CLUTTONS

COMMERCIAL MARKET REPORT

QUARTER THREE 2021

Cluttons commercial market reports track investment and occupier activity across the UK office, retail and industrial sectors. This edition provides an update on market data and trends across all three sectors in Q3 2021.

In this report

KEY HEADLINES

Polarisation in the office market

There are emerging signs of polarisation in the office market between top spec buildings versus those of a lower quality. The post pandemic bounce in leasing activity has been driven in particular by demand for higher spec buildings which has meant that headline rents have been maintained, albeit by pushing out incentives.

Retail capital values rebound

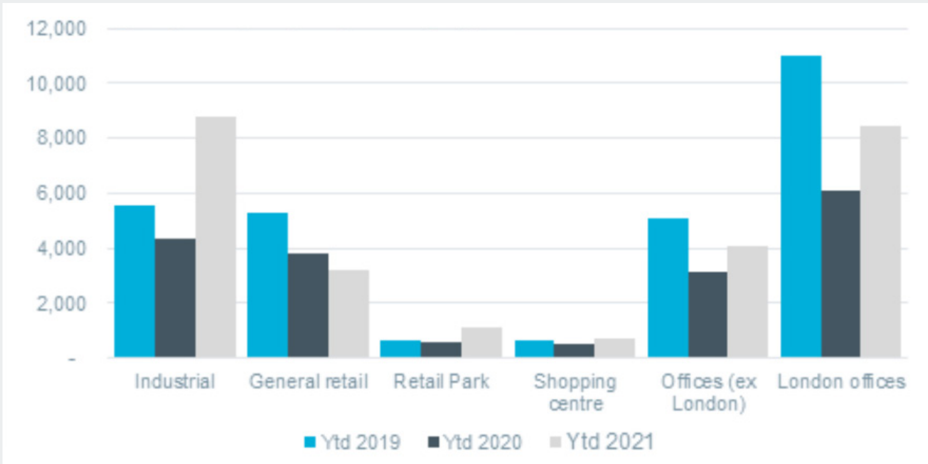
All eyes have been on the retail market looking for firm evidence that the market has found its floor following the re-rating prompted by the pandemic. Retail capital values over the last three months have grown by 3.2% (the strongest quarterly rate since 2010) with values stabilising across all retail segments but the strength in retail warehouse performance driving this rebound (+5.8% over the quarter).

Industrial investment strong

Investment sales volumes across all sectors of the market (with the exception of standard retail) are ahead of 2020 levels. Most notably industrial investment flows are now not only ahead of the same period in 2020 but also significantly ahead of 2019 levels, driven by the continued strength of investor interest in the logistics sector.

Investment sales

First 9 months of each year: £ million



Source: Cluttons, CoStar

OVERVIEW

Growing anticipation of interest rate rise

It was a surprise when interest rates weren't increased by the Bank of England in their early November meeting. Financial markets had fully expected them to increase, mortgages rates have already started to price in that rise. Likewise, the 10-year government bond yield has started to rise, tipping above 1% for the first time since April 2019. The average forecast for the Bank of England base rate is for 0.37% by the end of 2022. This is from the consensus forecasts compiled by the Treasury and therefore suggests that most forecasters expect rates to be either 0.25% or 0.50% by then.

Real estate yields still sit a margin above the 10-year bond yield, although with industrial yields continuing to fall and the now rising bond yield, this gap is narrowing. In contrast to industrial yields, retail yields have notably risen over the last year – exaggerating a trend already in place. In the middle, office yields have been remarkably stable.

