CLUTTONS

# COMMERCIAL MARKET REPORT

QUARTER TWO 2021

Cluttons market monitors track investment and occupier activity across the UK office, retail and industrial sectors.

# In this report

# SUMMARY

## With retail sales recovering and the economy picking up speed, the emerging danger is inflation.

The annual inflation rate jumped more in August than at any time since the Bank of England was granted independence. Economists are split on whether inflation will become a significant problem in the months ahead or disappear after largely one-off price rises as the economy opens up.

Lessons from the last two decades suggest the trajectory of the wider economy and market dynamics for the various property sectors tend to count for more than inflation when pricing real estate.

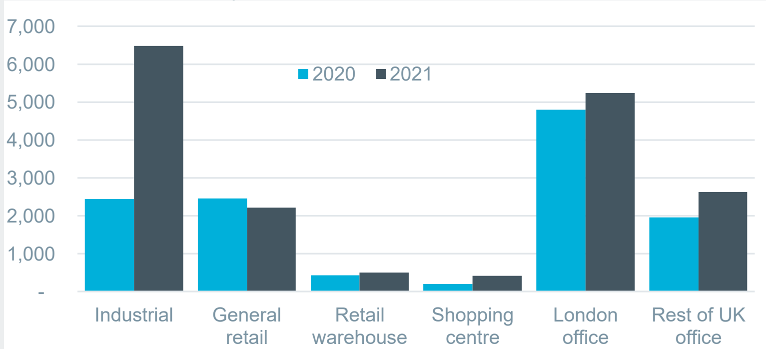
Investors, albeit with marked differentiation between sectors and geographies, still put faith in the yield story for direct real estate investment. Strong investment flows have been particularly acute for the industrial sector, where yields and yield spread (measured as the margin over 10-year bonds) have fallen below that for the office sector for the first time.

With any strongly performing market, the question is: how much further yields will sharpen? For now, investors are putting faith in the outlook for industrial rental growth.

In the opposite direction, retail assets have seen pricing and rent levels deteriorate, in some instances dramatically. Given the extent of re-pricing, there is a sense that investors should look anew at the sector, particularly in more resilient high street locations. Retail should be a beneficiary of the unwinding of the household savings accrued through the pandemic, but this will certainly be a case-by-case scenario depending on location, asset strength and type of retail property. Parts of the market will contract further, with new permitted development rights expediting the conversion of secondary retail assets to residential.

### Investment volumes

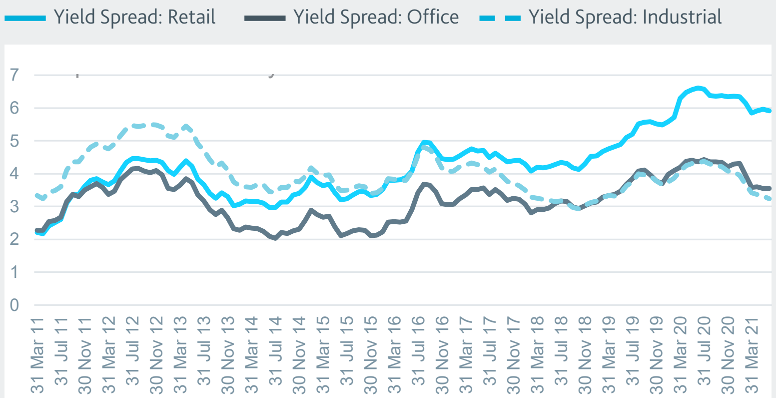
First 6 months of each year: £million




Source: CoStar

### Real estate yield spreads over 10 year bond

Spread: Real estate yield less bond yield (percentage points)




