Quarterly Review: Q1 2021

Top Five

• With virus case numbers falling back over recent months in the UK and restrictions set to ease further by the end of June, economic activity is likely to recover strongly in H2.

• Despite government advice remaining to work from home if you can, the proportion of those present in the office in April was higher than at any other point since the start of the pandemic.

• Central London office take-up was down almost 40% y/y to just 1.2m sq. ft. in Q1 2021, with falls in the City and West End broadly similar.

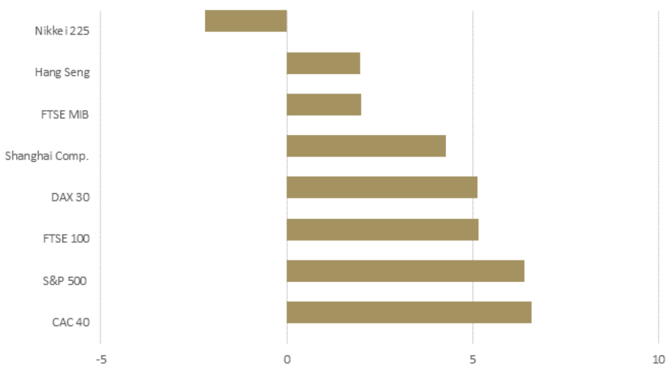
• The strong rebound in office investment in the capital city at the end of last year faded in early 2021 with £1.3bn transacting in Q1, down from £4.3bn in Q4.

• Across the regional office market and unlike in London, office supply has remained in check. In particular, supply in Leeds, Liverpool and Cardiff looks tight.

1. Economic Overview

The fast rollout of COVID-19 vaccines, lower number of infections and hospitalisations and the planned reopening of many advanced economies have boosted economic sentiment. This has resulted in rallies in most equity markets in recent months, though this has partly been offset by a fall in prices over inflation concerns in recent weeks (see Chart 1.)

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



Source: Refinitiv

In the US, GDP growth accelerated to 6.4% annualised in Q1, leaving output levels just below their pre-pandemic peak. This rise was helped by two rounds of government stimulus cheques sent out in the first three months of the year, which supported a surge in consumption. Indeed, retail sales increased by 9.8% m/m in March, as stimulus cheques pushed up spending on big ticket items such as cars and electronics. That said, only a small fraction of this cash was spent immediately, most was instead saved or used to pay down debt, which suggest that consumption will remain strong.

Meanwhile, a boost to leisure & hospitality employment after the lifting of virus restrictions resulted in a 266,000 rise in non-farm payrolls in April. Nevertheless, this still leaves employment at 7.3 million below its pre-pandemic peak of just over a year ago and the unemployment rate at an elevated 6.1%. Admittedly, a sharp drop in demand for vaccines in recent weeks has raised concerns about another virus wave. But with household savings strong and restrictions still easing, the US economy is still likely to benefit from a boost in spending over the coming months.

In Europe, elevated numbers of coronavirus cases and slow vaccinations prolonged restrictive measures in many countries. It was not a surprise that GDP declined by 0.6% q/q in Q1, leaving the euro-zone economy 5.5% below its pre-crisis peak. With the pace of vaccinations accelerating in Q2, the more recent economic data has been encouraging. At the current rate of vaccination, the EU should meet its target to deliver first doses to 70% of the adult population by the end of the summer. Some countries are easing restrictions already, with Italian prime minister Mario Draghi recently encouraging tourists to book their summer holidays.

Although lockdown restrictions were still tight in March in the UK, a rise of 2.1% m/m in GDP left the economy 5.9% below its pre-crisis level, which may indicate that January was the low point of the year. Since then, hospitalisation rates have fallen sharply and some measures have been eased. Meanwhile, the surge in retail sales volumes in April shows that households flooded back to the shops once they reopened in the middle of the month, with clothing sales seeing a strong rebound. And while there were pockets of inflation in those sectors that reopened, with clothing inflation bouncing back from -3.5% to +0.5%, the jump in CPI inflation from 0.7% in March to 1.5% in April was almost entirely driven by energy price effects that are likely to be temporary. With case numbers falling back and restrictions set to ease further in May and June, economic activity is likely to accelerate in the second half of the year.

