UK Property Market Update
Quarter 3 2020

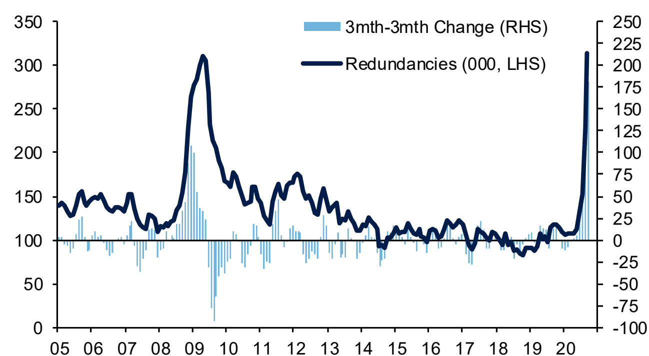
- The economic recovery had already slowed sharply prior to the current lockdown. Additional fiscal support, including an extension of the furlough scheme, and more QE by the BoE will help to shore up confidence, but the next 3-6 months is likely to be bumpy.
- GDP growth for 2021 has been downgraded, to 5.4%, though a mass vaccination programme could provide some upside, especially in the second half of the year. Despite worries about the labour market, so far office-based employment has been resilient.
- Office take-up in London dipped further in Q3 to take the wooden spoon from Q2 as the weakest quarter on record. Where deals are taking place, occupiers are increasingly focused on good quality space. Signs suggest that the leasing market is close to a bottom, although we expect take-up to remain subdued until there is a more settled outlook and greater businesses confidence. With availability jumping to the highest level since 2009, further cuts to both prime and average rents have been recorded.
- Retail sales continue to paint an upbeat picture of the sector, with September's sales 6.4% higher than a year earlier. However, year-to-date sales are still -1.7% lower than a year earlier and there remains big differences in performances between segments.
- The latest lockdown could give retail sales a boost in the run up to Christmas as consumers switch from spending on services (e.g. eating out, travel) to goods again. Nonetheless, the first half of 2021 is likely to be tough going as higher unemployment and job security concerns weigh on consumer spending.
- Strong industrial demand continues to push average rents higher. While rental growth prospects have been revised up, some weakness is still expected in the short term. Industrial investment had its second-best quarter since Q4 2018, while prime multi-let industrial yields have broken the 4% barrier, falling to 3.75% in October.
- All-property total returns turned marginally positive, at 0.1% - an improvement on Q1 and Q2, when returns were -1.4% and -1.9% respectively. Retail returns remain in negative territory, while industrial returns jumped to their best quarterly level since Q4 2018.

UK politics and economy

Economic overview

- With the economy re-open, Q3 GDP was always going to look good, following Q2's near 20% q/q fall. And it didn't disappoint, with a record-breaking rise of 15.5% q/q. But the headline figure hides an alarming slowdown in the recovery even before new lockdown measures were imposed. Following a 6.3% m/m rise in July, the economy grew by just 2.2% m/m in August and an even slower 1.1% in September. Business surveys suggest that the economy lost even more momentum at the start of Q4.
- November's lockdown is expected to see GDP fall by around -8%, according to Capital Economics – smaller than the -25.3% cumulative fall in March and April, but larger than the -6% hit during the financial crisis. With the likelihood of on-going restrictions after 3 December, the next few months will be bumpy for the economy heading into the new year. Prior to the announcement of the second four-week lockdown, Oxford Economics had lowered its 2021 GDP forecast to 6.7%, from 8.3%. It's latest 2021 forecast has been cut to 5.4%.
- The extension of the furlough scheme until 31 March 2021 will help to limit job losses from the latest lockdown. However, redundancies have already risen sharply, increasing by 182,000 in the three months to September – the highest quarterly rise on record. The number of redundancies has also passed the peak during the financial crisis. (chart 1).

