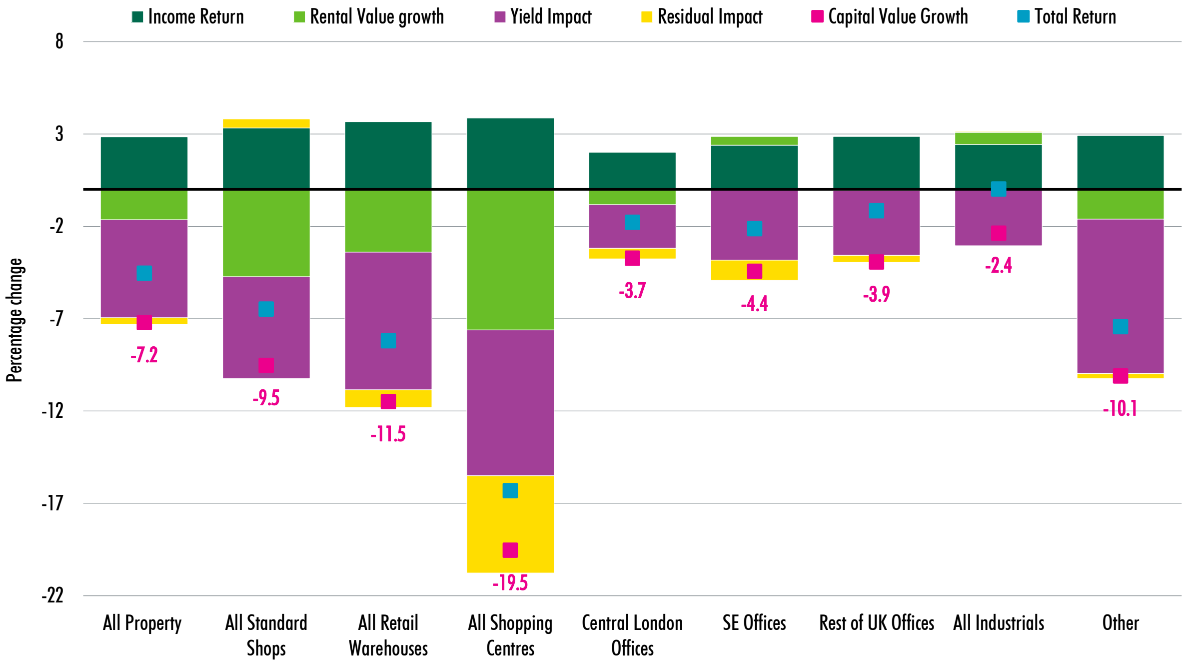
September 2020

CBRE MONTHLY INDEX: MARKET AND ASSET LEVEL PERFORMANCE ANALYSIS

AUGUST 2020 MONTHLY INDEX

SECTOR RESULTS, SINCE BEGINNING MARCH 2020

In the six months covering the onset of Covid-19 in the UK, values have fallen by -7.2% at the all property level. The fall has been considerably greater for large format retail, but less severe in the office and industrial sectors. It is predominantly yield driven.



Source: CBRE UK, Monthly Index, August 2020.

Across UK commercial property capital values decreased -7.2% in the last six months. This was driven by a -1.6% fall in rental values and 32bps rise in yields. Total returns have been -4.5% as income return has been 2.8%.

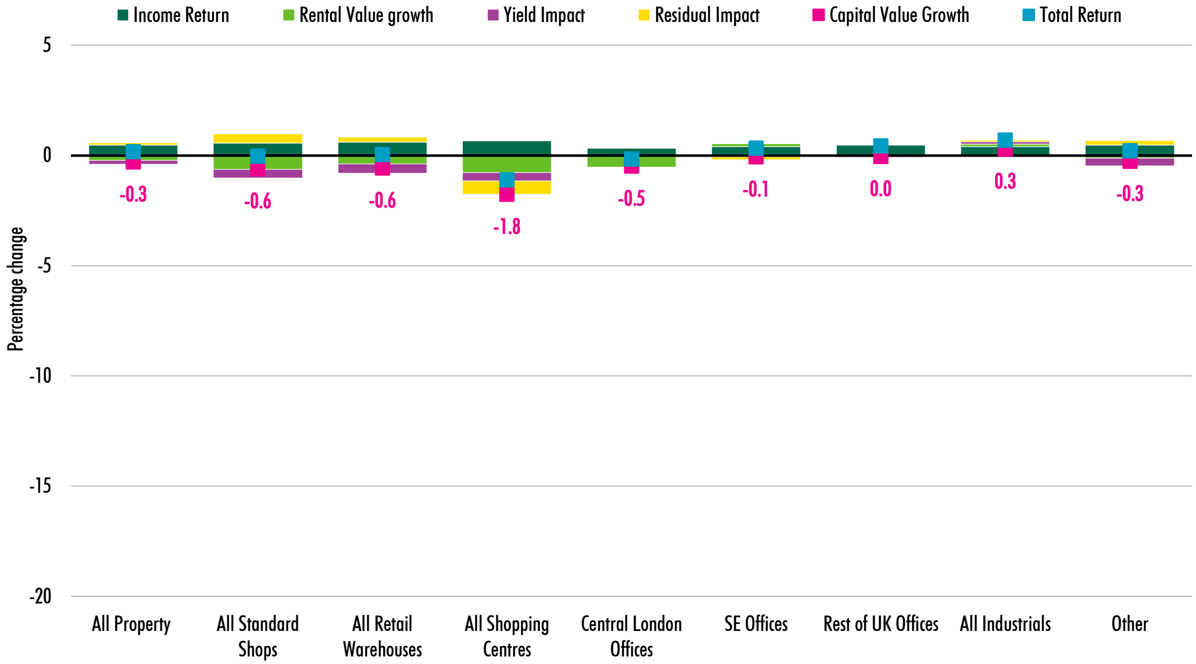
The decline in values has mainly been yield driven and has shown strong differentiation by sector; Retail yields have risen by 50bps, Offices by 17bps and Industrials by 16bps.

