Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

Quarterly Review: Q2 2024

Top Five

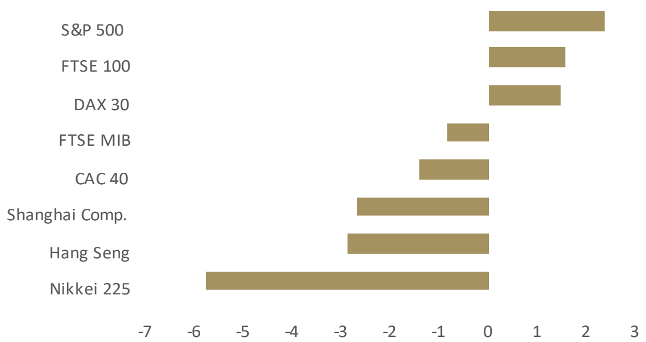
- The latest data generally suggests that global growth will be positive but unspectacular in the second half of this year. The headline data for the UK has recently been improving, albeit with some caveats around labour productivity and the sustainability of GDP growth. After cutting rates by 25bps in August, the Bank of England looks set to cut again before the end of the year.
- After a slow start to the year, Central London office demand picked up in Q2, driven by the City. Demand is still subdued compared to pre-COVID levels, but under offers also increased, implying take-up will see a further rise over the second half of the year. New, prime space continues to be the most in demand with only around half of all deals for second-hand offices, compared to an average of around 65% over 2018 and 2019.
- Outside of the capital office demand softened in Q2. Take-up in the South East dropped 7.5% q/q, and in the 10 largest regional cities take-up declined by 4% q/q in Q1. Developers are now responding to that moderation in demand, with under 1m sq. ft. of space planned to complete in 2025.
- In other sectors, logistics take-up increased in Q2 to 7.3m sq. ft, from 4.5m sq. ft. in Q1 2024. But that didn't prevent a further rise in availability and the vacancy rate. Meanwhile, hotel occupancy and revenues have continued to improve in both London and the rest of the UK, with golf & spa and upscale hotels outperforming.
- Investment in Central London offices ticked-up in Q2 to £1.1bn, but that is still low by historical standards. Office investment outside of London also stayed relatively low, with investors holding back on concerns over whether capital values have found a floor. Retail investment performed better, helped by several deals for New Bond Street shops and regional shopping centres.

1. Economic Overview

The latest data generally suggest that global growth will be positive but unspectacular in the second half of this year. Survey indicators point to a potential slowdown in world industrial production and trade, but the US is still performing relatively well despite fears about its labour market. Meanwhile, China's growth has stabilised and should gain some pace as policy support kicks in. The ongoing gradual decline in inflation around the world should allow the global monetary policy loosening cycle to broaden in the months ahead. And with growth set to remain positive pretty much across the board, central banks will be able to normalise policy steadily rather than aggressively.

Data in the US have been positive lately, with the July price data helping to assuage worries around inflation. The 0.15% m/m increase in all-items CPI and the 0.17% increase in core CPI in July suggest that, after the temporary relapse in the first quarter, the disinflationary trend has firmly reasserted itself. The Fed therefore looks on track to cut rates by 25bps in September. It was also a reassuring week for those still worried about an imminent recession, with the three-month-on-three-month growth rate of control group retail sales accelerating to an eight-month high of 4.9% in July. The combination of easing inflation and an apparent soft landing for the economy have been positive for equities, with the S&P 500 outperforming other markets over the past 40 days. (see Chart 1).

Chart 1: Change in Selected Major Equity Market Indices over the Last 40 Trading Days



Source: Refinitiv

The euro-zone economy is growing at a steady pace. GDP grew by 0.3% q/q in Q2, although timelier data suggest the economy made a slow start to Q3. But the region is still suffering from labour shortages and wage growth is therefore strong. As a result, the inflation rates of the most wage-sensitive components of core inflation have stopped falling and are still high. But most ECB policymakers will likely judge that a cut is justified in September. Beyond September, assuming the euro-zone economy continues to expand and the US avoids a hard landing, further cuts will require evidence of easing underlying price pressures.