Meanwhile, despite a decline in employment in the three months to February, a fall in the workforce meant that the unemployment rate dipped to 4.9%. But although the worst of the jobs contraction is probably behind us, once the furlough scheme ends in September, there could be some further shake out in unemployment.

2. London

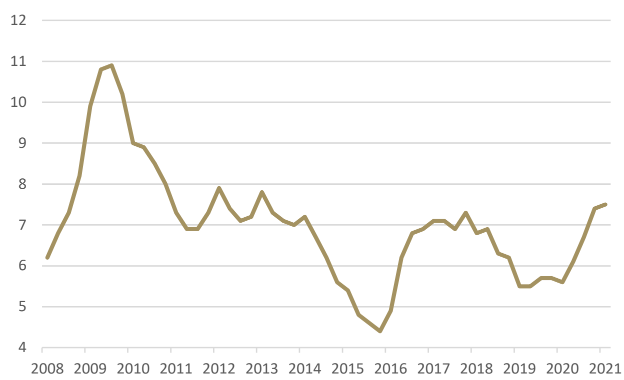
2.1 Occupational Market

Government advice remains to work from home if you can, but this has not deterred workers from returning to the office in recent weeks. According to Metrikus, 45% of employees were present in the office in April, which was higher than at any other point since the start of the pandemic and a marked improvement on the lows of 16% seen in January.

That said, companies remain hesitant to commit to long-term requirements for now. While Q2 2020 was the low point for office occupier demand in Central London, the recovery in demand has remained extremely weak since then. Knight Frank report that Central London office take-up was down almost 40% y/y to just 1.2m sq. ft. in Q1 2021 and this was only slightly higher than the 1m. sq. ft. recorded at its low point in Q2 2020. Within the two largest London sub-markets, the falls were broadly similar. In the City, take-up fell 40% y/y to just 0.7m. sq. ft. and even this was boosted by Latham & Watkins pre-let of around 200,000 sq. ft. in 1 Leadenhall. Similarly, occupier activity in the West End was weak too, with take-up down 35% y/y to 0.4m. sq. ft..

At the same time, a marked rise in tenants returning space to the market meant available office space in London rose by 40% y/y to 17.9m. sq. ft in Q1. In turn, vacancy in Central London had soared from 5.6% in 2019 to 7.4% by the end of 2020. Since then, it has edged up slightly to 7.5% in Q1, its highest since Q1 2013 (see Chart 2).

Chart 2: Central London Vacancy Rate (%)

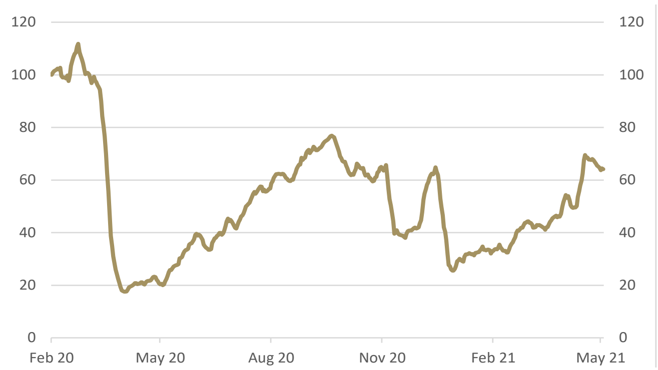


Source: Knight Frank

Further, Knight Frank estimate that completions are set to rise to 5.9m. sq. ft. in Central London this year from 4.7m. sq. ft. last year. Around a third of this space is speculative, so vacancy is likely to rise further. Indeed, the latest RICS commercial survey showed that although surveyors were less pessimistic in Q1 than in the previous quarter, they expect London office rents to fall this year.