Rental growth has been similarly split along sector lines. Retail rental values have declined by a total of -4.8% since the end of February, with the bulk of that decline coming from May onwards. The fall has been greatest for shopping centres (-7.6%) but still significant for shops (-4.7%) and retail warehouses (-3.4%).

Office and Industrial rental values have been essentially flat; indeed, Industrial rental value growth has been positive throughout the period. This resilience in tenant demand may be behind the 0.4% rise in capital values over July and August, which seems to have set the total peak to trough decline for the four months March to June at -2.8%.

SECTOR RESULTS, AUGUST 2020

At the all property levels values declined -0.3% in Agust (from -0.3% in July, -0.7% in June, -1.1% in May, -2.1% in April and -3.0% in March). Retail was again the worst hit, particularly Shopping Centres, while Offices and Industrials were more resilient.



Source: CBRE UK, Monthly Index, August 2020.

Across UK commercial property capital values fell -0.3% in August as rental values decreased -0.2%. August is the second month since the start of the Covid-19 crisis to report positive all property total returns, at 0.2%.

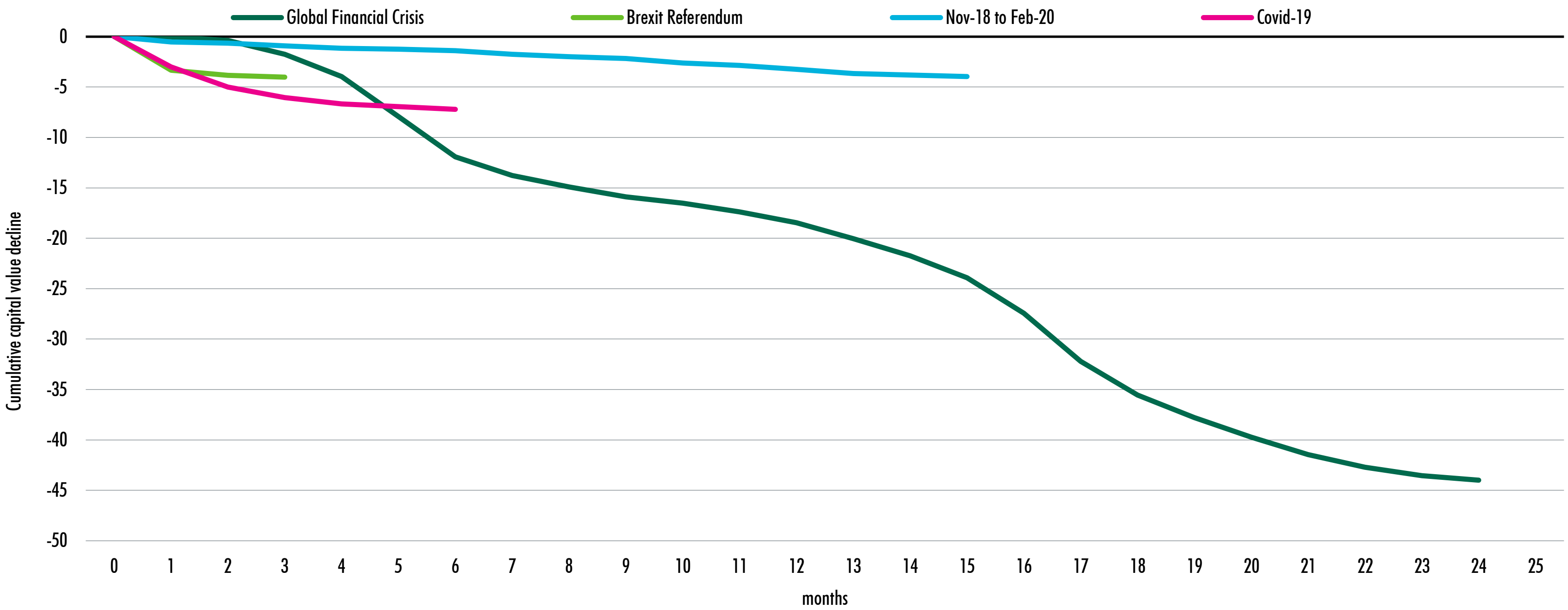
The Retail sector reported a -0.8% decline in capital values in August. Rental values declined -0.7% and total returns were -0.2%. Standard Shops South East was the strongest performing Retail subsector with capital values falling -0.2% and returns of 0.4%.

The Office sector saw capital values fall -0.1% in August, rental values also fell -0.1%. At 0.2% Outer London/M25 offices stood out as the only Office subsector to post an increase in capital values, the first instance of increasing values in the Office sector since February

The Industrial sector saw positive capital growth continue for the second consecutive month in August, increasing 0.1%. Sector rental values increased 0.1% and total returns for the month were 0.5%.

