Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

Quarterly Review: Q3 2021

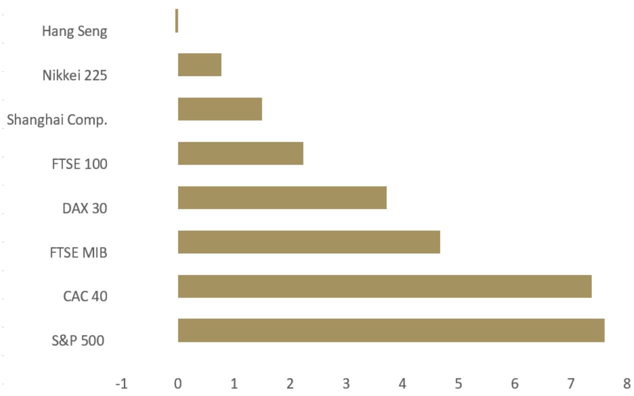
Top Five

- Global economic recovery seems to be faltering slightly, as the initial post-lockdown momentum fades, policy support is gradually reduced and supply shortages emerge. Concerns about inflation have also intensified, most notably in the US.
- The latest property data, however, hints that the post-pandemic economic recovery is feeding into UK commercial markets, with tentative signs of improvement in all sectors and regions, and across occupier and investment indicators.
- This upturn is apparent in the London data, with office market activity turning a corner in Q3. Although reopening has not helped the capital's retail as much as in the rest of the UK, with visitor levels still well down in the largest cities.
- Investment activity was slightly weaker in Q3, albeit still on track to exceed last year's lows. Within this, there was a strong contribution from Central London offices, while yields edged lower in City and West offices and South East industrial.
- Regional office markets recorded some of their strongest out-turns since the start of the pandemic and this is also mirrored in somewhat stronger underlying investment activity. Despite this, prime yields held broadly steady across most sectors and markets.

1. Economic Overview

Despite some jitters on the back of worsening inflation concerns, rising bond yields and fears of the collapse of Chinese property developer Evergrande, developed world equities have risen further over recent months. The MSCI Index of DM equities has gained about 4% since August and stands 30% above its pre-pandemic peak. Within this, European bourses recorded the biggest increases, while the weakest were in Asia (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over 40 Trading Days to 23/11/21 (%)



Source: Refinitiv

But the global economic recovery seems to be faltering, as the initial post-lockdown momentum fades and policy support is reduced. These effects have been exacerbated by supply shortages that are likely to persist well into next year. Shortages have been especially acute in the US, where GDP growth slowed to only 2.0% q/q annualised in the third quarter, much weaker than the strong Q2 rebound. This was led by softer consumer spending and highlighted by disappointing retail sales. Meanwhile the lingering impact of the Delta variant has also stalled the recovery in employment, which remains well adrift of pre-pandemic levels even after a strong October outturn.

The US is also where the concerns about stagflation are most pointed. US CPI inflation surged to more than 5% during September due to a jump in energy prices, the impact of supply shortages and the rebound in prices of high contact services, as restrictions have eased. While these should be temporary, there are concerns that price pressures and labour shortages could fuel wages and prevent inflation rates easing next year, though as yet the Fed seems in no hurry to respond.

Euro-zone GDP increased by 2.2% q/q in Q3, slower than in Q2, but leaving the economy only half a percentage point below its pre-pandemic level. But even in Europe, the outlook has deteriorated. Retail sales have been flat since May, which suggests that the period of rapid catch-up growth in goods spending is ending. Meanwhile, the auto sector has been hit by chip shortages and a lack of skilled workers, and higher energy prices will also dampen activity in other industries in the near term.

The increase in euro-zone headline inflation from 3.4% in September to 4.1% in October was driven by both energy and core price rises. Pressures look set to intensify before year-end too, as higher input costs continue to feed through, though generally inflation concerns are less pronounced than in the UK and US.

While economic activity in August was supported by the easing of the summer "pingdemic", UK GDP too has also been held back by shortages of goods and labour. These are likely to persist until at least mid-2022 and will put the brakes on the economic recovery. In addition, retail sales fell for the fifth consecutive month in September, adding to the evidence of slowing consumer momentum. Meanwhile, record job vacancies indicate that the labour market is tighter than unemployment rates suggest and that staff shortages will persist, despite the end of the furlough scheme in September.