Chart 1: UK redundancies

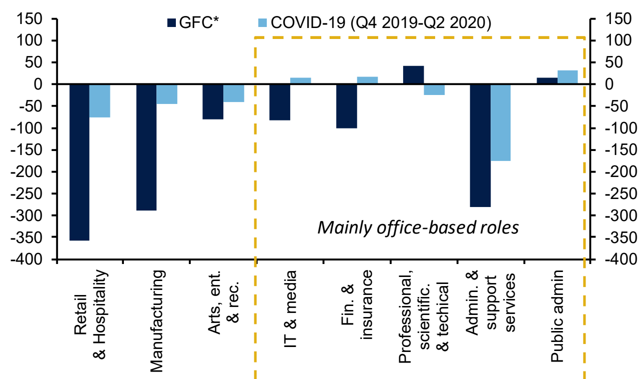


Sources: Macrobond, Savills IM (Nov. 2020)

- In its latest forecasts, the Bank of England (BoE) raised its peak in the unemployment rate to 7.75% in Q2 2021, from 7.5% (originally expected to occur in Q4 2020). The unemployment rate currently sits at 4.5%.

- While rising unemployment is never good news, the ability to work from home is creating a divergence around the impact of the pandemic on the labour market. During the financial crisis, job losses were felt across the main sectors of the economy, albeit more heavily concentrated in the manufacturing and retail and hospitality sectors. However, as at the end of Q2, employment in 'core' office-based sectors has held up well, with higher numbers of people employed in IT, media and financial services than prior to COVID-19 (chart 2). Although the administrative and support service sector has seen a significant fall in jobs, this sector includes travel agencies, security services and building and landscape services which are less likely to have a significant impact on office leasing activity.

Chart 2: Change in workforce jobs (000s, s.a.)



**GFC is sector peak to trough fall, or Q1 2008-Q4 2009*
Sources: ONS, Savills IM (Nov. 2020)

- While some office-based roles are likely to be lost as government support is ultimately wound down, the implication of rising unemployment on office demand will be significantly different this time, leaving aside the future impact of working from home itself.

- Consumer spending appears to have recovered well, with incomes holding up better than they ordinarily would have in an economic downturn due to the government's furlough scheme. Retail sales supported by increased savings, a switch from spending on services (e.g. eating out, travel) to goods. But while retail sales in September were 6.4% higher than a year earlier, not all lost sale from earlier in the year have been made up. For the first nine months of the year, retail sales are still down by -1.7% compared to the same period in 2019.

- Although retail sales, especially online are likely to have reached another boost from the latest lockdown (as consumers switch from spending on services to goods again), the outlook is likely to remain difficult, especially for sectors more dependent on discretionary footfall such as clothing, footwear and accessories. With consumer confidence still subdued, spending may yet stutter if unemployment starts to rise as expected, weighing on incomes and job security.

- Due to the now unavoidable slowdown in the economy, the BoE increased its quantitative easing programme (QE) by a GBP150 million at the start of November, but left interest rates unchanged at 0.1%. The BoE noted that the risks around the outlook for GDP growth are skewed to the downside. This could yet see more stimulus provided in 2021. Debate continues around whether the BoE will push interest rates into negative territory, though Capital Economics expects QE will remain the banks main policy tool of choice over the next 6-12 months.

- Following a breakdown in Brexit negotiations in mid-October, UK and EU trade negotiators have returned to the table in a bid to resolve differences. Though an agreement is in both sides' best interests, any deal will require some big compromises on both sides. With only six weeks before the transition period end on 31 December 2020, in a game of brinksmanship, negotiations look likely to go to the wire.