DOWNTURNS COMPARED, CUMULATIVE DECLINE IN ALL PROPERTY CAPITAL VALUE

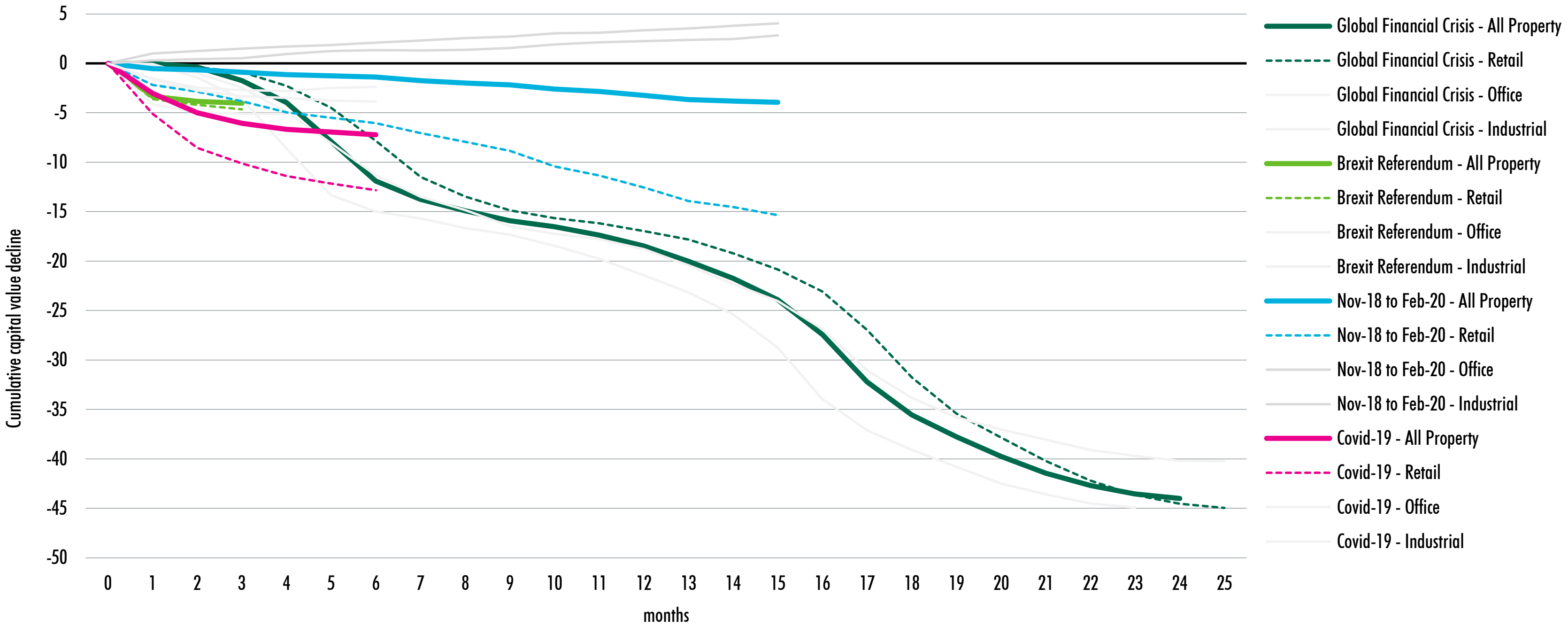
Six months in and the market reaction to Covid-19 is no longer the sharpest beginning to a downturn we have seen; the GFC's comparative acceleration in Q4 2007 was faster, and of course the overall peak to trough, at -44%, extremely severe.



Source: CBRE UK, Monthly Index, August 2020.

DOWNTURNS COMPARED, SECTOR DIMENSION

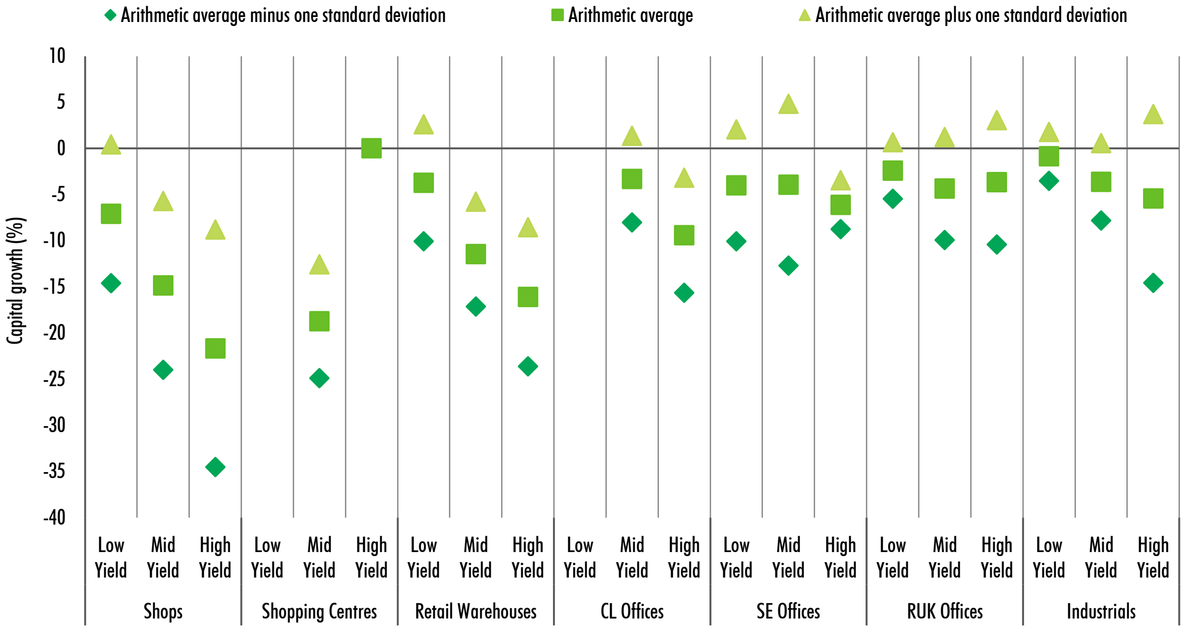
The current downturn is differentiated from, say, the GFC and Brexit corrections in that the impact has not been universal across sectors; Retail's significant under-performance is a continuation of its trend since the end of 2018, when it alone saw values decline.