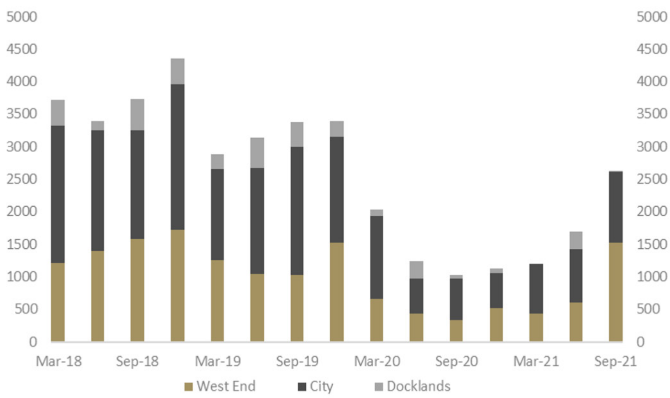
Limited labour supply appears to be generating faster underlying wage growth. This should contribute to a further rise in CPI inflation, which dipped from 3.2% to 3.1% y/y in September, which is expected to rise further in the coming months. Although the Bank of England did not raise interest rates from their all-time low of 0.10% in November as many had expected, markets have priced in several rises over the next 12 months.

2. London

2.1 Occupational Market

The latest data hint that the economic recovery is now feeding through to the capital's real estate markets. In particular, Central London offices appear to be turning a corner, with Q3 take-up rising to a post-pandemic high of 2.6m sq. ft. according to Knight Frank, only slightly below the previous two quarters combined. The upturn in West End activity was particularly marked, including the most notable deal with a 310,000 sq. ft. let to Facebook in Triton Square (see Chart 2).

Chart 2: Central London Office Take-Up (M. Sq. Ft.)



Source: Knight Frank

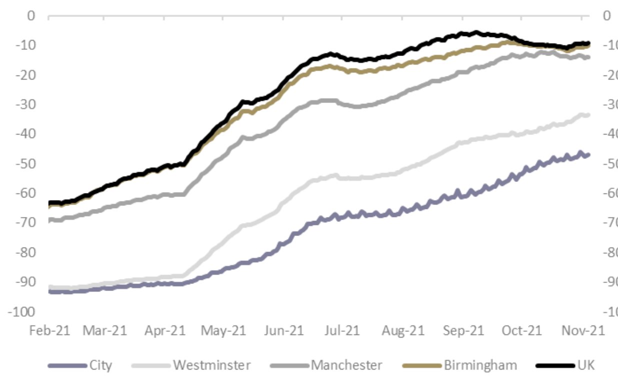
And encouragingly, office availability in London stabilised in the quarter at 18.3m sq. ft, ending a six-quarter run of increases stretching back to end-2019. This was enough to bring a small decline in the vacancy rate from 7.8% to 7.7% in Q3 according to Knight Frank. But given that remote working is expected on weigh on office demand for some time, vacancy is unlikely to decline as quickly as it rose.

A healthy supply pipeline will not be helpful here either. CBRE revised up their estimates for supply in Central London this year to 6.7m sq. ft., up from 4.6m sq. ft. last year, including around 1.8m. sq. ft. due in be delivered in Q4. They report a further 10m. sq. ft. under construction and due to complete over the next three years, only about a third of which is under offer or pre-let.

The opening up of the economy over recent months has given a lift to London's beleaguered retail and leisure. But although most restrictions ended in July, UK virus case numbers have remained higher than in other countries and national retail sales have been weak. Although there is tentative evidence that Central London is faring slightly better in the latest footfall data, it is still likely to be a hard road ahead.

The latest Google mobility data highlight some of the issues facing the capital's shops. They suggest that despite a rising willingness to travel for retail and recreation purposes in recent months, London activity is still 27% below its baseline, compared with the nationwide figure of about 10% below. And the capital's core boroughs are weaker still, while regional cities see a much smaller shortfall (see Chart 3). Workplace visits are also lower in the capital, which, as it has a much larger share of daytime visitors than other UK cities, will also be unwelcome news for Central London's retail and leisure.

Chart 3: Mobility Data - Retail and Recreational (% from pre-COVID baseline, 30-day moving average)



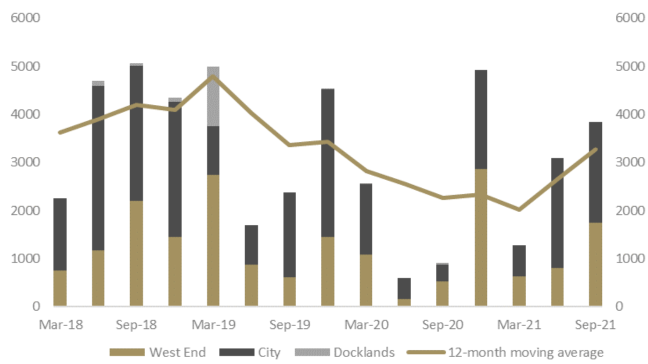
Source: Google

2.2 Investment Market

Nationally, there was a slight slowdown in investment activity over the summer and transactions dipped from £16 billion in Q2 2021 to £14 billion in Q3 according to Colliers. But on an underlying basis, the recovery has continued, bolstered by a strong contribution from industrial. In turn, UK activity is on track to exceed £50bn this year, about 20% up on 2020.

