THE REAL ESTATE MARKET

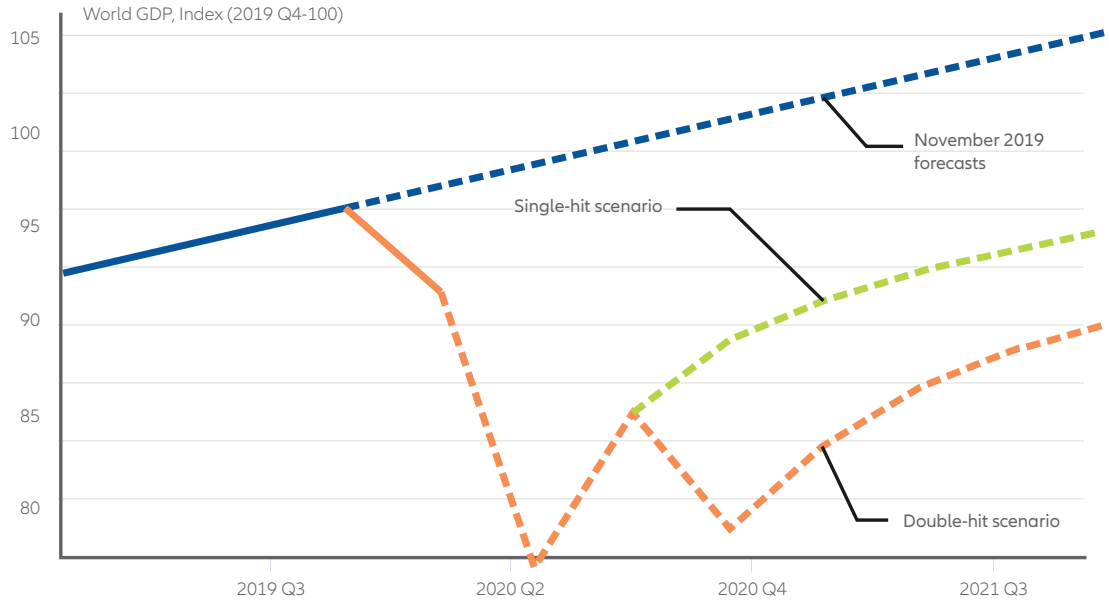
KEY TRENDS AND INSIGHTS

UK ECONOMIC OUTLOOK

As we come to the end of 2020, we are hoping to see some positive signs of economic recovery, but the fate of the economy relies on whether it continues on a path of steady recovery or suffers a "double hit" as the OECD term it (below). This article looks at how the real estate market currently stands using Q2 figures. This is a pivotal moment as we reflect on the impacts of lockdown and anticipate what trends are likely to result as the economy recovers or experiences a delayed recovery.

A COLLAPSE IN OUT PUT FOLLOWED BY A SLOW RECOVERY

In both scenarios, we won't be back at 2019-Q4 level for at least 2 years



Souce: OECD (2020). 'OECD Economic Outlook No. 107 (Edition 2020/1)', OECD Economic Outlook Statistics and Projections (database).

(OECD Economic Outlook, 2020)

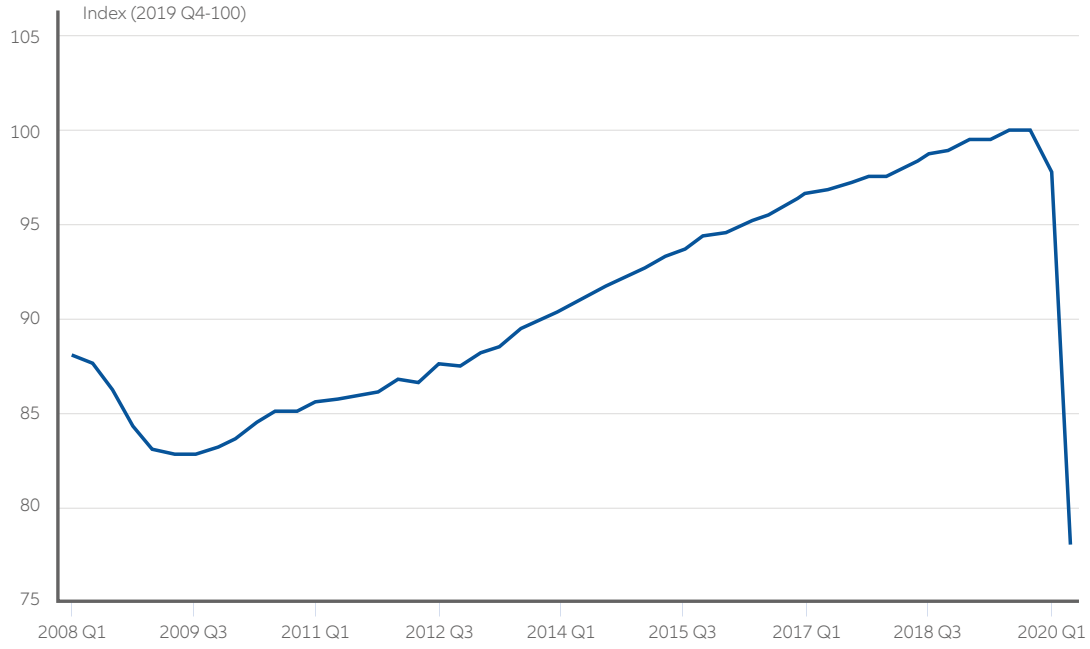
Written by Allianz London Market Real Estate