With non-essential shops closed in Q1, most retailers had a tough start to the year. Central London retailers, which are more reliant on office workers and tourists, have suffered especially. That said, LDC report that retail vacancy in London was stable at 10.7% in Q1 compared to the previous quarter, whereas the UK total rose by 40bps to 14.1% in this period. Since then non-essential stores have re-opened and some workers have returned to the office, which has seen footfall rise in London over recent weeks (see Chart 3).

Chart 3: London Footfall (100 = Feb 20)



Source: Apple

Admittedly, it remains well below pre-pandemic levels, but this should provide some relief to London retailers.

In the industrial sector, take-up of smaller units in West London and the Thames Valley saw a marked decline last year. JLL recently reported that, although occupier activity in the Western Corridor improved significantly in H2, take-up was still down by 30% y/y in 2020. That said, availability in the corridor trended down and was 20% y/y lower by year-end, which should help support rents.

2.2 Investment Market

The strong rebound in office investment in the capital city at the end of last year was not sustained in Q1. CBRE reported transactions of £1.3bn in Q1, down from £4.3bn in Q4, but investment tends to drop in Q1 and totals were similar to the £1.4bn transacted a year ago. In Q1, the largest transaction was the acquisition of 66 Shoe Lane in EC4 by a consortium of Hong Kong investors for £255m.

3. Rest of UK

3.1 Occupational Market

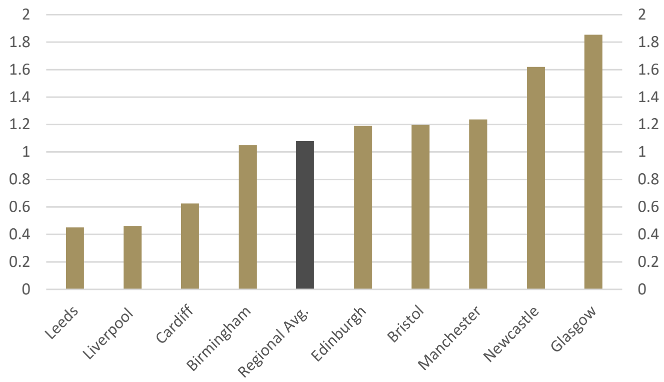
Although occupier demand in the top regional city centres has improved since a dramatic drop in Q2 last year, take-up levels remained subdued. Avison Young report that regional city centre take-up was 0.8m. sq. ft. in Q1, which was slightly down on the previous quarter and around 40% lower than levels in Q1 2020. On a year-on-year basis, Newcastle was the only market to see an improvement in take-up. The 60% y/y rise in Q1 was in part due to 44,700 sq. ft. pre-let to lawyers Womble Bond Dickinson.

By contrast, demand for out-of-town regional locations fared better. It's not clear whether some of these occupiers have favoured peripheral locations due to more remote working and less need to be in city centres, or if this demand will be sustained. Indeed, take-up increased by 20% y/y to 0.7m. sq. ft. in Q1. This was most evident in Leeds, Bristol and Liverpool, which all saw take-up more than double from a year ago. Notable was the Lowell Group pre-let of 133,000 sq. ft. in Thorpe Park Business Park in Leeds, which was the largest regional deal of the quarter. At the same time, total office availability in the regional cities rose by 25% y/y to 10m. sq. ft. in Q1. Regional vacancy had risen by 80bps y/y to 5.8% in Q1, although it has stabilised since Q4 2020 and remains low by recent standards.

That said, the rental outlook for regional offices remains weak. While the latest RICS commercial survey shows that surveyors are less pessimistic about the outlook for this year, an average net balance of 33% of surveyors still expect rental values will fall. And although the development pipeline increased by 20% y/y to 6.1m. sq. ft., it remains limited , with only enough space to cover a year's take-up based on the five-year average.

On this basis, cities such as Leeds, Liverpool and Cardiff seem particularly tight, which bodes well for rents there. (See Chart 4.)