'Smart' buildings versus ESG 'dumb' buildings

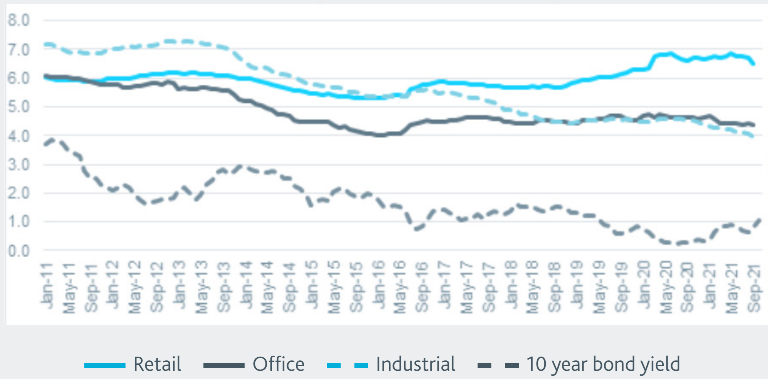
Sustainability is firmly on the agenda this month with COP26 in Glasgow. Commentators have suggested that as much as 87% of office stock across UK's major markets needs to be improved to meet the government's 2030 energy efficiency deadlines. The minimum standard required will be for a Grade B Energy Performance Certificate (EPC). Whilst a large share of that 87% is likely to be buildings that need relatively minor adjustments there will be a portion of that can't be sufficiently upgraded to meet ESG requirements (dubbed dumb buildings as being the opposite end of the smart building spectrum).

Evident in recent quarters has been the polarisation of the office market with a flight to quality for investors and occupational markets. Part of this flight to quality trend is about ESG compliance. ESG credentials are increasingly on investor and occupier wish lists.

New post pandemic norms being established

With more shoppers back in the shops and more workers back in the office, we can begin to see the dust settling on a new normal, although there is, of course, no guarantee that we are through the worst of the pandemic. By October passenger numbers across TfL tube, TfL bus and National Rail was between 63% and 76% of pre-pandemic levels. With more hybrid working, it could well level out at this sort of proportion. Online retail sales, prior to the pandemic accounted for 20% of sales, this reached 37% in November 2020, and now seems to be finding a new level at 25% of sales (although it could tip up in the lead up to Christmas).

Real estate yield versus bond yield (%)



Source: Cluttons, MSCI, Bank of England

INDUSTRIAL

- Industrial rental growth running at just over 6% p.a.
- Average £3.4 billion of investment transactions each quarter 2021 to date

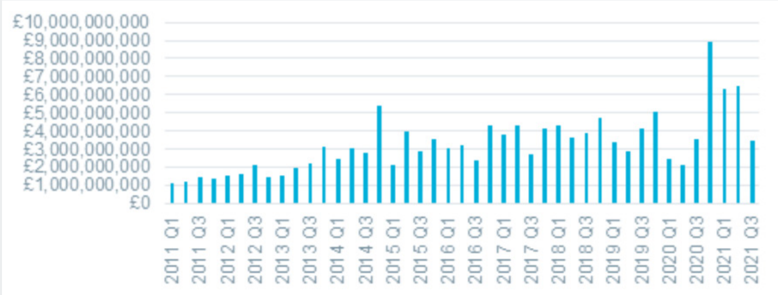
Industrial sector continues to attract significant inflow of capital
Investment volumes show how unusual the last year has been; with an average £3.4 billion a quarter of sales transactions. This compares with £2.3 billion a quarter average over the last five years. Whilst Q3 2021 currently looks a little lower than the last few quarters this could still be revised upwards as more deals agreed late in the quarter get added to the total. In this context, yields continue to trend lower; from 4.5% a year ago, the average UK industrial yield is now 4.0%. With such strength of demand focused on the South East, there is a significant margin between industrial yields; 3.4% in the South East and 5.0% average for the rest of the UK.

Low vacancy rates continue to drive rents higher
With vacancy rates persistently below 4% since mid-2016, market momentum continues to drive rents higher. Rental growth is running strong at 6.2% per annum average across UK industrial. A key factor of this strength is online retail and logistics demand. With the complexities of an efficient distribution network, new demand is likely to be ongoing as companies seek to optimise for efficiencies in their distribution network.

Construction completions adding to available space
As previously acknowledged, there has been an upswing in the development cycle. Some of this space is now completed and on the market with the largest quarterly delivery of new space in over 10 years for the South East (3.3m sq ft). Low vacancy rates are indicative of the strength of demand ready to absorb new completions: at average demand levels (measured by net absorption) over the last five years that represents just nine months of demand.