UK commercial real estate market

London offices

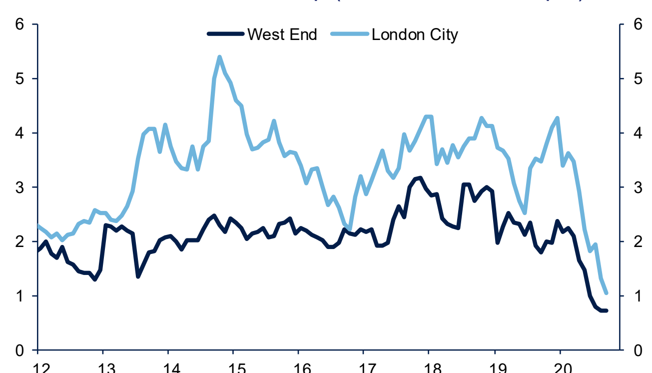
- Office occupiers continued to hold back from making decisions on space requirements in Q3 as firms focus on balance sheet preservation. Office take-up across central London fell to just 1 million sq. ft, from 1.1 million in Q2, CBRE data show.

- The extent of the weakness was highlighted by the fact that Q3 took the wooden spoon from Q2 for recording the lowest quarterly take-up on record. Uplifts in the West End and London City – albeit still at very low levels, were off by large declines in the Southbank and Docklands.

- A two-tiered market has developed, with firms focusing on good quality space. CBRE report that seven of the top 10 deals in Q3 were for new/early marketed space, representing 43% of take-up.

- While it is too early to call the bottom of the leasing cycle, there are tentative signs that it could be close. On a rolling 6-month basis, Savills Research data show that West End take-up recorded a small increase in September. Take-up in the City remained on a downward trajectory, although the rate of decline in September was less than a month earlier (chart 3).

Chart 3: London office take-up (6mth MA, million sq. ft)



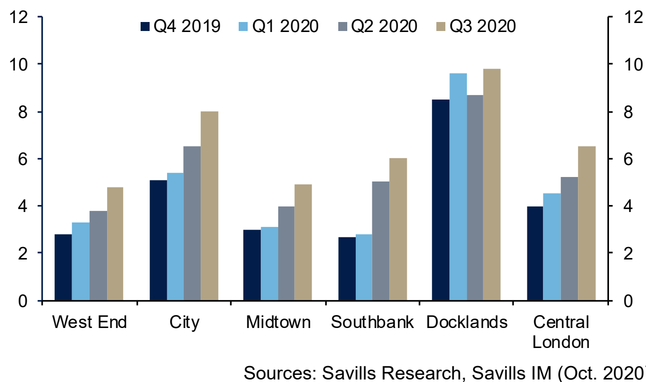
Sources: Savills, Savills IM (Nov. 2020)

- Even as leasing activity starts to turn, we expect it to remain subdued until the economic and pandemic outlooks are

more settled, allowing businesses to take occupation decisions with greater confidence.

- With office leasing deals at depressed levels, central London availability jumped by 23% q/q in Q3, or 3.8 million sq ft, to sit just under 20 million sq ft. CBRE report that this is the largest quarterly increase since 2001, with availability at the highest level since 2009 when supply reached 21.4 million sq ft following the financial crisis.
- Two-thirds of the rise was attributed to the release of second hand tenant controlled space as firms continue to rationalise own space and preserve cash. At 14.7 million sq ft, the amount of available second hand space is up from 8.8 million sq ft in Q4 2019 and accounts for 75% of total available space.
- Increased availability has pushed the vacancy rate up to 6.5% - a 130bps increase from Q2's 5.2% and the highest rate since 2009 according to CBRE. Across the submarkets, vacancy rose by more than 100bps in all submarkets except for Midtown were vacancy rose by 90bps. London City recorded the sharpest quarterly rise, up from 6.5% in Q2 to 8% in Q3. West End vacancy rose 100bps on the quarter to 4.8% (chart 4). Given the likelihood of firms continuing to put expansion plans on hold, availability and vacancy is likely to rise further heading into the new year.

