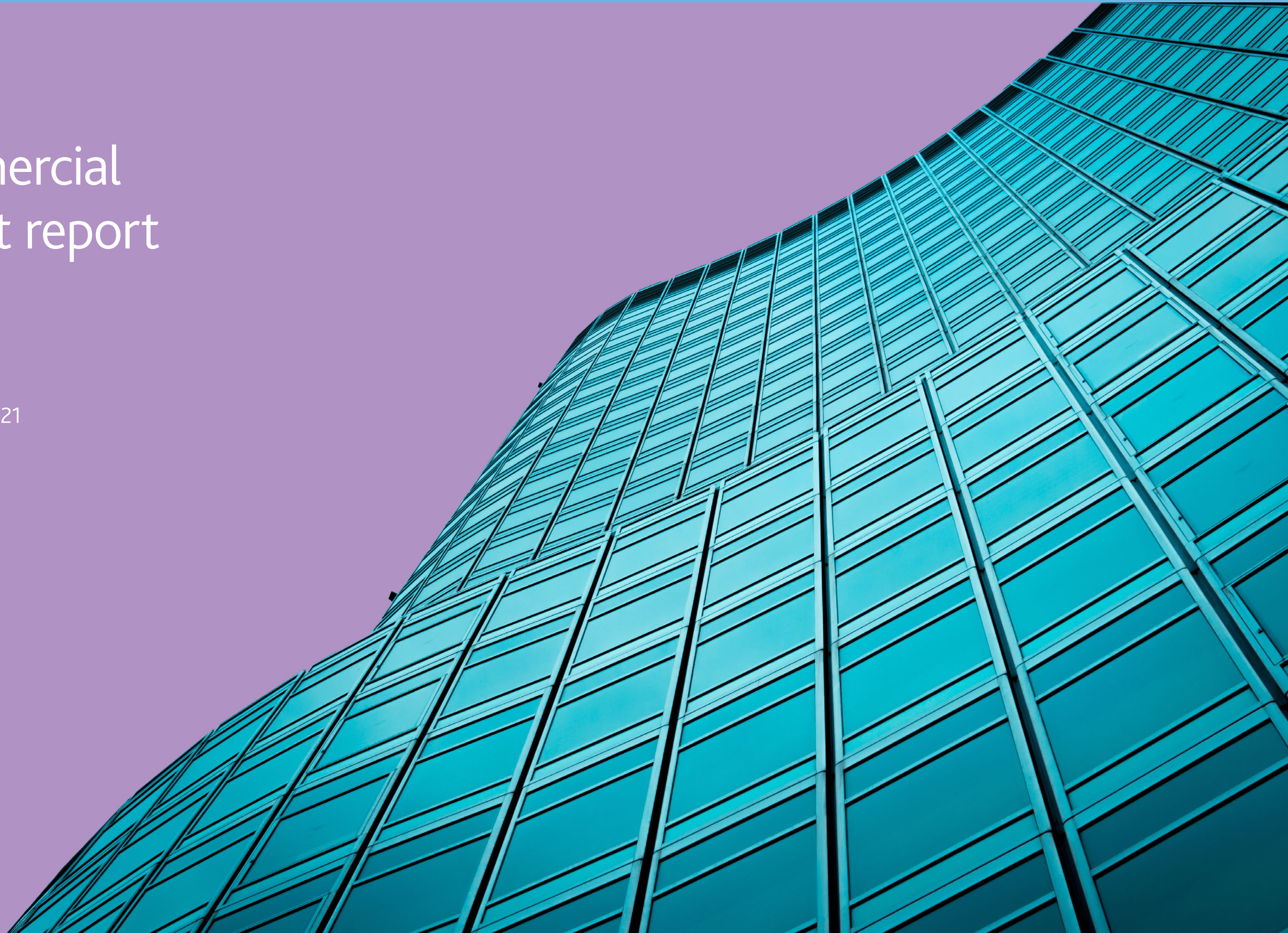
CLUTTONS

Commercial market report

Quarter four 2021



Contents

Key headlines

Recovery across all sectors with a firm emphasis on quality

It has been a long pandemic, and Omicron provided a sharp reminder that it might not be quite over yet. Despite this, there are signs of recovery in all sectors. Industrial continues to lead on most indicators but retail – the most directly impacted sector – also shows signs of getting back on its feet with renewed investor interest. Several large office deals secured in the final quarter of 2021 place confidence to the London outlook.

