cluttons.com

CLUTTONS

UK OFFICE INVESTMENT
Q2 REVIEW

UK OFFICE INVESTMENT

TRANSACTION VOLUMES DECLINE DURING LOCKDOWN

The security of (future) income, the basis of investment value, has found itself on sudden shaky ground. Economic, leasing and investment activity nosedived during the second quarter (Q2 2020) after a national lockdown was imposed on 23rd March to decrease the spread of COVID-19. A halt in all but the most essential activity put a strain on cash flows for occupiers and investors. Genuine distress and opportunism by some tenants meant that rent payments to landlords were lower than usual. How much of this loss can be recouped and how much of it could become structural are some of the questions facing investors.

Uncertainty and hurdles to doing business led to UK office investment activity falling by 78% during Q2 2020. Low investment activity meant that property valuations, based on market comparables, frequently invoked a valuation uncertainty clause during that period. In Q2 some voices arose claiming that office valuations should be marked down more swiftly. With low transaction volumes in Q2 (and without knowing how much of the drop in income is temporary or not) this criticism is perhaps a little premature.

TABLE 1: QUARTERLY OFFICE INVESTMENT ACTIVITY IN £M VS 5-YEAR AVERAGE IN Q2 2020

	TOTAL OFFICE INVESTMENT ACTIVITY IN £MLNS						Q2 2020	
	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020		5-yr avg	vs 5yr avg
UK	**4,660.5**	**5,253.0**	**6,273.4**	**4,880.5**	**1,356.0**		**6,250.3**	**-78.3%**
Central London	**3,290.7**	**2,989.2**	**4,048.0**	**3,750.9**	**835.2**		**4,320.8**	**-80.7%**
West End	1,113.4	1,330.0	1,391.8	1,278.1	171.0		1,596.8	-89.3%
City	491.7	1,381.8	1,763.8	1,654.5	557.2		1,660.3	-66.4%
Southbank	196.6	70.4	237.1	14.0	2.9		256.9	-98.9%
Docklands	1,225.5	0.0	110.2	29.5	1.1		162.9	-99.3%
M25 West	**267.1**	**227.9**	**293.8**	**497.9**	**83.2**		**387.8**	**-78.5%**
South East	**367.6**	**254.1**	**605.2**	**300.9**	**89.1**		**458.4**	**-80.6%**
Regional cities	**700.6**	**1,358.1**	**813.6**	**417.1**	**275.2**		**995.2**	**-72.3%**
Birmingham	219.1	58.2	138.1	47.1	10.7		158.4	-93.3%
Bristol	55.5	139.8	136.8	21.3	70.3		109.1	-35.5%
Edinburgh	145.2	251.1	73.5	37.8	47.2		112.7	-58.1%
Glasgow	74.0	133.7	34.6	44.8	6.1		98.6	-93.8%
Leeds	61.3	518.9	37.8	82.6	26.2		105.9	-75.2%
Liverpool	6.0	76.7	19.5	11.0	56.5		38.0	48.8%
Manchester	49.0	68.9	177.1	25.2	10.5		191.6	-94.5%
Newcastle	18.9	21.6	43.7	29.0	3.6		37.3	-90.3%
Oxford	40.2	21.4	104.1	12.5	10.4		31.3	-66.6%
Sheffield	22.9	2.7	15.1	40.0	1.3		33.8	-96.0%

Source: Cluttons

Investment deals were delayed, postponed or cancelled for a variety of reasons in Q2. With a relaxation of the lockdown in Q3 2020 activity is expected to come back noticeably yet be relatively subdued going forward. Many investors are keen to wait and see.

The enduring attraction of UK offices for overseas investors remains. Overseas investors like the liquidity, transparency, rule of law and importance of London in international trade and finance. The yield also compares positively on a relative basis across Europe. For example, Paris prime offices start at 2.75%, Berlin and Munich start at 2.6-2.7%, while London City offices are at 4.25% (see Table 2).