Chart 4: London office vacancy (%)



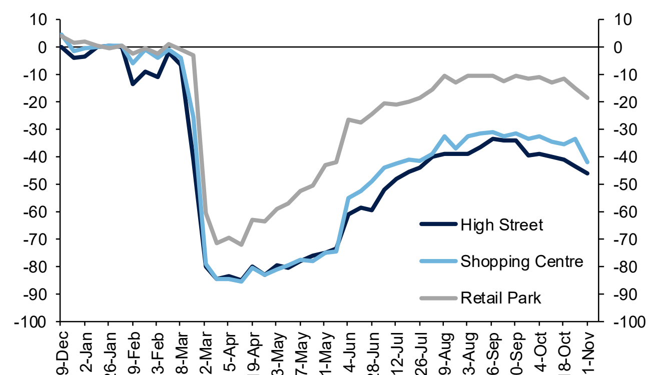
Sources: Savills Research, Savills IM (Oct. 2020)

- A lack of transactional evidence continues to make it difficult to fully determine shifts in headline office rents. CBRE lowered their prime West End and London City rents in Q3 for the second consecutive quarter, albeit the shift continues to be sentiment rather than transactional based. However, Knight Frank also lowered their prime London office rents in Q3. Data from the agents suggest that City rents have fallen by between 2.5-3.5% since Q1 while West End rents are down by between 4-8%.
- The MSCI monthly index indicates that average office rents across the UK fell by -0.4% q/q in Q3, following Q2's -0.3% q/q fall. Due to a small increase in rents at the start of the year, average UK office rents have fallen by just -0.4% since the start of the year. Most of the weakness has been recorded in London's West End (-1.3%) and the rest of the South East (-0.7%). In contrast, average rents in the rest of the county are up 0.6% so far this year. However, this masks a weakening trend in Q3 which saw rents fall by -0.1% m/m in September.
- We think that there is likely to be a divergence in rental growth performance between top quality, well located buildings, and those in more secondary locations.

Retail

- Headline retail sales figures for September suggest that consumers remain enthusiastic shoppers. But while retail sales (ex. fuel) in September were 6.4% higher than a year earlier, for the first nine months of the year sales are still down by -1.7% y/y. The recovery has also been heavily bifurcated.
- On one hand, sales in sectors more heavily dependent on discretionary footfall spending (e.g. clothing, footwear, jewellery) remain -20% to -30% down over the January to September period compared to a year ago. Computer and telecommunication sales have also suffered heavily, down by -35% y/y. On the other hand, home and garden related purchases (e.g. garden centres, hardware and paint), are up by 4-5% on 2019, with pharmacy sales up by 36%.
- The divide in retail performance is highlighted in footfall data. By the end of summer, footfall at retail parks was only 10% down on 2019. By comparison, high street and shopping centre footfall was still down by around one third. Footfall started to fall away again as local restrictions started to come into force in October (chart 5).

Chart 5: UK weekly footfall (% y/y)



Source: Springboard (Nov. 2020)

- Not only are retail warehouses benefitting from the resilience of the food and spending on home-related goods and DIY, better access by private car, they are also less effected by the decline in tourist and city office worker footfall.
- As shoppers ventured back to the high street through the summer months, the share of online sales declined to 27.5% in September, from May's peak of 34%. With non-essential retailers close for much of November and social distancing measures likely to remain in force in December, the share of online retail sales will pick-up again.
- While the latest lockdown measure is another blow to high street retailers, sales could get a further boost ahead of the

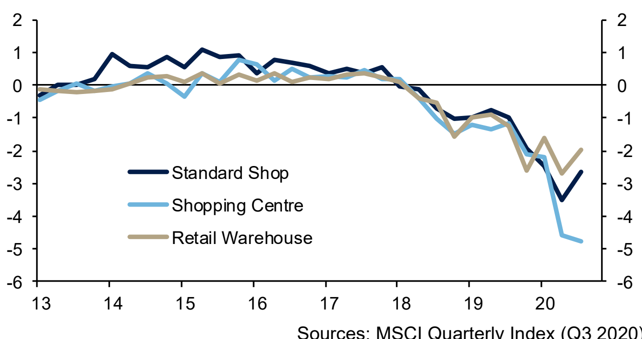
pivotal Christmas period as consumers spend less on services and more on goods again. Evens so, we think that the first quarter of 2021 will be tough.

