-ended property funds;
- The widespread shutdown of many businesses over the next few months will lead to conditions in the retail sector in particular worsening, which will weigh more on investment volumes for the sector, as rents fall and yields rise over the year.

The Federal Reserve had already responded by cutting its Fed Funds Rate by 100bp, taking it back to its crisis-era low of between 0.0% and 0.25% and restarting large-scale quantitative easing – buying at least $500bn of Treasury securities and at least $200bn of agency mortgage-backed securities. What's more, as things stand, the Federal government looks to be on the verge of a stimulus package valued at around 10% of GDP.

The Fed recently confirmed that it will continue its large-scale asset purchases "in the amounts needed" and to include corporate bonds. It is already buying $75bn of Treasury securities a day and will step up its MBS purchases to $50bn per day. And by bringing in stricter measures at an earlier point of the crisis than European countries, the US may manage to mitigate the size of its economic downturn to some extent, if businesses can re-open sooner.

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European governments have stepped up their efforts to contain the coronavirus in recent weeks, with countries declaring a state of emergency and imposing near-total lockdowns. Major European governments have pledged significant packages, of between €100bn and €500bn, to support their respective economies. Further, the European Central Bank announced they plan an extra €750bn in bond purchases, which should reduce some financial market stress. And timely survey data for Germany show that those concerns are not unfounded. There was a sharp drop in the ZEW investor sentiment measure in March, which points to sharp falls in GDP. Moreover, March's euro-zone Composite PMI slumped from 51.6 in February to 31.4, the lowest level on record.

In the UK, the government has announced stricter measures, amounting to its version of "lockdown". Initially, the Chancellor and Bank of England had announced a coordinated fiscal and monetary stimulus package. The Bank of England cut interest rates from 0.75%, back to a record low of 0.25%, while the Chancellor revealed a large fiscal stimulus of £30bn (1.4% of GDP) in 2020/21. Since, the Chancellor has pledged a further £330bn (15% of GDP) of state guarantees for bank loans to firms and an additional package of direct support for businesses worth more than £20bn (or 0.9% of GDP). The government also took unprecedented measures with its Coronavirus Job Retention Scheme in which the government will pay 80% of the salaries of the employees who are asked to stop working but kept on company payroll.

The Bank of England has also made an additional rate cut, to 0.1%. It remains to be seen whether this is sufficient, but the government has stated that it is ready to do whatever is necessary to support businesses and consumers. And this may be more necessary as the first conventional data for March confirmed that the coronavirus was having a massive negative impact on activity in the UK. The Composite IHS Markit PMI, plunged from 53.0 in February to 37.1 in March, its lowest level since the index started in 1998.

Property Overview

The suspension of several open-ended property funds in March is likely to concern investors. Admittedly, some funds have been struggling for some time but previously, suspensions have tended to relate to a spike in demand for cash withdrawals. This time around, funds have cited issues with valuations. Recently, two of the largest independent valuers have stated that they cannot accurately value the properties within the funds due to the current market environment, reflecting concerns in the property industry as a whole about what the virus will mean for prices.

The latest Colliers investment numbers showed that activity picked up significantly in February from a very weak January. But, on a 12-month rolling average basis, investment was down by almost 20% y/y at just £3.9bn in February, from £4.7bn a year ago. The jump in investment in February was largely due to Blackstone's purchase of the iQ student housing portfolio for £4.7bn. However, the rapid escalation of the virus outbreak is likely to be reflected in subdued investment activity in the coming months.

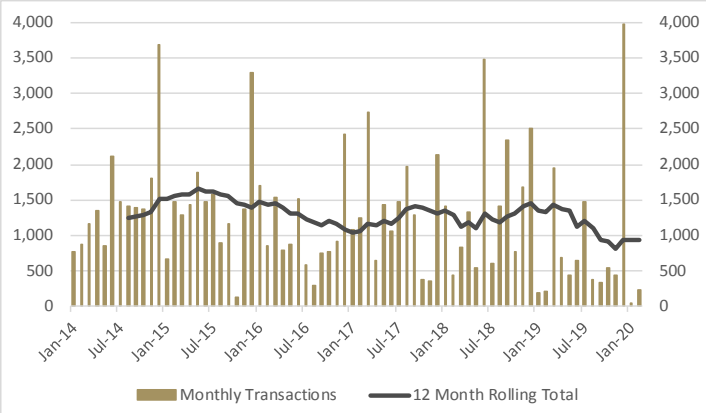
As well as a fall in investment appetite amongst investors, in practical terms, the prospects for property viewings are poor with most workers in the sector now working from home. At a sector level, the widespread shutdown of many businesses over the next few months will lead to conditions in the retail sector worsening, which will weigh even more on investment volumes for the sector, as rents fall and yields rise over the year.