Source: Cluttons, MSCI, Bank of England

# INDUSTRIAL

## Manufacturing PMI at 10-year high and 58 million sq ft of industrial space under construction.

| Industrial Q2 2021 (Distribution and multi-let estates) | United Kingdom | Greater London | South East |
|---|---|---|---|
| Availability rate (%) | 5.9% | 6.1% | 6.4% |
| Availability (m sq ft) | 185,778,884 | 12,892,412 | 29,686,707 |
| Vacancy rate % | 3.4% | 3.4% | 3.6% |
| Completions (Net delivered sq ft) | 4,816,436 | -204,745 | 442,072 |
| Total under construction (sq ft) | 58,963,477 | 1,442,017 | 10,580,928 |
| Quarterly take up (sq ft) | 16,185,588 | 864,297 | 1,802,836 |
| Quarterly net absorption (sq ft) | 7,476,647 | 300,518 | 32,172 |
| Quarterly sales volume £m | £3,234m | £547m | £425m |
| Prime headline rent per sq ft | - | £25 (Park Royal) | £12 (Hemel) |
| Average yield | 4.2% | - | 3.7% |
| Prime rack rented yield | 4.25-4.5% | 3.25% | 3.75-4.0% |
| Rental growth (12-month growth rate) | 5.4% | 3.6% | 4.6% |

Source: Cluttons, CoStar, MSCI, Property Data

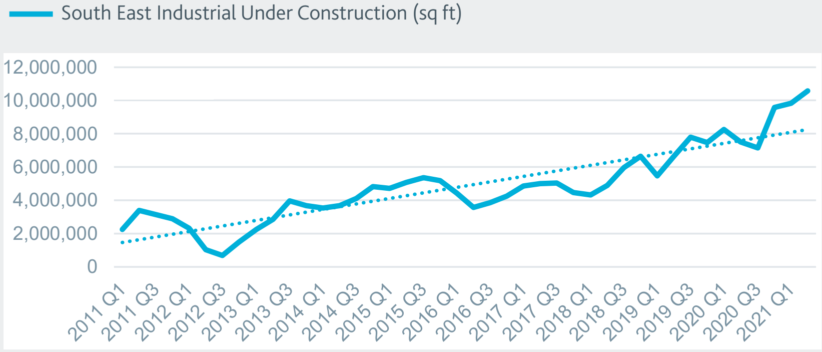
### Online retailing continues to drive strong demand

There have been many headlines about the strength of growth in online retail sales (reaching 82% year on year at its peak in 2020) but that could not continue indefinitely and with stores reopening there has been a drop in the value of online sales. There is no doubt though that online retail remains strong and will continue to fuel strong occupancy demand. Demand for distribution space is both for large scale regional hubs but also smaller requirements for last mile logistics. With low vacancy rates (3.4% across UK industrial) a shortage of suitable stock may limit future take-up levels and help to drive futurerental growth.

### Upturn in manufacturing conditions

Readings of the IHS Markit/CIPS UK manufacturing PMI signals a strong pace of expansion in the manufacturing sector. In particular, new order growth and the pace of job creation remain close to the highs reached mid-year (May-2021). The business confidence component of the index suggests that the upturn in current manufacturing conditions has further to run.

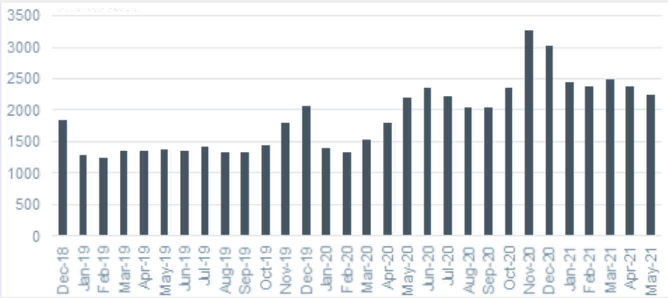
### South East Industrial: Under construction




Source: Cluttons using CoStar

## Online sales

Value of online retail sales £m




Source: Cluttons, ONS

### An upswing in the development cycle is well underway

The current shortage of available space will change as developers have already responded to the opportunity. Construction levels are at their highest in over 10 years. For the UK as a whole there is now 58 million sq ft under construction, a jump of 43% on levels this time last year. Similarly, for the South East, industrial space under construction has increased by 41% to 10.6 million sq ft.

### Industrial sector remains in favour with investors

Investment levels in the sector have soared with prospects for rental growth a significant factor in attracting investment attention. The final quarter of 2020 was exceptional with £4.6bn invested and investment levels have remained robust into 2021 (Q1 £3.1bn and Q2 £3.2bn). This has driven yield levels lower; the question now is how much further the sector has left to run. Through the last year or so average UK yields industrial have fallen below office yields. Current prime yields sitting between 3.25% and 4.5% dependent on location.