Source: CBRE UK, Monthly Index, August 2020

VARIATION OF VALUE MOVEMENT, BY SEGMENT AND YIELD CATEGORY SINCE BEGINNING OF MARCH 2020

The Monthly Index shows a high level of asset volatility, even over a short six month period; generally, volatility and downside risk are highest for lower quality assets, whereas prime has been more resilient.



We split the Monthly Index sector samples into low yield, mid yield, and high yield by:

- Taking sector average yield at end Feb.
- Taking standard deviation of sector yield at end Feb.
- Classifying anything >1 standard deviation above sector average yield “high yield”.
- Classifying anything >1 standard deviation below sector average yield “low yield”.

This produces 21 sector/yield cuts. For each of these, we calculate:

- Average capital growth
- Standard deviation of capital growth

This allows us to say what the average, and +/-1 standard deviation range is around the average, giving us a good idea of asset level volatility.

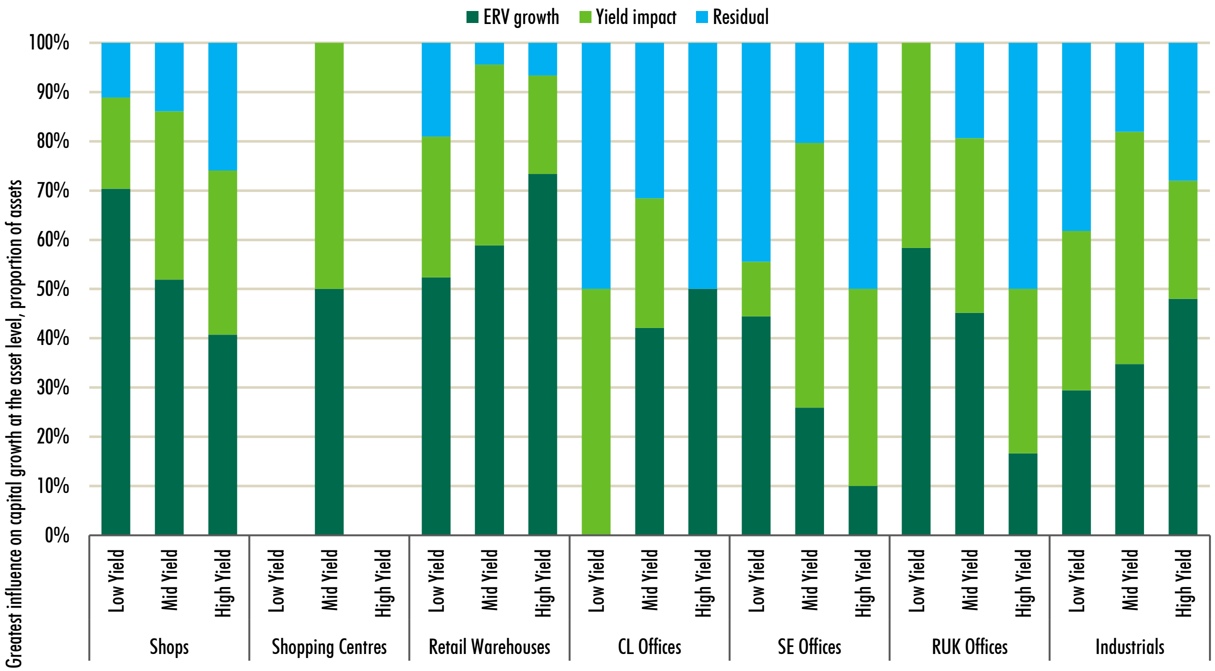
What this shows is:

- There is a very high level of asset level variation – making indexation a poor risk management tool compared to valuation.
- There is greater volatility and greater downside (generally) on high yield assets – prime has thus far been more resilient in this crisis.

Source: CBRE UK, Monthly Index, August 2020.

INFLUENCE ON CAPITAL VALUE DECLINE, PROPORTION OF ASSETS, SINCE BEGINNING OF MARCH 2020

March and April saw a much higher proportion of assets' valuation movement dominated by yield movement or residual. May, June, July and August however have seen ERV growth (or rather, in many cases, decline) increasingly come more to the fore.



Source: CBRE UK, Monthly Index, August 2020.

For each of the 21 sector/yield cuts we examine at the asset level which of the three influences on capital growth – ERV growth, yield impact and residual – have been most significant. The chart shows the proportion of assets in each cut where each one of these three factors is most dominant.