Inflation and interest rates are the main sources of concern

Concerns are mounting as 2022 begins with rapidly rising inflation leading to much-anticipated interest rate rises just as domestic fuel bills are set to rise by more than 50%. There is a clear threat to consumer confidence with many households suffering a real cost of living squeeze.

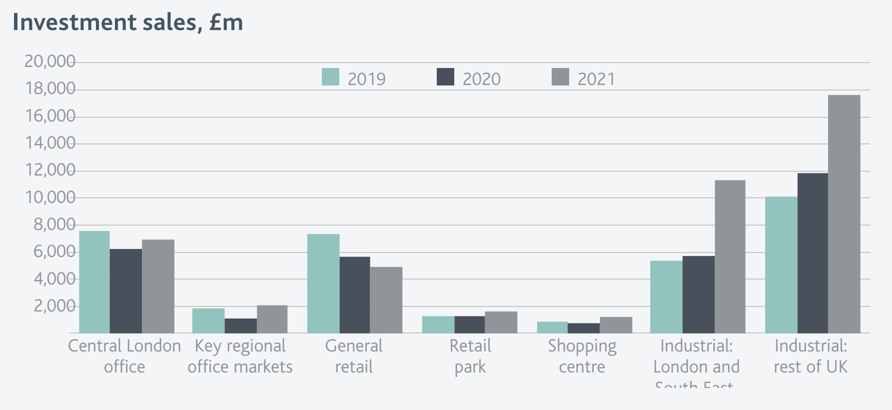
Overview

Total returns in the final quarter were the highest since early 2010
Tthis was a very strong end of 2021, even in the context of a typical Q4 spike. Across the board total returns were positive in the final quarter including high street retail and offices. Industrial performance was exceptional, with retail warehouses the best performing retail component (8.7%).

Investment sales volumes have held up, in some sectors remarkably. Over the course of 2021 £11.3bn had been invested in industrial across London and the South East and another £17.3bn across the rest of the UK. This was more than all the other sectors combined. However it is notable that whilst the investment value was high the number of deals was thinner, reflecting a shortage of investment grade stock.

MSCI Total Returns	Final quarter of 2021 (3-month return)
All property	7.9%
All retail	5.8%
All office	2.7%
All industrial	13.5%
Other	3.3%

Source: MSCI



Source: Cluttons analysis of Costar data

Yield compression
MSCI data showed significant yield compression over the final quarter of 2021, net initial yields moved from 4.7% in September to 4.4% by end of December. Such yield compression is unprecedented. Yields are expected to continue to tighten this year with the economic recovery boosting rental growth potential further. Rising interest rates will have an impact as swap rates rise but this is likely to be moderate given that interest rates are predicted to remain low.

Given that inflationary pressure remains in the economy, thanks to pandemic impacts and wider shortages caused by global logistics problems, interest rates might rise more than expected. Although following on from the February base rate increase, consensus forecasts suggest this could be just once more this year (0.75% by Q4 2022).

Big Box distribution sheds consume land
While much of the attention through Covid lockdowns has been worrying about the future of the office, another sector – big boxes – has proliferated to such an extent that some local authorities have seen ten year's supply of employment land consumed in half that time. Along the arterial roads from ports there is huge demand for very large distribution centres – For example, Belgian company Weert's first UK operation in Bury St Edmunds, an 800,000 sq ft shed.

While Q4 industrial completion levels were nowhere near Q3's record 4m sq ft for London and the South East, pressure for strategic-scale sheds seems unlikely to retreat in the immediate future. This has knock-on implications for other uses, especially smaller scale industrial. It has contributed to industrial rental growth hitting a new record of 7.2% as yields continue to harden and London and the South East investment volumes reaching a new record of £3.5bn, contributing to a very strong end of year overall for investment.

Small sheds matter too
One sector that has, unarguably, benefitted from the pandemic is online retail. This is one element that has driven the strong performance of industrial property, and one emerging trend of urban or last mile logistics. While there will undoubtedly be consolidation as the pandemic eases it is inescapable that many consumers have got used to very efficient delivery promises.