> One Old Queen Street, St James' Park, sold for £24m above the quoting price of £23.35m during Q2 2020, an asset located in the heart of Westminster with asset management opportunities shows the enduring attraction of London offices to foreign investors as a liquid and transparent office market while offering relatively attractive yields.
>
> Andrew Mitchell, Investment Agency

Total office investment activity across the UK is shown in Table 1. The areas where activity fell most strongly were London Docklands and the Southbank. For the Docklands, this likely reflects investors' fears that banking occupiers will shed space. The Southbank does not have a particularly vulnerable occupier base and should recover activity later in the year.

The regional cities Sheffield, Manchester, Glasgow and Birmingham recorded falls between 93-96% of the 5-year average. Office investment activity in Oxford and Edinburgh came off lightly with a 58-67% decline, although Liverpool and Bristol came off best on a relative basis. Smaller markets with fewer deals see greater swings if just one or two deals do or do not happen.

ONLY PRIME WEST END OFFICES RECORD STABLE YIELDS

Cluttons prime equivalent yield estimates for Q2 2020 are shown in Table 2. Only prime West End offices recorded stable yields, with yield decompression elsewhere of up to 25bps as investor caution resulted in yields moving out. The West End is a prime market with a mixed occupier base that is less exposed to occupier failures, missed rental payments and occupiers shedding large floors like the City or Docklands. It is thus relatively attractive.

Pressure on the economy led to negative sentiment in the first half of 2020, even though the economy and the UK property sector was relatively healthy prior to the onset of the pandemic. The office sector is more shielded from the COVID-19 storm with a diversified tenant base paying 88% of rent on time during Q2, better than the retail sector, but less than residential.

TABLE 2: PRIME OFFICE EQUIVALENT YIELDS ACROSS THE UK

EQUIVALENT YIELD	DEC-19	MAR-20	JUN-20	TRENDING	COMMENTS
City of London	4.00-4.25	4.00	4.25	weaker	Higher yields where let to serviced offices
West End	3.75-4.00	3.75-4.00	3.75-4.00	weaker	The sale of the Chanel store in New Bond Street eagerly awaited
M25/Thames Valley	5.25+	5.25	5.50	weaker	Trending weaker for shorter income, 15+ yr lease 25bps lower
SE business parks	5.00	5.00	5.25-5.50	weaker	Better yields achievable for selective assets
Regional offices	4.75-5.00	4.75-5.00	5.00	weaker	Trending weaker for shorter income assets

Source: Cluttons, MSCI

INVESTMENT INTO REAL ESTATE REMAINS RELATIVELY ATTRACTIVE WHEN COMPARED TO OTHER ASSET CLASSES

Despite current weaker market sentiment, investment into real estate remains relatively attractive when compared to other asset classes such as stocks and bonds. Property fits into a multi-asset portfolio due to its low volatility, with lagging and smoothing of valuations aiding diversification and steadying the ship.

The stock market true to form showed huge levels of volatility in Q2 with some companies actually going bust and investors losing all. This does not happen in direct property investment where in the worst-case scenario a tenant goes bust and an asset can be re-let or repurposed. The bond market faces a lower-for-longer environment, and property yields (often seen as akin to 'fixed income') remain relatively attractive on that basis. Some investors are lowering their allocation towards offices somewhat, but the growing weight of money looking to invest in real estate will support pricing of prime stock.

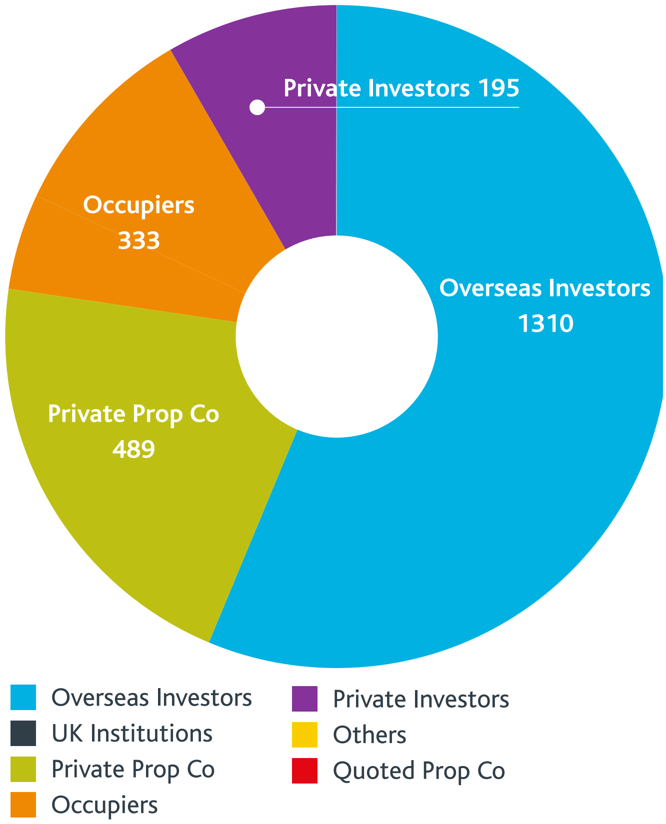
Listed real estate became an interesting tactical play for many large investors during Q2 (for those allowed to invest in this) due to strong discounts to NAV for REITS and other listed companies. Many institutional investors do not classify property share investing as real estate and listed real estate is covered by the equities team instead.