The recent news around the UK economy has been positive. The economy grew by an above-trend rate for the second quarter in a row in Q2 and the unemployment rate dropped back to 4.2%. And at 2.2%, CPI inflation is only a touch above the Bank of England's 2.0% target. Even services inflation, which until now had looked sticky, fell more convincingly back towards its long-run average rate of 3.5%. That said, growth has been supported by stock-building and government spending, which is not a strong basis for sustainable growth. Labour productivity is also still weak which means higher unit labour cost growth and higher inflation. That implies that after August's 25bps cut in rates, the Bank will be in no rush to cut again at its next meeting in September.

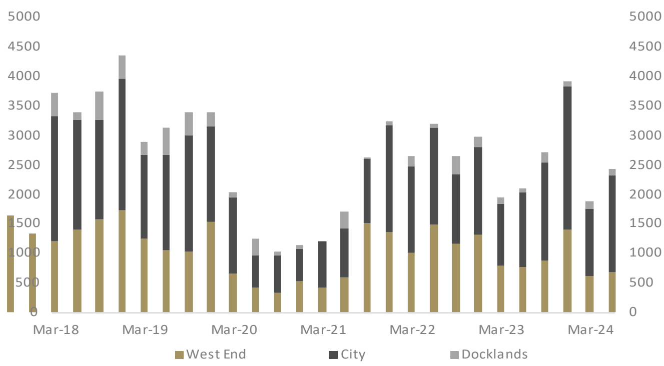
2. London

2.1 Occupational Market

Central London office demand picked up in Q2 after a slow start to the year. According to Knight Frank, take-up rose to 2.5m sq. ft., a 30% increase on the previous quarter, driven by the City (see Chart 2). On a 4-quarter rolling average basis take-up has now been close to 2.7m sq. ft. since the end of 2023, around 15% below its pre-COVID-19 level.

The rise in take-up in the City was supported by Citadel taking 250,000 sq. ft. at 2-3 Finsbury Avenue, which was the largest deal in the quarter by some distance. Other notable deals include Revolut taking 114,000 sq. ft. at YY London in the Docklands and Amazon acquiring 109,000 sq. ft. at The Bard at the Stage in the City.

Chart 2: Central London Office Take-Up (M. Sq. Ft.)



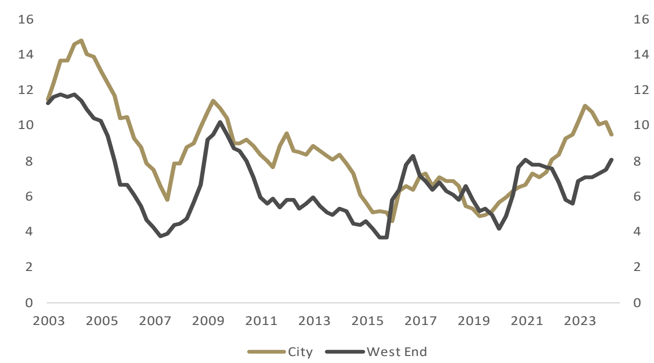
Source: Knight Frank

As has been the case for the past few quarters new, prime space is most in demand. According to CBRE, the five largest deals that transacted in Q2 were for new or pre-let space. And only around half of all deals were for second-hand offices, compared to around 65% on average in 2018 and 2019.

Under offers totalled 4.2m sq. ft. by the end of Q2, representing a 5% rise on Q1 and 21% above the 10-year average. That implies take-up will rise in Q3. The largest of these was BDO placing 222,000 sq. ft. under offer at the M Building, 334 Oxford Street. As with take-up, under offer demand was concentrated in new, prime space with seven of the 10 largest units in development schemes.