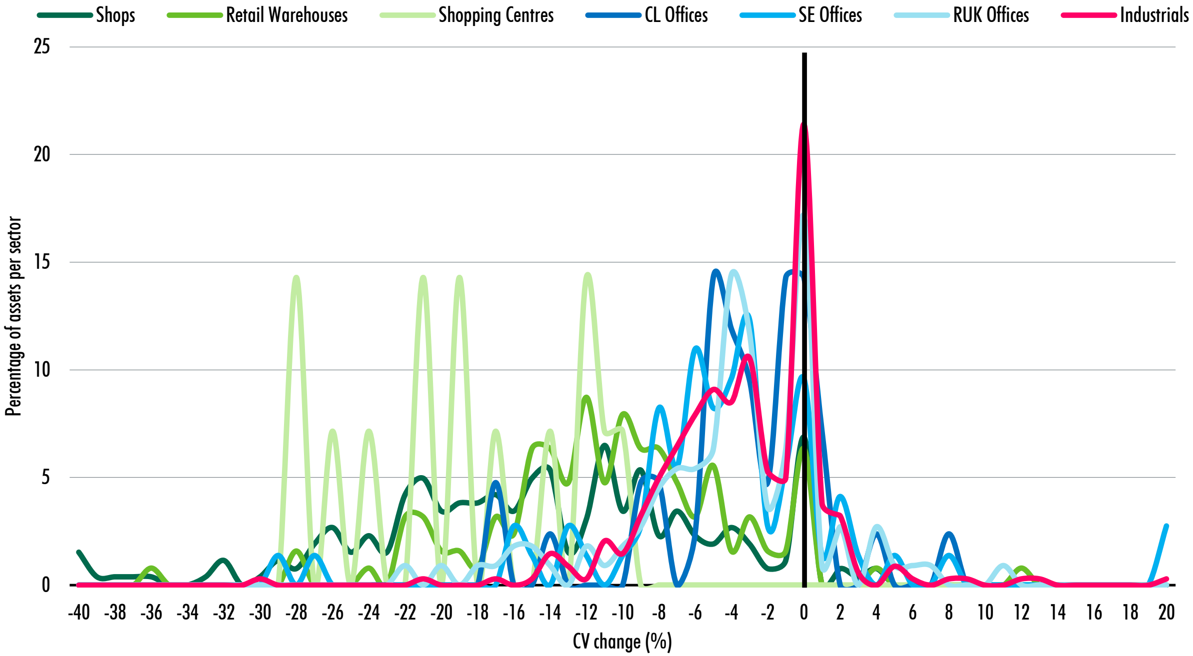
All property level yield impact, at -5.1%, is more significant than ERV growth, at -1.4%, over the last five months. However at the asset level ERV growth (426 assets, 44%) has overtaken yield movement (369 assets, 38%) as the biggest influence. Residual dominates on 174 assets (18%).

At the sector level, ERV growth is the most dominant influence (57% of assets), for industrials it is yield movement (46%) and for offices it is neck and neck (both 38%).

For lower quality assets, there is a greater tendency for residual to be the single biggest influencer on value change (27% versus the overall average of 17%). This might be because with yields already high and rents already low, a bigger influence on value change comes from changed income assumptions – longer void periods, longer rent frees, high capital contributions, higher capex etc.

CAPITAL VALUE GROWTH, ASSET DISTRIBUTION (%) BY SEGMENT, SINCE BEGINNING OF MARCH 2020

Observing the distribution of asset level capital value change reinforces the points that sector averages tell us astonishingly little about asset performance, and that retail has seen more volatile and more extreme movement at the asset level.



At the sector level, we show the proportion of assets seeing various levels of capital value change (rounded to the nearest whole number). We use proportion of assets to allow all sectors to be compared on the same chart (without sample size dwarfing some, such as shopping centres for example).

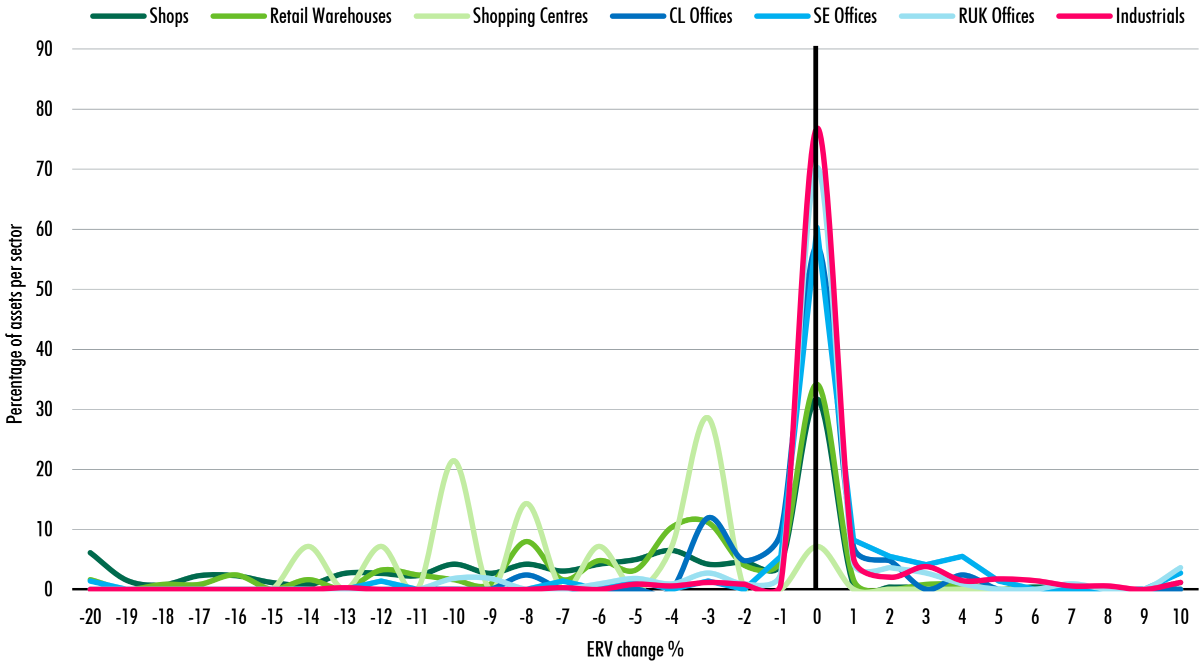
A few broad observations are possible:

- The sheer range of asset level outcomes over a five month period is remarkable.
- The average value movement in each sector is observed extremely infrequently at the asset level. This underlines again the lack of accuracy of indexation approaches relying on sector averages.
- Generally speaking, the left tail of the distribution – where the largest falls in value occur – has proportionally more retail and fewer industrial observations. This shows the high and low risk nature respectively of these sectors in this downturn.