OVERSEAS INVESTORS REMAIN THE DOMINANT INVESTOR GROUP

Overseas investors have become a dominant force in the office investment market growing from 34% in 2006 to a peak of just over 65% of the total in 2016. In Q2 2020 they still made up 57% of office investment, followed by UK institutions with a 25% share of transactions (Figure 1). UK institutions have a greater market share in the regions, while overseas investors tend to be most active in Central London. One example is the sale of newly refurbished and BREEAM 'excellent' rated Procession House on Ludgate Hill (close to a Crossrail station) selling for £140m in May to Union Investments representing a 4.5% NIY. It is 92% let on 15-year leases, meaning short-term market wobbles are not a problem.

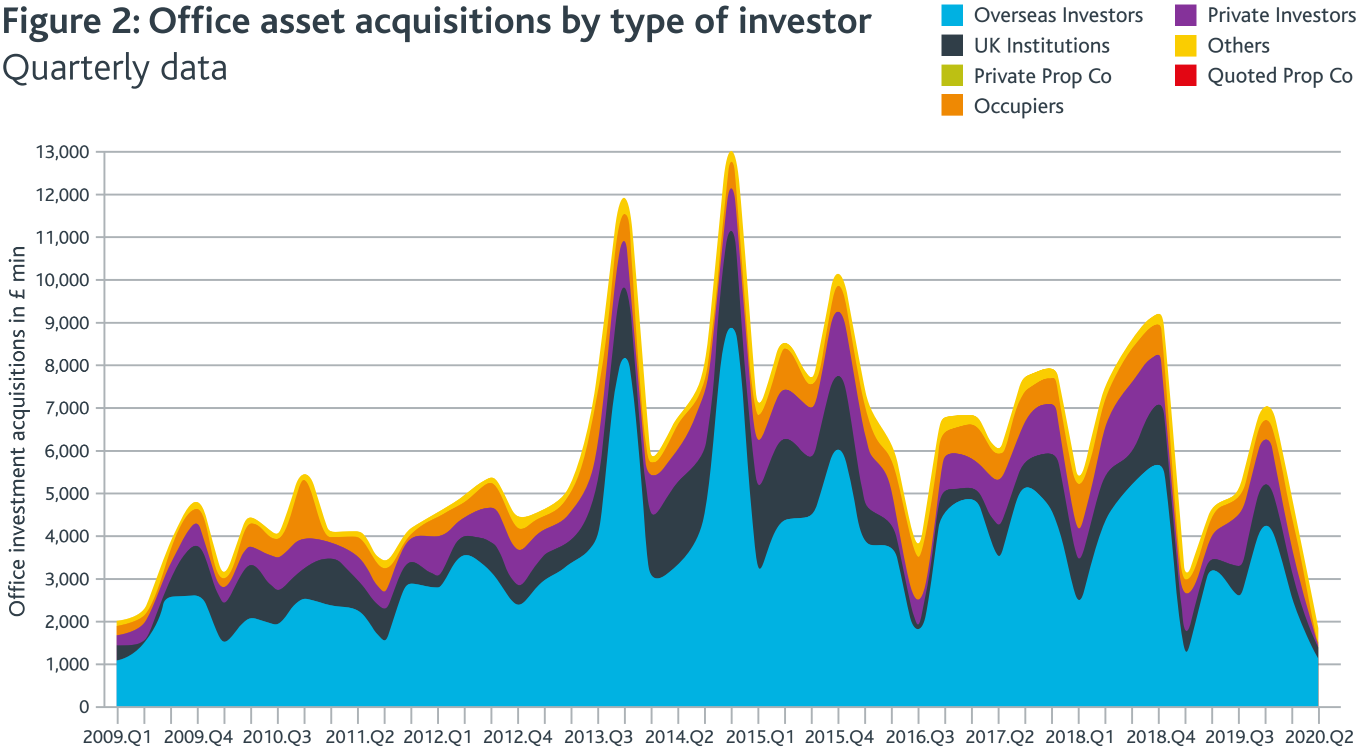
Figure 1: UK office purchases total £1.49bn in Q2 2020, 77.5% below the 5-year average

