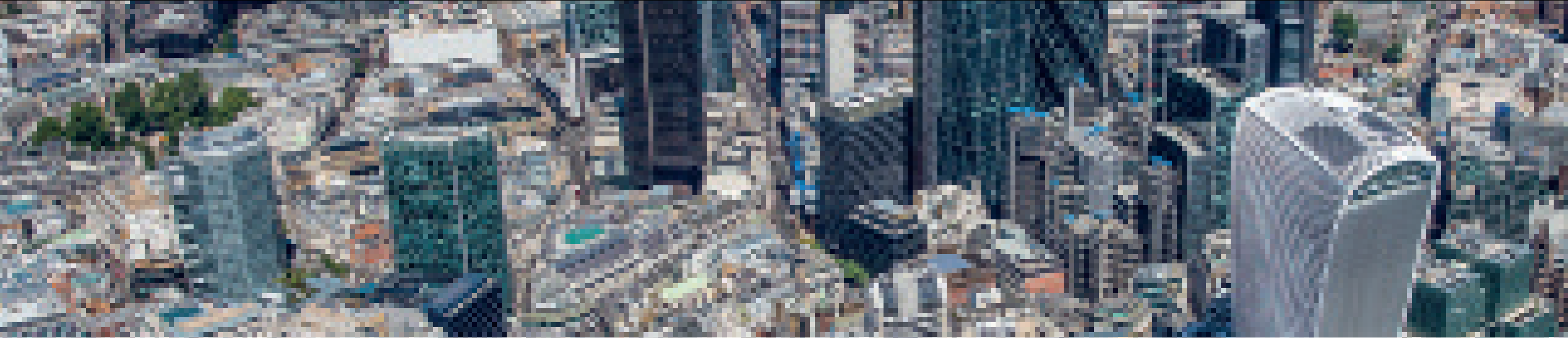
Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

Quarterly Review: Q4 2020



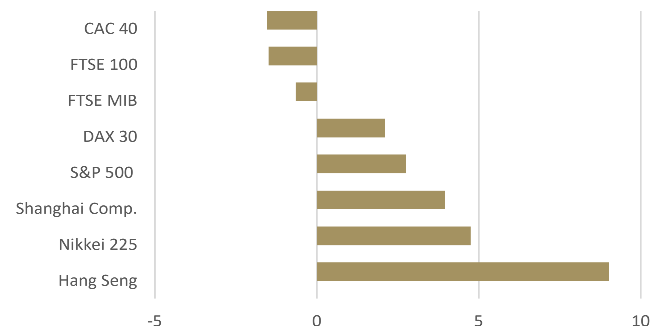
Top Five

- While COVID-19 case numbers in the UK are falling, they remain very high. This is likely to mean that severe restrictions will remain in place in the near-term.
- Second hand space causes a surge in central London office supply, and a two-tier market emerges.
- In the regional office market, there is less than a year's worth of new supply. Leeds, Liverpool and Cardiff have the lowest supply levels.
- The weakness in the retail occupier market caused by lockdowns, office workers working from home and weak tourism flows meant that retail yields rose by between 50bps and 100bps y/y in Q4 across prime Central London retail streets.
- A rise in online sales supported industrial take-up across the regions, which rose by around 60% y/y to 42m sq. ft. in 2020.

1. Economic Overview

The relatively muted rise in most equity markets in recent weeks reflects the fact that positive news about the fast rollout of COVID-19 vaccines has been partly offset by a high number of infections in many advanced economies (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days (%)



Source: Refinitiv

That said, the growing number of new vaccines and the speed of the rollout in some economies poses an upside risk to growth in the second half of the year.

In the US, GDP saw a more modest gain of 4% annualised in Q4, from a 33.1% annualised rise in the previous quarter. The slowdown in growth was due to some temporary weakness in consumption, which was dragged down by the resurgence in coronavirus infections. Indeed, poor retail sales figures show the impact that restrictions were having on retailers. The headline sales figure fell 0.7% m/m in December, following a 1.4% m/m fall in November.

Further, a plunge in leisure and hospitality employment as businesses closed resulted in a 140,000 drop in non-farm payrolls in December, though the unemployment rate remained stable at 6.7%. With coronavirus cases now falling and Congress agreeing on a new $900bn stimulus late last year and the Democrats looking to push through further stimulus, this could support consumption growth and pave the way for restrictions to be eased in the first half of this year.