- Consumer confidence deteriorated in October according the GfK survey, while higher unemployment and job security fears could see consumers put the wallet away come the new year. In addition, as a ban on evictions and government support comes to end, a number of retail and food and beverage operators are unlikely to avoid inevitable insolvency.

- Prime high street rents fell in all nine of the UK's main cities, including London. Cushman and Wakefield data show that rents on New Bond Street fell by 3% q/q, having been steady since Q3 2018. Since Q1 2020, prime high street rents have fallen by between 3% (London, Manchester, Glasgow) and 14% (Bristol).

- MSCI data show that average rents continued their downward trend. However, the rate of decline eased a touch in all retail segments except shopping centres which experienced the largest quarterly decline since the series started in n 2000, of -4.8% q/q. While rents are expected to fall further yet, an easing in the rate of decline could suggest that the worst is behind us, particularly for standard shops and retail warehouses (chart 6). That said, one quarter's data doesn't make a trend.

Chart 6: MSCI quarterly retail rental growth (% q/q)



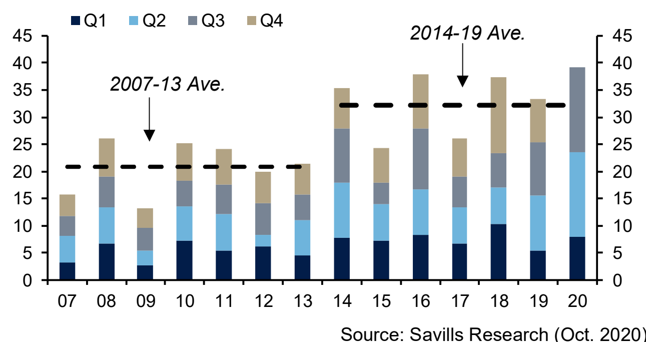
Sources: MSCI Quarterly Index (Q3 2020)

Industrial & Logistics

- Demand for industrial and logistics space continued apace in Q3, following an already strong Q2. At 15.7 million sq ft, take-up was more than 60% above Q3 2019's volume and more than double the Q3 10-year average. Since 2007, there have only been four quarters where take-up exceeded 10 million sq ft – two of those being Q2 and Q3 this year (chart 7).

- For the first three quarters of the year, take-up hit 38.6 million sq ft – breaking the previous annual record of 37.8 million sq ft in 2016. Of the total so far, 54% has been built-to-suit; 26% second hand; and 19% has been speculatively developed. Unsurprisingly, given the surge in online retail sales, online retailers have been particularly active, accounting for 36% of take-up. Amazon alone accounted for 29%. 7% of deals have been for leases of less than 12 months, which is likely to reflect some of the short-term requirements resulting from COVID-19 and potentially Brexit-related stockpiling.

Chart 7: UK industrial & logistics take-up (million sq ft)



Source: Savills Research (Oct. 2020)

- All else equal, a lessor of a need for short-term requirements next year would cut occupier demand. And with online retailers being particularly active, in the absence of another large increase in the share of online retail sales, take-up in 2021 could be materially weaker.

- The supply of warehouse space fell to 34.4 million sq ft in Q3, from 37.6 million sq ft. A preference for Grade A space has pushed the share of available second hand space up to 75%, with just 25% new. At the national level, vacancy stood at 6%, down from 6.6% in Q2. Vacancy declined in all regions in Q3, except for the Inner M25 where vacancy was stable at around 2.5%.

- Prime rents remained steady across the UK according to Cushman and Wakefield. However, MSCI average rents continued to head higher, rising by 0.4% q/q – up on Q2's 0.2% q/q rise. Despite this uptick, the annual rate of growth slowed to 2% y/y, from 2.2% y/y in Q2 – the slowest annual rate of growth since the middle of 2014. Rents rose in all regions except for Scotland, where rents have dipped for the second consecutive quarter to be around 1% lower than a year earlier.

Investment & Capital Markets

- Despite looser social distancing restrictions in Q3, investment volumes improved only marginally compared to Q2, RCA data show. At GBP8.6 billion, transactions were only GBP200 million ahead of Q2 and just two-thirds of the 10-year Q3 average of GBP13 billion.

