April 2021

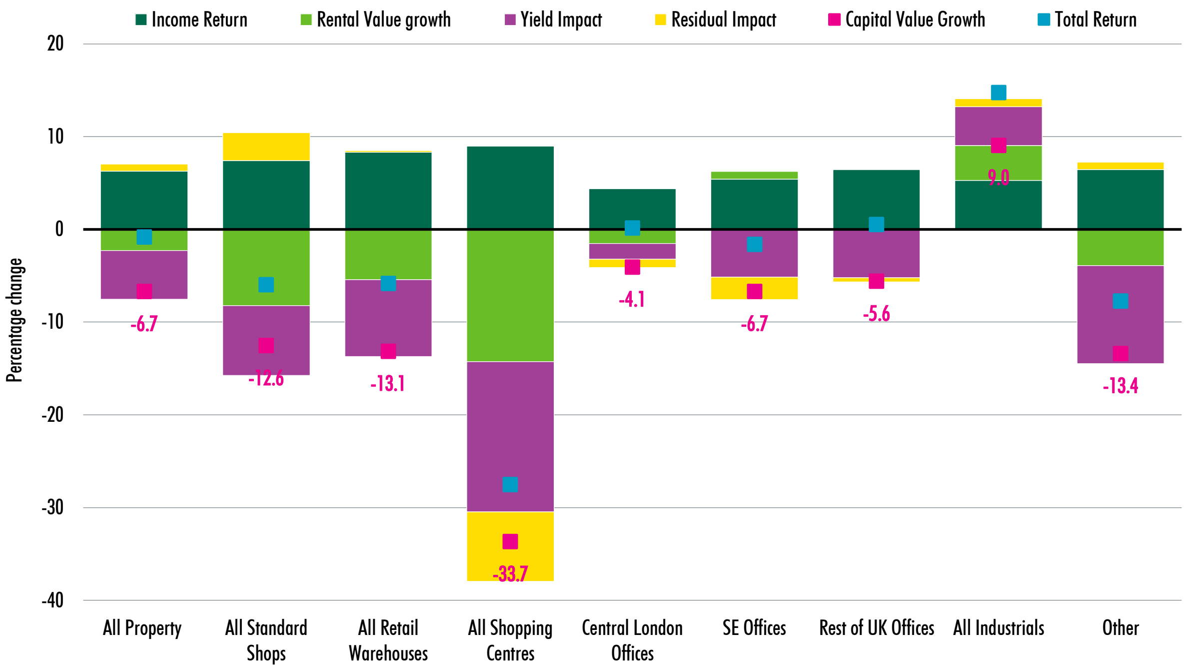
CBRE MONTHLY INDEX: MARKET AND ASSET LEVEL PERFORMANCE ANALYSIS

MARCH 2021 MONTHLY INDEX

CBRE

SECTOR RESULTS, SINCE BEGINNING MARCH 2020

In the thirteen months covering the onset of Covid-19 in the UK, values have fallen by -6.7% at the all property level. The fall has been considerably greater for retail, but less severe in the office and industrial sectors. It is predominantly yield driven.



Source: CBRE UK, Monthly Index, March 2021.

Across UK commercial property capital values decreased -6.7% in the last thirteen months. This was driven by a -2.3% fall in rental values and 32bps rise in yields. Total returns have been -0.8% as income return has been 6.3%.

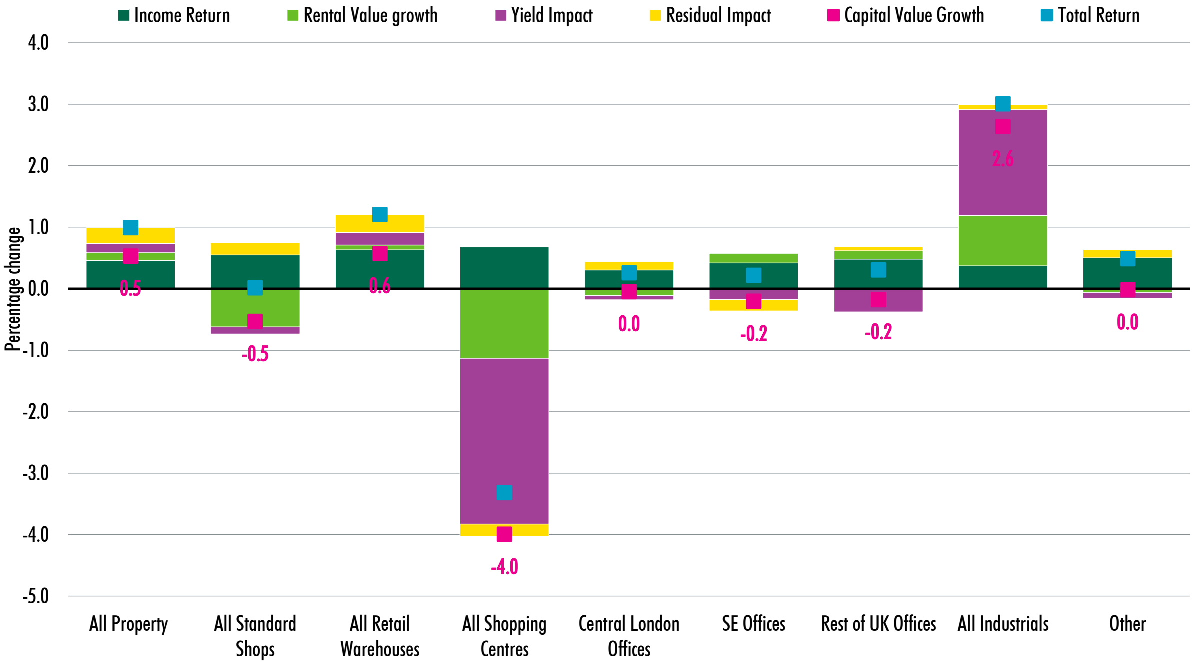
The decline in values has mainly been yield driven for most sectors and has shown strong differentiation by sector; Retail yields have risen by 74bps and Offices by 21bps whereas Industrial yields have fallen 21bps.