Allianz

In Q2, GDP in the UK fell by 20.4% which is "the largest quarterly contraction in the UK economy since Office for National Statistics quarterly records began in 1955" (ONS, 2020). The contraction of the economy is largely the result of reduced consumer spending during national lockdown and subsequent social distancing measures. The Financial Times explains that "Household spending makes up the largest part of the economy" and so "the recovery largely depends on consumers regaining the confidence to increase spending from ultra-low levels." (FT, 2020)

REAL GDP FELL BY 20.4% IN QUARTER 2 2020, THE LARGEST QUARTERLY CONTRACTION ON RECORD

UK, Quarter 1 (Jan to Mar) 2008 to quarter 2 (Apr to June) 2020



Office of National Statistics Q2 GDP

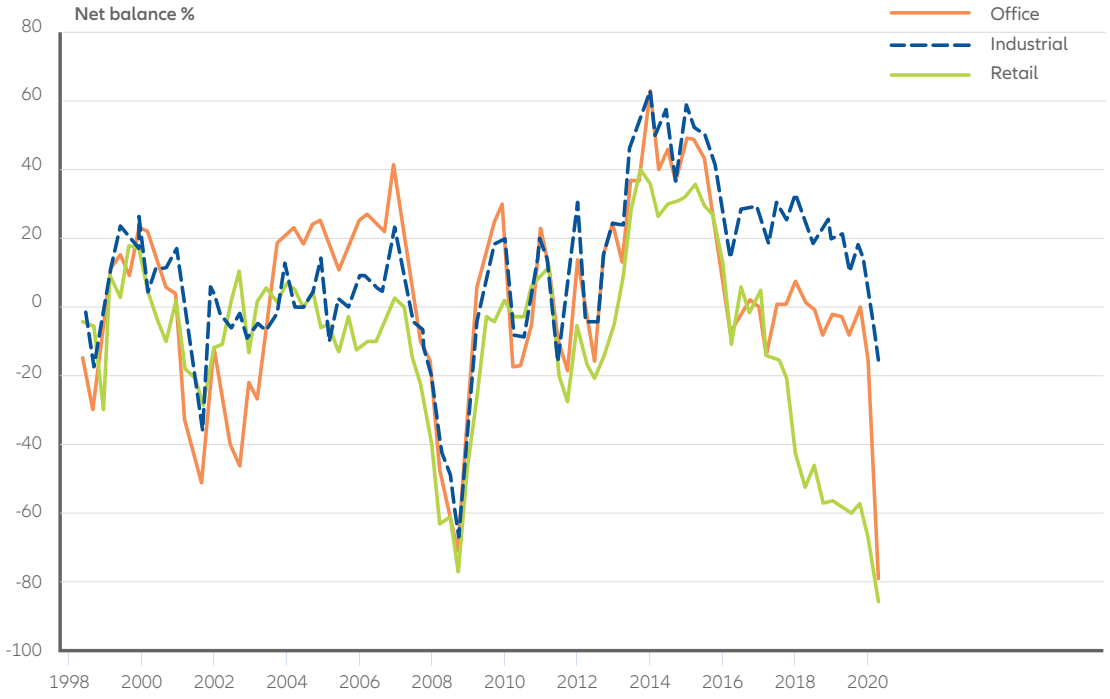
Households have cut back their spending for a number of lockdown related reasons. There has been a plunge in hours worked and national incomes have been under pressure with average earnings falling by 1% (year on year 3 month average reported by the ONS for July) (ONS, 2020). Unemployment rates have not risen as drastically, with the ONS reporting an unemployment rate of 4.1% between May and July (ONS, 2020). However, this does not take into account those not actively seeking work and also as the furlough scheme ends this figure is likely to rise further. On top of this, confidence levels have plummeted as uncertainty grows around the future of the economy.

As well as a strain on finances, an ONS publication (ONS, 2020) provides insight into how the government lockdown measures have directly affected spending. In the financial year preceding lockdown, on average a household would spend "22% of a usual weekly budget of £831" on "activities that have since been largely prevented by government guidelines (such as travel, holidays and meals out)" which leads the ONS to conclude that "more than one-fifth of usual household spending has largely been prevented during lockdown".