In £ min by type of investor, 3 months to June 2020



Source: Property Data, Cluttons

Figure 2: Office asset acquisitions by type of investor
Quarterly data

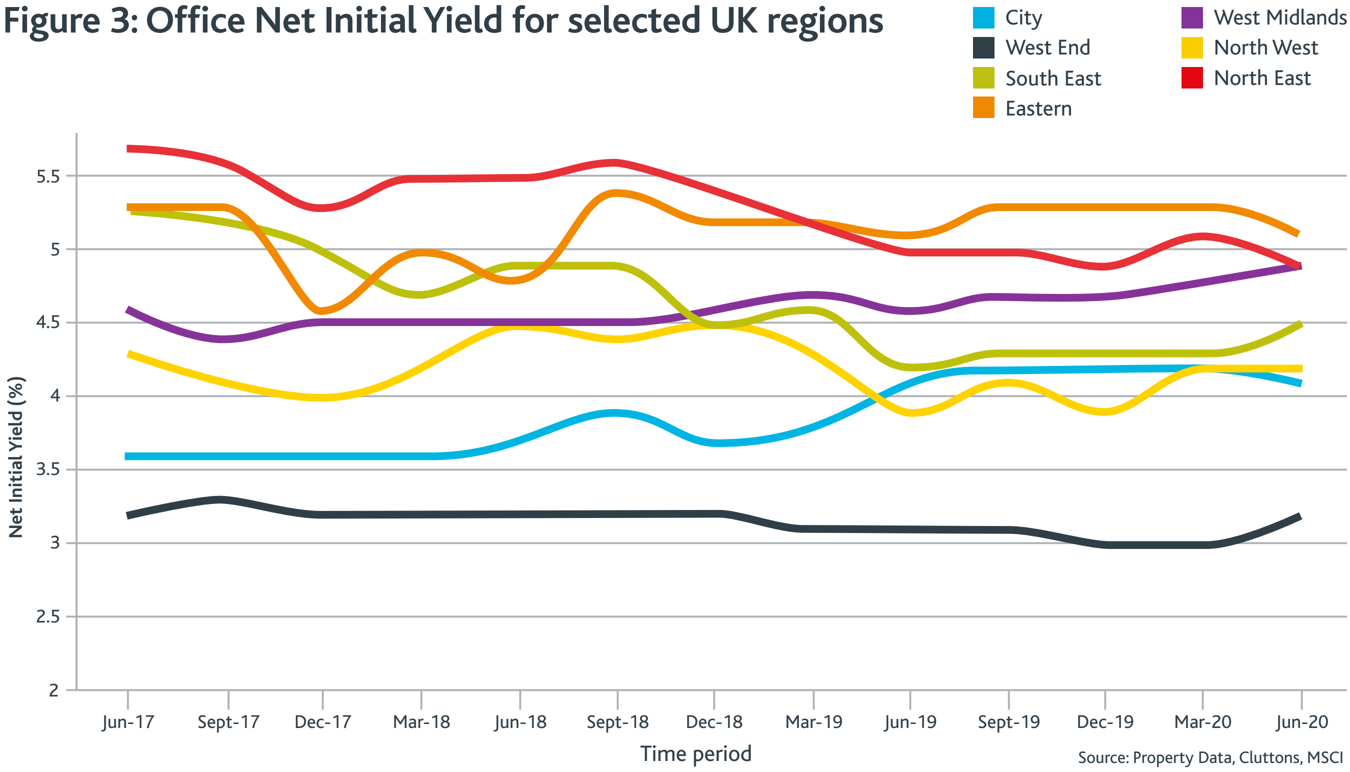


Source: Property Data, Cluttons

Figure 2 shows how dominant overseas investors have been over time, driving peaks in market activity to a large extent. Going forward we expect them to remain the largest investment force, with investment from Asia-Pacific increasing further as the population there grows wealthier and puts money into pensions and investments.

