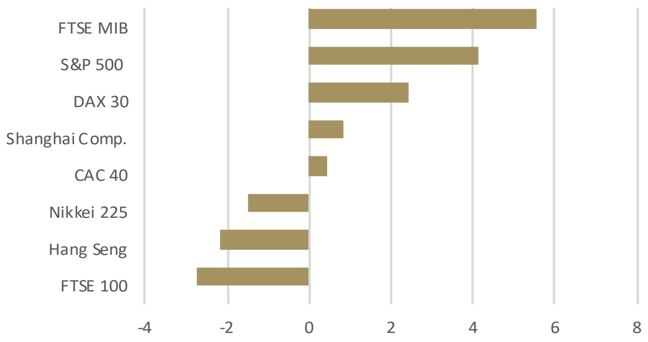
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update February 2020

Economic Overview

Global market developments have been varied considerably over the past month or so (see Chart 1). While global equities took a hit in the middle of February, they had recovered most or all of their initial falls after the initial coronavirus outbreak, before falling drastically towards the end of the month. Virus induced falls aside, the US S&P 500 had been set to outperform thanks to signs of economic recovery in the US after a temporary slowdown during much of 2019, as well as progress in trade talks with China.

1.0 Change in Selected Major Equity Market Indices over 40 Trading Days to 21/02/20 (%)



Source: Refinitiv

In the US, economic growth appears to be bottoming out, with growth of 2.1% annualised in Q4. The economy benefitted from a boost from lower interest rates last year. Nevertheless, GDP growth for the first quarter might be constrained due to supply chain disruptions resulting from global measures to contain the spread of coronavirus. Further, the halt in production of the Boeing 737 Max is also likely be a drag on the economy. Despite both hitting the economy simultaneously in Q1, the impact on the economy is expected to be limited. In fact, the latest Markit composite PMI is consistent with growth remaining close to 2% annualised in the first quarter.

Top 5

- Supply chain disruptions resulting from global measures to contain the spread of coronavirus are heavily impacting the stock market and may constrain Q1 GDP growth;

- The UK economy appears to have reached a turning point following the decisive election result, with the all-sector PMI jumping up 3.9 from late 2019 to January 2020;

- January was a slow month for UK commercial property investment, after a jump in December. Weaker totals may reflect uncertainty related to trade negotiations and some impact on the demand from Asia due to coronavirus;

- Prime rents have shown resilience in central London and some large transactions in the city have led Knight Frank to predict a 21% rise in 2020 London investment volumes;

- London office take-up was slow in Q4 2019. A recent boost in employment may support this however, and pre-lets are bolstering vacancy rates, which are continuing to drop from their 2017 peak.

In Europe, GDP growth slowed in Q4. As Germany's economy stagnated, and France (-0.1%) and Italy (-0.3%) contracted, GDP growth in the euro-zone slowed from 0.3% q/q in Q3 to just 0.1% q/q. Looking ahead, the German economy is likely to continue to flirt with recession in the first half of this year. Although February's Ifo Business Climate Index saw a small rebound from the previous month, the index is below its level and still consistent with the German economy not growing at all in Q1. Meanwhile, the labour market in the euro-zone looks resilient, with employment growing by 1.0% y/y in Q4.

The UK economy appears to be at a turning point, as Brexit uncertainty has waned following a decisive election result. True, GDP growth stagnated in Q4, but timelier survey data suggests that GDP growth edged up early this year. In fact, the all-sector PMI jumped from 50.0 in late-2019 to 53.9 in January.