Meanwhile, euro-zone GDP contracted by 0.7% q/q in Q4 as the surge in coronavirus cases prompted countries to impose renewed restrictions on activity. And the decline in the composite PMI in January to 47.5, down from 49.1 in December, confirms that the tighter measures are taking their toll on the economy at the start of this year too. Further ahead, the arrival of new, more transmissible variants, as well as the slow speed of vaccination programmes compared to the UK and US, could delay the lifting of restrictions. This is likely to have a much bigger effect on the Mediterranean economies that are more dependent on summer tourism.

In the UK, the latest GDP figures show that due to the second lockdown, GDP contracted by 2.6% m/m in November, which left the economy 8.6% below the pre-crisis level. With hospitalisation rates rising, national restrictions tightened again in December and remained in place throughout January. This meant the closure of non-essential shops in the period before Christmas, which cut short the rebound in retail sales. Nevertheless, the 0.3% m/m rise in retail sales in December left sales 2.7% above their pre-virus level. But daily card payment data show that consumption fell to about 35% below pre-virus level in January as non-essential stores remained closed. While COVID-19 case numbers had fallen back by the end of January, they remain very high along with the number of virus patients in hospitals. This is likely to mean that severe restrictions will remain in place in the near-term.

More encouragingly, the furlough scheme has prevented a sharp rise in unemployment. Despite the contraction in the economy, the unemployment rate has only risen from 4% in February to 5% in November. But once the furlough scheme finishes at the end of April, unemployment will probably increase further.

2. London

2.1 Occupational Market

Occupiers continue to take a wait-and-see approach on their longer-term use of office space. As such, Central London office take-up saw its lowest quarter on record in Q4. According to CBRE, Q4 take-up was just 853,000 sq. ft., down almost 80% from the same quarter in 2019.

Occupier demand in the two largest Central London office markets, City and West End, was hit particularly hard. In the City, leasing activity fell by around 75% in Q4 2020 compared to Q4 2019, reaching just 380,000 sq. ft. The largest deal of the quarter was City University taking 74,000 sq. ft. at 33 Finsbury Square. Similarly, take up in the West End declined by 75% y/y to 330,000 sq. ft. in Q4.

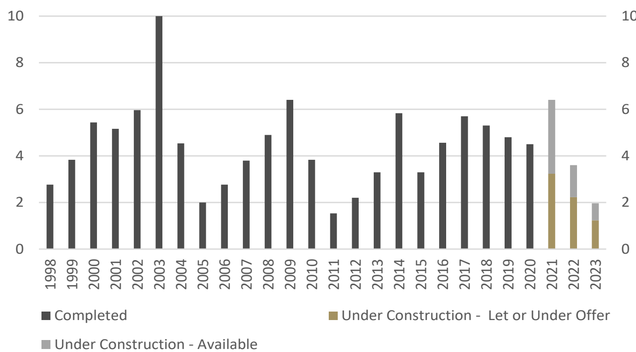
Over the same period, available office space in Central London increased by 90% y/y to 23.2m. sq. ft. This was largely due to tenants releasing space back to the market. As a result, availability was at its highest point since 2004, when it reached 25m. sq. ft. following the dotcom crisis.

In the City, availability increased from 5.3m. sq. ft. in Q4 2019 to 10.8m. sq. ft. in Q4 2020, the highest since its peak in Q2 2004. Meanwhile, West End availability rose from 3.1m. sq. ft. to 6.6m. sq. ft., its highest since Q4 2009.

The increase in available space translated into a marked rise in vacancy in 2020. City vacancy rose from 5.1% at the end of 2019 to 10.7% in Q4 2020, while vacancy in the West End increased from 2.8% to 5.8%. Overall, Central London office vacancy more than doubled from 4% to 8.1%.

With completions in 2021 likely to reach their highest level since 2009 at around 6.4m. sq. ft., Central London vacancy is likely to rise further in the next 12 months (see Chart 2).