If at some point the influx of money were to be reversed this would have a marked impact on the investment market. A reversal could happen if, for example, the bond and stock markets or other geographical property markets became more attractive and offered better growth, and UK real estate lost its relative appeal. But this is unlikely to happen in the short-to-medium term. Real estate has recently seen returns on new acquisitions declining due to the sheer weight of money looking to invest pushing up prices. As other asset classes suffer the same fate, and government bonds now sometimes deliver a negative yield, property still offers attractive returns on a relative basis, and offers diversification in a multi-asset portfolio.

Figure 3: Office Net Initial Yield for selected UK regions



Source: Property Data, Cluttons, MSCI

VARIANCES IN PERFORMANCE REGIONALLY AND OVER TIME

The MSCI UK Quarterly Property Index tracks performance of more than 8,000 property investments, with a total capital value of more £150bn. Figure 3 shows net initial yields for office space reported in the index over time. Peak-to-trough movements range from 185bps for the East Midlands to 450bps for Wales.

The London Docklands office market is expected to see its yield level rise most in the second half of this year. It is an area with vacancy at above average levels of 9% for all stock, and 10% for prime stock. Banks and financial service providers located here easily shed staff and space. The former trading floors are often too big for most requirements, and stiff competition is felt from other London areas. The City, traditionally one of the most volatile office markets (and with a large share of banking, financial and business services tenants slated to cut floor space per employee) is in second place to see yields rise by the end of 2020.

Looking at the rental growth component, MSCI reports a 0.3% fall for office rents during Q2 2020. This compares well to the 1.1% decline experienced by the UK property market as a whole (the latter figure being weighed down by rental declines in retail assets). Variances in office asset performance relate to how secure rental income is. For office markets across the UK this will depend on a range of factors, including supply-demand dynamics, local occupier profiles, economic growth forecasts and the exposure to Brexit and COVID-19 related risks.

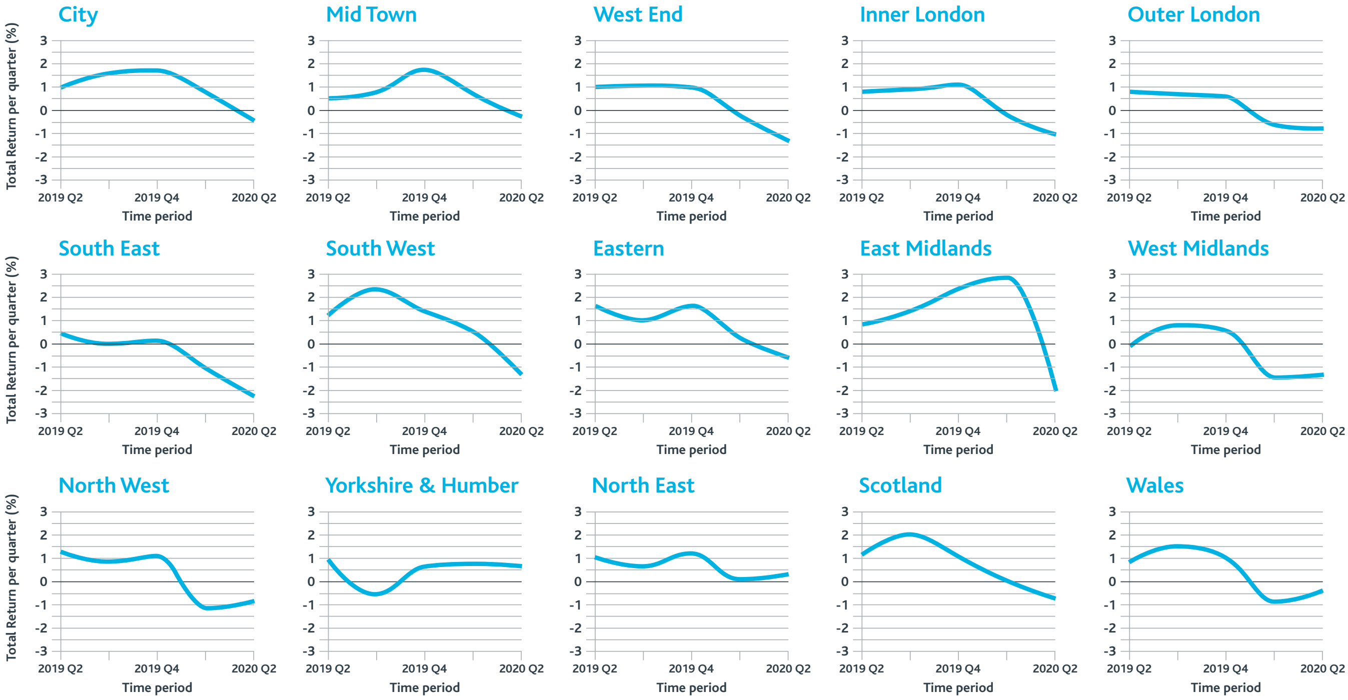
TABLE 3: I&D INVESTMENT PERFORMANCE VS OTHER SECTORS IN THE UK QUARTERLY INDEX, Q2 2020

