Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Quarterly Review: Q1 2022

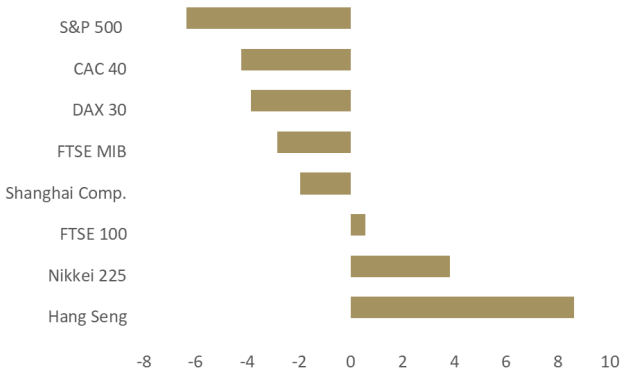
Top Five

- Global economic conditions have worsened as a result of the ongoing war in Ukraine. Higher commodity prices have been a key factor driving inflation to new highs in recent months, forcing central banks to increase rates faster to curb inflationary pressures.
- Data shows that the UK commercial property market maintained momentum in Q1. The industrial sector continued to be the driving force, while other sectors also showed improvement.
- Despite a dip in London office occupier activity from Q4 levels, Q1 leasing was on par with historical first quarter activity, but the high levels of new completions due over the next year or two may pose an upside risk to vacancy. In the industrial market, regional industrial take-up is outpacing that of the capital and the South East.
- Regional office markets had a more subdued start to the year. Regional occupier demand fell in Q1 and even more so in the South East. But regional industrial activity, especially in the East Midlands remained strong.
- Investment activity rose to its highest first quarter level since 2015. Within that figure, Central London office investment continued to rise, but investment in the regional office markets came in lower. Industrial and retail investment reached Q4 2021 levels, suggesting a strong start to the year for those sectors. But alternative sectors attracted the most investment in Q1.

1. Economic Overview

Against the backdrop of the war in Ukraine, increasing inflationary pressures, lower economic growth and higher interest rate expectations, volatility in DM equity markets continued over the last month or so. Overall, European markets have seen the largest percentage decline from their peaks, while the US was also hard hit over the last 40 days. Equity markets in Asia have performed better during this period (see Chart 1.)

Chart 1: Change in Selected Major Equity Market Indices over 40 Trading Days to 09/05/22 (%)



Source: Refinitiv

While some countries like China are still grappling with the Omicron variant, most countries' recoveries post Omicron have been hampered by the war in Ukraine. In fact, the spill-over effects from the war have exacerbated issues the global economy faced even before the war. Commodity prices have been driven up, pushing inflation markedly higher. With inflation likely to stay elevated this year, it will squeeze household real incomes. And with central banks reacting to this by tightening monetary policy, economic growth is set to slow over the next couple of years.

In the US, GDP unexpectedly declined by 1.4% q/q annualised in Q1. The contraction was largely attributed to net exports, which subtracted 3.2 ppts, while inventories also took off another 0.8 ppts. Inflationary pressures started to ease in April but remained elevated. Headline inflation fell to 8.3% y/y in April, from 8.5% y/y in the previous month, while core inflation dipped to 6.2% y/y from 6.5% y/y.

Euro-zone GDP rose by 0.2% q/q during the first quarter, meaning that the region will probably avoid a recession in H1. But spill-over effects from the war in Ukraine and increasing inflationary pressures will likely result in a contraction in Q2. Inflation rose to 7.5% y/y in April, in line with expectations. But core inflation unexpectedly shot up to 3.5% y/y, from 2.9% y/y in the previous month. This was mainly driven by big increases in services and non-energy goods components.

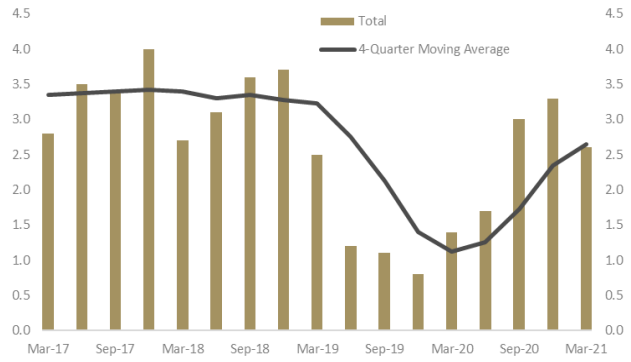
Economic activity in the UK surprised to the downside in Q1. GDP contracted by 0.1% m/m in March, which brought overall GDP growth to 0.8% q/q in Q1. Most of the growth was frontloaded in January, with GDP growth much weaker during the last two months of the quarter. The recent performance will weigh on activity in Q2, which is already likely to be weak as the cost of living crisis dampens economic growth. UK inflationary pressures continued to increase, reaching 7.0% y/y in March. Core inflation also rose to 5.7% y/y, from 5.2% y/y in the preceding month. With the war in Ukraine pushing commodity prices even higher inflation is likely to rise further, which will add pressure on the Bank of England to raise rates even further.

