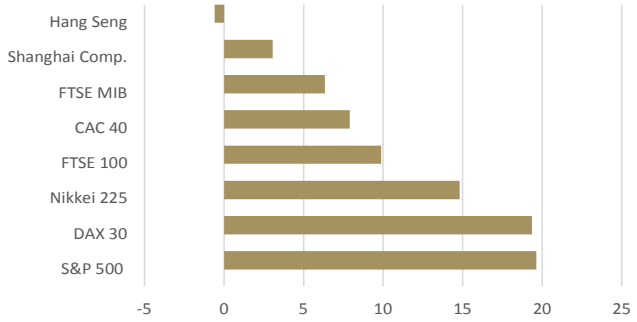
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update May 2020

Economic Overview

Most major equity markets have seen a growth in prices in the last month or so. The exception was the Hong Kong index, which has been affected by growing concerns about political tensions with China (see Chart 1).

1.0 Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 28/05/20 (%)



Source: Refinitiv

While the number of new daily infections appear to have peaked in most developed markets, in terms of cases per million of the population, developed economies are still faring badly. In those countries where the virus has seemingly been brought under control, governments are starting to slowly ease lockdown restrictions.

Although the US still has the highest number of cases worldwide, the tide appears to be turning. Nevertheless, the US economy has taken a substantial hit from the lockdown. Indeed, GDP has already contracted by 4.8% q/q annualised in the first quarter and unemployment rocketed to almost 15% in April. And the latest business surveys suggest output fell sharply in April, particularly in the services sector and point to a worsening in the economy in Q2. Most of the 50 states have now begun to ease their lockdown restrictions, with many states in the interior now maintaining only minor restrictions on normal activity, although states on both coasts still have major restrictions in place.

Top 5

- Most major equity markets have seen a growth in prices in the last month, although developed economies continue to fare badly;

- The tide appears to be turning on coronavirus cases, but we are already seeing the negative effects of lockdown, with GDP contracting 4.8% q/q annualised in Q1;

- Early signs suggest the demand for commercial property space across all sectors will be very weak for Q2;

- With a combination of containment measures that have restricted viewings, alongside investor caution, there was a marked decline in investment activity in April across all sectors;

- Investment in Central London retail held up better than expected, however there is likely to be further upward pressure on yields.

Nevertheless, the reopening of the economy appears to be a slow-moving process, with activity from consumers and firms far from normal levels.

In Europe, countries worst affected by the virus, such as Italy, Spain and France, have seen some of the most stringent containment measures. As a result, they saw a greater fall in Q1 GDP than elsewhere in the euro-zone. Overall, euro-zone GDP slumped by 3.8% q/q in Q1 and although May's composite PMI suggest the euro-zone is now on the slow road to recovery, the biggest hit to activity will be seen in the second quarter. Meanwhile, the impact of lockdowns on the labour market appears to have been muted so far. The unemployment rate rose from 7.3% to 7.4% in March but the small rise reflects that many of those who became unemployed appear to have dropped out of the labour force altogether. Although short-time working schemes will limit some of the increase in unemployment, the outlook for employment in the coming months is bleak, with firms' hiring intentions falling steeply.

Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

The number of new daily infections across Europe however has fallen steadily since the start of April. This has led to some shops and restaurants reopening, and children starting to return to schools in some countries. But even as restrictions are loosened, service sector activity is likely to remain depressed as consumers remain cautious and travel restrictions continue to limit tourism.

Elsewhere, the UK has seen a collapse in economic activity, with indicators beginning to reveal the extent of the destruction caused by the lockdown and social distancing measures. In fact, Q1 GDP confirmed one of the greatest quarterly hits to the economy on record. Furthermore, business surveys suggest the data will only get worse in Q2. There is also likely to be a significant hit to the labour market, though government action will in part mitigate this. Nevertheless, the recent extension of the furlough scheme will not prevent an increase in unemployment, but it will prevent average earnings and employment falling by as much as the slump in hours worked. Even though the UK government's road map outlines the easing of restrictions, normal economic activity is still a distant reality. But, with the 18.1% m/m fall in retail sales volumes in April easily the largest on record, the opening of all non-essential retailers from mid-June will come as some relief for the retail sector.