REAL ESTATE MARKET TRENDS

When it comes to how the real estate market sits within this overall economic outlook, the contraction seen in GDP is mirrored in the commercial property market. The Q2 2020 RICS UK Commercial Property survey (RICS, n.d.) identifies "trends in occupier demand over the past quarter, a net balance of -55% of respondents reported a decline during Q2, down from an already negative reading of -22% previously." On the investment side, "46% of respondents reported a fall in investor enquiries during Q2". In terms of future outlook on different subsectors within commercial real estate, "twelve month rental expectations now stand at -4% and -7% for prime and secondary office space respectively." While retail has even poorer expectations with "secondary retail rents are seen falling by -14% while prime retail rents are seen posting declines of around -10%." Meanwhile, "prime industrial rents still display a positive outlook, with respondents pencilling in growth of just under 2". Occupier demand patterns can be seen in the graph below and we will go on to explore trends which explain these variations between subsectors.

OCCUPIER DEMAND



RICS Q2 2020: UK Commercial Property Market Survey

INDUSTRIAL SECTOR

One clear shift in household spending, which has accelerated during lockdown, has been toward online rather than in store consumption. This has had two major impacts, one that is positive for the industrial sector and one that is negative for high-street retail. An increase in purchases from grocery and online retailers has led to increases in warehouse demand. The CBRE Logistics Market Update (CBRE, UK Logistics Market Update September 2020, 2020) reported that there was a "record high quarterly demand in Q2" with a "UK recorded take-up of 19.1m sq ft during H1 2020". It also reported that "online retailers were directly responsible for 40% of the demand" which led to a record-breaking quarter. In fact, the demand driven by online sales has been so significant that a JLL article (JLL, Why big-box retail stores are turning into warehouses, 2020) describes how "pressure on the logistics sector to keep pace with the boom in online shopping is prompting developers to convert large-format retail sites into warehouses" For example, "Industrial property company Prologis purchased Ravenside Retail Park, 15km from central London, for £51.4 million and has earmarked the site for ecommerce fulfilment."

Another contributor to increased demand within industrial and logistics is from the R&D space. A Savills publication (Savills, Big Shed Briefing Topic Response issue 2: mid-tech industrial, 2020) on the mid-tech industrial space explains how the rising global interest in vaccine production due to COVID has "stimulated a much larger real estate interest in the R&D and life science sector than any time during the past 20 years". The report suggests that "mid-tech industrial units could be the solution to this rising demand." The publication anticipates that "in order to be desirable, the quality of construction of the industrial unit, cladding, glazing and internal finishes must be comparable to contemporary office building". This is a trend that could further accelerate as a vaccine is produced and "landlord and developers of 'mid box' industrial units could start to make minor amends in both marketing strategy and offering to attract the influx of R&D occupiers seeking to locate throughout the UK."

Overall, the future outlook for the industrial / logistics space looks positive, CBRE (CBRE, Market Update: UK Logistics, 2020) anticipates "rental growth to regain some traction again during Q3, pushed by the strong demand and lack of ready-to-occupy units". A JLL report (JLL, COVID 19: Global Real Estate Implications, 2020) expects that logistics will continue to experience "increased online penetration rates, expansion of online grocery, omni- channel retailing and the integration of technology into warehousing."

RETAIL SECTOR

In contrast to this, high street retail has experienced a drop in demand as consumers move to shopping online. Overall retail consumption saw a rebound in sales over summer, with retail sales growing for the 4th consecutive month, the ONS reported figures (ONS, September) show that "retail sales volumes increased by 0.8%" for August compared to July. However, a FT article (FT, UK retail sales rise for fourth consecutive month, 2020) reflects on the ONS data that "high-street stores remained under pressure despite the fourth consecutive monthly sales expansion, as consumers continued to shop online." Looking more closely at where these sales have been sourced, ONS data reported for August that "non-store retailing volumes were 38.9% above February, while clothing stores were still 15.9% below February's pre-pandemic levels."

As well as reduced high-street retail transactions, Savills Property Management (Savills P. , 2020) reported "19% of shopping centre rents being received on the June quarter date, whereas single-let and high street retail received 58%." The Savills report also identified other trends including "rising rent-free periods as well as landlords using capital contributions to entice potential tenants" These findings highlight the potential risk that COVID presents of tenants defaulting on their rent. In fact, across the whole commercial real estate market, it was found that "only 48% of rent was collected, and only 40% of service charge."

