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Quarterly Review: Q2 2021

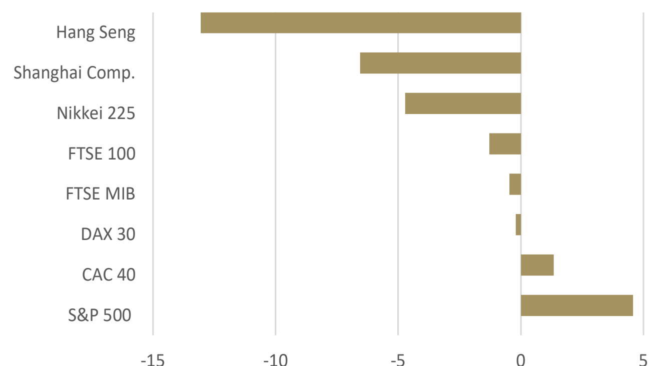
Top Five

- The 0.8% m/m rise in UK GDP in May was driven by the re-opening of indoor hospitality mid-month. But this rise was smaller than expected and more timely indicators suggest that the recovery lost momentum in June.
- Central London office take-up edged up from its lows of 1.1m sq. ft. in Q1 to 1.2m sq. ft. in Q2, with activity dominated by leasing of second-hand space.
- After very strong take up in both H1 and H2 last year, industrial take-up in London and the South East has eased in line with its long-term average.
- Following a weak start to the year, there was a partial recovery in Central London office investment. According to CBRE, transactions totalled £2.7bn in Q2, which was up from a low £1.3bn in Q1.
- Meanwhile, investment in regional offices saw a sharp rise in June. On a 12-month rolling basis, transactions totalled £300m in June, up from £210m in the previous month.

1. Economic Overview

Despite further evidence of improving global economic activity recently, concerns around the Delta variant and the prospect of tighter monetary policy on the back of rising inflation have led to price falls in most equity markets in recent weeks (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days to 28/07/21 (%)



Source: Refinitiv

In the US, the 6.5% annualised gain in second-quarter GDP was well below the consensus expectations (of 8.5%), but at least meant that the economy surpassed its pre-pandemic level. However, although 60% of American adults are now fully vaccinated, the uptick in coronavirus infections linked to the Delta variant has rekindled fears about the spread of the virus. While most states appear unlikely to reimpose restrictions, the upturn poses a downside risk to the economy over the coming months if it prompts people to stay away from in-person services. Despite the solid rise in retail sales in June, the 0.9% rise in prices suggests a small fall in real consumption for the second month running.

Indeed, driven by core prices, the jump in headline CPI pushed inflation up to 5.4% y/y, the highest rate since the early 1990s.

Meanwhile, the 850,000 gain in non-farm payroll employment in June was much stronger than the average 550,000 monthly rise over the first half of the year. Over half of the remaining shortfall in employment from pre-pandemic levels is concentrated in the leisure & hospitality, education and health sectors, which were hardest hit by coronavirus restrictions. And the sustained surge in job openings, particularly in leisure and hospitality and manufacturing industries, point to labour shortages.

In Europe, while the aggregate number of new daily cases continued its rapid downward trend in June, it begun to pick up in early July, driven by increases in Spain. Meanwhile, the vaccine rollout continued at a steady pace in June. Daily vaccinations have been running at an impressive pace, allowing the euro-zone to close its gap with the UK and catch up with US rates.

Business surveys suggest that the euro-zone's economic recovery accelerated in June. The composite PMI rose to a 15-year high, buoyed by a sharp increase in the services component, as restrictions were lifted in much of the region. And while the upward trend in inflation took a break in June, as both headline and core inflation dipped, a stronger economic recovery is likely to restart the upward trend in the second half of the year. Meanwhile, the euro-zone's unemployment rate fell to 7.8% in May and the combination of the strong economic recovery and government support mean it is unlikely to rise from here.

In the UK, the slightly disappointing 0.8% m/m rise in GDP in May was driven by the reopening of indoor hospitality mid-month. More timely indicators suggest that the recovery lost a bit more momentum in June. Meanwhile, case numbers have been falling recently and the full vaccination of 71.4% of all adults appears to have weakened the link between cases and hospitalisations, which should prevent further restrictions.

After falling by 1.3% m/m in May, retail sales grew by 0.5% m/m in June. The bulk of the gain was due to a 4.2% m/m rise in food sales, related to the Euro 2020 finals, so many high street shops will not have seen much of a benefit. Meanwhile, a jump in energy price and re-opening effects led to CPI inflation increasing from 2.1% y/y in May to 2.5% in June, its highest level in almost three years. Moreover, there was a 25,000 rise in LFS employment in May and the sharp increases in hiring intentions point to further growth. The ILO unemployment rate was steady at 4.8%, though it is likely to drift up again once the furlough scheme expires later this year.