Rental growth has been similarly split along sector lines. Retail rental values have declined by a total of -8.4% since the end of February, with the bulk of that decline coming from May onwards. The fall has been greatest for shopping centres (-14.3%) but still significant for shops (-8.2%) and retail warehouses (-5.4%).

Office and Industrial rental values have been essentially flat; indeed, Industrial rental value growth has been positive throughout the period (3.8). This resilience in tenant demand may be behind the 12.2% rise in capital values between July 2020 and March 2021, which set the total peak to trough decline for the four months March to June at -2.8%.

SECTOR RESULTS, FEBRUARY 2021

At the all property level capital growth was 0.5% in March (increase of 0.2% in February, decrease of -0.1% in January, an increase of 0.3% in December 2020, falls of 0% to -1% in June to November, and of -1.1%, -2.1% and -3.0% in May, April and March respectively).



Across UK commercial property capital growth was 0.5% in March. Rental values increased 0.1%.

The Retail sector reported a -0.8% decline in capital values in March. Rental values declined -0.4% and total returns were -0.1 %. Retail Warehouses outperformed with capital growth of 0.6%, the greatest increase in values for the sector since May 2017. Retail Warehouse returns were 1.2% in March.

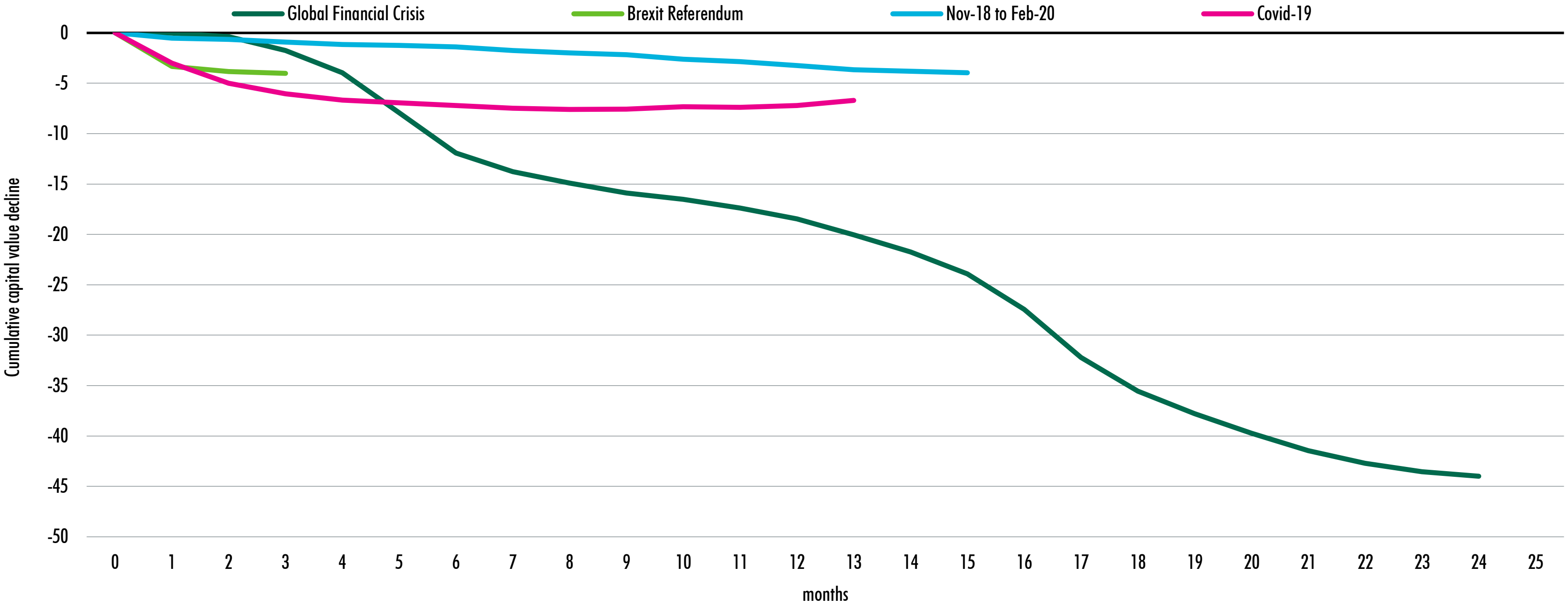
In March Office sector capital values fell marginally at -0.1% while rental values were unchanged. Capital values for Central London Offices were unchanged over the month. Offices in the rest of the UK posted a -0.2% fall in values.