INDUSTRIAL MARKET PERFORMANCE	3 MONTHS	12 MONTHS	3 YEAR	5 YEAR	10 YEAR
Income return (%)	1.1	4.4	4.5	4.8	5.7
Capital Growth (%)	-1.0	-0.4	6.7	6.5	5.5
Total Return (%)	0.0	4.0	11.4	11.6	11.5
Market Rental Value Growth	0.2	2.2	3.7	3.9	2.3
OFFICE MARKET PERFORMANCE	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	0.9	4.0	4.0	4.1	4.7
Capital Growth (%)	-1.9	-2.5	0.6	1.4	4.1
Total Return (%)	-0.9	1.4	4.6	5.5	8.9
Market Rental Value Growth	-0.3	0.8	1.0	2.1	3.0
RETAIL MARKET PERFORMANCE	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	1.3	5.4	5.2	5.2	5.5
Capital Growth (%)	-5.5	-17.3	-9.1	-5.7	-1.8
Total Return (%)	-4.2	-12.7	-4.3	-0.8	3.6
Market Rental Value Growth	-3.0	-7.7	-3.8	-1.8	-0.9
ALL YEARS	**3 MONTHS**	**12 MONTHS**	**3 YEAR**	**5 YEAR**	**10 YEAR**
Income return (%)	1.1	4.6	4.6	4.7	5.3
Capital Growth (%)	-3.0	-7.2	-1.5	0.0	2.0
Total Return (%)	-1.9	-2.9	3.0	4.7	7.4
Market Rental Value Growth	-1.1	-2.0	-0.1	0.9	1.1

Source: MSCI UK Quarterly Property Index, Q2 2020

Office rental values are likely to fall at least 5% over the year to December 2020, with a similar range in 2021. Office markets like the M25 West will suffer the least, together with the smaller cities. This owes to the nature of the business located there, their likelihood to sit tight, and a relatively subdued number of office developments in local pipelines. The markets more at risk of jobs cuts, companies cutting space and space under construction are the Docklands and the City of London. A recovery of sorts is expected to start during 2022 and last for 2-3 years to get us back to where rental values left off. The silver lining is that more efficient business practices will arise due to this crisis, leading to a higher productivity and more sustainable economy within the UK.

Figure 4: Quarterly Total Return UK offices by region



Source: MSCI UK Quarterly Property Index Q2 2020; Cluttons

Figure 4 shows the quarterly returns by region from Q2 2019 through to Q2 2020, virtually all markets peaked in either Q2 or Q3 2019 before falling to varying extents. The East Midlands sticks out for its steeper peak and subsequent fall in total returns. This could well be an abnormality in the index rather than being a full representation of the East Midlands. The office market has performed better than the market average (which has been dragged down by retail). This has not only been the case in the past 3 and 12-months, but also over 3, 5 and 10 years.