Use class E
The new E category use class for 'commercial, business and services' is a very broad-ranging use class, incorporating retail space (use classes A1-A3), office space (B1), as well as other elements including research and development facilities; industrial uses; and elements of the previous D uses. This has been compounded by the weakening of Article 4 Direction powers. The changes were intended to ease the path of converting redundant commercial space to housing via Permitted Development Rights (PDR). This certainly had the effect of accelerating the conversion of obsolete stock but seems likely hit the availability of light industrial space, especially in smaller towns. The flipside of this is that local authorities are seeing the chance to repurpose tired buildings, for example by letting small offices and maker spaces that breathe life into struggling shopping centres.

Industrial

- **Rental growth continues to rise, hitting 7.2% a year in Q4 2021**
- **UK industrial construction at highest level recorded at 71m sq ft**

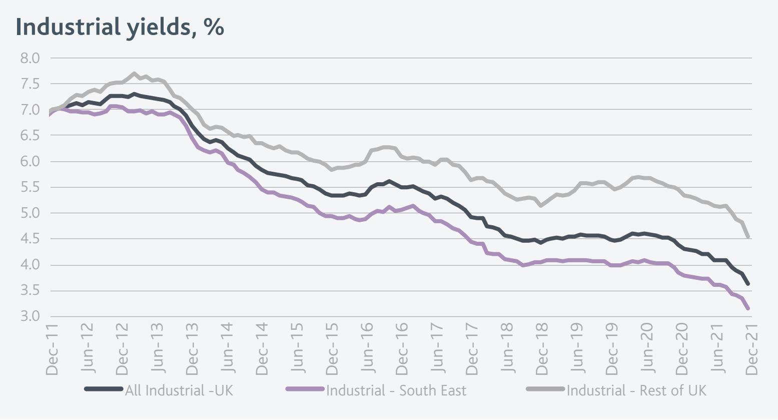
Yields fall as sales volumes soar
Industrial yields continue to fall, especially in the South East where hot spots such as Park Royal and Wembley are achieving sub -3% yields. Meanwhile the volume of quarterly transactions remains high, at a wide margin above the trend rate pre-Covid. Shortage of suitable investment stock is a challenge rather than any lessening in appetite for investment. West London is now expensive, but there are still pockets of value in East London.

Strong rental growth continues
Rental growth for the industrial sector ended the year at 7.2%. Such strong rental growth raises the question how far rents can go before occupiers run into affordability problems. This is made all the more acute by rising energy costs. There have certainly been cases of London occupiers moving out to M25 locations such as Watford in the hunt for more affordable space. But for the most part there continues to be a wealth of occupiers looking for space even at higher rent levels and with very limited availability (vacancy rates are now 2.8% across the UK) rental growth is likely to continue for now.

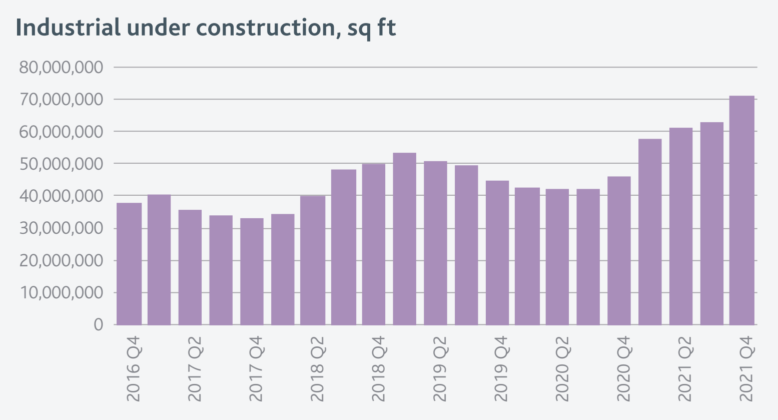
Construction breaks all records
Both in terms of quarterly data and four-quarter rolling average, construction levels have never been so high. Of course, a very small number of very big sheds easily swells construction totals, but even with this caution there does seem to be a case of supply rising to meet demand. With the significant demand and supply imbalance for occupier space it remains to be seen whether completed construction will stabilise rents. Oour sense is that rental growth will continue in the short-term despite increasing supply.

Investor demand will be sustained this year?
While there is some limited evidence that investors are looking to sell, ways to recycle capital back into the real estate sector are somewhat limited. Strong rental growth is also helping investment deals to stack up. Other investors are now finding themselves accidentally under-exposed to the sector and need to rebalance portfolios to bring themselves back in line with the market. In these conditions investor demand is set to continue through this year, alongside significant interest in alternative sectors like residential and specifically build-to-rent.