Total available space in Central London edged back in Q2 but, at 24.2m sq. ft., it remains above the 10-year average figure of 16.8m sq. ft. A relative abundance of supply is also evident in the vacancy rate, which at 9.4% in Central London compares to 5.7% prior to the COVID-19 lockdowns. A number of large deals in the City in recent months has helped bring the vacancy rate there down from 11.1% in Q2 2023 to 9.5% in Q2 2024. And a concurrent rise in the West End vacancy rate has helped narrow the gap between the two subsectors (see Chart 3).

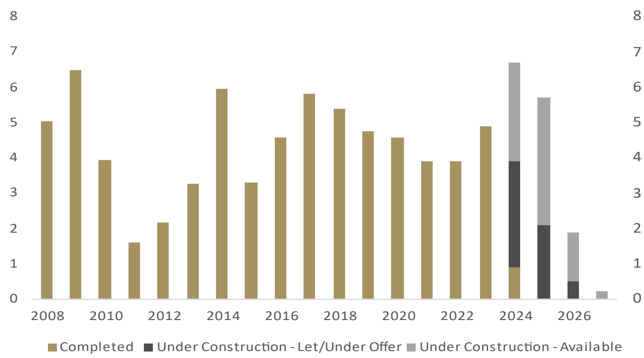
Chart 3: Central London Vacancy Rates (%)



Source: Knight Frank

Despite the relatively high level of vacancy the London development pipeline is still substantial. Central London office completions in 2024 are expected to come in at just over 6m sq. ft., which would be the highest amount of new space since 2009 (see Chart 4). And 2025 is expected to see a similar level of space hit the market. Given demand for new, prime space is holding up, tenants for these buildings shouldn't be too hard to find. But that may feed through to worsening vacancy for secondary buildings.

Chart 4: Central London Development Pipeline (M. Sq. Ft.)



Source: CBRE

Retail sales volumes rose 0.5% m/m in July, although that only partially reversed June's 0.9% m/m fall. But rising real household incomes have helped consumer confidence rise to a two-year high and that will support retail activity over the next year.

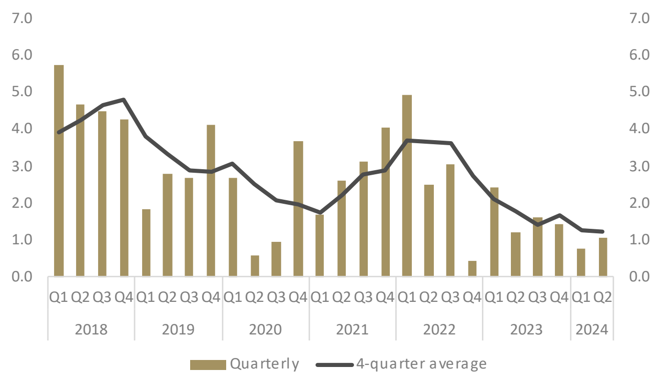
London hotel occupancy has continued to recover from the impact of COVID-19, with occupancy of 73.2% in Q1 up 4.6% pts from a year earlier and just 1.3% pts below Q1 2019 levels. Strong growth of overseas visitors is driving vacancy down, although the impact of rising demand on the luxury sector has been offset to some extent by the opening of an additional 600 rooms in 2023.

2.2 Investment Market

Lambert Smith Hampton reported that investment in Central London offices ticked-up in Q2 to £1.1bn, from £780m in Q1. But that is still a very low level of transactions by historical standards, with investors still holding back over fears of further capital value falls (see Chart 5).

The low level of transactions in London meant there were only two notable deals in Q2. Yellow Tree purchased Herbal House, 8-10 Back Hill from Aerium for £102m, and LetterOne acquired 20 Grafton Street from a private seller for £100m.

Chart 5: Central London Office Investment (£bn)



Source: Lambert Smith Hampton

Overall, retail investment continued to outperform in Q2, being the only sector to post transaction volumes above its long-run trend. That was helped by a healthy performance in the shops subsector, which in turn was supported by four deals along New Bond Street. That included Weybourne Investments buying 126-127 New Bond Street from a private seller for £71m at a yield of 2.8%, and Richemont acquiring 178 New Bond Street from Circle Prop Dev Ltd for £82m at a yield of 2.2%.