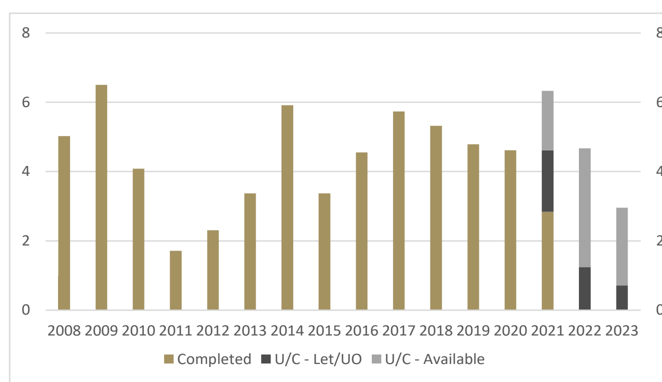
2. London

2.1 Occupational Market

The recovery in occupier demand in Central London offices has been slow since its nadir a year ago. According to CBRE, on a 12-month rolling basis, Central London office take-up edged up from its lows of 1.1m sq. ft. in Q1 to 1.2m sq. ft. in the second quarter. Indeed, take-up in Q2 was dominated by second-hand space which accounted for almost three-quarters of the total, which was largely sub-let activity. The largest of second-hand deal was Shell International sub-letting 132,000 sq. ft. to IBM at 1 Southbank Place.

On the same basis, a rise in second-hand space pushed up Central London availability in Q1 by 12% to 23.6m sq. ft.. As such, vacancy rose from 8.9% to 9.3%, its highest level since 2004. Moreover, CBRE estimate that completions are set to rise to 6.3m. sq. ft. in Central London this year from 4.6m. sq. ft. last year. (See Chart 2.)

Chart 2: Central London Office Development Pipeline (M. Sq. Ft.)

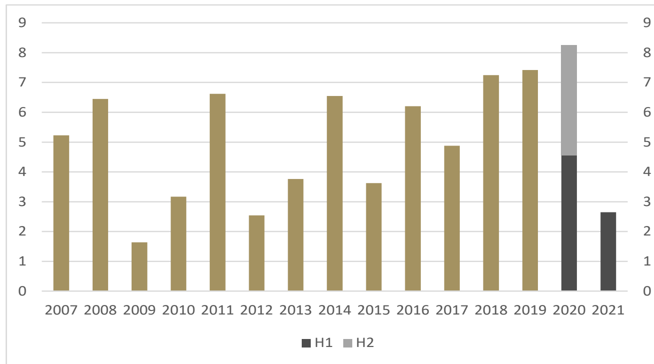


Source: CBRE

Around a third of this space is speculative construction that is not pre-let, so vacancy will probably creep up further this year if demand remains weak.

After very strong take up in both H1 and H2 last year, London and South East industrial take-up has eased in line with its long-term average according to Savills. Indeed, take-up in the region fell by 40% y/y to 2.7m. sq. ft. in H1 2021 (see Chart 3).

Chart 3: London & South East Industrial Take-Up (M. Sq. Ft.)



Source: Savills

And while available space edged up by 5% y/y to 4.9m. sq. ft. in H1 this year, vacancy remained stable at close to 4% over this period. That said, with developers keen to build in the region, the construction pipeline has seen a notable pick-up in activity from 1.5m. sq. ft. at the end of last year to 5.3m. sq. ft. in H1, which is likely to put rental growth under pressure in the coming quarters.

In the retail sector, although non-essential retailers reopened in Q2, with London more reliant on office workers and tourists, occupiers have continued to struggle. Moreover, although most restrictions ended on 19th July ('Freedom Day'), the rise in case numbers until recently is likely to result in a slow return of office workers over the summer, which will prolong the pain for many London retailers. According to LDC, Greater London saw the highest increase in vacancy of all regions, rising from 8.9% in Q1 to 9.1% in Q2.

2.2 Investment Market

Following a weak start to the year, Central London office investment started to recover in the second quarter. According to CBRE, transactions totalled £2.7bn in Q2, which was up from a low £1.3bn in Q1. Activity was boosted by some large transactions such as the acquisition of 30 Fenchurch Street in EC3 by Brookfield for £635m and Union Investment Real Estates purchase of One Braham in E1 for £470m.

And while yields for Bond Street were stable at 2.75% in Q2 from the start of the year, CBRE report that Regent and Oxford Street both saw yields rise by 25bps to 4% and 4.25% respectively. In turn, this left yields in Regent and Oxford Street 100bps and 125bps higher respectively than before the pandemic, while the 50bps rise in Bond Street look relatively modest.

3. Rest of UK

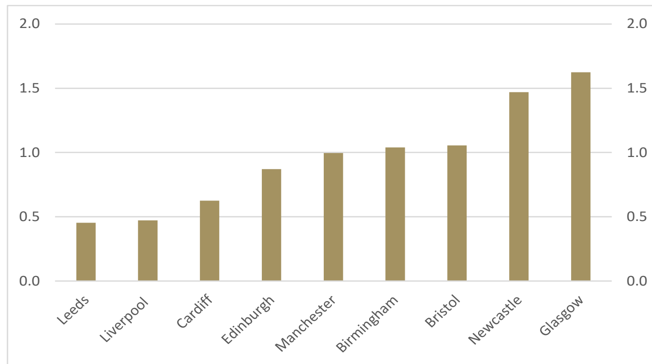
3.1 Occupational Market

According to Avison Young, regional city centre take-up has improved by 30% q/q to 1m. sq. ft. in Q2. That said, regional office take-up remains below its five-year average of 1.5m. sq. ft. and its pre-pandemic levels. Indeed, the only regions that were above the long run average were Edinburgh and Birmingham. In particular, Birmingham saw a significant improvement in take-up due to a number of medium sized transactions, of which its largest deal saw IWG take 50,000 sq. ft. at the Mailbox.

