Real Estate House View

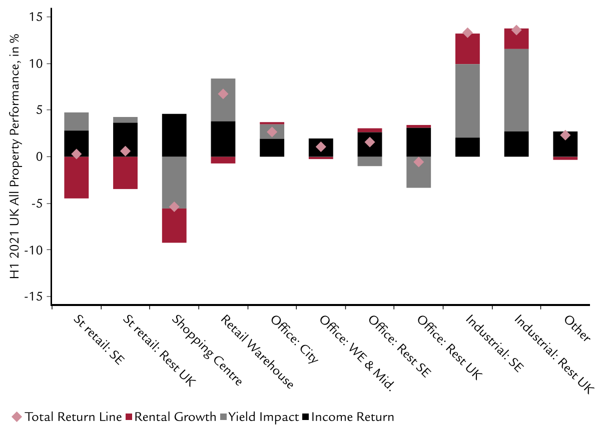
United Kingdom

Second half-year 2021

Key takeaways

- **UK All Property performance improving:** Six-month total returns in H1 2021 equated to 6.2% compared to -0.1% in H2 2020 based on the MSCI UK monthly index. This was led by the exceptional performance of industrial and logistics, while retail and office continued to struggle over the first half of the year.
- **Investors returning to the market:** Q2 2021 saw investment volumes at 3% above the 10-year quarterly average but overall H1 investment volumes were down on H2 2020 by 7.2%. As travel restrictions have eased, international investors have been able to access the market more easily.
- **Logistics continues to outperform:** The first half of the year saw logistics outperform again. Yields compressed and rental values increased. H1 2021 saw another period of record take-up levels. With supply expected to be disrupted in the short term, the sector is set for further yield compression and rental growth.
- **Offices' resilience focused on core:** Offices saw capital losses of -1.4% in H1 compared to -2.0% in H2 2020. The London City and West End segments were the strongest performers. Occupiers are expected to concentrate activity on high quality assets with an emphasis on ESG credentials.
- **Retail remains cautious:** Retail warehouse performance across H2 was strong, up 6.7%. However, high street retail and shopping centres continue to struggle. This has led to annual total returns of 1.6% with capital loss of -5.4%. We expect to see further tenant insolvencies as the effects of online penetration continue to impact the market.

Chart in focus



Source: MSCI, Yield impact measures the impact of pricing movements on capital values

Headline UK All Property returns do not reveal the full level of polarisation within and between sectors. At a sector level, industrial (logistics) outperformed, returning 13.4% in H1 2021. Retail returned just 3.2%. The level of disparity in performance within sectors can be seen, with shopping centres returning -5.4% while retail warehouses deliver a return of 6.7% in H1 2021. The divergence in performance is a clear illustration of the impact of the structural changes within our economy and the emerging winners and losers. As occupiers target the best assets, stock selection and sector allocation are critical.

Although the lifting of all restrictions in England was postponed giving the vaccination campaign more time, the delay in the reopening plan is likely to have only a minor impact on growth. While the services sector Purchasing Managers' Index (PMI) cooled slightly in June, it remains comfortably in growth territory. Brexit, however, continues to put a brake on the UK economy. Export order intake is more sluggish than elsewhere in Europe according to the PMI survey, indicating continued uncertainty regarding trade relations. The precise implementation of the Northern Ireland Protocol remains a bone of contention and is a stubborn dispute, which is currently holding back progress in other areas and, at worst, could lead to retaliatory measures such as tariffs.

Activity improving

Preliminary data indicates investment volumes picked up in Q2 2021 with total volumes amounting to GBP 12.4 bn, (+49% to Q2 2020). Investment volumes reached GBP 22.5 bn over the year to date, up 23% over the same period last year. Activity was heavily concentrated in industrials, which saw investment volumes for the year to date almost treble over the corresponding period in the previous year. Retail volumes increased as investors sought assets in the more stable retail warehouse segment. Liquidity is expected to further improve in 2021 as international travel restrictions relax and overseas investors can more easily access the market.