Source: CBRE UK, Monthly Index, August 2020.

RENTAL VALUE GROWTH, ASSET DISTRIBUTION (%) BY SEGMENT, SINCE BEGINNING OF MARCH 2020 (1)

In April c70-90% of assets (varying according to sector) had seen headline rental values unchanged (due to lack of evidence); however the picture has increasingly changed in the last four months, particularly for retail.



At the sector level, we show the proportion of assets seeing various levels of ERV change (rounded to the nearest whole number). We use proportion of assets to allow all sectors to be compared on the same chart (without sample size dwarfing some, such as shopping centres for example).

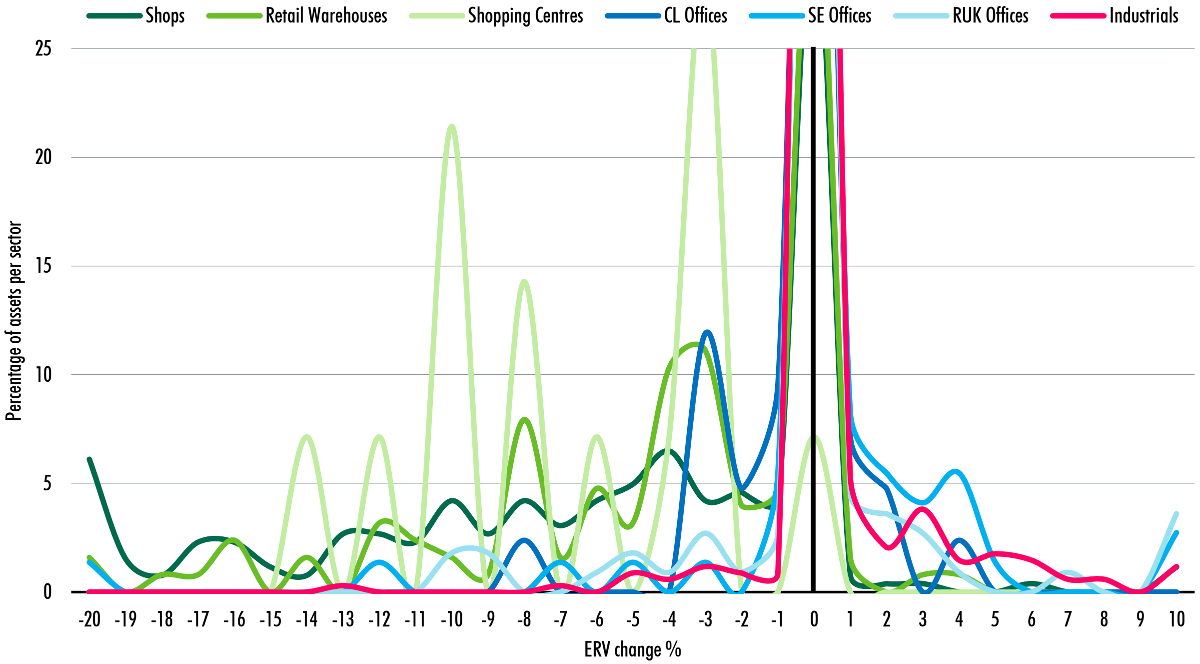
The key point to make here is that subdued letting activity makes establishing evidence to move ERVs a tricky exercise. With rent collection lower than in 2019 but still high in office and industrial (c80-90% according to our data) there is less drive to move ERV “on sentiment”.

However in retail (c60% rent collection) the matter is more pressing, and the last three months in particular have seen levels adjusted. But the stickiness of ERV levels in the office and industrial sectors skews the chart considerably, making any analysis of the distribution tricky, and necessitating the following chart.

Source: CBRE UK, Monthly Index, August 2020.

RENTAL VALUE GROWTH, ASSET DISTRIBUTION (%) BY SEGMENT, SINCE BEGINNING OF MARCH 2020 (2)

More granular analysis of ERV growth movement at the asset level suggests shopping centres, retail warehouses and standard shops as the sectors where more ERV change is being factored in. This likely suggests greater stress rather than greater leasing activity in these markets.



At the sector level, we show the proportion of assets seeing various levels of ERV change (rounded to the nearest whole number). We use proportion of assets to allow all sectors to be compared on the same chart (without sample size dwarfing some, such as shopping centres for example).

By re-setting our axis (to the same scale as for capital growth) we can make out more of the pattern of asset level ERV change.