Manufacturing continues its positive trend
Manufacturing production, as measured by the IHS Markit/CIPS UK manufacturing PMI, grew at its strongest pace for four months and has now been above its neutral position for 19 consecutive months, even though a new wave of Covid restrictions continuing, hit exports at the end of the year and even though supply chain issues had stymied growth. With Covid and supply chain restrictions even stronger momentum has been recorded early in 2022.



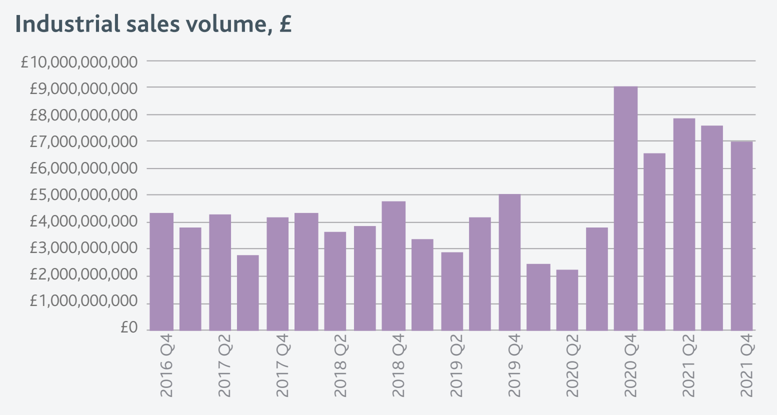
Source: MSCI



Source: Cluttons analysis of Costar data

Industrial

Industrial Q4 2021	UK	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% (5.6% / 5.9%)	6.1% (6.2% / 5.7%)
Vacancy rate %	2.8% (2.9% / 3.0%)	3.2% (3.3% / 2.8%)
Rental growth (12-month growth rate)	7.2% (6.5% / 5.6%)	7.3% (6.4% / 5.9%)
Quarterly take up (sq ft)	22.1m sq ft (24.6m / 25.7m)	5.0m sq ft (5.5m / 5.9m)
Supply		
Completions (net delivered sq ft)	6.7m sq ft (13.5m / 9.9m)	1.5m sq ft (4.1m / 2.1m)
Total under construction (sq ft)	71.9m sq ft (62.7m / 48.8m)	11.2m sq ft (10.5m / 9.1m)
Investment		
Quarterly sales volume £m	£6,999m (£7,575m / £4.870m)	£3.475m (£2.760m / £1,750m)
Average yield	say 3.5% (4.0% / 4.6%)	3.2% (3.4% / 4.1%)
Prime yield (rack rented)	-	3.0%



Source: Cluttons analysis of Costar data

Industrial: Key investment transactions

Property Address	Town /City	Building size (sq ft)	Sale Price (£m)	Net Initial Yield	Buyer
Portfolio	BizSpace portfolio	4.3m (Industrial and office)	£380m	-	Sirius Real Estate
Matrix Park, Park Royal	London NW10	256,000	£140m	2.8%	SEGRO Plc
Peterborough	Peterborough 736	736,000	£120m	3.22%	M&G Real Estate
Wolverhampton	Wobaston Road	450,000 (Distribution)	£68m	3.63%	4th Industrial Ltd

Source: Cluttons, Costar, Property Data

Office

- **Large year end London office deals show confidence in the outlook**
- **TfL volumes took another hit as Omicron deterred passengers in December**

TMT grabs the headlines:
2021 ended in spectacular fashion with Google's purchase of the entire Central St Giles estate in London, totalling more than 700,000 sq ft for £762.5m. Google securing its office space for the long term is only the most recent move by a string of TMT companies, including Facebook, Apple, Tiktok and Snapchat leasing large amounts of space over the past few years, as well as established media such as ITV. Interest in the media sectors is not limited to the techcos themselves – another of the largest investment deals in Q4 was Land Securities' acquisition of a 75% stake in MediaCity in Salford.