Hotel investment had another strong quarter in Q2, helped by a number of deals in London which included Grove HR Limited buying the Radisson Blue Heathrow for £43m from Starwood Capital and Gruppo Statuto buying Six Senses London from Warrior Group for £180m.

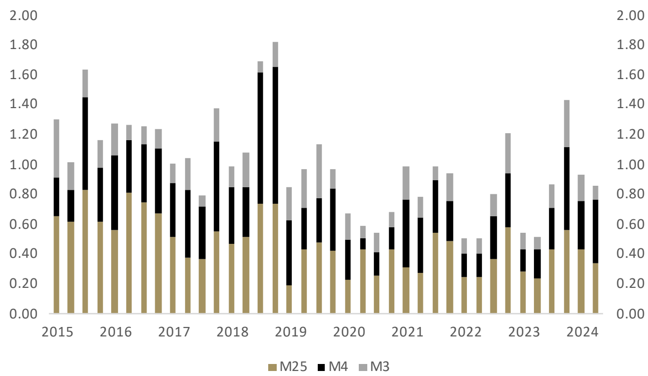
3. Rest of UK

3.1 Occupational Market

In contrast to Central London, which saw a pick-up in occupier demand in Q2, Knight Frank reported that take-up in the M25, M3 and M4 markets dropped back to 860,000 sq. ft., from 930,000 sq. ft. in Q1. The moderation in demand was particularly evident in the M3 market, which saw a 44% q/q decline (see Chart 6). By contrast, the M4 market saw a rise in take-up of 32% over the quarter.

Key deals in the South East region in Q2 included Allwyn leasing 65,323 sq. ft. at Clarendon Works, Watford and AWE taking 64,207 sq. ft. at Green Park, Reading.

Chart 6: South East Markets Take-Up (M. Sq. Ft.)

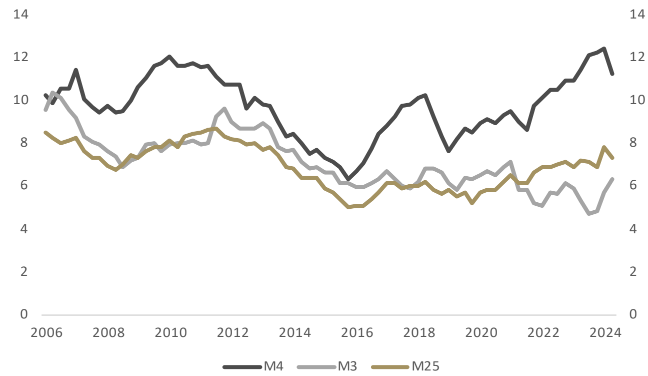


Source: Knight Frank

Beyond the South East, CBRE reported that take-up in the UK Markets, which consists of 10 city markets outside of Central London, totalled 1.2m sq. ft. in Q1, a 4% decline on the previous quarter. Key deals in the quarter included BBC Studio Productions taking 84,000 sq. ft. in the Typhoo Building in Birmingham, and University College Birmingham took 44,700 sq. ft. at Baskerville House, also in Birmingham.

The pick-up in occupier demand in the M4 corridor helped bring the vacancy rate there down from the 22-year high of 12.4% in Q1 to 11.2% in Q2 (see Chart 7). That was enough to offset a small rise in the M3 vacancy rate and leave the overall South East rate at 8.3%, down from 8.8% in Q1 2024.