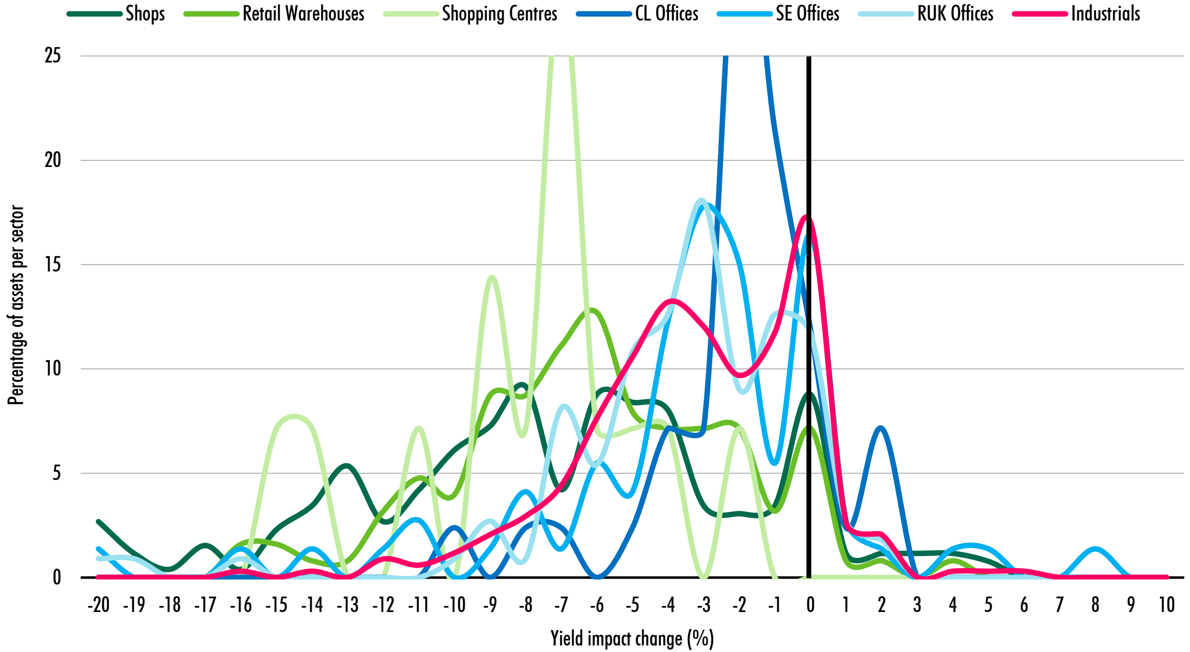
Zero change may remain the most common observation for asset level ERV growth over the last three months for shops (31%) and retail warehouses (34%), but it is no longer the majority. For shopping centres only 7% have seen no change, the best outcome obtained by any asset.

In fact, the majority of retail assets have seen ERV decline; 65% of shops, 63% of retail warehouses and 93% of shopping centres, with the proportions seeing falls of -5% or more being 46%, 33% and 57% respectively.

Source: CBRE UK, Monthly Index, August 2020.

YIELD IMPACT, ASSET DISTRIBUTION (%) BY SEGMENT, SINCE BEGINNING OF MARCH 2020

Yield impact is extremely broadly distributed at the asset level, reinforcing earlier analysis showing that this factor is predominantly what is driving value movement outside the retail sector.



At the sector level, we show the proportion of assets seeing various levels of yield impact (rounded to the nearest whole number). We use proportion of assets to allow all sectors to be compared on the same chart (without sample size dwarfing some, such as shopping centres for example).

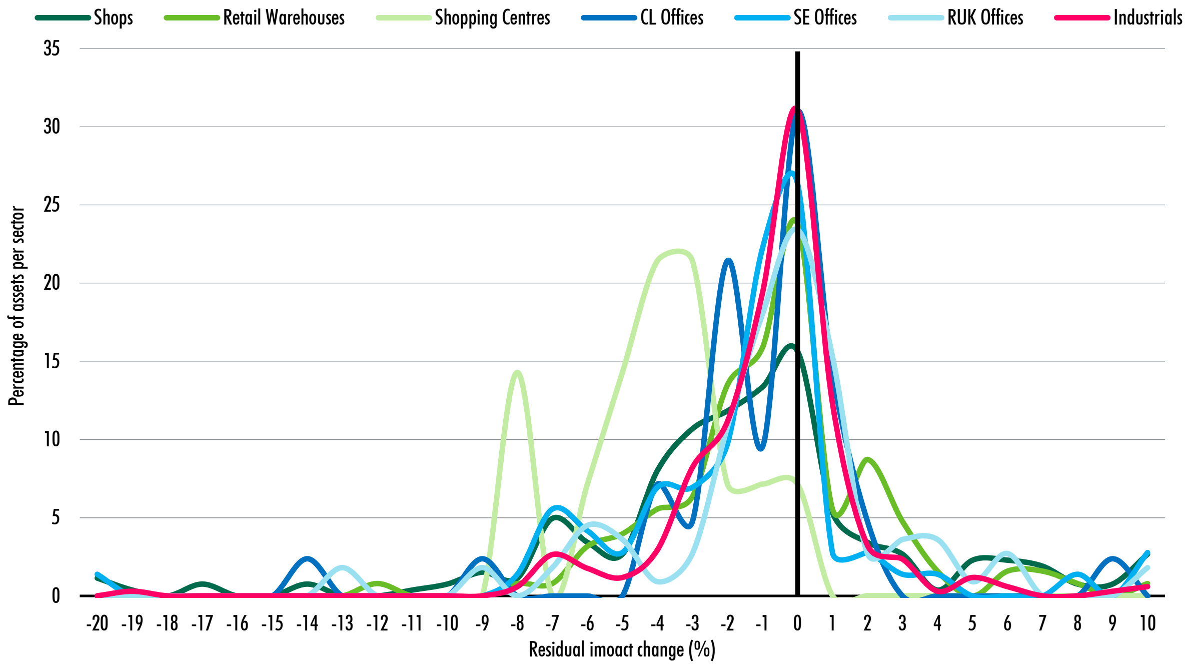
A few broad observations are possible:

- The most frequent observation is zero in only one sector (industrials).
- Indeed, there is a very broad spread of observations at the asset level, with a large proportion of assets seeing yield impact somewhere in the 0% to -10% range.
- Generally speaking, the left tail of the distribution – where the largest negative yield impacts occur – has proportionally more retail and fewer industrial observations. This shows the high and low risk nature respectively of these sectors in this downturn.