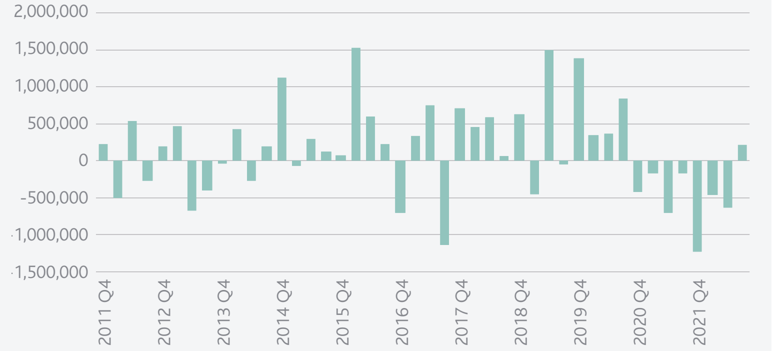
Another noteworthy deal at the tail end of 2021 was the Goldman Sachs purchase of a 75% stake in Edge's £500m London Bridge office. This alongside the Google deal is a strong statement of confidence in the outlook for London.

Take up is still lagging overall
Q4 saw 2.1m sq ft of take up in Central London and although it has edged up from the 2020 Q3 nadir, it is still well below the 2018 Q3 peak, as well as the 5 year quarterly average of 2.8m sq ft – a figure that itself is pulled down by the 2020 trough. But take up is edging up, with net absorption in London positive for the first time since 2019. For the key regional office markets the story is very similar with Q4 take up of 1.1m sq ft close to 40% below its 5-year average with net absorption still negative. The key question for 2022 is how long any Covid hangover lasts, and whether things will return to the prior status quo.

Demand slowly edges up
In Q3 we looked at the impact of the pandemic on journey numbers and it seemed a slow but steady recovery was underway. Omicron put a stop to that and placed in a slightly longer context it is clear that, by year-end, public transport journeys in London still had a long way to go to return to pre-pandemic levels. It feels like 2022 has got off to a surprisingly good start, with public transport usage improving once more.

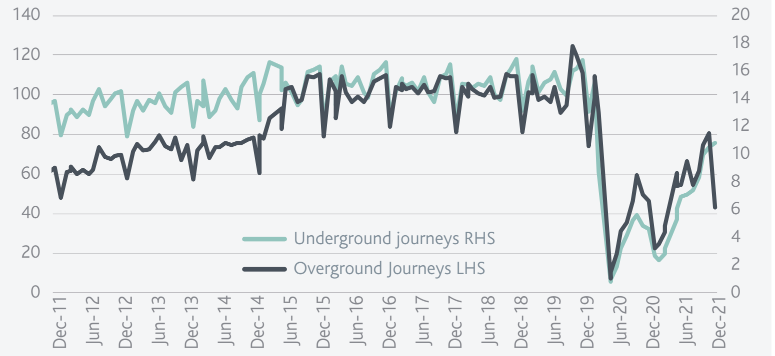
Cambridge-Milton Keynes-Oxford Arc
There is strong interest in the Cambridge-Milton Keynes-Oxford Arc, exemplified by Royal London Mutual paying over £60m for 2600 Oxford Business Park, well above the asking price, with the buyer stating that The Oxford and Cambridge Arc continues to be a key investment focus. Funds are especially keen to acquire life science assets.

Central London office net absorption, sq ft



Source: Cluttons analysis of Costar data

TfL passenger volumes, millions



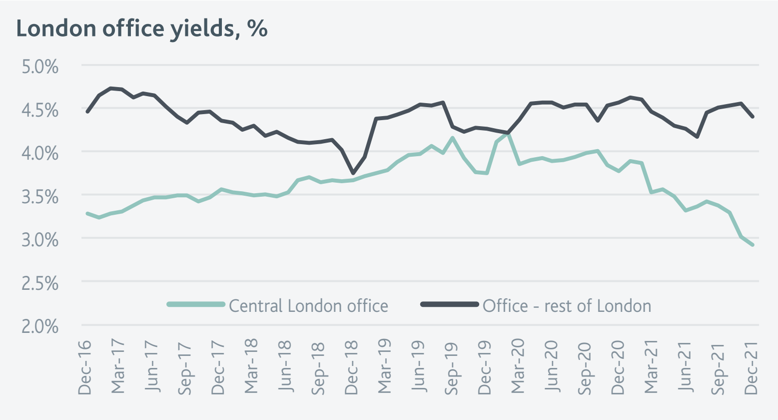
Source: TfL

Office

Flight to quality

One of the most discussed topics is how companies will revise their office space requirements and what the future of the office looks like and in what form. A confluence of pressures drives this; from staff seeking a better workplace experience, companies revaluating how to best retain their workforce (including wellness) and drive the best efficiencies from office space (collaboration), through to a much stronger focus on ESG credentials and potential associated costs. This means in the occupier market and investment market alike we are seeing a strong flight to quality.