Industrials reported very strong capital growth in March at 2.6%. Industrials in the rest of the UK posted record breaking growth at 2.6%, the greatest monthly increase in values for the subsector in the history of the index. Rental growth for the Industrial sector was 0.8% in March and total returns were 3.0%

Source: CBRE UK, Monthly Index, March 2021.

DOWNTURNS COMPARED, CUMULATIVE DECLINE IN ALL PROPERTY CAPITAL VALUE

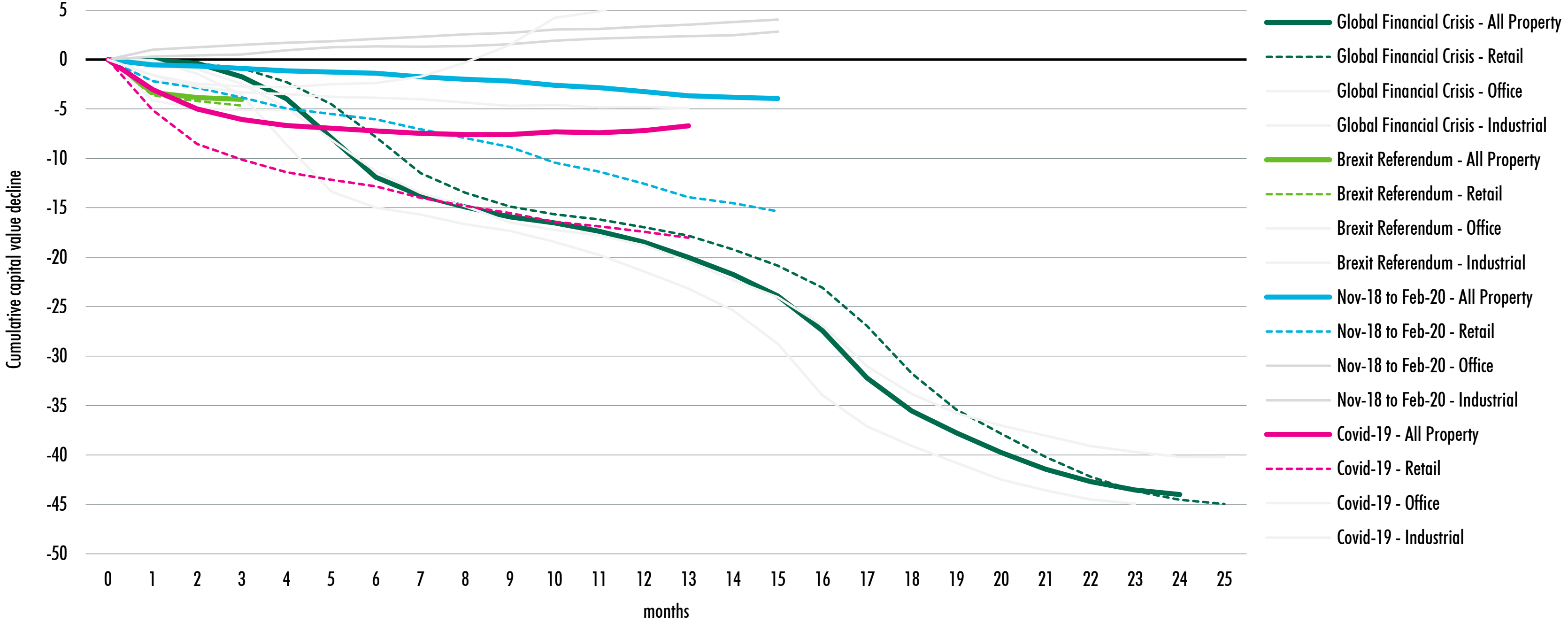
Thirteen months in and the market reaction to Covid-19 is no longer the sharpest beginning to a downturn we have seen; indeed, after Thirteen months the all property decline (-6.7%) is a third that seen at the same stage of the GFC (-20.0%).



Source: CBRE UK, Monthly Index, March 2021.