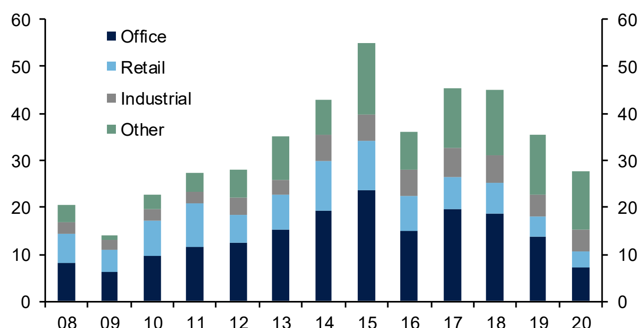
- Investors clear focus on the industrial sector is highlighted by Q3 being the second-best quarter for investment since Q4 2018, as well as being 22% above the Q3 10-year average. Moreover, industrial investment matched office transactions for the first time at almost GBP2 billion.

- In comparison, office investment was -64% below the Q3 10-year average and still close to levels recorded during the financial crisis. Retail volumes improved to GBP1.4 billion, from GBP680 million in Q2, but were only around half of the long-term quarterly average.

- For the year-to-date, GBP27.8 billion of assets have traded. This represents a 22% fall compared to the same period last year and would have been worse if it was not

for Blackstone's GBP4.7 billion student accommodation acquisition earlier in the year. Even so, 2020 is the worst Q1-Q3 performance since 2011 (chart 8).

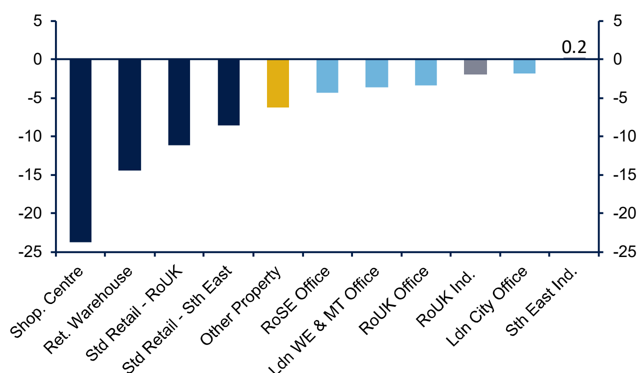
Chart 8: Q1-Q3 cumulative investment volume (GBP billion)



Source: Real Capital Analytics (Nov.2020)

- While we expect the general economic uncertainty and on-going travel restrictions to continue to hold back cross-border capital flows, particularly inter-continental, monthly data suggest that there has been a pick-up in activity since the summer. While investment in June, July and August volumes were between 40% and 70% down their respective 2017-19 averages, the underperformance improved in September and October, with transactions 15% to 20% lower. Well located core assets and long income assets with good covenants are particularly appealing to investors in the current environment.
- The problems facing the retail sector have seen Savills Research shift out their prime high street and shopping centre yields by 50bps in since June, to 6.50% and 7.00% respectively in October. However, there is a notable divergence within the retail sector, with the relative strong performance of retail warehouses seeing yields in this segment come in 25bps. The strength of the industrial sector has resulted in yields compressing by 50bps since Q2, with multi-let industrial assets breaking the 4% barrier, falling to 3.75% in October. London City office yields remain steady at 4%, with West End yields compressing 25bps in October to 3.75%.
- At the all-property level, the MSCI equivalent yield was steady at 5.8% in Q3. However, the monthly series suggests that yield expansion may have peaked in August, with the all-property equivalent yield compressing a touch in September and October. Stark differences remain, however. For example, while standard shop, London and South East offices and industrial yields declined between August and October, shopping centre yields rose by 15bps.
- Capital values generally added to their downward correction in Q3. The industrial sector was the exception, where rental growth helped to push capital values higher. A 1.2% q/q rise in South East industrial values more than reversed the falls in Q1 and Q2 (chart 9). While capital values in the retail sector have fallen by 10-25% so far this year, the rate of decline did ease in Q3.