Even before the virus had spread to the extent it has now, the CBRE monthly index for February showed that all-property capital values fell by 0.1% m/m. In the three months to February, values declined by 0.7%. The decline in capital values was mostly due to the retail sector, which saw values fall 1% m/m, while the industrial sector saw capital value growth slow slightly, although the office sector improved on a monthly basis. Although all-property capital values declined, income returns meant that total returns were positive, but only just, at 0.3% m/m.

London Property Market

Central London office investment in February saw a slight improvement on January's very low transaction volumes. But investment remained weak by historic standards. According to CBRE, transactions in February totalled £229m, but this was still significantly below the February average of £600m seen over the past five years (see Chart 2).

2.0 Central London Investment Transactions (£m)



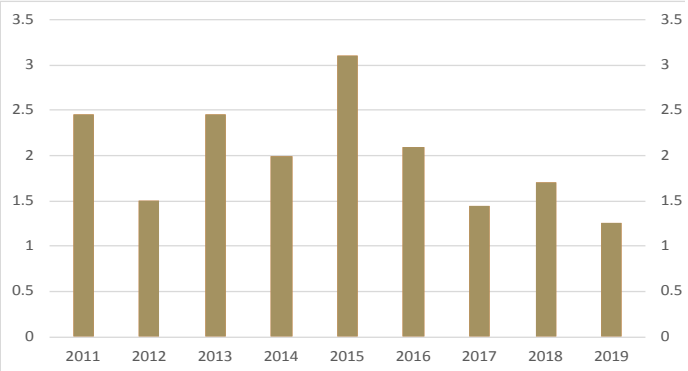
Source: Avison Young

In the office occupier market, February's figures showed a further slowdown from the month before. CBRE reported that take-up totalled around 600,000 sq. ft. in February, which was down 12% on January and well below its historic average. In fact, the Linklaters pre-lease at 20 Ropemaker Street in the City accounted for just over half of activity for the month.

Meanwhile, office availability picked up by 5% to 13.9m sq. ft. in February. This pushed Central London vacancy up from 4.2% in January to 4.4% in February. True, at the end of February there was 12.5m sq. ft. under construction across Central London, which could put upward pressure on vacancy. But around 7.4m sq. ft. (59%) was already let or under offer. In any case, vacancy is likely to rise further this year as business activity is interrupted by containment measures.

In the retail sector, investment was also weak. The latest data for 2019, according to CBRE, show that investment in Central London retail totalled £1.2bn in 2019, which was well below the 10-year average of £2bn (see Chart 3).

3.0 Central London Retail Investment (£bn)



Source: CBRE

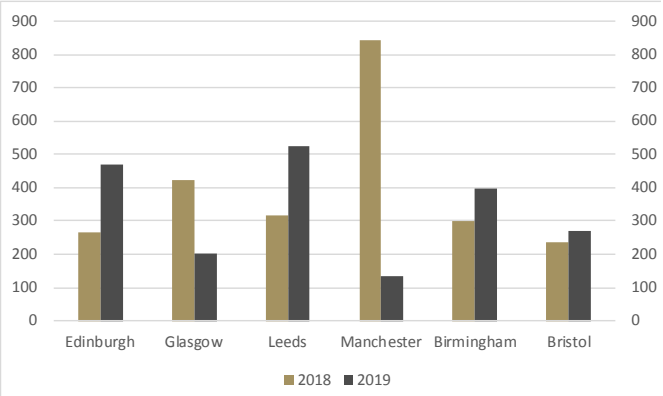
In particular, investment fell in Q2 and Q3, as anecdotal evidence suggests that investors remained cautious about the occupier market. As a result, apart from Bond Street, yields increased across major Central London retail streets for the first time in at least a decade. The closure of all shops selling non-essential goods will increase the pressure on some retailers who may have already been struggling, while others may decide to close stores and not renew expiring leases.

Although Central London rents have mostly been more resilient than national rents, Savills reported that prime Zone A rents across Central London were still down on average 5.8% y/y in 2019. To put this into context, the rate of decline was faster than the minus 3.7% seen during the Global Financial Crisis. Further, Central London retail sales could be disproportionally affected by the effects of the coronavirus due to the stronger reliance on international sales.