DOWNTURNS COMPARED, SECTOR DIMENSION

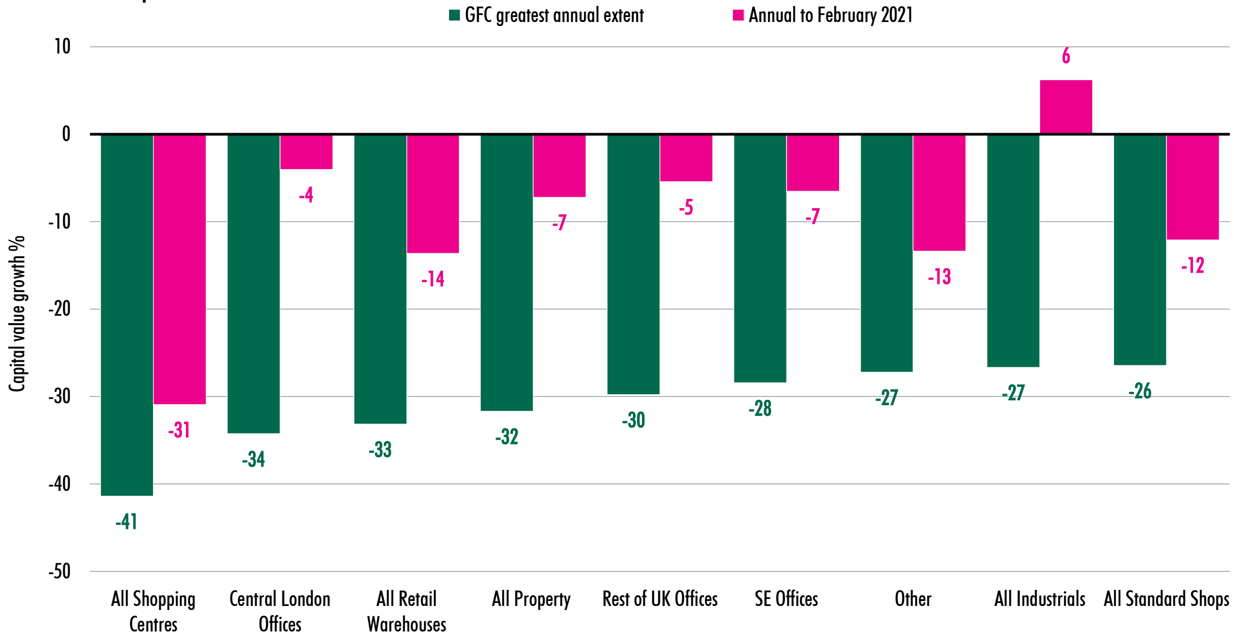
The current downturn is differentiated from, say, the GFC and Brexit corrections in that the impact has not been universal across sectors; Retail's significant under-performance is a continuation of its trend since the end of 2018, when it alone saw values decline.



Source: CBRE UK, Monthly Index, March 2021

EXTENT OF CAPITAL VALUE DECREASES, GFC VS COVID-19

The change in capital values in the 12 months following the first Covid lockdown in March 2020 ranged from 6.2% for Industrials to -30.9% for shopping centres. In all cases the annual fall in values to February 2021 was significantly less than that seen in the worst 12 month period of the GFC.



We have compared the change in capital value for each sector over two 12 month periods. Firstly taking the 12 months in which the greatest falls in capital values were reported during the GFC. Depending on the sector this ranged from 12 months to April, May or June 2009. This is plotted beside the change in capital values for the 12 months leading to February 2021.

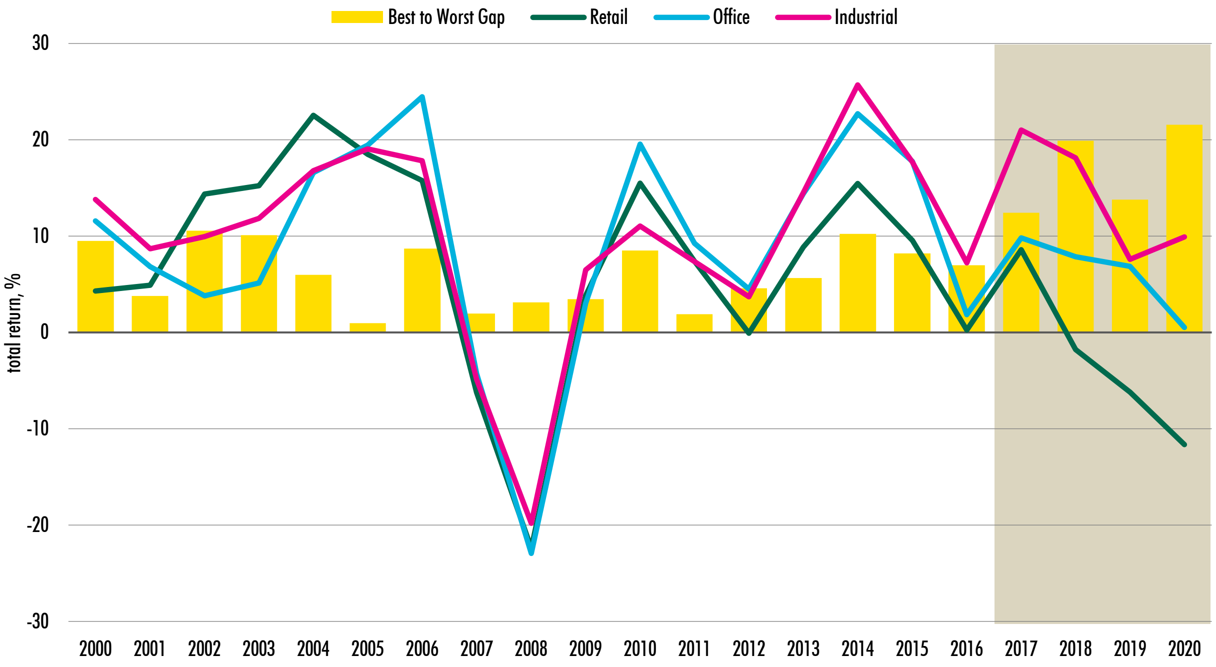
This reveals that although value decreases throughout the Covid-19 crisis have been considerable, in the majority of sectors they are far less than those seen at the hight of the GFC. In fact only Shopping Centres has reported a decline of more than half the worst 12 monthly GFC fall in values.