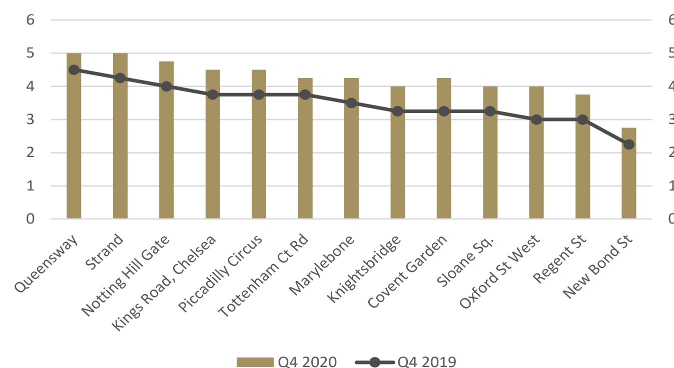
Chart 2: Central London Development Pipeline (M. Sq. Ft.)



Source: CBRE

Admittedly, in the face of a weak occupier market, in which incentives have risen and lease lengths and rents have fallen, there is a chance that developers could push the completion of some projects into next year, which may ease some of the downward pressure on rents. As things stand though, CBRE expect a much lower 3.6m. sq. ft. and 2m sq. ft. to complete in 2022 and 2023 respectively. Those figures are low by recent standards, although as they will add to stock while firms are downsizing their office space, they are likely to contribute to further increases in vacancy, albeit at a much slower pace than the last 12 months.

Chart 3: Central London Prime Retail Yields (%)



Source: CBRE

Central London retail has suffered from the closure of non-essential stores, as well as people working from home and weak tourism flows. Prime Central London retail yields are reported to have risen by between 50bps and 100bps in Q4 from Q4 2019. Indeed, Oxford Street and Covent Garden saw the largest increases over this period.(see Chart 3).

Meanwhile, with online sales elevated, industrial occupier demand in London and the South East strengthened in 2020. According to Savills, annual take-up rose by 5% y/y to 8.3m. sq. ft., which was a record year for take-up. Consistent with other years that have seen very strong levels of take-up, Amazon took 40% of space in the year.

Industrial availability in London and the South East declined by almost 30% y/y to 4.2m. sq. ft. in 2020, pushing the vacancy rate down from 5% to just 3.5%. With occupier demand strong, this points to a positive outlook for rents this year. Admittedly, the development pipeline has doubled to 2.7m. sq. ft. during this time, which could limit the extent of rental growth in the near term.

2.2 Investment Market

Meanwhile, CBRE report that Central London office transactions totalled £4.3bn in Q4, which was lower than the £4.9bn transacted in Q4 2019. In part, the national lockdown in November and December, which prevented some viewings and inspections again, as well as the nearing Brexit deadline probably weighed on activity. More encouragingly, the quarter saw the return of a few large office deals in Central London, which included Sun Venture's £550m purchase of 1 & 2 New Ludgate, EC4 from Landsec and AGC's acquisition of 1 London Wall.

This meant that Central London transactions ended the year at £7.5bn in 2020, down a third on the year before. Despite travel restrictions, overseas investors represented a larger share of purchases of Central London offices at almost 90%, up from 52% in 2019.

3. Rest of UK

3.1 Occupational Market

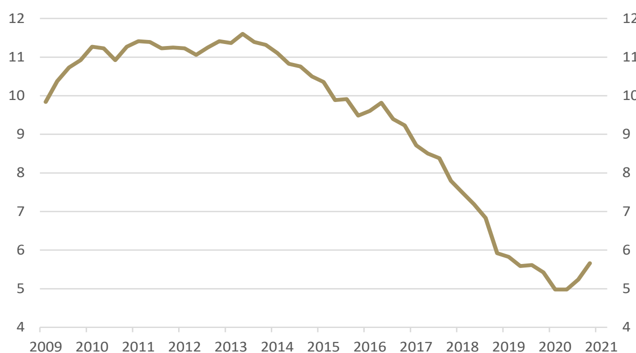
In the regional office occupier market, city centre take-up in Q4 continued to improve from its very low level in Q2. But at 1m. sq. ft. in Q4, according to Avison Young, take-up across the top nine regional markets was still down by 30% on Q4 2019.