Property Overview

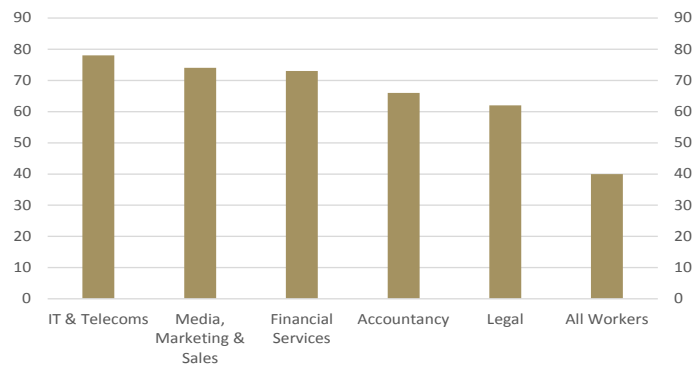
The reduction in economic activity and the poor near-term outlook for the economy are likely to hit commercial property hard. In occupier markets, while there wasn't much of a decline in the first quarter, early signs suggest that demand for space will be very weak across all traditional sectors in the second quarter.

With the retail sector already in structural decline, the outlook has worsened dramatically since March, when non-essential UK stores were forced to close as the country locked down. Evidence from landlords suggests that even though this hit late in the quarter, it adversely affected rent collection. With most stores closed until mid-June, retailers' revenues will be a mere fraction of their usual level in Q2. This poses further risk of withheld rent payments in June, as well as more retailers going under, causing vacancy to rise.

For the industrial sector, despite social distancing accelerating the shift to online spending in recent months, demand will probably weaken too. This is largely because retailers have accounted for around 40% of industrial take-up in recent quarters, which will have knock on effects for the sector.

Meanwhile, the likelihood of a steep fall in UK employment implies a sharp fall in office occupier demand this year. However, office-based employment could hold up better as occupiers have faced less disruption than other sectors because more employees able to work from home (see Chart 2).

2.0 Most likely to work from home (%)

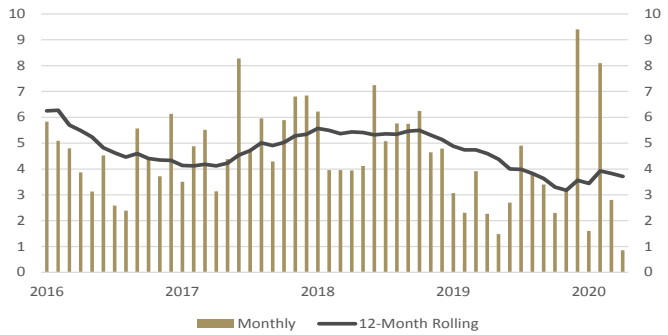


Source: You Gov

Of course, if companies find their employees are as productive away from the office and that more flexible working helps to retain talent this could lead to issues for office demand in the long-term.

With a combination of containment measures that have restricted viewings, alongside investor caution, there was a marked decline in investment activity in April across all sectors. In fact, Colliers reported that the total value of investment transactions in April was just £850m, 60% down on the year before. In turn, on a 12-month rolling average basis, investment activity was 20% lower than a year ago. (See Chart 3.)

3.0 Monthly Investment (£bn)



Source: Colliers

With virus containment measures still in place, investment activity is likely to be very low in the second quarter. Beyond this, an easing of social distancing measures could see activity pick up in the second half of the year. However, with pricing concerns leading to some sellers withdrawing assets from the market, along with buyers likely to remain cautious, the value of investment is likely to remain well below pre-COVID levels.

Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Commercial property pricing has also been a concern in recent months. The spread of the virus brought dramatic turbulence on financial markets, which has had an impact on property valuations. Equity dividend yields rose sharply in Q1 after markets crashed in March, leaving property more overvalued against shares. By contrast, as government bond yields hit historic lows, the spread to property yields rose to new highs. While this implied a better valuation position for property, the reality is that its risk premium is likely to have risen sharply due to the concerns about rent payments and occupancy levels. This has already begun to be reflected in pricing moves in the last two months.

According to CBRE, there were signs of capital values continuing to fall in April. Admittedly, on a month-on-month basis, capital values fell at a slightly slower pace across all sectors in April than in March. Indeed, as the rise in yields slowed, all-property capital values fell by 2% m/m in April, after falling by 3% m/m in March. Unsurprisingly, as the retail sector has been most affected by the lockdown, retail capital values fell by 3.6% m/m in April, albeit less than the 5% m/m drop reported in the previous month. The office and industrial sectors saw more modest declines in values at around minus 1% m/m. Declining all-property capital values and slightly weaker income returns meant that annual total returns fell to minus 1.6%, from minus 2.6% in March. With investor caution only likely to ease, rather than dissipate, in the coming months, yields will probably rise further, which will lead values to fall and returns to remain negative for the remainder of this year.

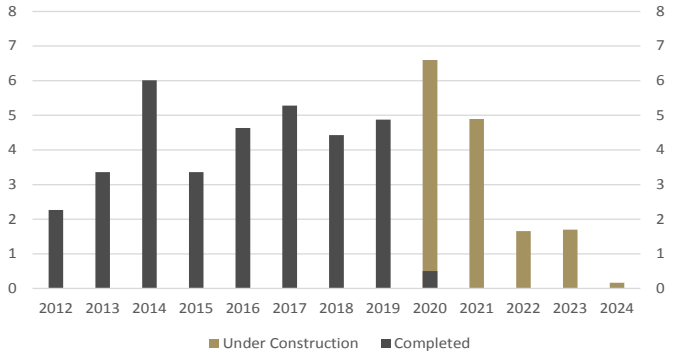
London Property Market

Investment activity for Central London offices was very weak in April. According to Colliers, the total value of investment fell to just £90m, from £2bn a year ago. In fact, the largest deal reported was the sale of an office building in the City to La Francaise for £50m, just over half of the value of transactions in the month.

Similarly, leasing activity for offices showed further signs of slowing in Central London. CBRE reported that take-up fell by around 50% y/y to just 230,000 sq. ft. in April. Indeed, this was the lowest monthly Central London take-up since 1999. On the other hand, at 13.8m sq. ft., Central London office availability was relatively stable over the same period.

Weaker demand led to a rise in the vacancy rate to 4.6% in April, from 4.3% a year before. However, the size of the development pipeline for the next couple of years points to vacancy rising substantially. Indeed, at 6.6m sq. ft., there is a record-high amount of space under construction in Central London, which is largely concentrated in the City (see Chart 4).

4.0 Central London Office Space Under Construction (%)



Source: CBRE

This figure is 35% higher than a year ago. Admittedly, 60% of that space has been pre-let or is under offer, but firms moving to that space are still likely to be releasing older space onto the market at a time when demand is weak.

For the industrial market, there was a notable slowdown in London and the South East. Knight Frank noted that industrial investment in London and the South East was down 60% y/y in Q1 to £460m. This was consistent with a decline in occupier market activity, as take-up also fell by 60% to just 1.2m sq. ft. in Q1 2020, from Q1 2019. Over the same period, while availability rose by around 55% to 8.2m sq. ft., there was a sharp decline in stock under construction, which dropped from 3.5m sq. ft. to 1.6m sq. ft. in the last 12 months, which could provide some relief to rents this year.

Meanwhile, investment in Central London retail held up better than expected. Although Savills reported that total transactions were down 50% from Q1 2019, at £330m in Q1 2020, it is worth noting that this was a particularly strong quarter, skewed by a large one-off deal. One notable transaction last quarter was Hines' acquisition of a mixed-use scheme that included 80 New Bond Street and 325 Oxford Street in February. Nevertheless, given the extent of the challenges facing retailers in Central London at present, investor sentiment for retail assets in Central London is likely to be weak. In fact, all prime Central London high street yields increased by 25bps in Q1 and looking ahead, there is likely to be further upward pressure on yields.