The Office and Industrial sectors have reported significantly smaller falls than during the GFC. Indeed the Industrial sector has actually reported positive capital value growth over the last 12 months. This indicates that for some sectors the Covid-19 crisis has been far less damaging than the GFC . However, with some Retail subsectors continuing to post sizable monthly falls in value, the full extent of decline may be yet to be seen.

Source: CBRE UK, Monthly Index, March 2021.

A DECADE OF RETAIL UNDER-PERFORMANCE HAS DRIVEN SECTOR POLARISATION

Retail was performing weakly long before Covid-19, delivering the lowest total returns of the three main sectors in each of the last ten years. The extent of under-performance has widened in the last four years, which have been the most polarised on record.



Source: CBRE UK, Monthly Index, March 2021.

The chart shows annual total returns for the three main sectors over the full 21 year history of the Monthly Index, with the yellow bars indicating the gap between the best-performing and worst-performing sectors.

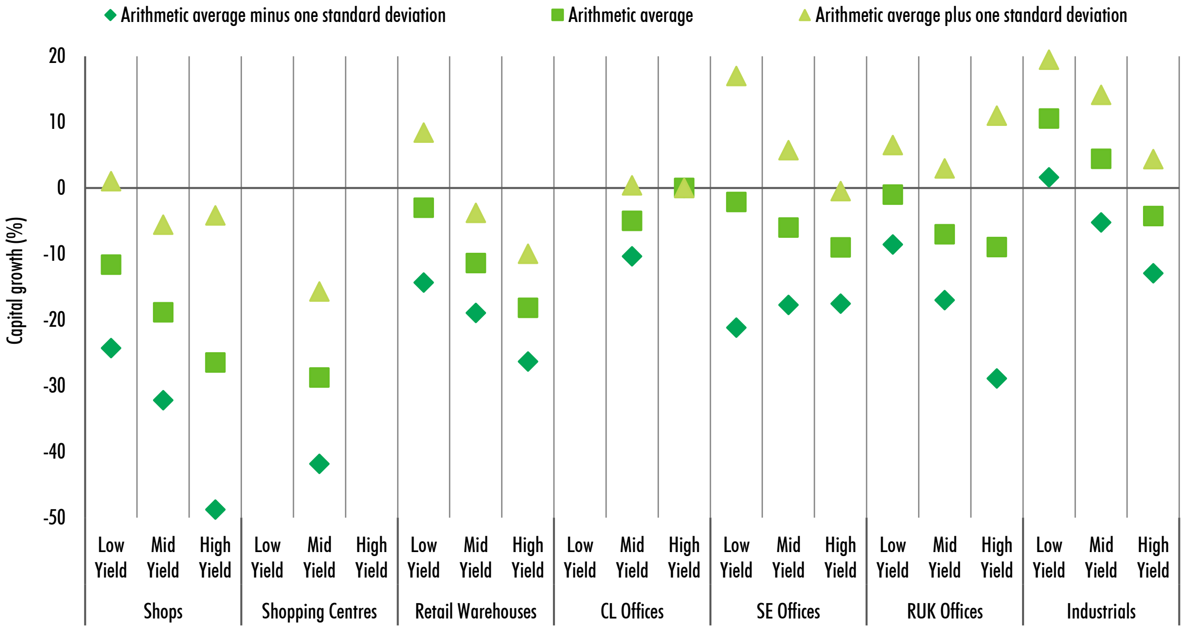
In each of the last ten years, retail delivered the lowest total returns, and over the last decade averaged just 2.7%pa, compared with an all property average of 7.4%pa. Offices were the best performer in three years (2011, 2012 and 2015) and averaged returns of 9.3%pa. Industrials meanwhile were top in seven years, including all of the last five, and averaged 13.1%pa.

The scale of retail's under-performance has been increasing; the last four years are the most polarised on record and have seen the gap to industrial climb to 21.5pp in 2020.

This ten year track record cannot be blamed on Covid-19. Structural changes in retail have been undermining the performance of retail real estate for some time, albeit that the pandemic has likely brought forward some pain in 2020 that might otherwise have been endured in other years.

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

The Monthly Index shows a high level of asset volatility over the thirteen 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.