2. London

2.1 Occupational Market

London occupier activity had a solid start to the year. According to CBRE, take-up reached 2.6m sq. ft. in Q1.. Take-up was just below the 10-year quarterly average and rose by almost 90% compared to Q1 last year (see Chart 2.)

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



Source: CBRE

The largest deal was a 280,000 sq. ft. lease by Hogan Lovells at 21 Holborn Viaduct in the City. This was followed by a 94,500 sq. ft. lease by Citi at 40 Bank Street in the Docklands area. Space under offer stood at 3.9m sq. ft. at the end of Q1, above trend and the 10-year average. Two significant deals under offer are a 528,300 sq. ft. deal comprising multiple tenants at Stanza London in the City and a 272,000 sq. ft. lease by multiple tenants at Paddington Square in the West End.

Despite a solid first quarter for occupier demand, office availability remained elevated at 26m sq. ft. at end-Q1. According to CBRE, the number was somewhat inflated by a 44% increase in the availability of early marketed space. This is space not ready to be leased yet but will become available within the next 12 months.

Therefore, although the Central London vacancy rate was steady at 9.0% in Q1, a very healthy supply pipeline poses an upside risk to vacancy as those buildings complete. And even though vacancy is likely to decline further ahead, that is likely to happen only slowly as remote working weighs on occupier demand. CBRE estimate new supply in London at 5.5m sq. ft. this year, before rising to just over 6.0m sq. ft. in 2023 (see Chart 3.)

Chart 3: Central London Development Pipeline (M. Sq. Ft.)

Source: Google

In general, the retail sector had barely recovered from the Omicron hit before it was a dealt another and possibly more sustained blow. Rising inflation will severely squeeze households' real disposable incomes over the course of the year, which will weigh on retail sales. In addition, with restrictions gone, a greater share of spending is again likely to be directed towards leisure and other activities.

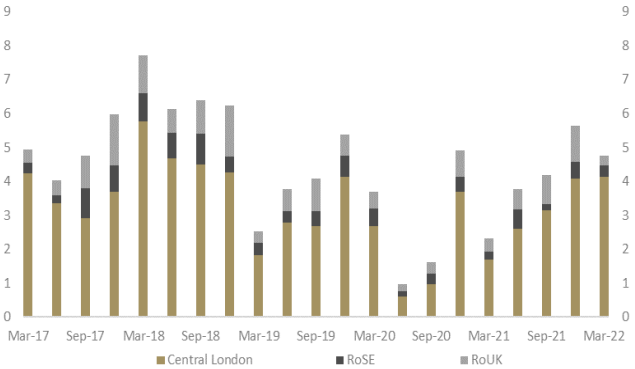
According to CBRE, South-East (which includes London) industrial take-up reached 2.2m sq. ft. in Q1 2022. Two-thirds of this was built-to-suit units, while another 1.6m sq. ft. of space was under offer at the end of the quarter, all of which was speculative developments. Supply has responded quickly in this region as available space rose by 30% q/q to almost 4.0m sq. ft. in Q1. More than half of this is speculative space under construction. With more space available and ready to occupy it will put downward pressure on rental growth.

2.2 Investment Market

Investment typically has a slow start to the year and this was also the case in Q1 as UK investment totals dipped to £16.7bn, from £17.3bn in Q4. But the bigger picture is that this year's first quarter was the highest since Q1 2015. Investment in alternative sectors accounted for the largest share in Q1, while offices were not that far behind. On a 12-month rolling basis office investment continued to rise, while industrial and retail investment were broadly flat.

Central London office investment was £4.1bn in Q1, a 144% y/y rise on Q1 2021. According to Lambert Smith Hampton, the capital also had the two largest deals in the UK in Q1. These were Google's acquisition of Central Saint Giles for £763m and Ho Bee Land's acquisition of the Scalpel for £718m (see Chart 4).