Chart 4: Years of Supply in the Regions (Based on 5-Yr Avg. Take-Up)

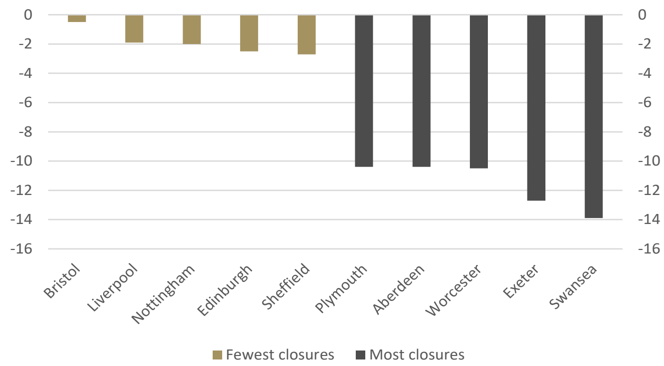


Source: Avison Young

In the South East, there have been few signs of occupiers rushing to take cheaper office space outside of the capital city. Though office take-up has improved since its lows in Q3 2020, it remains weak by past standards. According to CBRE, take-up was 1.0m. sq. ft. in Q1, which was up on 0.6m. sq. ft. recorded in the previous quarter, but 30% down on the same quarter last year. Three, the telecommunications firm, took 120,000 sq. ft. in Reading, which was the largest deal in the South East. In addition, a marked rise in second-hand space resulted in total availability increasing by 10% y/y in Q1, though this is a relatively modest rise compared to the other regions and London. But that hasn't been enough to prevent vacancy in the South East rising by 70bps y/y to 7.5% in Q1, which is not far from highs of 9-10% seen after the GFC and Dotcom crisis.

Meanwhile, given that most leisure facilities have been shut or operating at a low capacity, it is unsurprising that the leisure sector has seen a raft of closures since the start of the pandemic. For licensed property such as pubs, bars and restaurants in the regions, major city centres have recorded fewer closures than smaller ones. In February, large cities such as Bristol, Liverpool, Nottingham, Edinburgh and Sheffield have all lost fewer than 3% of sites compared to March last year. By contrast, five relatively small city centres such as Plymouth, Aberdeen, Worcester, Exeter and Swansea have seen a net decline of more than 10% of premises. (See Chart 5.)

Chart 5: Net Decline in Licensed Premises in Feb 21 (vs Mar 20 %)



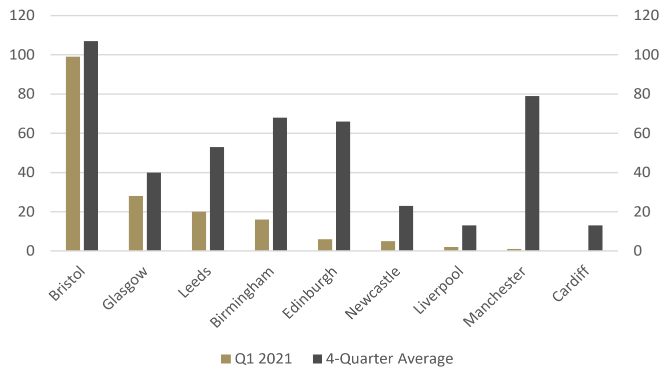
Source: Alix Partners

3.2 Investment Market

In Q1, investment in regional industrial assets registered its highest quarterly total since Q4 2018. Lambert Smith Hampton report that regional industrial investment was up to around £0.8bn in Q1 2021 from £0.1bn in the same quarter last year.

By contrast, after a strong Q4, investment in regional offices took a hit at the start of this year. According to Avison Young, transactions were down 40% y/y to £180m in Q1. On the same basis, while all the major regional markets saw falls, activity held up in Bristol in Q1 (see Chart 6 - following page). This was thanks to the sale of Temple Quay House to Aberdeen Standard, which accounted for three-quarters of the city total. Meanwhile, the average prime yield in the regions remained stable at 5.3% in Q1 compared with a year ago.

Chart 6: Regional Office Investment (£mn)



Source: Avison Young

For more information:

Please contact Sarah White;

sw@rivercap.co.uk