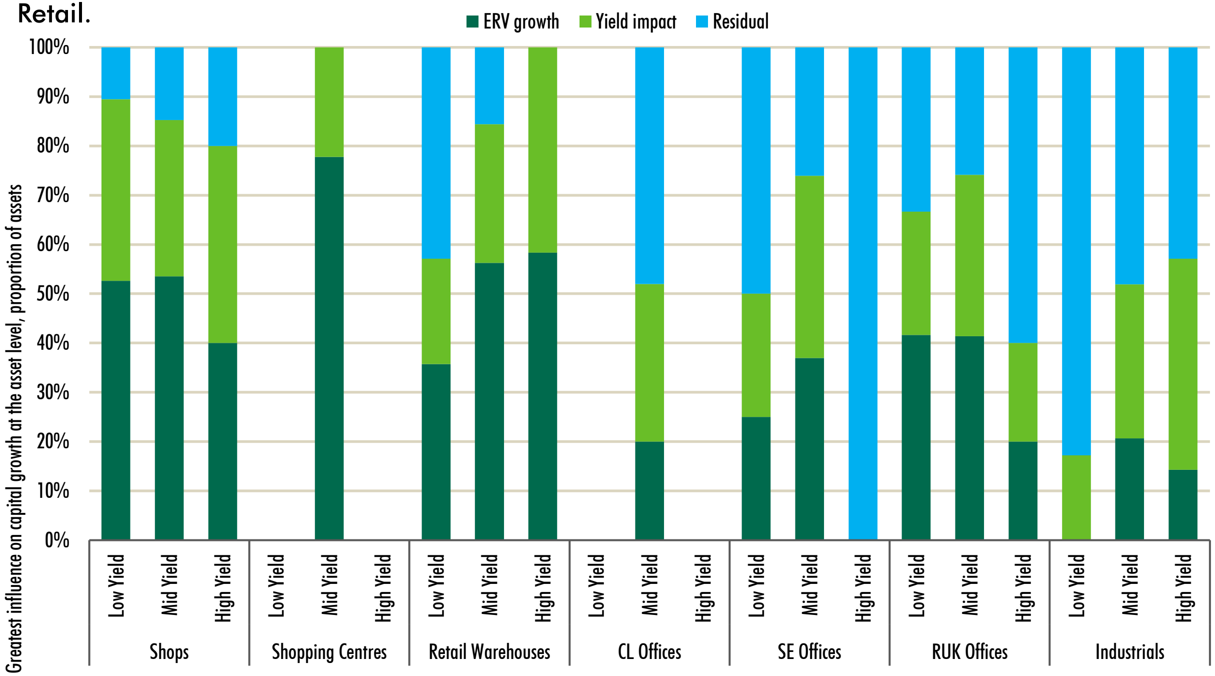
What this shows is:

- 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 – for some sectors prime has thus far been more resilient in this crisis.

Source: CBRE UK, Monthly Index, March 2021.

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

March and April 2020 saw a much higher proportion of assets' valuation movement dominated by yield movement or residual. May 2020 to the present however has seen ERV growth (or rather, in many cases, decline) increasingly come more to the fore, especially in Retail.



Source: CBRE UK, Monthly Index, March 2021.

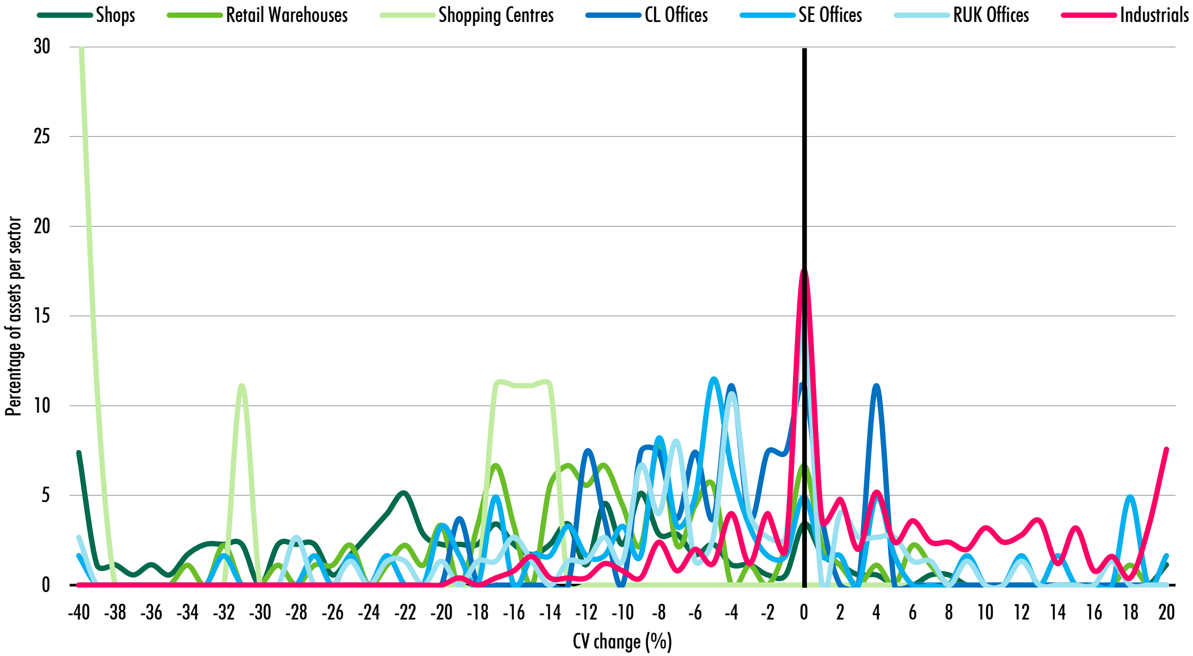
For each of the 21 sector/yield cuts we examine at the asset level which of the three influences on capital growth – ERV growth, yield impact and residual – have been most significant. The chart shows the proportion of assets in each cut where each one of these three factors is most dominant.