This is clearly seen in the London investment market, where Central London yields have been driven down to sub 3% according to MSCI. The rest of London averaged 4.4% in Q4, creating a gap with Central London that hasn't been seen for several years, and it should be no surprise given the overall superior quality of stock in Central London. The rest of the UK is also seeing investors look for quality, even though with lower overall stock levels it is much harder to find suitable investment opportunities. This isn't a new trend but has intensified recently.



Source: MSCI

Office

Office: Q4 2021	Central London	Key regional cities*
	Current quarter (last quarter / 5yr ave)	Current quarter (last quarter / 5yr ave)
Occupier		
Availability rate %	11.1% (11.5% / 9.2%)	9.4% (9.6% / 9.0%)
Vacancy rate %	8.2% (8.1% / 6.5%)	5.9% (5.6% / 5.4%)
Qly take up (sq ft)	2.1m (1.9m / 2.8m)	1.1m (1.3m / 1.8m)
Prime headline rent per sq ft	£120 (West End) £75 (City)	-
Average rent per sq ft	£56.50 (£57 / £57.60)	£19 (£19 / £17.60)
Rental growth (12-month rate) %	-1.6% (-1.0% / -0.1%)	2.6% (2.8% / 4.1%)
Supply		
Completions (net delivered sq ft)	762,000 (25,000, 700,000)	291,000 (414,000, 413,000)
Total under construction (million sq ft)	6.8m (7.5m / 8.2m)	4.6m (4.4m / 4.5m)
Investment		
Qly sales volume (£m)	£2,071m (£1,364m / £2,195m)	£797m (£405m / £517m)
Average yield %	2.9% (4.2% / 4.5%)	-
Prime yield %	3.25-3.5% (West End) 3.75% (City)	4.75 - 5.25%

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

Office: Key investment transactions

Address	Town/ City	Building size (sq ft)	Sale Price (£m)	Net Initial Yield	Buyer
Central St Giles	London, WC2	710,000	£762.5	-	Google
250 Euston Road	London, NW1	165,900	£189.9m	2.47%	Derwent London Plc
MediaCity	Salford	37-acre tech hub	£425.6m	-	Land Securities (75% stake)
Harbour Exchange	London E14	278,192	£196.5m	3.99%	Blackstone Real Estate
Bristol	Assembly (Building A)	319,643	£134.5m	4.73%	LCN Capital Partners
Cambourne Business Park	Cambridge	130,000	£50.1	5.47%	Life Science REIT Plc

Source: Cluttons, Property Data

Retail

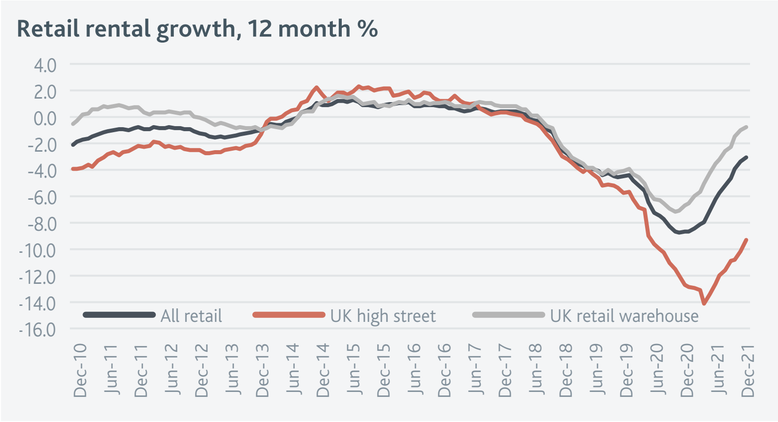
- **Slide in retail rents halts**
- **Inflation and interest rates pose a threat as cost-of-living bites**

Rents have largely stabilised
Rents plummeted as the pandemic emptied our high streets and retail destinations and, although not yet back into solidly positive growth, they have largely stabilised. Such that it would not be surprising to see positive growth early in 2022, at least on retail parks which have weathered the Covid storm in much better shape. Whilst over the last year rents are still lower, in the final quarter of the year retail warehouse rents improved by +0.1%, but shopping centre rents fell by -0.7% and high street retail -2.3% (3 months to end quarter).