Manufacturing conditions remain stronger than 2019
Latest readings of the IHS Markit/CIPS UK manufacturing PMI signals a strong pace of expansion in the manufacturing sector, albeit at a marginally lower level than the high achieved in May 2021. The survey is indicative of the strong bounce back in the sector with levels running higher than pre-pandemic. As with other sectors of the economy, production will be affected by supply chain issues (access to materials, staff and skilled labour).

Investment sales volume (£)



Source: Cluttons, CoStar

South east industrial new supply (completions sq ft)

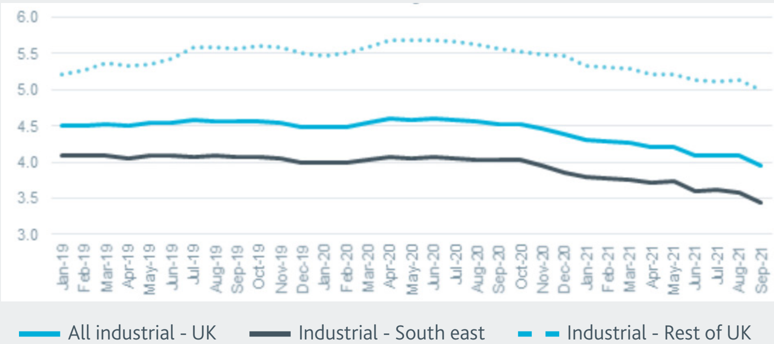
Source: Cluttons, CoStar

Headline market data Q3 2021

Industrial Q3 2021	United Kingdom	London & South East
Distribution, multi-let estates and specialised industrial	**Current quarter (last quarter / 5yr ave)**	**Current quarter (last quarter / 5yr ave)**
Occupier		
Availability rate (%)	5.5% (5.8% / 5.9%)	6.2% (6.3% / 5.6%)
Vacancy rate %	3.3% (3.3% / 3.5%)	3.7% (3.6% / 3.1%)
Rental growth (12-month growth rate)	6.2% (5.9% / 5.5%)	6.2% (5.2% / 5.9%)
Quarterly take up (sq ft)	19.9m sq ft (24.7m / 27.4m)	4.4m sq ft (5.1m / 6.2m)
Supply		
Completions (net delivered sq ft)	8.5m sq ft (7.9m / 7.6m)	3.5m sq ft (0.7m / 1.1m)
Total under construction (sq ft)	61m sq ft (59.1m / 43.6m)	9.8m sq ft (12.1m / 8.0m)
Investment		
Quarterly sales volume £ million	£1,878m (£3,561m / £2,254m)	£864m (£1,170m / £820m)
Average yield	4.0% (4.1% / 4.7%)	3.4% (3.7% / 4.2%) *
Prime yield (rack rented)	–	3.25%

Source: Cluttons, CoStar, MSCI, Property Data, * South East only

Industrial yields (%)



Source: Cluttons, MSCI

Key investment transactions Q3 2021

Property Address	Town/ City	Building size (sq ft)	Sale Price (£ million)	Net Initial Yield	Buyer
Primark NDC, Huntingdon Road	Thrapston	785,000 (Distr)	£102,000,000	4.1%	EQT Exeter
2 & 16 Evelyn St	Deptford	68,320 (Ind)	£38,600,000	2.67%	Westbrook Partners
Crown Point	Enfield	100,000 (Distr)	£43,000,000	2.17%	Mirastar REIM

Source: Cluttons, CoStar, Propertydata

OFFICE

- Flight to quality evident in occupational and investment trends
- Public Transport usage up to 63% of pre Covid levels

New hybrid work model will be a slow evolution

September and beyond was always likely to be a useful litmus test for the number of employees physically returning to the office. And indeed, public transport data shows that TfL tube usage by the end of October was back to 63% of its pre-pandemic level, TfL buses back to 76% and National Rail back to 67%. Transport usage might plateau at these sorts of rates: given a rough assumption that a third of London's workforce can't work from home and that the remaining two thirds now work from home two days a week this would equate to a new normal of 73% usage compared to pre-pandemic levels. The new hybrid work model is likely to be a slow evolution with decisions on office space usage undertaken at lease renewal.