All property level yield impact, at -5.3%, is more significant than ERV growth, at -2.3%, over the last thirteen months. However at the asset level ERV growth (246 assets, 36%) has overtaken yield movement (212 assets, 31%) as the biggest influence. Residual dominates on 231 assets (34%).

At the sector level, ERV growth is the most dominant influence only for Retail (53% of assets). For Offices and Industrials it is residual (36% and 52% of assets respectively).

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.



Source: CBRE UK, Monthly Index, March 2021.

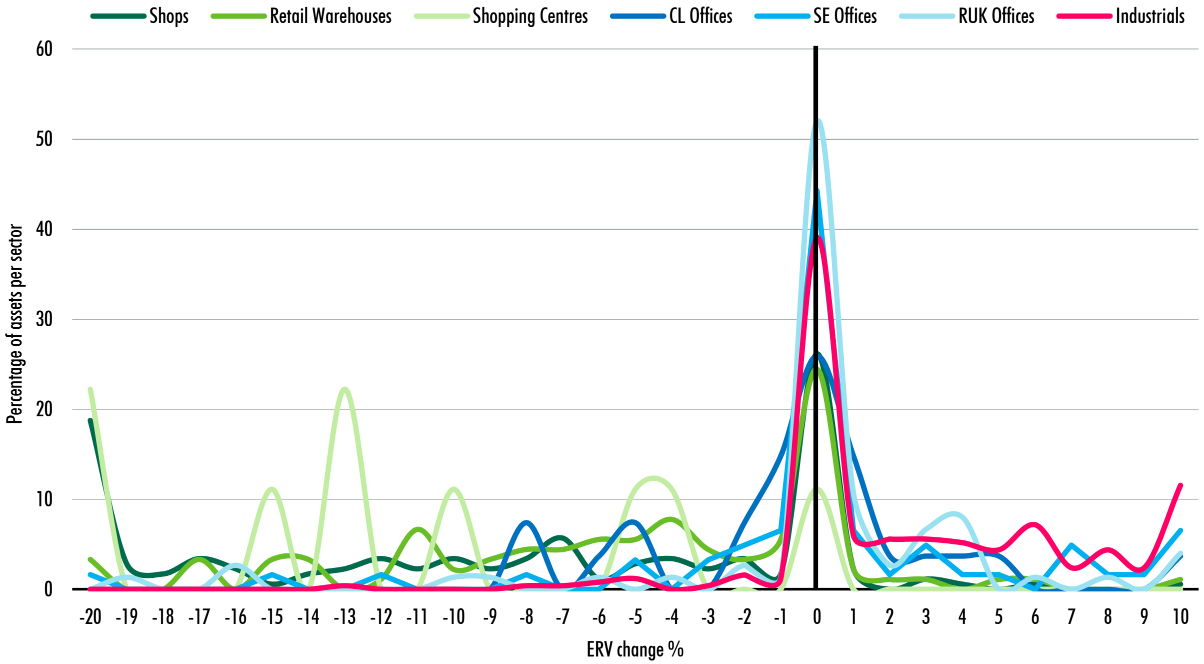
At the sector level, we show the proportion of assets seeing various levels of capital value change (rounded to the nearest whole number). We use proportion of assets to allow all sectors to be compared on the same chart (without sample size dwarfing some, such as shopping centres for example).

A few broad observations are possible:

- The sheer range of asset level outcomes over a thirteen 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.

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

As 2020 progressed, more and more assets (particularly retail) saw headline rental values change, although no change is still the most common observation for most sectors.



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).