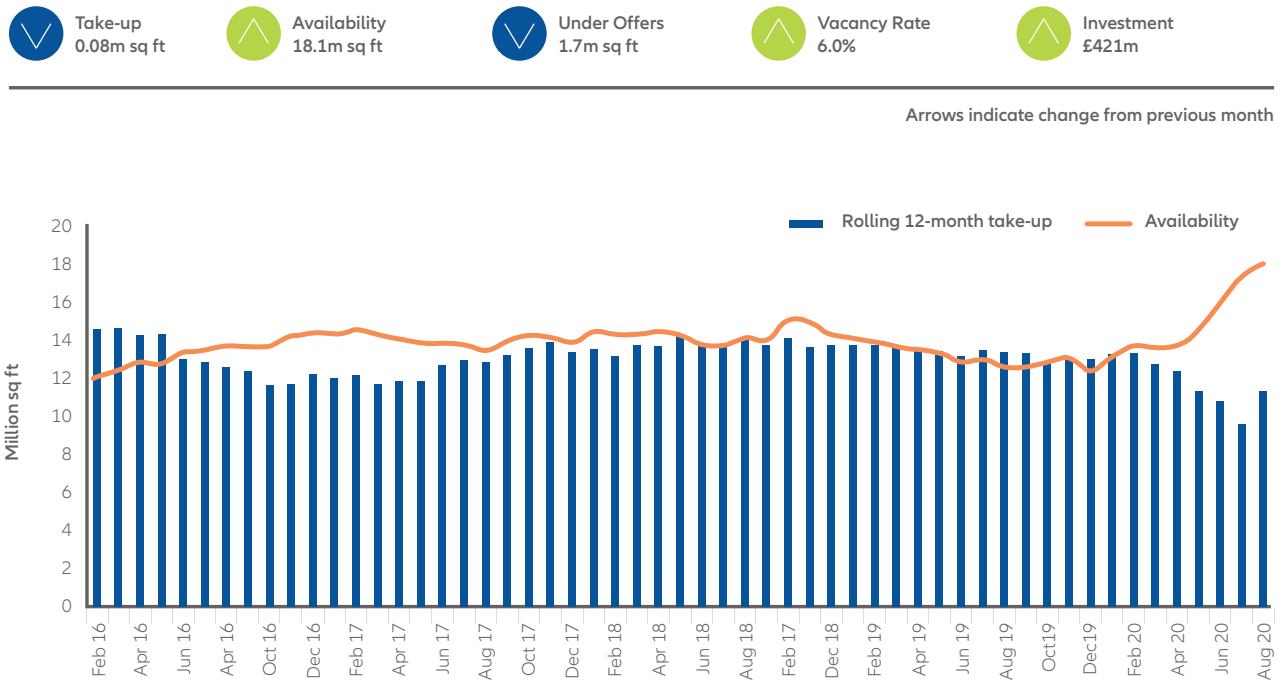
It is evident that high streets have a big challenge ahead in recovering back to pre-lockdown levels and the changes that the subsector has experienced are increasingly being viewed as structural rather than temporary. This is reflected in the CBRE Logistics Market Update which comments that "total retail sales recovered over summer as high street stores reopened but some behavioural changes formed during lockdown will have a lasting effects". High streets have been hurt as households choose to purchase more items from home, but it is also the lack of office workers due to government restrictions which have led to reduced footfall and subsequent sales. Trends that are starting to become evident include retailers seeking more flexible leases due to uncertainty in 2021 and constraints on cash flow. Additionally, JLL's global report comments that "as the structural change in the retail market accelerates, greater emphasis will be placed on the shift toward a flexible omni-channel retail model and sustainable fulfilment".

Allianz

OFFICE SECTOR

While consumer spending patterns go some way to explaining retail occupier demand fall, the retraction in demand for office space is increasingly being seen as a cultural change. There has been clear shift as a result of COVID as remote working has proved successful in lockdown. CBRE research (CBRE, Investment market supported by key Docklands deal, 2020) reflects the increased vacancies of offices and reduced take up, which is shown in the graph below.

CENTRAL LONDON AVAILABILITY VS 12-MONTH ROLLING TAKE-UP



Source: CBRE Researchm August 2020

CBRE 'Investment market supported by key Docklands deal'

The outlook for the office sector portrayed by the RICS Commercial Property survey is that "93% of respondents anticipate that businesses will look to scale back their office space requirements to some extent in the coming two years on account of the increase in remote working during the pandemic." Another trend which was suggested in the RICs survey was that there would be a shift in demand for office space from urban centres over to suburban locations over the next two years and "64% of respondents thought this shift would occur".