On the other hand, out-of-town regional office demand has been soft. Indeed, take-up fell by 20% q/q to 0.5m. sq. ft. in Q2. That said, aside from Glasgow and Newcastle, take-up in these peripheral locations were still up on last year.

Meanwhile, regional office availability continues to climb. Available space in the regions rose by 11% q/q to 11.1m. sq. ft. in Q2, which left it almost 40% above its levels a year ago. At the same time, speculative space under construction has fallen by 14% q/q to 5.3m sq. ft. in the second quarter. Put together, amounting to just under a year's worth of take-up based on the five-year average, the pipeline seems tight. This is particularly the case for cities such as Leeds, Liverpool and Cardiff, which bodes well for rents in these cities (see Chart 4).

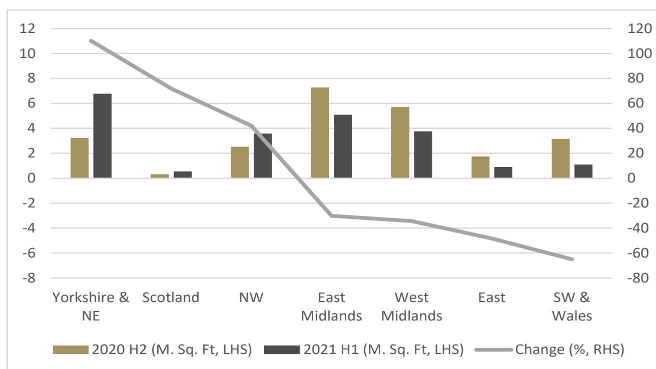
Chart 4: Years of Office Supply in the Regions (Based on 5-Yr Avg. Take-Up)



Source: Avison Young

While industrial demand in the regions remained strong in the first half of this year, it slowed from a very high level in 2020. Savills report that take-up in H1 was 21.7m. sq. ft, down slightly from 24.0m. sq. ft. in H2 2020. Indeed, the only regions to see a pick-up in take-up activity were Yorkshire and the North East, North West and Scotland, albeit the rise in Scotland was from a low base (see Chart 5).

Chart 5: Industrial Take-Up by Region



Source: Savills

For more information:

Please contact Sarah White;

sw@rivercap.co.uk

At 6.7m. sq. ft, the Yorkshire and the North East region saw take-up more than double its H2 2020 levels, partly due to Amazon leasing around 2m. sq. ft. in Wakefield.

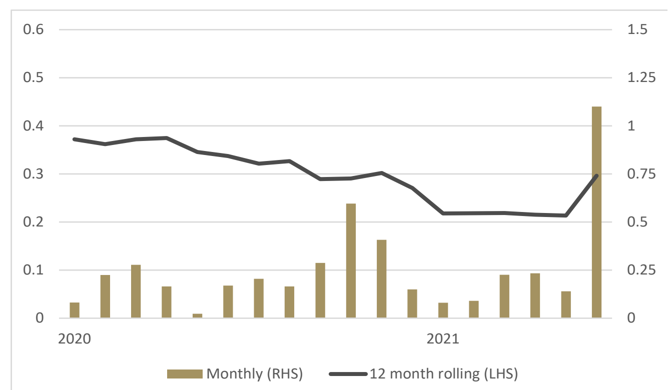
Decent demand resulted in regional industrial availability falling by 27% from 27.8m. sq. ft. in H2 2020 to 20.2m. sq. ft. in H1. In fact, all regions saw availability fall in this period. After very strong demand in Yorkshire and the North East, these regions saw the largest drop in available space, which led to vacancy plunging from 5.7% to just 2.9% in H1. But, with developers keen to build industrial units, the pipeline has risen from 5.5m. sq. ft. to 11.5m. sq. ft. over the same period and will probably continue to increase as the sector sees relatively strong performance. This will probably lead to some upward pressure on vacancy across the regions in the coming months.

In the retail market, while most regions saw vacancy stabilise after rises in recent quarters, some continued to climb. The largest rise in vacancy was in the West Midlands, which rose by 20bps to 14.4% in the second quarter.

3.2 Investment Market

Investment activity in regional offices saw a sharp rise in June. Colliers report that, on a 12-month rolling basis, transactions totalled £300m in June, up from £210m in the previous month (see Chart 6). June's total was boosted by the sale of the Arlington portfolio of science and technology assets for £710m to Brookfield, which are mostly concentrated in the Oxford-Cambridge-London "Golden Triangle".

Chart 6: Regional Office Investment (£bn)



Source: Colliers