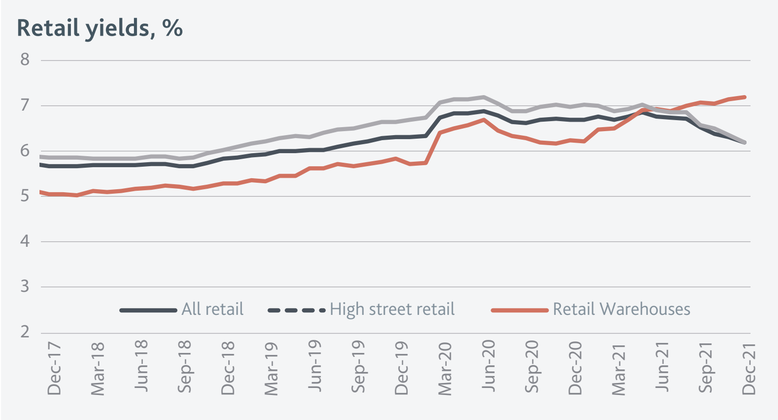
Construction levels are low
It is not surprising that construction levels remain low across the retail sector as a whole, with less than 1m sq ft completed in Q4 and just 7m sq ft under construction; the overwhelming portion of the latter being on the high street (6.6m sq ft). This is well below the five-year average of 10.4m sq ft. The halted decline of retail rents will need to turn unambiguously positive for new construction to look attractive.

Investment volumes holding up
Investment volumes, on the whole, have held up reasonably well. For high street retail Q4's £1.04bn matched the levels of Q3 but were still below the five-year average for the sector of £1.6bn a quarter. Yields eased a little to 7.2%, but there is still a wide margin above the five-year average of 5.8%. The rerating in high street yields stands in clear contrast to other parts of the retail sector that have fared better.

Reflecting the strength of investor interest in retail warehouses, investment levels in Q4 exceeded the five-year average at £426m, with yields sharpening slightly to 6.2% against the previous quarters 6.4% and bettering the five-year figure, also of 6.4%. As discussed previously this may be because retail warehouses offer secure income at a discounted price to sheds as well as the potential for repurposing. Overall, given the rebasing in retail rents and values, there is evidence that investors are starting to see the retail sector in a new post Covid light.



Source: MSCI



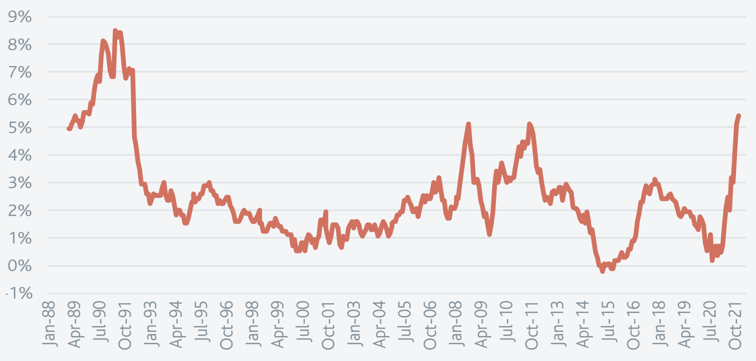
Source: MSCI

Retail

Class E: the threat and the opportunity
The introduction of Class E has, for the first time, brought retail within the scope of (PDR). PDR saw many cities lose large amounts of largely secondary office stock to residential – Norwich, for example, has lost a third of its stock. The thought of this happening to retail would not bode well for the high street. However, there is evidence that planners will look to actively work with owners who want to switch shopping centres to other commercial uses – be it incubator space, small business and co-working space or creative industry hubs – in order to protect the vitality of high streets.

Inflation worries
Inflation is back, with some forecasts expecting it to hit 7% during 2022. December data shows that it has already reached 5.4%. The most direct impact of this will be felt by consumers and, in the context of sharply rising energy costs and rising mortgage payments, the impact on footfall and retail sales might be significant. There are still high levels of Covid related savings in the system that for certain parts of the market will help offset these cost of living constraints. For investors interest rate rises – of which there have now been two, with the likelihood of more, could pose a threat to the more highly geared investors if long term rates and swap rates rise.