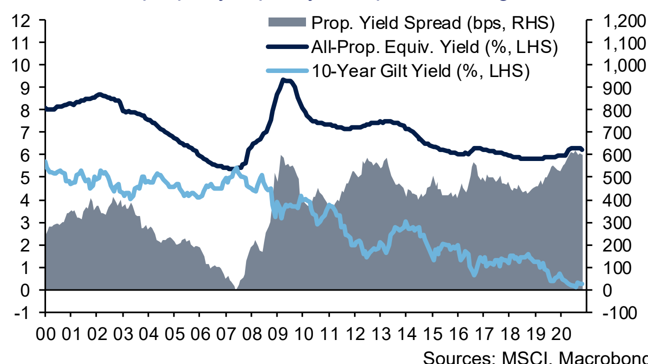
Chart 9: Change in capital values (%, Q3 2020-Q4 2019)



Sources: MSCI, Savills IM (Nov. 2020)

- With the all-property equivalent yield relatively steady in recent months, a rise in 10-year Gilt yields from a low of 0.12% in early August, the yield spread has eased back slightly from July's high of 617 bps, but remains high at around 600 bps at the end of October (chart 10)

Chart 10: All-property equiv. yield spread over gilts



Sources: MSCI, Macrobond

Total returns

- All-property total returns were marginally positive in Q3, at 0.1%, according to MSCI. This represents a sharp improvement on Q1 and Q2, when total returns were -1.4% and -1.9% respectively.
- The retail sector again weighed on the index, with total returns of -1.9%, albeit up from Q2's -4.2%. Returns in the office sector just snuck back into positive territory, at 0.1%, while industrial returns jumped to 2.1% to record the best quarterly return since Q4 2018.

UK residential real estate markets

Mainstream housing market

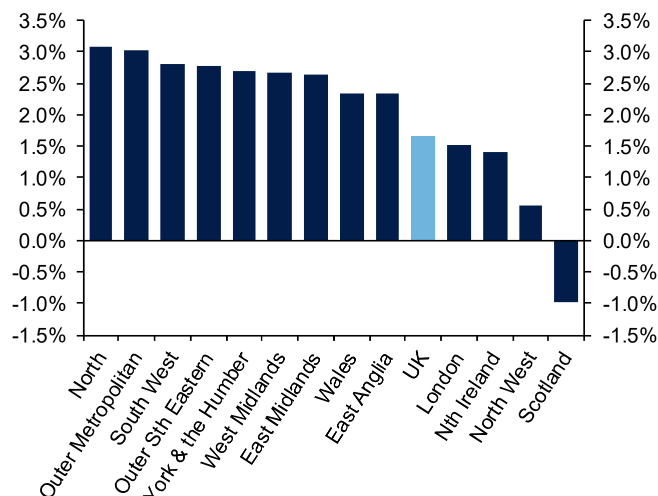
Prices

- A sharp turnaround in the housing market has taken most commentators by surprise. Concerns about the economic backdrop and higher unemployment were expected to keep a lid on housing market activity and prices this year,

following a slump in transactions resulting from the spring COVID-19 lockdown. However, a confluence of factors have unleashed a wave of activity: pent-up demand; a desire for more space as individuals and households re-evaluated their needs in the wake of the lockdown; a greater ability to work from home (and therefore live further away from city centres); and the government's stamp duty holiday for main residences up to GBP500,000. And along with it, strong house price growth.

- The price of an average UK house rose by 1.7% q/q in Q3 – above Q1's 1.4% q/q rise and the strongest rate of quarterly house price growth since the end of 2014, Nationwide report. The majority of regions recorded prices rise by at least 2% q/q/ in Q3. Scotland was the only region to buck the upward trend, with prices falling by -1% q/q (chart 11).