Central London office investment consolidated also its recent its Q2 gains. According to Knight Frank, transactions totalled £3.8bn in Q3, adding to £4.3bn in H1 as a whole (see Chart 4). While activity is likely to surpass last year's record lows even if Q4 is softer, transactions may still not exceed even 2019's relatively weak levels.

Chart 4: Central London Office Investment (£m)



Source: Knight Frank

For offices, there has been evidence of firmer pricing, with yields dipping by about 25bp in the City (to 4.0%) and for West End prime (3.50%) according to Knight Frank's latest survey. This was mirrored by a fall in yields for South East industrial estates. For retail, by contrast, Bond Street yields remained stable at 2.75% in Q3 and Oxford Street held at 3.50%. This means yields in Oxford Street are 100bps higher than before the pandemic, against a 50bps rise in Bond Street, which still compares favourably with a jump of 200bps or more in prime stock outside of the capital (see Chart 5).

Chart 5: Selected prime yields (%)

Source: Knight Frank

3. Rest of UK

3.1 Occupational Market

According to Avison Young, regional city-centre office take-up improved to 1.3m sq. ft. in Q2. This was a two-year high, though still just shy of the historic average. Birmingham, Manchester and Glasgow accounted for much of this activity, with Leeds also strong. The biggest in-town deal was the 87,130 sq. ft. let to Cloud Imperium at Manchester Goods Yard. With out-of-town demand at a three-year high of just over 1m sq. ft. in Q3, after an exceptional 217,000 sq. ft. let to Just Eat near Newcastle, overall regional office take-up edged above its 10-year average.

One theme of the recent regional office data has been a flight to quality space, even if overall requirements remain modest. There is also evidence of more refurbishment activity, as property owners use enforced voids to address the evolving needs of tenants adapting to remote working, and also to meet new energy efficiency standards. Related to this, a steady increase in demand for serviced offices over recent quarters, with Q3 the busiest in two years, also hints that occupiers may be seeking greater flexibility post-COVID-19.

But improvements in take-up were not enough to prevent regional office availability rising further. Across the Big Nine city centres, this has risen from 8.1m sq. ft. in Q1 last year to 11.6m sq. ft. in Q3 2021. There is a further 5.1m sq. ft. of office space under construction in the regions, of which about 2.3m sq. ft. remains available, which implies that it will take 2.7 years to absorb the existing pipeline based on past take-up.

In the South East, Avison Young report that take-up hit a post-pandemic high too, with 571,410 sq. ft. transacted, strongly up on Q2. This was dominated by business parks, with an above-average 70%-plus share of deals and the most notable transaction of 150,000 sq. ft. to Canon in Stockley Park. Despite this, office vacancy remained elevated at 10.3% overall and 6.3% for grade A stock.

For more information:

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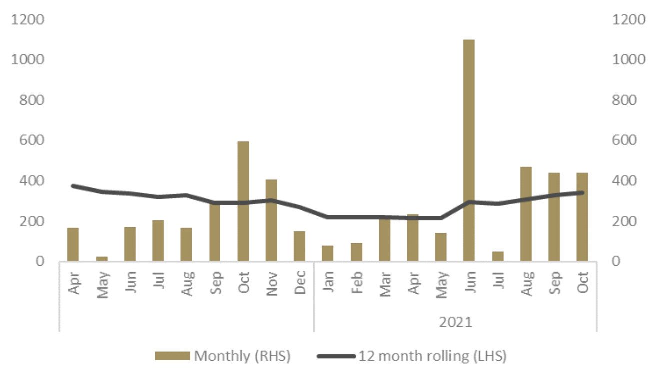
3.2 Investment Market

Avison Young report that total regional office investment in Q3 was £753m, well above the 10-year average. Activity was dominated by a large portfolio purchase by the Regional REIT for £236 m, with the Big Nine office assets accounting for two thirds of this. The largest single-let deal was the purchase of 3-4 Piccadilly Place Manchester for £143 million. After an even stronger Q2, this means overall activity is already above 2020 levels, though Colliers monthly figures suggest that the upturn in underlying activity remains relatively slow (see Chart 6).

The South East market was less buoyant but is also reviving. In Q3, £605m of offices were traded, around 25% below the five-year average. Three major transactions accounted for half of this - Blackstone's purchase of Cambridge International Tech Park for £135m, Brydell's acquisition of Castle Park Cambridge for £65.5m and British Land's investment in Peterhouse Technology Park for £81.3m. Strong activity in Cambridge highlights that investors are seeking to buy into the life sciences sector.

Regional pricing was broadly stable in the last quarter according to Knight Frank. Regional retail yields have been stuck at 6.5% since early 2021, while city office yields held flat at between 5.0% and 5.75% and regional industrial held firm too. South East in-town and business parks also showed no movement at 5.25% for prime assets (see again Chart 5).

Chart 6: Regional Office Investment (£m)



Source: Colliers