Regional Property Market

JLL's Big 6 report, which monitors the major regional office markets, reported a 16% fall in investment in 2019, albeit after a strong 2018. In truth, most markets saw a rise in office investment, but the huge year-on-year decline in Manchester office investment – around 80% – weighed heavily on the regions (see Chart 4).

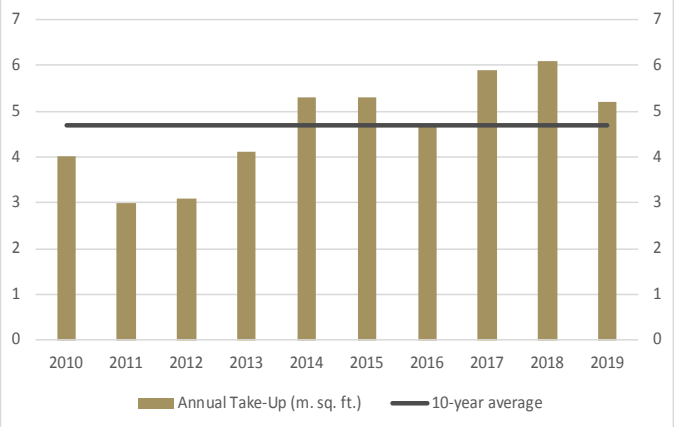
4.0 Big 6 Office Investment (£m)



Source: JLL

For the office occupier markets, there was a mixed picture across the regions. True, take-up fell from 6.1m sq. ft. in 2018 to 5.2m sq. ft. last year (see Chart 5).

5.0 Big 6 Office Take-Up (M. Sq. Ft.)



Source: JLL

But 2018 was a particularly strong year and take-up in all major regions apart from Edinburgh was above its historic 10-year average. Last year, there was a record number of pre-lease deals, equal to 2017, which showed an increasing willingness for occupiers to take space promptly.

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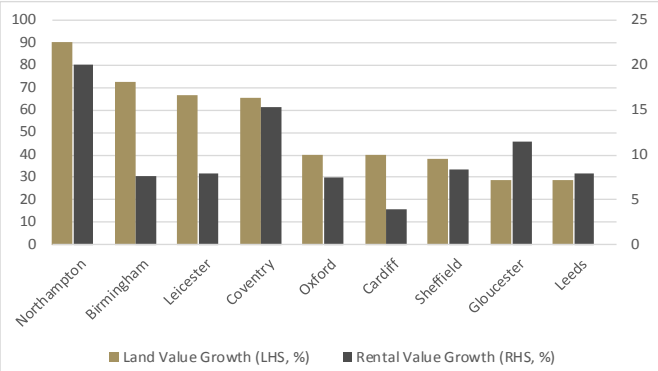
Leasing activity last year was largely driven by the technology, media, and telecommunications (TMT) sector, which saw large deals such as BT, who leased over 200,000 sq. ft. in Bristol and Sky Bet who leased 135,000 sq. ft. in Leeds. Meanwhile completions, at around 550,000 sq. ft., were 3% down on the year before and their lowest level since 2015. In fact, completed space was concentrated in just Manchester and Leeds last year. As a result of tight supply and resilient take-up, prime rents in the major regions grew on average by 5.4% y/y in 2019, with Leeds, Birmingham and Manchester seeing the strongest growth. Looking ahead, although take-up in the regions will face a hit from the coronavirus this year, as not much new supply is being built, this is likely to support regional office rents.

For the industrial sector, occupier demand in the regions remained buoyant last year. Savills reported that take-up in the regions fell by 6% from 2018 to 26m sq. ft. in 2019 from the year before. This was still 5% higher than the average for the four-year period for which we have data. Meanwhile, there was a rise in supply, from 26m sq. ft. in 2018 to 30m sq. ft. However, as land values in some of the regional markets are relatively high, this has restricted speculative supply somewhat in regions such as the Midlands, which has supported rental growth. More timely data from Carter Jonas show that, between Q1 2017 and Q1 2020, the highest industrial land value growth outside of London and the South East was mostly in locations in the Midlands such as Northampton, Birmingham and Leicester, which grew around 60-90% (see Chart 6).

5.0 Top Regional Markets for Land Value Growth



Source:Carter Jonas

Admittedly, the relationship with prime rental growth isn't clear cut, but given the data available, developers have been willing to pay higher land values in these regions as they are expecting higher rental values.

For further information please contact:

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