These results encompass cultural changes which have been accelerated due to lockdown restrictions, trends were already identified pre lockdown by the Deloitte's Economic Outlook (Deloitte, 2019) include "changing workforce demands, such as flexible location and workspaces, and technology advancements". As a result of such a shift, the CBRE EMEA mid year report (CBRE E. , n.d.) sees "occupier demand shifting increasingly towards tech-enabled 'smart' space, offering development or refurbishment opportunities." Despite the contraction in demand for office space, there are many reasons to believe that offices will continue to be an integral part of working life as behavioural changes lead to reinvention in the concept of offices. JLL published a report which argues that "increased working from home doesn't equate to less demand." (JLL, The Future of global office demand, 2020). It suggests that employers will increasingly have "focus on well-being and some de-densification, along with improvements to design to encourage the interaction that is difficult to facilitate at home" which is "likely to offset a decline in space as a result of increased homeworking." Additionally as the Knight Frank COVID publication (Knight Frank, 2020) puts it, "the office will become a personal choice rather than professional obligation" which is likely to set a trend which "heightens the flight to quality office space that has been evident in major global markets for the last few years. The office must be a compelling proposition."

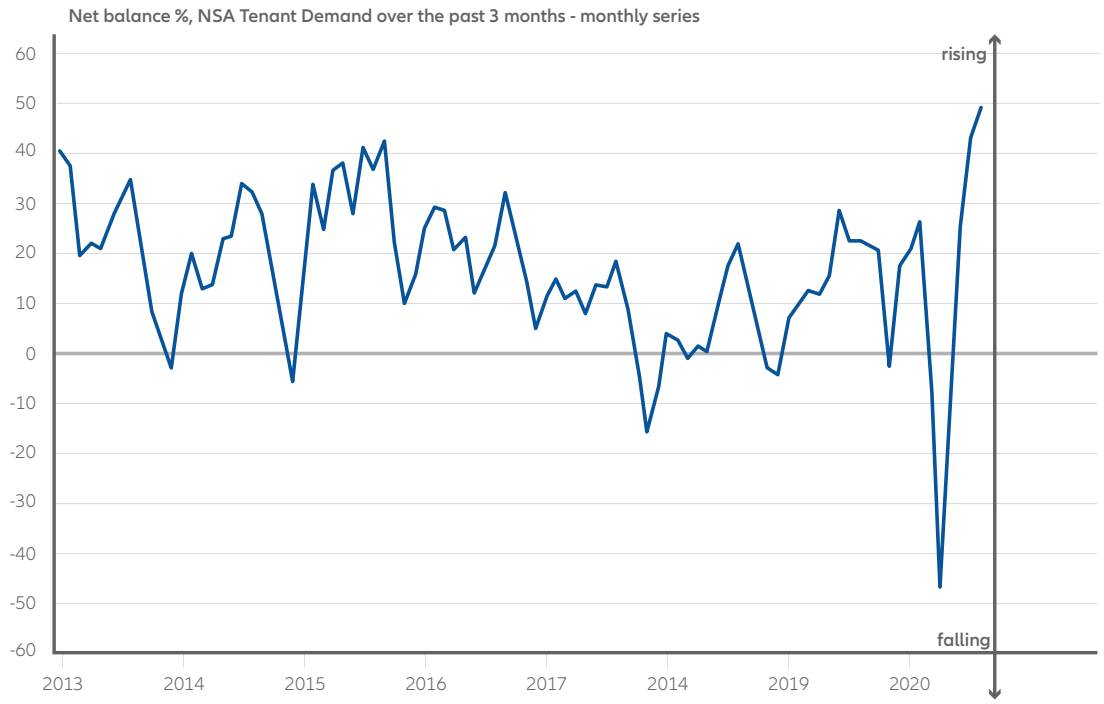
LEISURE AND HOTEL SECTOR

Meanwhile, the Leisure and Hotel industry has been impacted by the reduction in tourists due to travel restrictions. Savills research (Savills, Where's leading the recovery in the hotel market?, 2020) shows that "much of the recovery has been led by typical domestic leisure-led holiday destinations during the peak summer holiday season." There has also been a trend toward domestic consumers choosing more remote and less busy locations as social distancing continues, for example Savills research indicated coastal markets experiencing "a significant bounce of occupancy rates with Plymouth, Bournemouth and Brighton recording over 90% across periods of August". While "larger urban centres continue to be hindered by an absence in corporate and international demand". However, hotels in particular have still been suffering as domestic travellers take preference in self-catering options such as Airbnbs. The RICS commercial survey report shows that "hotels display particularly weak expectations, with a net balance of -94% of contributors envisaging a decline in capital values across the sector in the year ahead." In addition to this, the Savills research article expects that corporate-reliant markets are to be "amongst the slowest to recover, in line with companies scaling back work travel whilst conferences and events remain largely online." Whereas it is the budget hotel segment which is likely to see a speedier recovery as "travellers watching their wallet in the face of an economic downturn"

RESIDENTIAL SECTOR

On the residential side of the market, the August RICS UK residential survey (RICS Residential, 2020) highlights how there have been a "sharp rise in enquiries" and "strong growth in agreed sales". In terms of trends within this, Rightmove (Rightmove, 2020) describes how buyers are looking for more space for their families as well as working at home, "The trend of up-sizing to a larger home has continued at pace over the past month, leading to record asking prices in the second-stepper sector, made up of three- or four-bedroom homes." Buyers are increasingly moving away from cities as being close to an office in the city is of less importance, Tim Bannister, Rightmove's Director of Property Data comments that "some people are now choosing to move out of London altogether, but these latest figures show that there's still plenty of activity in the outer areas of the capital."