New demand focused on better building quality

Given the pandemic uncertainty it is no surprise that office occupational trends have been weaker, demand levels remain down. In Q3 the tentative pickup in take-up gained some momentum in Central London but is yet to translate into a significant bounce. For regional office markets, the pickup has been less significant with strongest evidence of a rebound in Birmingham.

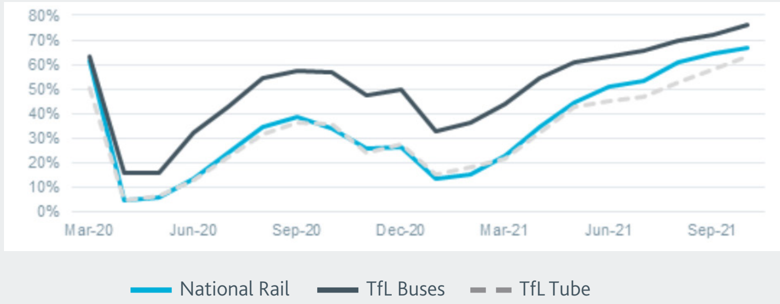
There is an increasingly apparent split in the market between leasing activity for prime buildings and leasing activity for lower quality secondary buildings. This makes sense in a pandemic environment where companies are looking to enhance the office-based experience for employees. This split is only showing tentatively in the data as yet, and is best represented by monthly data, but certainly allies trends observed by Cluttons in the market. For landlords with lower quality buildings there is a strategic decision to be made about whether to invest and upgrade their buildings.

Rising vacancy rates

Even with large parts of the office work force returning to their place of work more regularly since September there is still evidence in the market that companies are making decisions to shed space. Alongside, weaker demand data vacancy rates are above their levels a year ago for both Central London (current 8.0% versus 5.9%

Public transport usage

Usage as percentage of an equivalent day or week



Source: Cluttons using Gov.uk Official Stats

Central London leasing demand: by building star rating

Monthly take up sq ft

Source: Cluttons, CoStar

a year ago) and key regional office markets alike (current 5.9% versus 4.7%). This rise in vacancy rates is likely to be focused on poorer quality space.

Strong investment inflows

The current market is unusual that despite overall vacancy rates rising, investment flows over the last quarter have been stronger than the five-year average. For the London office market, there was £2.4 billion of investment deals compared to a quarterly average of £2.2 billion over the last five years. Strong international interest in City and West End offices has seen yields compress by -0.25% for best in class. As such there is a flight to best in class and secondary assets are not benefiting from the same strength of investor interest.

Central London office: investment volumes

Rolling annual £ million

Source: Cluttons, CoStar

Headline market data Q3 2021

Office Q3 2021	Central London	Key regional cities*
	Current quarter (last quarter / 5yr ave)	Current quarter (last quarter / 5yr ave)
Occupier		
Availability rate (%)	11.4% (11.0% / 9.1%)	9.6% (9.8% / 9.1%)
Vacancy rate %	8.0% (7.5% / 6.4%)	5.9% (5.7% 6.0%)
Quarterly take up (sq ft)	1.8m (1.5m / 2.9m)	1.0m (1.1m / 1.8m)
Prime headline rent per sq ft	£120 (West End) £75 (City)	–
Average rent per sq ft	£56 (£56 / £57)	£19 (£19 / £17)
Rental growth (12-month rate) %	-1.0% (-1.8% / 0.3%)	2.3% (3.6% / 4.2%)
Supply		
Completions (net delivered sq ft)	25,000 (63,000, 319,000)	92,000 (801,000 / 169,000)
Total under construction (million sq ft)	6.9m (6.9m / 8.2m)	5.1m (5.1m / 4.6m)
Investment		
Quarterly sales volume £m	£2,360m (£1,730m / £2,242)	£393m (£670m / £496m)
Average yield	3.4% (3.3% / 3.7%)	–
Prime yield %	3.25-3.5% (West End) 3.75-4.0% (City)	4.75 - 5.25%

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

Key investment transactions Q3 2021

Property Address	Town/ City	Building size (sq ft)	Sale Price (£ million)	Net Initial Yield	Buyer
King William Street, 85	London EC4	125,590	£143,000,000	4.5%	Barings Real Estate
Times Square, Queen Victoria St	London EC4	380,000	£450,000,000	4.2%	Assicurazioni Generali
RAC Control Centre	Bristol	63,598	£27,000,000	5.2%	Blue Noble LLP
Cambridge Science Park	Cambridge (Business Park)	–	£50,000,000	4.6%	Kadans Science Partner