## Key investment transactions Q2 2021

| Property Address | Property City | Building size (sq ft) | Sale Price (£m) | Net Initial Yield | Buyer |
|---|---|---|---|---|---|
| Chertsey Rd | Woking | 840,000 | £170,000,000 | - | Global Net Lease, Inc. |
| 345 Southbury Rd | Enfield | 216,808 | £87,250,000 | 2.2% | British Land Company Plc |
| Britannia Rd | Waltham Cross | 115,000 | £43,800,000 | 3.5% | London Metric Property plc |
| Selco Trade Centre, Walthamstow Avenue | London (E4) | 37,609 (industrial) | £21,500,000 | 2.6% | Aberdeen Standard Investments |
| Amazon Fulfilment Centre | Bardon | 1,063,206 (distribution) | £161,000,000 | 3.8% | Savills IM |
| Brackmills Trade Park | Northampton | 66,633 (industrial) | £15,580,000 | 3.8% | Mayfair Capital (PITCH) |

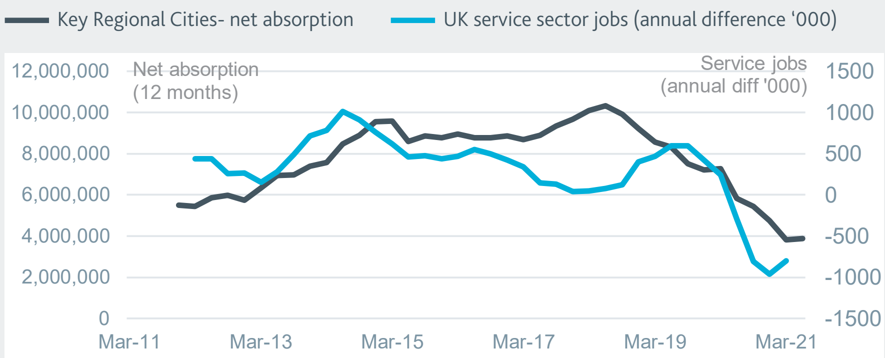
Source: Cluttons, CoStar, Propertydata

# OFFICE

## Business expectations strongest in six years and transport usage at 47% of pre Covid levels.

**More evidence companies favour hybrid work model**
Seemingly for every company that announces it would like its employees back in the office there seems to be a commensurate number that announce a long-term commitment to more flexible working practices. More evidence is starting to emerge on a consensus for the way forward and the hybrid model seems the most favoured; 82% of the financial service firms surveyed by the latest quarterly PWC/CBI Financial Service are implementing a hybrid work strategy. Other evidence increasingly suggests that companies want time in the office to be focused on deriving benefits from collaboration and team engagement which could require a rethink of current office layouts. Commuting patterns still show that use of public transport is low, at around 47% of pre-covid levels, dependent on transport type. September is likely to be the litmus test for the number of employees physically returning to the office. The growing emphasis on sustainability has been overshadowed by the pandemic but will be important as conditions settle.

### Employment & office demand




Source: Cluttons, Coastar, ONS

| Office: Q2 2021 | Central London | Key Regional Cities* | United Kingdom |
|---|---|---|---|
| Availability rate (%) | 11.1% | 9.9% | 8.3% |
| Availability (sq ft) | 12,896,000 | 10,182,000 | 73,286,202 |
| Vacancy rate % | 7.5% | 5.4% | 4.8% |
| Completions (net delivered sq ft) | 139,249 | 1,051,000 | 2,573,000 |
| Total under construction (sq ft) | 6,137,000 | 5,003,000 | 28,357,000 |
| Quarterly take up (sq ft) | 1,332,679 | 706,402 | 5,726,000 |
| Quarterly net absorption (sq ft) | -478,472 | 415,837 | -2,694,000 |
| Quarterly sales volume £m | £1,863m | £523m | £4,167m |
| Prime headline rent per sq ft | £120 | £40 | - |
| Average yield | 3.5% | - | 4.5% |
| Prime rack rented yield | 3.75% (West End) 4.0% (City) | 5.25% | - |
| Rental growth (12-month growth rate) | -2.0% | 2.9% | 1.1% |

Source: Cluttons, CoStar, MSCI, * Key regional cities: Bristol, Birmingham, Leeds, Manchester