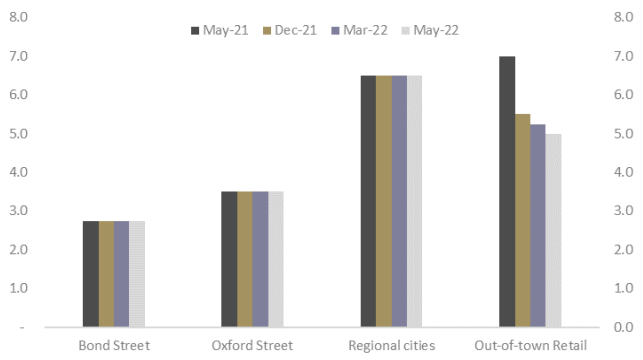
Chart 4: Central London Office Investment (£)



Source: Lambert Smith Hampton

In the retail sector, prime yield data from Knight Frank appeared to show that sentiment towards London High Street retail has not changed. Prime yields for Bond Street and Oxford Street held steady at 2.75% and 3.0% respectively in May, the same level as a year ago. But this has not been different for other major cities like Manchester and Birmingham where High Street prime yields also moved sideways over the last year. Within the retail sector, increased investor demand for out-of-town retail or retail parks has caused prime yields across this sub-sector to fall by 200bps over the last 12 months (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 fell to 1.1m sq. ft. in Q1, from 2.7m sq. ft. in Q4. The fall in leasing activity was ascribed to a strong preceding quarter and left take-up 17% below the 10-year quarterly average. The strongest activity during Q1 was recorded in Bristol, Cardiff and Newcastle. The two biggest deals were a 65,092 sq. ft. let to BT at 3 Capital Quarter in Cardiff and a 54,767 sq. ft. take-up by Paymentsense at EQ in Bristol. Out-of-town demand was steady at 0.8m sq. ft. in Q1, only 3% below the 10-year quarterly average.

But across the Big Nine city centres availability rose to 12m sq. ft. in Q1, which pushed the vacancy rate higher to 8.3%, from 8.1% in the previous quarter. According to Avison Young, roughly 4.6m sq. ft of space was under construction at end-Q1, with almost a quarter of this activity taking place in Glasgow. Due to high demand in this area, about 97% of that space is already pre-let.

According to Avison Young, office occupier demand in regional markets is focussed on the best quality space, which continues to put upward pressure on prime rents. As a result, most of the Big Nine markets experienced rental growth in Q1, with the net effective rent rising by 3% during this period.

The year also did not get off to a good start in the South East. According to Avison Young, take-up fell by 25% y/y to 313,790 sq. ft. in Q1. Within this region, out-of-town occupier activity accounted for roughly 60% of total leasing activity in Q1.

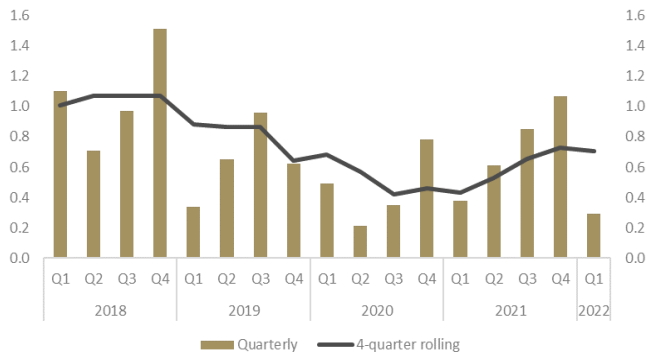
Regional industrial occupier activity accounted for almost 80% of total UK industrial take-up in Q1. East Midlands alone accounted for roughly one-third of total take-up as leasing activity reached 3.4m sq. ft. in Q1. This was followed by the West Midlands with 1.5m sq. ft. worth of take-up and the North West with 1.3m sq. ft. in Q1. Surprisingly, the normally busy Yorkshire & North East region completed only one built-to-suit deal at 0.4m sq. ft. But CBRE expect activity to pick up as the region had 5.8m sq. ft. under offer at end-Q1, which included three built-to-suit units of over 1m. sq. ft. each.

To meet rising demand, supply has risen sharply in the East Midlands area. At end-Q1 about 5.0m sq. ft. was under construction, of which almost 75% is speculative space. The vacancy rate has fallen to 1.1% in the East Midlands, lower than the national average of 1.5% in Q1. The South West has the highest industrial vacancy rate at 4.2%, with Yorkshire & North East the lowest at 0.9%.

3.2 Investment Market

According to Lambert Smith Hampton, Rest of UK office investment fell to £300m in Q1, down from £1.1bn in the previous quarter, and lower than the £600m worth of deals completed in Q1 2021 (see Chart 6).

Chart 6: Regional Office Investment (£m)



Source: Lambert Smith Hampton

Meanwhile, after an impressive end to 2021, investment in the South East office market was more subdued in Q1. Investment totalled £507m in Q1, down from £1.3bn in the previous quarter. The two biggest deals during the first quarter were Keppel DC REIT's £57m acquisition of Waterside House in Bracknell and Bridge Industrial's £55m purchase of Weybridge Business Park in Addlestone.

For more information:

Please contact Sarah White;

sw@rivercap.co.uk