Annual inflation, %



Source: ONS

Retail

Retail: Data to end Q4 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 %	3.0% (3.7% / 4.0%)	4.3% (3.9% / 3.7%)
Vacancy rate %	2.6% (2.6% / 2.4%)	3.7% (3.3% / 2.6%)
Qly take up (sq ft)	3.0m sq ft (3.4m sq ft / 4.2m sq ft)	368,000 (171,000 / 718,000)
Rental growth (12-month rate) %	-9.3% (-11.0% / -5.2%)	-2.5% (-2.3% / -2.5%)
Supply		
Completions (net delivered m sq ft)	812,000 (1.2m / 1,85m)	0 (0 / 164,000)
Total under construction (sq ft)	6.6m sq ft (7.0m sq ft / 8.2m sq ft)	290,000 (290,000 / 623,000)
Investment		
Qly sales volume (£)	£1,043m (£1,019m / £1,597m)	£426m (£559m / £390m)
Average initial yield %	7.2% (7.1% / 5.8%)	6.2% (6.4% / 6.4%)
Prime yield %	6.5% (city/major regional)	6.0%

Source: Cluttons, Costar, Property Data, MSCI

Address	Location	Building size sq ft (sub-sector)	Sale Price (£m)	Net Initial Yield	Buyer
Cannock	Voyager Drive	73,000 (SU)	£75.8m	4.2%	Supermarket Income REIT
Bristol	Avonmeads Retail Park	166,000 (RW)	£48.83m	5.95%	Realty Income Corp
Manchester	West One, Eccles	151,406 (RW)	£28m	5.41%	M7 Real Estate
London	214-218 Oxford Street, W1	241,990	£378m	-	Ingka Group

Source: Cluttons, Costar, Property Data

Conclusions

2022 has started well with a swift recovery from the Omicron threat which shut down many parts of the economy at the tail end of 2021 and early indications showing a quick reversal in falling passenger numbers, people working from home and declines in retail and hospitality footfall. Indeed, economic growth for the year as a whole was 7.5% (remembering that economic growth fell by -9.4% in 2020) with an impressive 1.0% in the final quarter given the negative impact of Omicron.

For the office market, this year is likely to resolve the hybrid office debate as occupiers road test and develop new occupational strategies. The amount of 'me' space allocated per worker is likely to be reduced in favour of amenity and collaboration 'we' space. While the final outcome of the new hybrid working model remains unclear for now, what is clear and will be a persistent trend is the two-tier market of grade A prime versus secondary space. This flight to quality is driven not just by occupiers seeking improved space but by the ESG agenda too and recognition of costs involved in becoming more energy efficient.

The retail sector, given the significant rebase in rents and values, is attracting investor interest once more. Two large shopping centre deals in the final quarter of 2021 stand as testimony to the start of renewed confidence to the sector. The fall in rents has been dramatic in places but by the end of 2021 that rental decline had largely found a stable floor. There are headwinds for the consumer (cost of living squeeze) but with large Covid household savings yet to be fully unwound there is still an expectation that consumer spending will be strong.

The industrial sector has enjoyed a spectacular 2021 and 2022 looks set to run along a very similar theme. With rental growth running at over 7% p.a. investors look willing and able to chase yields lower yet. There is a large pipeline of development activity but even this looks likely to be absorbed given current market conditions.

Weight of money will continue to chase prime assets through this year and with limited ability to recycle capital back into the market, investors are likely to hold onto assets rather than realise profits. The industrial sector is likely to be a chief beneficiary of investment interest but alternative assets such as residential are also likely to be high on investors strategic ambitions.

The consensus is that higher inflation will be temporary, but if this becomes a longer-term problem then higher rates are the likely consequence. For now, the small increase in forecasts for interest rates for this year and next present only a very minor dent to investor enthusiasm for real estate assets.

Cluttons LLP
2 Portman House
Portman Street
London W1H 6DU

T: 020 7408 1010
cluttons.com

For further details contact
Sophy Moffat
Partner, head of insight & research
T: +44 (0) 20 7647 7032
E: sophy.moffat@cluttons.com

3030 – 0222