## Key investment transactions Q2 2021

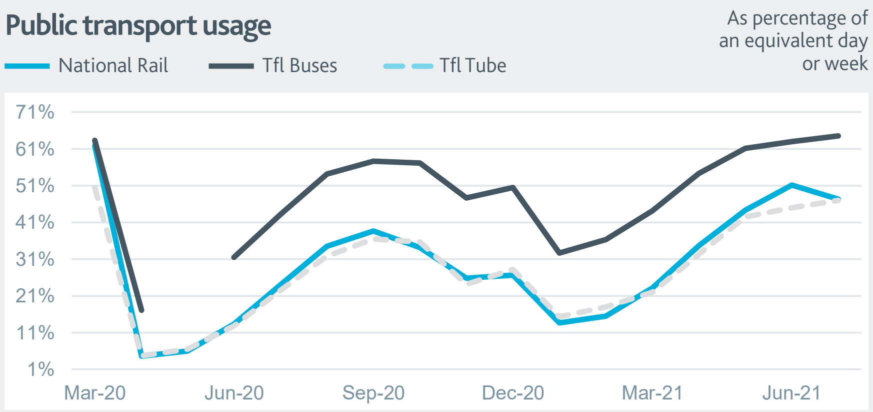
| Property Address | Property City | Building size (sq ft) | Sale Price (£m) | Net Initial Yield | Buyer |
|---|---|---|---|---|---|
| Astra Zeneca HQ, Milton Rd | Cambridge | 58,639 | £45m | 3.6% | Oxford Properties Group |
| Sherard Building, Edmund Halley Rd | Oxford | 28,261 | £25.5m | 3.6% | Kadans Science Partner |
| 30 Fenchurch St | London | 544,559 | £635m | 4.1% | Brookfield Asset Management |
| The Brick Works, Greyfriars Rd | Reading | 18,460 | £10.05m | 4.2% | CBRE Global Investors Ltd |
| The Capitol Building | Bracknell | 184,880 | £44m | 7.6% | Kennedy Wilson Europe |

Source: Cluttons, CoStar, Propertydata

### Occupational markets are weaker

It is no surprise therefore that occupational trends have been weaker, demand levels are down and whilst there has been a tentative pick up take-up both for key regional office markets and Central London, this is yet to translate into a significant bounce. Reduced lettings activity has seen supply increase, for regional office markets the vacancy rate remains well below the average over the last 10 years (current 5.4% compared to 8.2% over last 10 years) whilst for London the vacancy rate has just nudged above of the 10-year average (current 7.5% versus 7.1% 10 years). Despite the pandemic impact, rental growth has continued in some markets, +2% across key regional cities over the last year but slipped -2.0% in Central London. Investment volumes in the sector were certainly lower in 2020. Parts of the market have recovered this year and the deals that are getting signed are largely achieving robust yields. It looks likely that demand will focus on space that can be configured for new workstyles and with good sustainability credentials.

**Public transport usage**




Source: Cluttons using Gov.uk Official Stats

### Rising business expectations and sentiment will be welcome boost

Whilst there will be many road bumps ahead for the economy, overall, most of the sentiment indicators suggest a robust expansion of the service sector. The Accenture/ IHS Markit UK Business Outlook recorded its highest-level business expectations in 6 years in June and likewise the CBI/PWC Financial Service Survey reported its largest quarterly increase in business volumes since 2017. Historically improving business conditions, lead to a pick-up in employment which in turn drives increased office demand. Whilst the relationship might be changing, undoubtedly stronger business and service sector conditions (if sustainable) will have a positive impact on office markets.