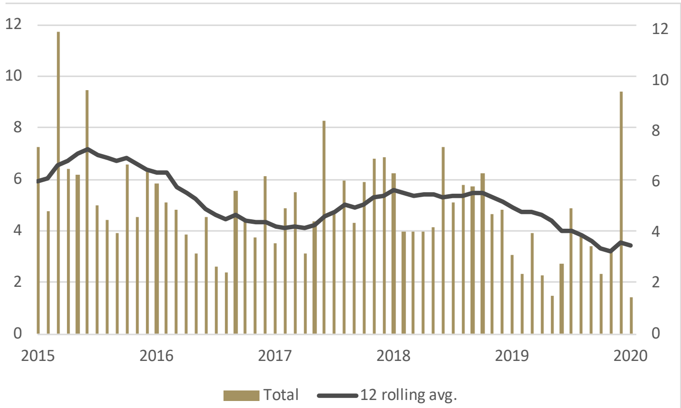
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Furthermore, employment grew strongly in December, rising by 180,000 in the three months prior, which was better than the 145,000 rise that the consensus expected. Although uncertainty related to trade negotiations with the EU is expected to linger for most of this year, looser fiscal policy will drive GDP growth. Indeed, with Rishi Sunak as Chancellor, there is a greater chance of a further relaxation of the fiscal rules, which could be an additional boost to GDP growth over the coming years.

Property Overview

After a notable pick-up in investment activity following the decisive general election in December, activity was subdued in January. According to Colliers' data, the value of commercial property investment was down by almost 60% on the 12-month rolling average at just £1.4bn in January, after jumping to £9.4bn in December (see Chart 2). Weaker totals are likely to reflect uncertainty related to trade negotiations as well as some impact from the coronavirus on demand from Asia.

2.0 Investment monthly rolling total (£bn)



Source: Colliers

Investment activity in January was down on the 12-month average in all of the traditional sectors. One sector particularly affected was industrial, which saw investment around 80% below its 12-month average at just £76m in January. This included Oxenwood Real Estate's purchase of a portfolio in Manchester and Eastleigh, which accounted for a third of the value of the industrial total investment in the month.

This year, there is unlikely to be a significant rebound in investment activity. For one, uncertainty related to trade negotiations with the EU is expected to linger for most of this year. Also, weak investment in the retail sector is expected to be a drag on overall activity as retail rental values are likely to decline further, while yields continue to rise.

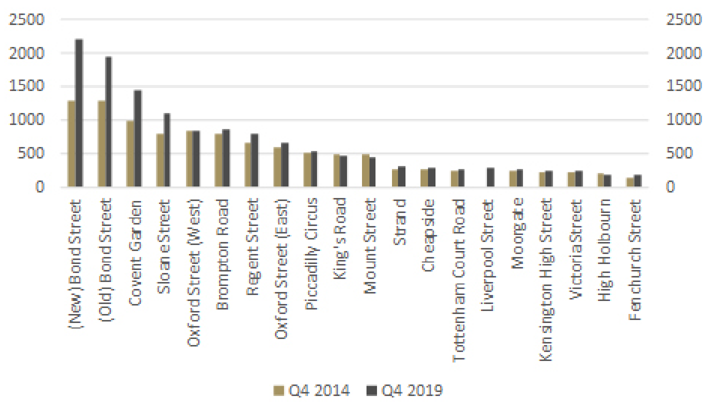
The CBRE monthly index for January which showed that, at the all-property level, capital values declined by 0.2% m/m, with values down by 1.1% in the three months to January. The fall in capital values was largely due to the retail sector, with the office and industrial sectors still reporting some monthly improvement. Despite the fall in capital values, income returns meant that total returns for all-property were positive, but only just at 0.3% m/m.

London Property Market

Knight Frank's Capital Tracker recorded around £40bn of investment in London property transactions across all commercial sectors during 2019, a similar figure to the previous year. And, so far this year, there have been some notable deals such as London's Kings Mall Shopping Centre to Ingka Centres (Ikea) for £137m at a 4% initial yield and the sale of Bedfont Lakes business park in London to Frasers Property, which was the largest UK transaction in January. As such, Knight Frank expects that investment volumes in London could rise by 21% to £48bn this year.