Office focused on core

Offices returned 1.1% in H1. Capital values fell -1.4% over the period as the impact of rising yields outweighed the limited rental growth. There was divided performance across the sector as yields hardened in the City and West End but moved out elsewhere. City offices were the strongest performing office segment. Occupiers are increasingly withdrawing surplus secondary space from the market, reflecting increased confidence. In the City and West End, Grade A space represented 90% and 85% of total take-up respectively in H1. With a high number of lease expiries and breaks imminent in the coming years, we expect to see occupiers relocate to modern, well-connected, flexible, amenity-rich accommodation with strong ESG credentials.

Logistics continues delivering

Industrials' standout performance continued into 2021. Total returns of 7.8% over the last quarter contributed to a return of 13.4% in the first half of the year. Capital values rose 10.9% over the last six months as yields hardened and rental values grew 2.9%. Occupational activity set another record as "big box" (> 100 000 sq ft) take-up over the first half of the year reached 24.4 m sq ft, up 82% on the long-term H1 average, according to Savills. The strength of occupier demand contributed to the lowest vacancy rate on record of 4.2%. Supply is expected to struggle to keep up with demand in the short to medium term. Global supply chain disruption is limiting the availability of necessary materials and causing build cost price inflation. This is expected to cause delays to developments, which could lead to further yield compression and rental growth in the near term.

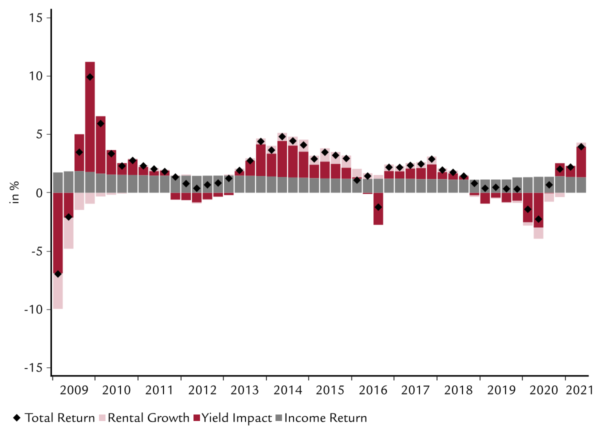
Physical retail struggles

Retail saw positive returns for the second consecutive quarter, returning 2.5% in Q2, and resulting in a total return of 3.2% in H1 2021. This was driven by a recovery in retail warehouses, which returned 6.7%. Retail capital values grew 0.7% in Q2, down -0.5% on the year to date with shopping centres the most impacted. Optimism is returning to the sector as the economy opens and restrictions ease. There was a shift back towards physical retail in May, with online sales falling 4.2% month-on-month. However, online penetration remains significantly above pre-pandemic levels and we expect this to persist. As many as one third of UK retail premises are either vacant, not producing income, or occupied on a short-term basis according to Colliers. With many of these assets likely to be obsolete, investors will need to focus on repurposing opportunities.

Market at a turning point

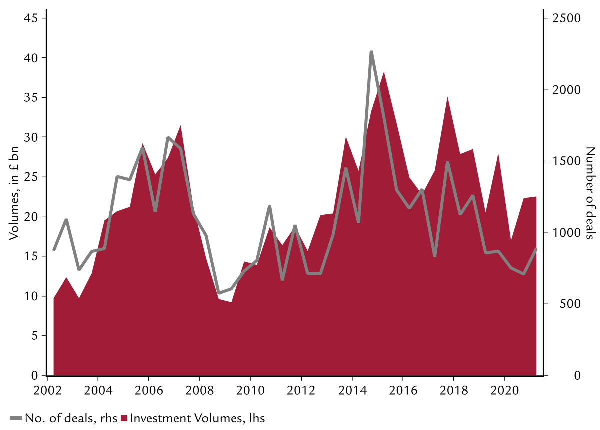
The return to positive capital and rental growth at an all property level, supports the proposition that we are at the start of a recovery within the property market. As the pace of economic growth increases over the second half of the year and the final restrictions end, this should support occupational demand and underpin further improvements in property performance.

Chart 1: All Property Return to Q2 2021



Source: MSCI

Chart 2: UK property investment volumes to Q2 2021



Source: RCA

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