Source: Cluttons, CoStar, Propertydata

RETAIL

- Retail warehouse capital values rise 5.8% in Q3 (strongest since 2010)
- Consumer confidence dented by supply shortages, inflationary costs and anticipated interest rate rises

Consumer confidence falters from its upward trajectory

It was always likely, emerging from the pandemic lockdowns, that retail and consumer confidence would have an uneven recovery. Last quarter consumer confidence was running high, but this quarter consumer confidence has felt the hit of fuel and food shortages alongside rising prices, and the looming spectre of rising interest rates, all these factors are squeezing household budgets. Rising Covid rates will also have played a role in denting consumer confidence. Faltering confidence is apparent in the latest retail sales data; with five consecutive months of declines.

Against this faltering trajectory there is the unwinding of Covid savings accrued through the pandemic. Household savings rates jumped to 22.5% in mid-2020 but this ratio is now back to 11.3% almost in line with its long-term average of 8.0%.

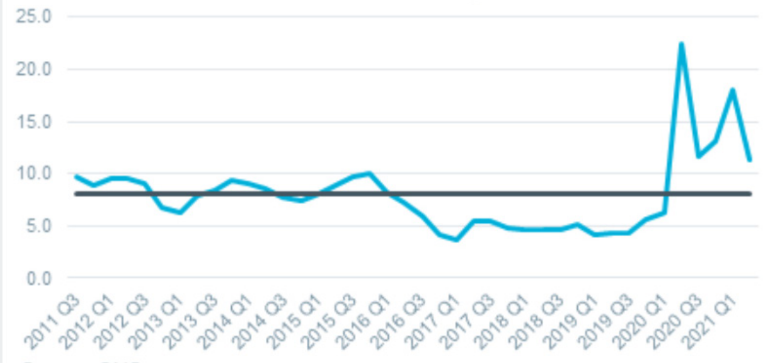
Internet sales found a new normal level

Prior to the pandemic online retail accounted for 20% of retail sales, this shifted dramatically through the pandemic, but over the last few months it seems to be stabilising at a new normal rate of close to 25%.

Rental values are a margin below last's years levels

Compared to average trends across all commercial real estate, retail rental trends are weaker. Over the year to end September 2021 All Property rents have been largely stable (+0.6%). The weakest retail segment has been high street shops where rents have fallen -11.0%, worse in central London where rents have fallen -13.2%. The better performing segments have been retail warehouses and supermarkets, although rents have still slipped by -2.3% and -0.2% respectively. And whilst rents have still fallen over the last three months the rate has lessened, adding to the evidence that the retail market has found its floor. Over the quarter alone high street retail rents fell just -1.2%, retail warehouses -0.2% and supermarkets -0.6%.

Household saving ratio



Source: Cluttons, ONS — Long term average

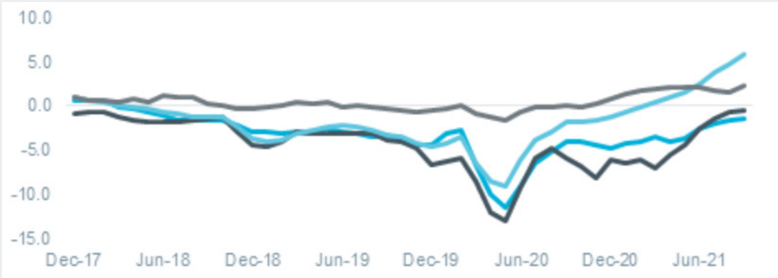
Internet sales as a proportion of total retail sales (%)

Source: Cluttons, ONS

Retail sector capital values are stabilising
Capital values are stabilising across all segments of the retail market with only marginal evidence of further decline from shopping centres (-0.5%) and standard retail (-1.5%) in the three months to end September 2021.