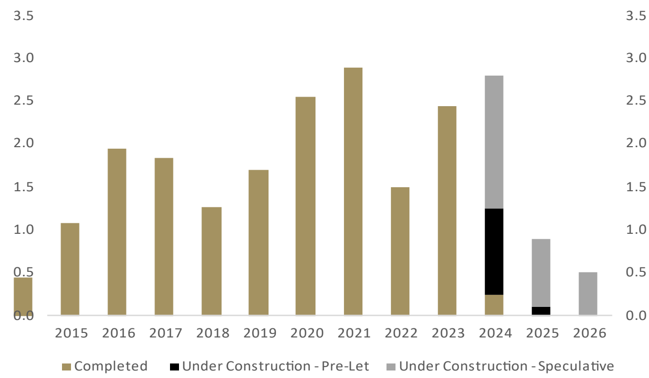
Chart 7: South East Vacancy Rates (%)



Source: Knight Frank

In line with Central London the UK Markets pipeline looks substantial in 2024, with close to 3m sq. ft. of space due to be completed (see Chart 8). And half of that is still available, which implies availability in the UK Markets will see further upward pressure this year. But developers have been quick to cut back, and beyond this year the pipeline is much smaller with under 1m sq. ft. planned to complete in 2025.

Chart 8: UK Markets Pipeline (M. Sq. Ft.)



Source: CBRE

CBRE reported that logistics take-up increased in Q2 to 7.3m sq. ft, from 4.5m sq. ft. in Q1 2024. But that didn't prevent a further rise in availability and the vacancy rate. From just 1.2% two years ago the vacancy rate had risen to 5.6% in Q2, slightly above its pre-COVID-19 level. That loosening in market conditions has caused developers to pull back. The amount of space under construction dropped back for the fifth quarter in a row to 18.9m sq. ft., under half of what it was at the start of 2023.

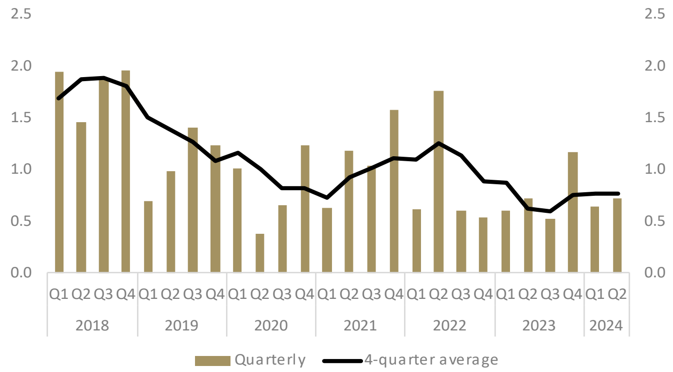
Two of the largest deals in Q2 were both in Magna Park, Corby. Nike took 1.3m sq. ft., and Bleckmann Logistics took 588,000 sq. ft.

Regional hotel occupancy saw another rise in Q1 2024 to reach 67.9%, up 1.1% pts. on a year earlier. The Average Daily Rate also picked up to £92 in Q4, helped by a blend of robust domestic demand, combined with the ongoing recovery from overseas. Golf & Spa and Upscale hotels have outperformed, seeing a rise in revenue per available room of around 9% y/y.

3.2 Investment Market

Office investment in the regions was stable in Q2 at around £730m across the South East and Rest of UK. But in line with London that is historically low, with the four quarter average figure of £770m around 30% below its pre-COVID level (see Chart 9). One deal of note was Greyarc Investments buying Oxfam House, Oxford for £37m from Sutton County Council.

Chart 9: Rest of UK and Rest of South East Office Investment (£bn)



Source: Lambert Smith Hampton

Industrial investment edged back in Q2 to £1.7bn, down from £2bn a year ago. A lack of large portfolio deals held the total down, with the number of transactions holding up better. The only deal to break £100m in the quarter was Legal & General buying Magna Park in Corby for £168m.

Retail investment was supported by a strong quarter for shopping centres, with transaction volumes reaching a seven-year high. That was driven by Norges Bank paying £360m for an additional 50% stake in Meadowhall, Sheffield and LandSec paying £120m for a 17.5% stake in Bluewater, Kent.

Hotel sector investment was once again very strong, driven by Blackstone paying around £850m for the Villages Hotels Portfolio from KSL Capital Partners and Ares Management paying £400m for the LandSec Hotel Portfolio.

For more information:

Please contact Sarah White;

sw@rivercap.co.uk