### Small offices in local high streets could have a renaissance

As people mix and match the hybrid working model, flexible space to work near home may be part of the solution. In cities, small office requirements are increasingly likely to be met in large flexible workspaces in mixed use environments.

| Retail: Data to end Q2 2021 | High Street Retail / General retail | Retail Warehouse /Retail park |
|---|---|---|
| Availability rate (%) | 4.3% | 4.1% |
| Availability (m sq ft) | 44,345,000 | 5,776,000 |
| Vacancy rate % | 2.6% | 3.5% |
| Completions (Net delivered sq ft) | 1,176,000 | 197,000 |
| Total under construction (sq ft) | 7,987,390 | 287,000 |
| Quarterly take up (sq ft) | 2,905,257 | 231,000 |
| Quarterly net absorption (sq ft) | -759,139 | -218,000 |
| Quarterly sales volume £m | £681,882,000 | £206,969,000 |
| Average initial yield | 6% | 7% |
| Prime yield | 6.75% (city/major regional) | 6.75% |
| Rental growth (12-month growth rate) | -10.3% | -5.8% |

Source: Cluttons, CoStar, Property Data, MSCI

# RETAIL

## £150bn of Covid household savings now being injected back into the economy. Consumer confidence highest since 2008 on some measures.

**Consumer confidence has soared**
the lifting of restrictions over the last few months has clearly helped put a spring in the consumer's step. The PWC Consumer sentiment survey recorded its highest score since the series began (2008) whilst the GfK Consumer Confidence index July result is already the highest since March 2020 as the opening economy shows signs of strengthening.

These stronger signals are positive for the retail sector, as many households have accrued savings through the downturn and appear ready to start spending again. The Bank of England believes that households have accrued £150bn in savings through the course of the pandemic. These savings are concentrated in affluent neighbourhoods particularly across London and the South East and it is in these areas that a big spending injection will help drive a speedier economic recovery.

**What proportion of retail sales can shops regain**
Key for physical retail assets is how much sales they can win back from online. Online retail sales grew to a record proportion of 36% of total sales in late 2020/early 2021 but as retail has re-opened this has fallen back to 27%.

**Secondary retail a potential focus for new permitted development rights**
From 1st August new permitted development rights came into effect. The key change relevant to the retail sector is an expansion of rights under the new use class 'MA' to include the whole of 'E' use class (shops, office, restaurants, cafes, health services, nurseries, gyms and leisure). Changes to these rights could affect secondary retail more significantly, for instance off-prime pitches in quieter streets could make for better conversion to residential potential particularly also given the upper size limit of 1,500 sq m (16,146 sq ft).

### Repricing tempting some investors to look again

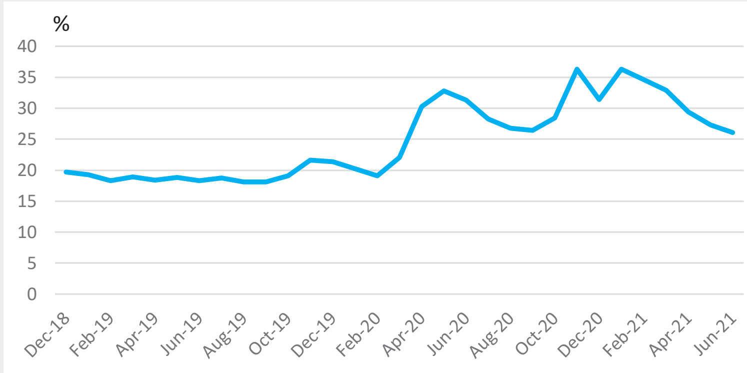
In performance terms, shopping centres have been the hardest hit by the pandemic owing to the seismic shift in shopping habits, but few corners of the market have escaped completely unharmed. Across all sectors of the retail sector rents are falling and void rates have been rising. The uncertain outlook for the sector, already reflected in falling rent levels, has impacted on yield levels albeit modestly for most segments of the market.

This repricing of assets has led to some investors reassessing the market, in a more positive light particularly resilient high street locations with the focus on strong covenants such as banks and "Covid-resilient" businesses such as pharmacies (e.g. Boots).

### Retail returns improved for the second consecutive quarter

Total returns were 2.5% in Q2 driven by a strong recovery in retail warehouses (4.4% over the quarter). Retail capital values did rise 0.7% in Q2 driven by retail warehouse performance (2.5%); declines were evident in all the other segments of the retail market with shopping centres the most impacted at -2.7%. Initial yields have also nudged lower over the last month to end June.