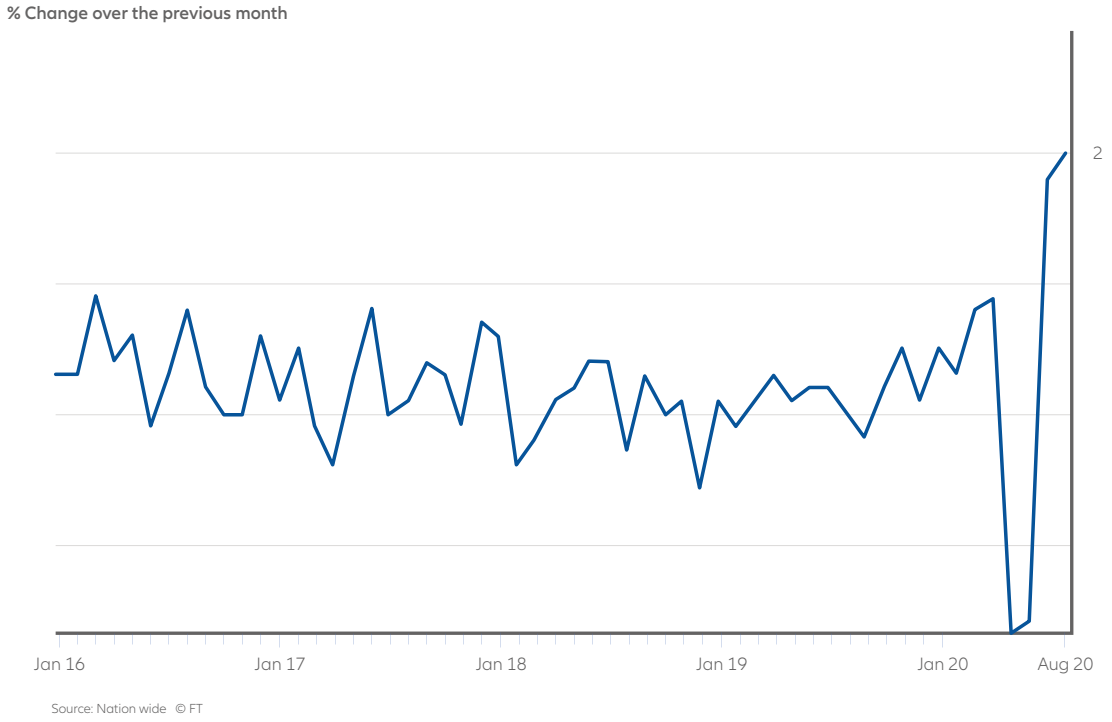
NATIONAL TENANT DEMAND



RICS residential market survey

Another Financial Times article (FT, High house prices paint a partial picture of UK real estate, 2020) describes how changing buyer attitudes have led to the property market boom. It is mainly due to "those who have seen no financial impact from the pandemic are able to pay the same price for a home as before. They may even be able to offer more if their savings have risen thanks to spending less during lockdown." It is these buyers that seem to in fact be pushing house prices up. Normally, recessions coincide with house price drops so it is rare to see the property market experiencing a period of boom while the economy as a whole suffers. Some of the factors contributing to this outcome include how "low mortgage rates and payment holidays mean most homeowners will sit tight if they can't sell for the price they want or need." In addition, it is first time buyers who are the hardest hit by the recession and the "fact that more people are priced out of the market will not have an impact on house prices."

UK HOUSES PRICES JUMP IN AUGUST



Source: Nationwide (FT, UK house prices surge to record high, 2020)

However, it appears unlikely this boom will continue much longer as "furlough schemes and mortgage payment holidays have delayed the negative impact on the market." Howard Archer, chief economic adviser to the EY Item Club, said: "We suspect that the housing market is likely to come under pressure over the final months of 2020 when there is likely to be a significant rise in unemployment as the furlough scheme draws to a close in October." The MPC's central forecast is that the LFS jobless rate will nearly double by the end of the year to "7.5% in Q4" (BofE, 2020) which is in line with Howard Archer's expectations. Further to this, a CBRE report (CBRE, Indicators of Recovery - The Residential Market, 2020) explains that "higher unemployment tends to suppress wage growth, which in turn affects the ability to buy." Conversely, the Financial Times article provides a different perspective by suggesting that "a future of persistently high house prices at much lower transaction levels is a real possibility."