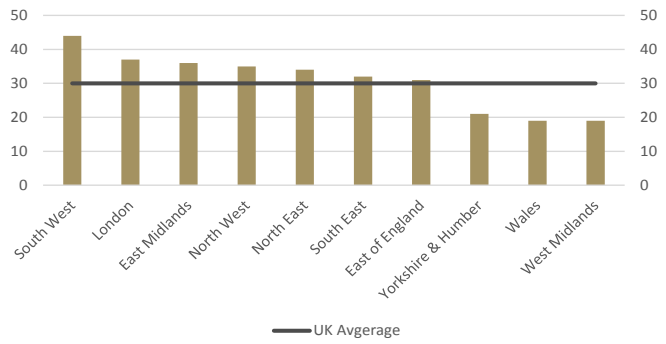
While the lockdown was not in place until the last week of the quarter, consumers were already making reduced shopping trips prior to late March. The NWEC reported that for the first 13 weeks of this year, average weekly footfall in the West End was down 16.6% y/y and worsened significantly in the final weeks of March. That reduction in footfall may have been a contributing factor to the accelerated decline in Central London prime rents, from minus 5.8% y/y in Q4 to minus 8.4% y/y in Q1.

Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Regional Property Market

In the regional market, as tenants struggled to pay their rents, there was a decline in rental collection in the first quarter. Data from Re-Leased show that most regions saw less of a steep decline in rent collection for all the traditional sectors than London, with the South West as the exception. Indeed, some regions such as the West Midlands (-19%), Wales (-19%) and Yorkshire & Humberside (-21%) have seen the least sharp declines from their average rent collection rates (see Chart 5).

5.0 Decline in rent collection in Q1 compared to two-year average (%)

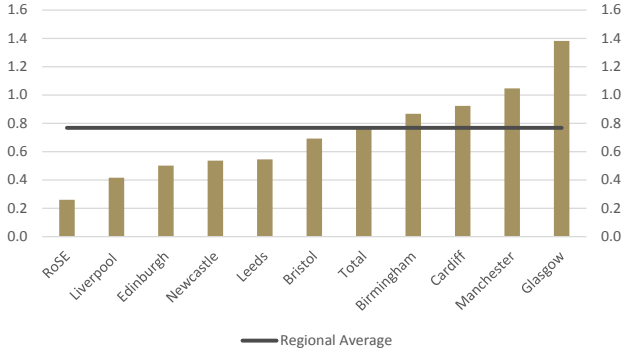


Source: Re-Leased

With buyers particularly cautious towards the end of the quarter, investment activity in regional offices continued to slow in Q1. According to Avison Young, the value of transactions fell by 20% from a year ago to just £230m, which was the weakest quarter for a number of years. However, some markets fared better than a year ago. For example, with almost £70m transacted in Leeds in Q1 2020, the city took the biggest share of office investment in the regions in Q1 and this was significantly up on the £15m transacted in Q1 2019.

On the other hand, the occupier market for regional offices held up relatively well. The occupier markets saw a rise in take-up in Q1. Admittedly, it was a mixed picture across the cities as Leeds and Cardiff saw declines, while Birmingham saw a notable boost. But overall, regional city take-up was 20% up on the previous year. Indeed, although they're likely to still fall, regional rents will probably be supported by a more limited supply pipeline. On average, based on annual take-up over the past five years, there is less than a year of new supply under construction (see Chart 6). On this basis, the pipeline looks particularly tight in markets such as Liverpool and Edinburgh.

6.0 Years of Supply Pipeline in the Regions (Based on 5-Yr Avg. Take-Up)



Source: Avison Young

For further information please contact:

Sarah White
Head of Marketing
sw@rivercap.co.uk