## Internet sales as proportion of total retail sales



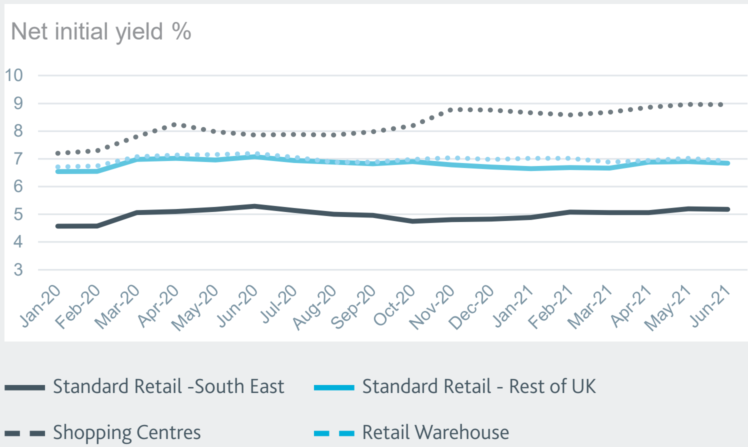

Source: Cluttons, ONS

## Key investment transactions Q2 2021

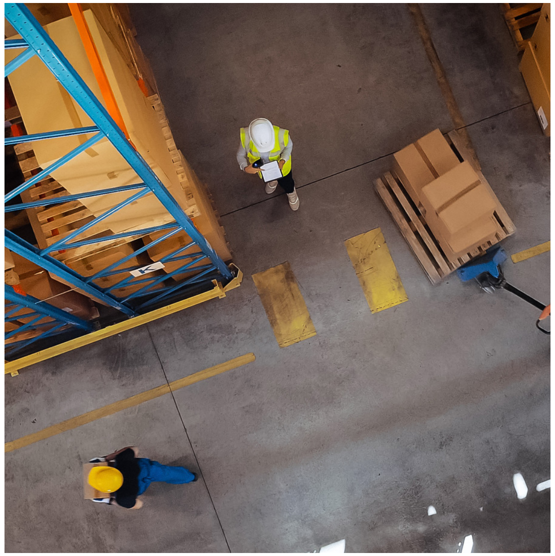
| Property Address | Location | Building SF (sub-sector) | Sale Price (£m) | Net Initial Yield | Buyer |
|---|---|---|---|---|---|
| 398 York Way | London | 570 | £14m | 4.7% | GMS Estates Ltd |
| Castle Vale Retail Park | Birmingham | 181,887 (RW) | £63m | 6.5% | Realty Income Corporation |
| Greenstead Road | Colchester | 54,300 (supermarket) | £63m | 4.5% | Supermarket Income REIT |
| A1 Retail Park | Biggleswade | 263,000 (RW) | £49m | 8.5% | British Land Plc |

Source: Cluttons, CoStar, Propertydata

## UK retail yields




Source: Cluttons, MSCI



# OUTLOOK

The shift in sentiment from the start of the year to the middle of the year has been dramatic. At the start of the year, many parts of the economy were in lockdown and the vaccine rollout had only just begun. Fast forward to mid-year and sentiment and optimism is significantly stronger across a range of Covid and economic related measures. This is matched by stronger market conditions for the real estate sector (both investment and occupier markets) which is expected to continue; particularly given the continued easing of restrictions and the strong bounce back in the UK economy.

Retail assets have borne the brunt of the downturn, but more stability across the sector is likely to emerge over the rest of this year. There are also potential opportunities for investors to benefit from the unwinding of 'Covid savings' with local high streets in affluent towns likely to be chief beneficiaries. There has also been a strong improvement in the prospects for retail warehouses, driven by the servicing of click and collect orders and redevelopment potential (either to increase density or repurpose for numerous alternative uses, including last mile logistics and/or residential accommodation).

For those investors holding a diverse portfolio of real estate investments, the stronger performance of the industrial sector will have provided protection from weaker performance in other sectors. For now, there continues to be strong demand for the industrial and logistics sector from investors and occupiers alike. Demand for distribution space is both for large scale regional hubs but also smaller requirements for last mile logistics. Notably now, affordability could become a problem for occupiers and investors. There may well prove to be a ceiling to what occupiers are willing to pay and similarly investment yields might be approaching their limit too.

For the office market, flexibility is a key element to the outlook. As organisations rework their hybrid working strategy, office configurations will need to be flexible to meet demand whilst still providing a high-quality mixed-use environment and a firm eye on sustainability criteria too.

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