The only market in which activity improved compared to Q4 2019 was Cardiff and this was due to Legal and General signing for 121,000 sq. ft. in the Interchange Building, which accounted for three-quarters of space taken in the city in Q4. In terms of size, this deal was the second largest regional deal of the quarter, behind BT taking 175,000 sq. ft. in Four New Bailey, Manchester.

Regional office availability rose by 9% y/y to 10m sq. ft. in Q4. As a result, vacancy increased by 23bps to 5.7% over this period. However, this remains low by recent standards and well below the recent peak of 11.6% in Q2 2013 (see Chart 4).

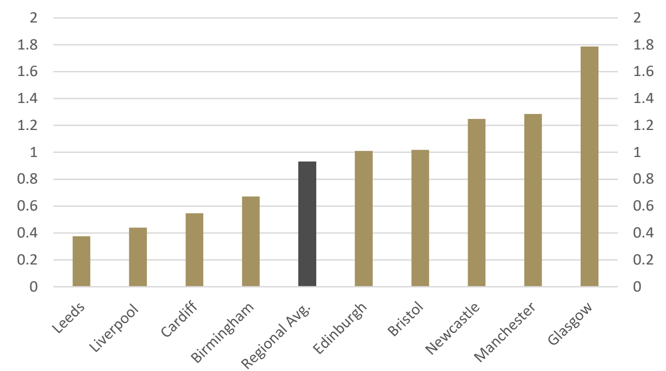
Nevertheless, the outlook for rents this year will be dented by weaker occupier demand. Indeed, the latest RICS commercial survey shows that surveyors remain pessimistic about the outlook for regional office rents this year as an average net balance of 48% of surveyors expect a decline in rental values. However, the relatively limited development pipeline in the regions should mitigate the size of the rent falls. On average, there is less than a year's worth of new supply in the regions based on annual take-up over the past five years. On this basis, cities such as Leeds, Liverpool and Cardiff seem particularly tight and rents could hold up better here than in other cities with more substantial pipelines (see Chart 5).

Chart 4: Regional Office Vacancy Rate (%)



Source: Avison Young

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

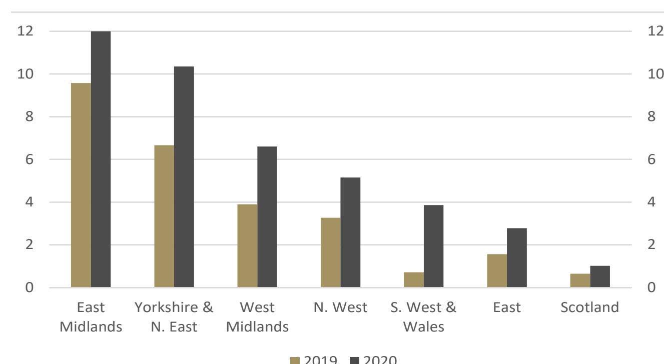


Source: Avison Young

As restrictions pushed more people to shop online, occupier demand for regional industrial property strengthened in 2020. Savills report that annual take-up in the regions rose by around 60% y/y to 42m. sq. ft. in 2020, with all regions seeing an increase compared to 2019 (see Chart 6). In fact, record levels of take-up were reported in the East Midlands, North West and Yorkshire and the North East.

Strong demand meant that industrial availability in the regions fell by 7% y/y to 27.8m. sq. ft. in 2020. Most regions saw availability fall or remain stable apart from Scotland and the South West and Wales. As a result, these were the only two regions that saw vacancy rise over this period. The rest of the regions saw vacancy fall between 60bps and 220bps.

Chart 6: Regional Industrial Take-Up



Source: Savills

3.2 Investment Market

Avison Young reported regional office investment of £580m in Q4 2020. This was a rise of 11% against Q3 but was still down on the same quarter from a year ago, when £640m transacted. Though admittedly Q4 2019 was a strong quarter by recent standards. The total was supported by a handful of large deals in the quarter such as Helical selling the Powerhouse Portfolio, comprising three Manchester office assets, for £119 million and Warrington Borough Council forward-funding BT's new superhub at 4 New Bailey for £112 million, reflecting a yield of 4.25%. Across the nine biggest regional office markets, the average prime yield ended the year at 5.3%, which was unchanged from a year ago and suggests that investor appetite remains strong for buildings in good locations with strong covenants.

For more information:

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