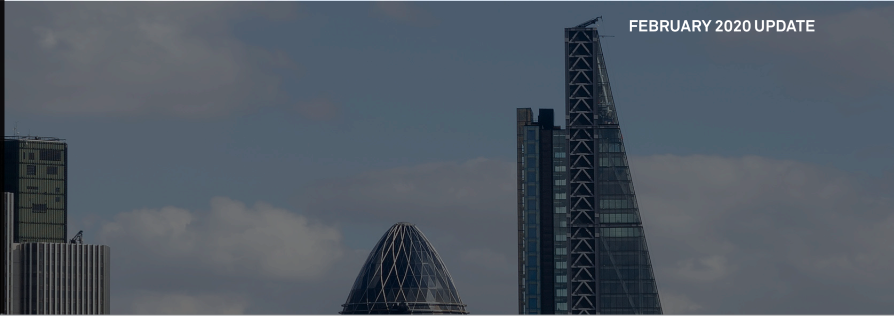
Meanwhile, according to CBRE, prime retail rents in Central London have largely been more resilient compared to their values in 2014. In particular, Bond Street, Covent Garden and Sloane Street Zone A rents have increased the most over a five year period (see Chart 3). Indeed, prime yields in Bond Street and Oxford Street remain unchanged in 2019 at 2.25% and 3% respectively compared with 2018.

3.0 Central London Prime Retail Rates (ITZA, £ sq. ft.)



Source: CBRE

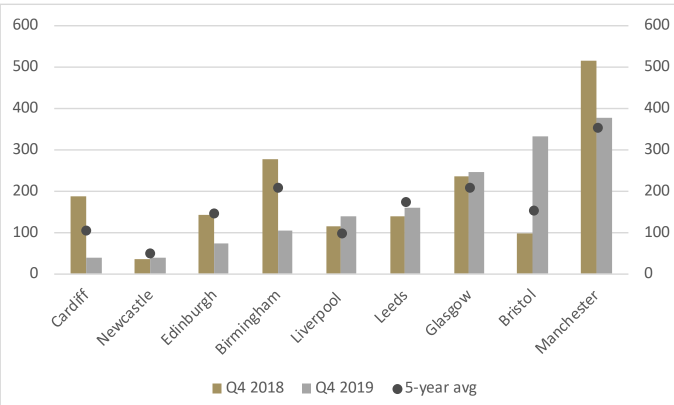
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE



Regional Property Market

In most of the regional cities, there was also a slowdown of office take-up in Q4 (see Chart 4). Bristol was the only city with take-up well above its five-year average at the end of 2019. However, take-up was lifted by BT's pre-lease in the Assembly scheme, which accounted for around 30% of total take-up during 2019.

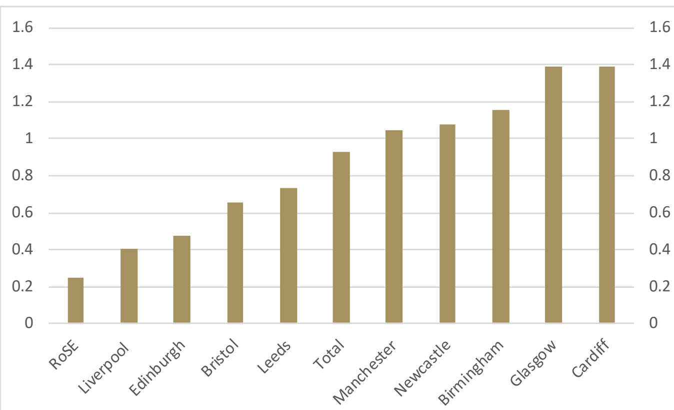
4.0 City Centre Office Take-Up (000s Sq. Ft.)



Source: Avison Young

Nevertheless, as reported by Avison Young, headline city centre office rental growth in the regions held up well, at 2.2% y/y in 2019. Supply in the regions remains tight, which is likely to support rental growth this year. On average, there is less than one year's worth of supply based on annual take-up over the past five years. Notably, the Rest of the South East, Liverpool and Edinburgh look to have particularly tight supply on this basis (see Chart 5).