Most notable has been the improvement in retail warehouse values which have risen 5.8% with investor interest driving yields lower. This is the strongest growth rate since 2010. Supermarket values are also rising; up 2.3% in the three months to end September. There will continue to be regional variance: some locations are emerging as resilient high streets and data is slowly emerging to support this.

Retail capital values
3 month change %



Source: Cluttons, MSCI

Headline market data Q3 2021

Retail: Data to end Q3 2021	High Street retail / general retail	Retail warehouse / retail park
	Current quarter (last quarter / 5yr ave)	Current quarter (last quarter / 5yr ave)
Occupier		
Availability rate (%)	4.0% (4.3% / 4.1%)	3.9% (4.1% / 3.7%)
Vacancy rate %	2.6% (2.6% / 2.3%)	3.3% (3.4% / 2.5%)
Quarterly take up (sq ft)	2.8m (3.6m / 4.3m)	138,000 (370,000 / 746,000)
Rental growth (12-month rate) %	-11.0% (-12.7% / -4.6%)	-2.3% (-3.6% / -2.4%)
Supply		
Completions (net delivered m sq ft)	623,000 (919,000 / 1,350,000)	- (197,000 / 180,000)
Total under construction (sq ft)	7.5m (8.0m / 8.1m)	285,000 (278,000 / 656,000)
Investment		
Quarterly sales volume £ million	£698m (£1,092m / £1,606m)	£550m (£343m / £396m)
Average initial yield %	7.1% (6.9% / 5.7%)	6.0% (6.9% / 6.4%)
Prime yield %	6.75% (city/major regional)	6.0-6.25%

Source: Cluttons, CoStar, Property Data, MSCI

Key investment transactions Q3 2021

Address	Location	Building size sqft (sub-sector)	Sale Price (£ million)	Net Initial Yield	Buyer
The Fort Shopping Park	Birmingham	314,500 (RW)	£84m	6.4%	INVESCO Real Estate
Thurrock Shopping Park	Thurrock	290,000 (RW)	£82m	5.75%	British Land Plc
Trafford Park	Manchester	143,000 (RW)	£33m	6.75%	UKCP REIT Ltd

Source: Cluttons, CoStar, Propertydata

CONCLUSIONS

As the economy recovers from the pandemic, there will be upward and downward swings in sentiment. There was a strong lift to mid-year and since then a few indicators have slipped sideways, largely the result of supply chain issues, emerging inflation and expected interest rate rises.

Alongside the bounce back in the economy, real estate markets are coming back to life but at different speeds and with different ferocity. Throughout the last few years, the industrial sector has hardly missed a beat; total returns for this sector over the last 12 months are 28.6% for standard industrial and 32.1% for distribution warehouses. Investment volumes in the sector have been particularly strong with year to date investment flows for the sector significantly ahead of 2019 levels (£5.6 billion in 2019 v £8.8 billion in 2021). This sector will continue to evolve with the changing face of retail and the ongoing drive to exact every last ounce of efficiency out of corporate distribution networks.

The retail sector was hit hardest through the pandemic but now there is mounting evidence across retail segments of values stabilising. For retail warehouses the bounce back has been most significant. Prime yields for the sector now stand close to 6.0% compared to 7.25% a year ago. This improvement has been driven by the servicing of 'click & collect' orders, many consumers favouring this retail format with ample opportunity for social distancing and also investors pricing in redevelopment potential (either distribution or residential).

There are varying degrees of recovery across office markets with an occupational and investor flight to quality apparent. For top spec buildings in Central London the bounce back in take-up and investor volumes has been stronger. The highest quality space has been able to maintain headline rents, albeit by pushing out incentives. Secondary space, particularly that without any real placemaking attributes, rents are under a lot more pressure. Across occupational and investor markets, ESG credentials are also becoming a more important component.

'Hybrid working' will be a dominant catch phrase for a while yet as a slow evolution of the way occupiers seek to use their office space unfolds. Covid numbers through the winter remain critical for how many workers regularly work from the office for the next few months versus those that predominantly work from home. Flexibility remains the key element to the outlook.

As with the economy, we should expect upward and downward shifts in activity and sentiment towards both occupational and investment real estate markets, but the overall trend will continue to be one based on stronger fundamentals.

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