Source: CBRE UK, Monthly Index, August 2020.

RESIDUAL IMPACT, ASSET DISTRIBUTION (%) BY SEGMENT, SINCE BEGINNING OF MARCH 2020

Although zero is the most common residual, it is not the majority – most assets have seen non-zero change in fact. This suggests an important influence on valuation has been changes in cashflow assumptions away from headline ERV.



Source: CBRE UK, Monthly Index, August 2020.

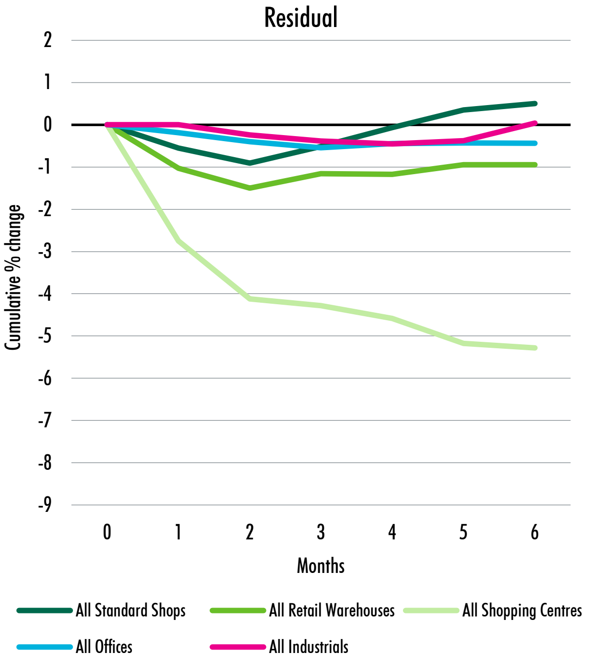
At the sector level, we show the proportion of assets seeing various levels of residual change (rounded to the nearest whole number). We use proportion of assets to allow all sectors to be compared on the same chart (without sample size dwarfing some, such as shopping centres for example).

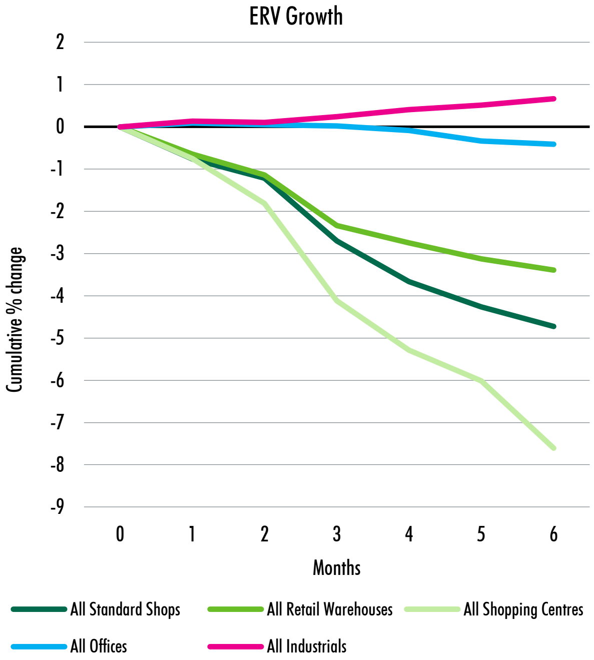
Residual is not often talked about because it is not always that significant. It reflects influences on value that aren't yield or headline rental movement; these could be adjustments to cashflow expectations away from simple moves to headline ERV, including longer void periods, longer rent frees, high capital contributions, higher capex etc.

As with ERV growth, many assets have seen zero change due to residual – although the proportion of assets at 15-30% or so is generally lower than for ERV. The majority of assets in all sectors in fact have seen non zero change in residual, with half of assets seeing a residual in the -1% to -8% range.

CUMULATIVE ERV GROWTH AND RESIDUAL, SINCE BEGINNING MARCH 2020

After six months of market reaction to Covid-19 cumulative residual impact for most sectors has levelled out, with value declines increasingly captured by adjustments to ERV. Shopping centres on the other hand continue to report increasing residual impact.





At the sector average level, we compare residual and ERV growth since the beginning of the decline in all property capital values.

As we have previously observed, in the initial couple of months of the crisis, residual had a significant impact on valuation movement – much more so than ERV growth.

However, from the third month onwards ERV growth has come to increasingly dominate, and in many cases – e.g. shops and retail warehouses – residual built up in the first couple of months has been reversed, as valuers have shifted from making adjustments to future cashflow and towards making cuts to headline ERV.

The exception s shopping centres, where the residual is still a very significant negative driver of value movement, alongside declining ERV. Here, valuers are making sharp downwards adjustments both to immediate ERV levels and to future cashflow prospects.

Source: CBRE UK, Monthly Index, August 2020.

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