Chart 11: Change in average UK house prices (Q3 2020, % q/q)



Source: Nationwide (Nov. 2020)

Transactions and mortgage markets

- Provisional figures from HM Revenue and Customs show that on a seasonally adjusted basis, just under 250,000 homes transacted in Q3. Although this was still down on Q3 2019's 293,000, the monthly breakdown shows a steady improvement in volumes back to normal levels, with the 98,000 transactions in September above the long-term monthly average of 95,800.

- Although current momentum remains strong, as buyers seek to take advantage of the stamp duty holiday, given the time it takes to complete a house sale, there is a risk that activity will drop away quickly in the new year as the 31 March stamp duty holiday deadline looms.

- Furthermore, expectations for sales over the next 12 months have deteriorated. September's RICS survey showed a net balance of -34% respondents expecting sales volumes to fall in the next year, down from -17% in August. Contributors continued to cite potential job losses once the furlough scheme is withdrawn as a significant risk.

- Unsurprisingly, lenders reported a sharp rebound in mortgage demand in Q3. According to the BoE's Q3 2020 credit conditions survey, demand for both house purchase and buy-to-let mortgages rose to the highest reading in the survey's history back to 2007. However, expectations for mortgage demand in the final quarter of the year declined.

Supply

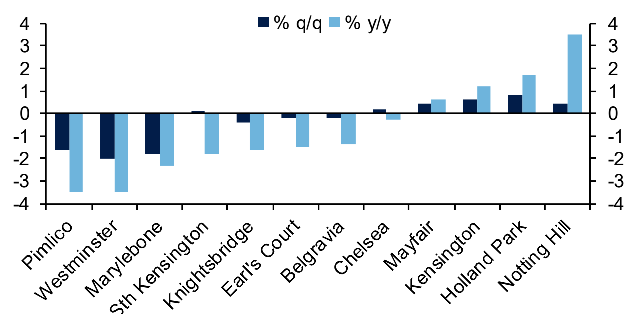
- Lockdown restrictions meant that construction on new developments stalled in Q2. While developers are keen to make up for lost time, Savills Research estimate that completions of new homes could fall by 31% in 2020, before returning to pre-COVID-19 levels in 2021-22. However, with an increasing risk of a slower economic recovery, Savills Research note that it could take until 2023 to recover to pre-pandemic levels.

Prime Central London (PCL)

Prices

- Savills Research report that PCL prices were broadly flat in Q3 (-0.2% q/q), following Q2's -1.1% q/q decline. The agent notes that the lack of price rebound, in comparison to the mainstream market, is due to travel bans limiting the number of overseas buyers – a key element of PCL demand. Notting Hill, Holland Park and Kensington were the best performing PCL markets in Q3, with prices up by between 0.4-0.8% q/q. In contrast, prices in Westminster fell by 2% q/q. Marylebone and Pimlico recorded similar falls. Prices in these three submarkets have fallen by around 4% since Q1 (chart 12).

Chart 12: Prime central London Price Performance by submarket, Q3 2020



Source: Savills Research

Transactions

- Following a 45% q/q decline in PCL transactions in Q2, transactions climbed by 79% in Q3 as the market re-opened and buyers returned following the COVID-19 lockdown. However, Savills Research note that while 352 GBP1 million plus transactions occurred in Q3, this was 14% lower than in Q3 2019.

- Activity in the GBP5 million plus category was particularly strong, with 95 transactions taking place – 76% higher than a year earlier and 28% higher than in Q3 2018 according to Savills Research.

Supply

- COVID-19 slowed the pace of construction, with 5,867 prime units completing in the year to Q2 2020, down from a record high of 6,500 completions in the 12 months to Q1 2020. Savills Research report that prime starts have been robust since April, with Q2 recording nearly double the level of starts of a year earlier and 21% higher than in Q1.
- Savills Research forecast an average of 6,000 prime residential units will be completed over the next two years. This is 77% more than the number completed in 2018 and over 51% higher than the 2014-2018 annual average. Over the next 5 years, on average 4,900 new build homes above GBP1,000psf will be completed every year.

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