REAL ESTATE INVESTMENT

Looking at the real estate market in its entirety, Savills research (Savills, Spotlight: UK Hotel Investment Report, 2020) has found that some investors "have shifted focus towards quality trophy assets in London," as "key assets in ultra-prime locations are unlikely to experience such pronounced fluctuations in regards to capital value compared to the wider market." The report also reflects regional variations, that "London has therefore accounted for an 87.3% share of total UK investment volumes so far in 2020". In terms of investment prospects moving forward, JLL's global report anticipates that "the low interest rate environment and financial asset price volatility will support the case for portfolio diversification. 'Flight to safety' in real estate, which continues to offer better relative returns in comparison to other asset classes, looks set to increase." The report also highlights that across the board "there will be increased demand for new workplace design, including more digital, flexible and health-oriented working solutions." While we can identify key trends at this moment in time, we are still not out of the pandemic so it is difficult to predict and anticipate just how the market will advance post lockdown. However, it is clear that each subsector within real estate is up against different challenges as the whole economy evolves in response to both government schemes and global market trends.

SUMMARY OF KEY POINTS

UK Economic Outlook

- The UK economy has experienced a significant contraction in GDP in Q2 which is largely due to reductions in household spending. Which in turn can be seen as attributable to national lockdown and government COVID measures.

Real Estate trends

- Commercial real estate has experienced a fall in occupier demand with 55% of RICS respondents seeing a decline. Respondents also show rental expectations for the next 12 months of office space and retail to be negative.

Industrial Sector

- The industrial subsector has experienced a record high quarterly demand in Q2. Contributing to this growth has been the shift in spending habits toward online consumption.
- The boom in online shopping is prompting developers to convert large-format retail sites into warehouses.
- The industrial sector is predicted to see continued increases in rental growth with technology further evolving warehouse propositions.

Retail Sector

- Meanwhile, online retail demand has reduced demand for high-street retail.
- While overall retail consumption has rebounded over summer, high-street retail continues to struggle.
- Savills reported that only "19% of shopping centre rents being received on the June quarter date, whereas single-let and high street retail received 58%." This reflects the ongoing threat to landlords of tenants defaulting on rent due to COVID impacts.
- Consumer habits within the retail space are increasingly considered as structural changes rather than temporary.
- CBRE anticipates a trend toward the "repurposing of retail assets, including retail warehouse parks to urban warehousing."
- While JLL looks longer term at how retail may evolve "as the structural change in the retail market accelerates, greater emphasis will be placed on the shift toward a flexible omni-channel retail model and sustainable fulfilment"

Office Sector

- There has been a contraction in demand for office space leading to vacancies in the market. 93% of RICS survey respondent's "anticipate that businesses will look to scale back their office space requirements to some extent in the coming two years on account of the increase in remote working during the pandemic."
- On the other hand, CBRE EMEA mid year report said "occupier demand shifting increasingly towards tech-enabled 'smart' space, offering development or refurbishment opportunities."
- Knight Frank publication anticipates a trend toward "quality office space that has been evident in major global markets for the last few years. The office must be a compelling proposition."

Leisure and Hotel Sector

- The Leisure and Hotel industry have been impacted by the reduction in tourists due to travel restrictions.
- Domestic travellers have helped the industry to rebound over summer. However, consumers have sought more remote and less busy locations such as coastline destinations.
- Within the Leisure and Hotel industry it is budget hotels which are seen as likely to recover the quickest, with the corporate-reliant markets suffering the most from reduced travel.

Residential Sector

- On the residential side of the market, the housing market has been booming despite the economy being in recession.
- Tim Bannister, Rightmove's Director of Property Data comments that "some people are now choosing to move out of London altogether, but these latest figures show that there's still plenty of activity in the outer areas of the capital."
- It is unlikely the housing boom will continue as furlough ends and unemployment figures are likely to rise.

Real Estate Investment

- Some investors have shifted toward higher quality assets.
- JLL's global report anticipates that "There will be increased demand for new workplace design, including more digital, flexible and health-oriented working solutions."