5.0 Years of Supply in the Regions (Based on 5-Yr



Source: Avison Young

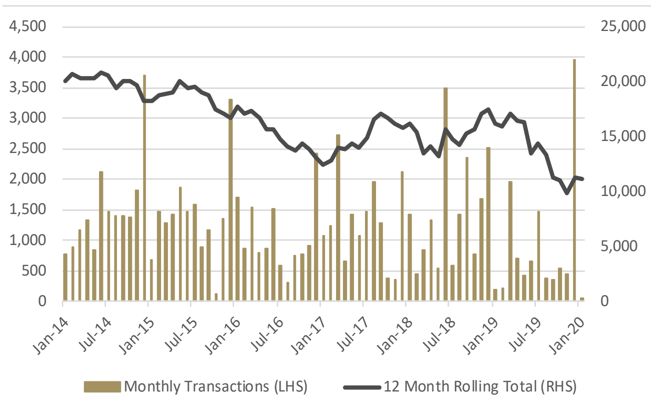
In 2019, occupier demand for industrial space in the regions remained resilient. As reported by Savills, take-up in the regions fell slightly from 28m sq. ft. to 26m sq. ft. in 2019, but it is worth noting that 2018 was a particularly strong year. The Midlands accounted for around half of the regional take-up, with build-to-suit schemes dominating that market. But, there was also an increase in supply in the regions, most notably in the East Midlands, South West and East of England as supply rose from 26m sq. ft. to 30m sq. ft. in 2019. As a result, this put upward pressure on national vacancy, which edged up by 40bps to 6.7% in 2019.

Sector Spotlight

London Offices

The significant increase in Central London office investment at the end of last year looks to have been short-lived as transactions declined sharply in January. According to CBRE, Central London office investment declined by almost 70% from 12-months ago to just £55m in January (see Chart 6).

5.0 Thomson Reuter's Poll - Property Allocation (%)



Source: CBRE

In fact, January's total was significantly lower than the £1.2bn monthly average seen over the past five years. Given that Knight Frank data shows that almost a quarter of investment in London offices in 2019 came from Greater China and other Far-Eastern countries last year, any fallout from the Coronavirus could weigh on activity at the start of this year.

Indeed, there were signs of a slowdown in the London occupier market towards the end of the year. According to Knight Frank, active requirements in the City and West End fell by 5-7% in the final quarter of the year. Despite a handful of deals reported in the final quarter that were over 100,000 sq. ft. such as Apple Pay and Monzo, take-up was down by almost 20% in the City and West End.

Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

There was some better news in the employment data for London, which could support demand for office space. Over the first nine months, about 90,000 new jobs were created in the capital, which was a marked improvement on the year before. However, as uncertainty around a UK-EU trade deal will persist this year, this is likely to weigh more on occupier demand.

Nevertheless, 8m sq. ft. of office space in Central London is expected to complete this year, which is more than the 4.8m sq. ft. that completed last year. As such, the high level of space under construction is likely to put upward pressure on vacancy rates in the near-term. However, there are two reasons why this may not cause a fall in rents. First, just over half of the space under construction in Central London this year has already been pre-let. Second, although it rose a little last year, from 5.5% to 5.7%, vacancy remains well below its recent peak of 7.3% in 2017.

Going forward, the latest IPF Consensus forecasts show that the average expectation is for City and West End office rental values to grow this year, albeit at a slower pace than last year, as rents grow by 0.7% y/y and 1.2% y/y respectively. As capital value growth is expected to improve for the City and West End, the IPF Consensus indicates that this will boost total returns to 4.1% and 4.6% per annum this year, from 3.3% and 3.9% a year in 2019.

For further information please contact:

Sarah White
Head of Marketing
+44 (0)20 7297 4480
sw@rivercap.co.uk