In the Office Leasing Review, we describe why we believe office space will remain essential to office occupiers going forward. For now, negative rental growth, lower investment volumes and weaker market sentiment have driven the decompression of yields impacting total returns. MSCI's UK quarterly index reports the UK market returned -1.9% during Q2 and -2.9% for the 12-month period.

The MSCI UK Quarterly Index also provides insight into income profiles and occupancy levels for assets in their database. For offices there are currently more under-rented than over-rented units across the regional markets, which does not point to an imminent weakness. Vacancy is more concerning for standard offices in peripheral London (at 30.7% by number of units). Office parks in the rest of the UK have the lowest vacancy (17.4% by number of units) but the highest number of units with a possible loss from over-rented leases (9.5% of units).

THE INVESTMENT MARKET CAN OFFER EXCITING OPPORTUNITIES TO THOSE WITH 'DRY POWDER'

Many letters of the alphabet have been used to describe the shape of a possible recovery. The shape of a flat-bottomed boat would be most appropriate for rental values. Investment yields tend to move ahead of rental growth, as investors anticipate such growth and do not want to miss out on a buying opportunity amid great competition. After the Global Financial Crisis, investment market sentiment turned in the space of a week when it became clear that some forecasts were no longer being adjusted on the downside. The sharp corrections up and down were relatively synchronous across the UK office markets after which the individual personalities of each local market took over once more.

The office market is set to outperform the retail market, a sector that is adjusting its market share of the whole naturally by having greater declines in value. Logistics have seen the greatest adjustment in values already, but interest in this sector remains high as many see it as the flipside of online retailing. Residential is seen as a safe bet and anti-cyclical. Hospitality and leisure although hard hit tend to bounce back strongly. The office sector belongs somewhere snug in the middle of it all.

The drop in office income should prove temporary. Institutional investors feel that the COVID-19 crisis merely accelerated trends already in place. This mere acceleration of trends does not warrant a change in investment strategy. The retail sector is much more negatively affected by market sentiment due to the impact of online shopping on some physical stores. Investors thus have turned to favouring more defensive assets over time such as residential and logistics, the latter benefiting from the acceleration in online shopping. Offices have a relatively stable income profile, but long-term questions about the future level of demand for office space does create some hesitancy amongst office investors.

When COVID-19 appeared the office market was considered expensive on a historic basis. Strong investor competition had lowered yields virtually back to pre-GFC levels. Brexit-uncertainty, turmoil in trade relations between China and the US, and a slowing of global economic growth were some of the main factors that were already impacting investment worries pre-COVID-19.

Those investors in the fortunate position of having 'dry powder' to invest largely wait to see how the crisis and its impact on the investment market unfolds. On a long-term strategic basis most investors still see property as a relatively attractive asset. Property yields are expected to rise a little, although office assets are less affected overall than sectors like retail, hospitality and leisure where non-essential functions closed during lockdown (putting the income from and viability of many tenants at risk). In a crisis there is a flight to core, to safety. Long let assets with strong covenants in the best locations will be least affected by a negative market sentiment. Those assets without those characteristics will unfortunately suffer much more.

cluttons.com

CLUTTONS

For more information contact:

SOPHY MOFFAT
Head of research
+44 (0) 7970 539 958
sophy.moffat@cluttons.com

STEVEN COOPER
Head of development and planning
+44 (0) 7968 477 895
steven.cooper@cluttons.com

JAMIE MCCOMBE
Head of investment management
+44 (0) 7958 207 027
jamie.mccombe@cluttons.com

ANDREW MITCHELL
Investment agency
+44 (0) 7901 518 749
andrew.mitchell@cluttons.com

MATTHEW PEAKE
Head of commercial and strategic asset management
+44 (0) 7717 558 773
matthew.peake@cluttons.com

RALPH PEARSON
Head of commercial agency
+44 (0) 7894 608 020
ralph.pearson@cluttons.com

JONATHAN RHODES
National head of valuation
+44 (0) 7971 809 798
jonathan.rhodes@cluttons.com

Cluttons LLP

2 Portman Street
Portman House
London W1H 6DU

020 7408 1010
cluttons.com

RICS