BIBLIOGRAPHY

BofE. (2020, September). ***The Economy and COVID-19: Looking Bank and Looking Forward.*** Retrieved from https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/the-economy-and-covid-19-looking-back-and-looking-forward-speech-by-michael-saunders.pdf

CBRE. (2020, August). Retrieved from Investment market supported by key Docklands deal: http://cbre.vo.llnwd.net/grgservices/secure/CL%20Monthly%20MarketView%20August%2020_Dv3N.pdf?e=1602437643&h=5e5c633c5477940303a17ac5f2731619

CBRE. (2020, September). ***Indicators of Recovery - The Residential Market.*** Retrieved from http://cbre.vo.llnwd.net/grgservices/secure/Residential%20Recovery%20Indicators%20Sept%202020.pdf?e=1602438604&h=2078e6a1d651999c04242897995519f7

CBRE. (2020, September). ***Market Update: UK Logistics.*** Retrieved from http://cbre.vo.llnwd.net/grgservices/secure/CBRE%20UK%20Logistics%20Special%20Market%20Update%20_Covid-19_%20-%20September%202020_R7kd.pdf?e=1602436897&h=a300c1665369b3a28e5342787844fc27

CBRE. (2020, September). ***UK Logistics Market Update September 2020***. Retrieved from https://www.cbre.co.uk/research-and-reports/United-Kingdom-Logistics-Market-Update-September-2020

CBRE, E. (n.d.). ***EMEA real estate market outclook 2020 mid year review***. Retrieved from http://cbre.vo.llnwd.net/grgservices/secure/EMEA%20Mid%20Year%20Outlook_Final.pdf?e=1602429222&h=0aadb0da899f5a7f2b13ed6ba38d5e98

Deloitte. (2019, October). Retrieved from https://www2.deloitte.com/us/en/insights/industry/financial-services/commercial-real-estate-outlook.html

FT. (2020, September). Retrieved from https://www.ft.com/content/272354f2-f970-4ae4-a8ae-848c4baf8f4a

FT. (2020, September 06). ***High house prices paint a partial picture of UK real estate***. Retrieved from https://www.ft.com/content/271ba975-34ce-4220-8cee-4433b15ada31

FT. (2020, September 02). ***UK house prices surge to record high***. Retrieved from https://www.ft.com/content/53a76828-7763-451a-99d6-e7bdd2bd96d7

FT. (2020, September). ***UK retail sales rise for fourth consecutive month.*** Retrieved from https://www.ft.com/content/8b2acee7-87c1-4320-aab8-eae1170331b7

JLL. (2020, April). ***COVID 19: Global Real Estate Implications***. Retrieved from https://www.jll.co.uk/en/trends-and-insights/research/covid-19-global-real-estate-implications

JLL. (2020, June 23). ***The Future of global office demand***. Retrieved from https://www.jll.co.uk/en/trends-and-insights/research/future-of-office-demand

JLL. (2020, October 07). ***Why big-box retail stores are turning into warehouses***. Retrieved from https://www.jll.co.uk/en/trends-and-insights/investor/why-bigbox-retail-stores-are-turning-into-warehouses

Knight Frank. (2020, September). ***COVID 19 - what we know, what we expect, what we question***. Retrieved from https://content.knightfrank.com/research/1957/documents/en/covid-19-commercial-research-september-2020-7430.pdf

OECD Economic Outlook. (2020, June). Retrieved from http://www.oecd.org/economic-outlook/june-2020/

ONS. (2020, August). Retrieved from https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/apriltojune2020

ONS. (2020, September). Retrieved from https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours

ONS. (2020, September 15). Retrieved from https://www.ons.gov.uk/employmentandlabourmarket/peoplenotinwork/unemployment

ONS. (2020, June 11). Retrieved from https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/articles/morethanonefifthofusualhouseholdspendinghasbeenlargelypreventedduringlockdown/2020-06-11

ONS. (September, 2020). Retrieved from https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/august2020

RICS. (n.d.). Q2 2020: ***UK Commercial Property Market Survey, Retail and office sectors hit hardest by pandemic***. Retrieved from https://www.rics.org/globalassets/rics-website/media/market-surveys/gcpm/rics-uk-commercial-property-market-survey---q2-2020.pdf

RICS Residential. (2020, August). Retrieved from https://www.rics.org/globalassets/rics-website/media/knowledge/research/market-surveys/uk-residential-market-survey-august-2020.pdf

Rightmove. (2020, September). ***House Price Index***. Retrieved from https://www.rightmove.co.uk/news/house-price-index/

Savills. (2020, October 06). ***Big Shed Briefing Topic Response issue 2: mid-tech industrial***. Retrieved from https://www.savills.co.uk/research_articles/229130/306098-0

Savills. (2020, October 01). ***Spotlight: UK Hotel Investment Report.*** Retrieved from https://www.savills.com/research_articles/255800/305787-0

Savills. (2020, October 01). ***Where's leading the recovery in the hotel market?*** Retrieved from https://www.savills.com/research_articles/255800/305791-0

Savills, P. (2020, August 06). ***Spotlight: Shopping Centre and Highstreet - Q2 2020.*** Retrieved from https://www.savills.com/research_articles/255800/303206-0/spotlight--shopping-centre-and-high-street---q2-2020/