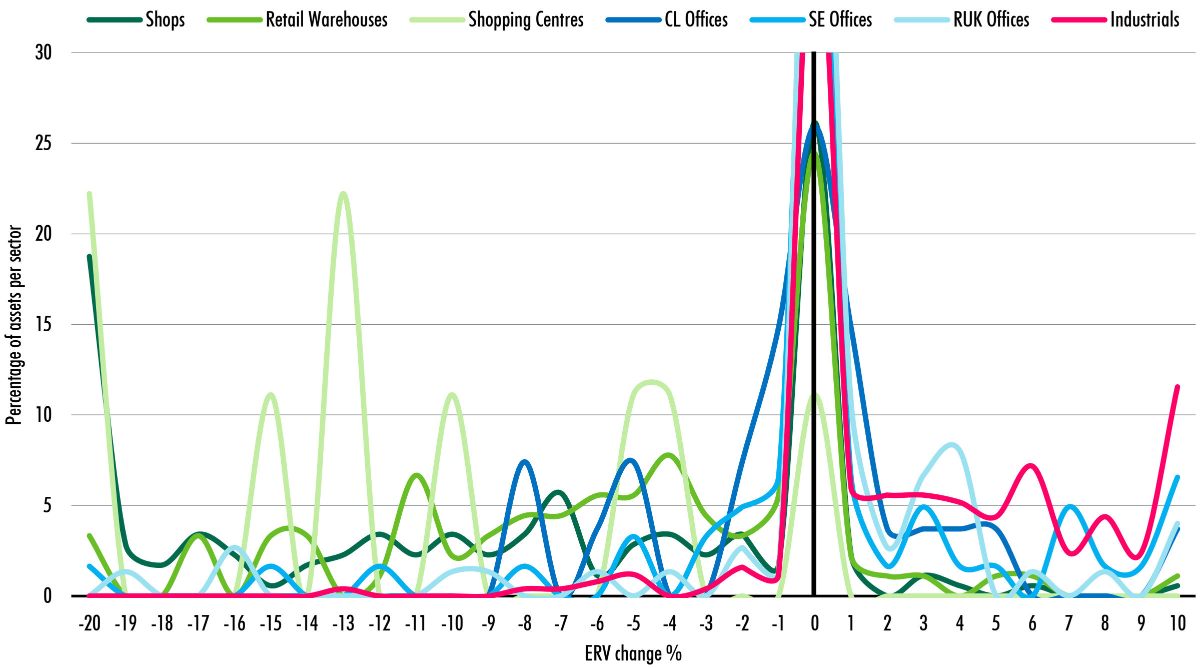
The key point to make here is that subdued letting activity makes establishing evidence to move ERVs a tricky exercise. With rent collection lower than in 2019 but still high in office and industrial there is less drive to move ERV "on sentiment".

However, in retail the matter is more obvious, and the last six 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, March 2021.

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.

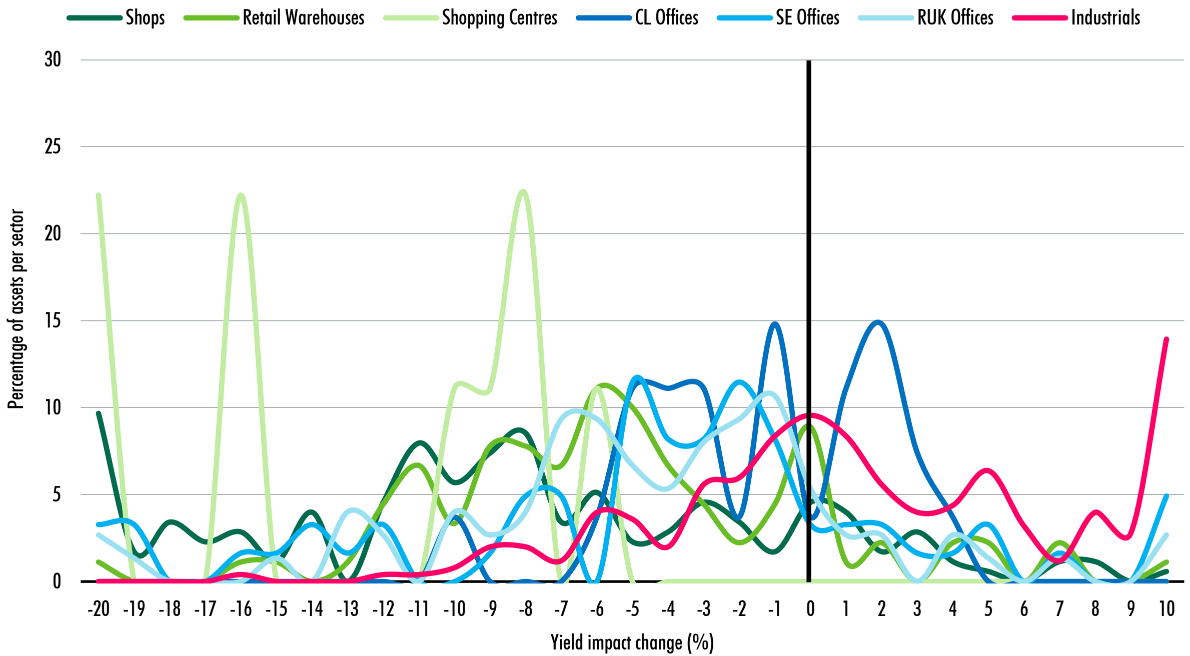
Zero change may remain the most common observation for asset level ERV growth over the last thirteen months for shops (27%) and retail warehouses (24%), but it is no longer the majority. For shopping centres.

In fact, the majority of retail assets have seen ERV decline; 69% of shops, 68% of retail warehouses and 89% of shopping centres, with the proportions seeing falls of -5% or more being 58%, 47% and 78% respectively.

Source: CBRE UK, Monthly Index, March 2021.

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).

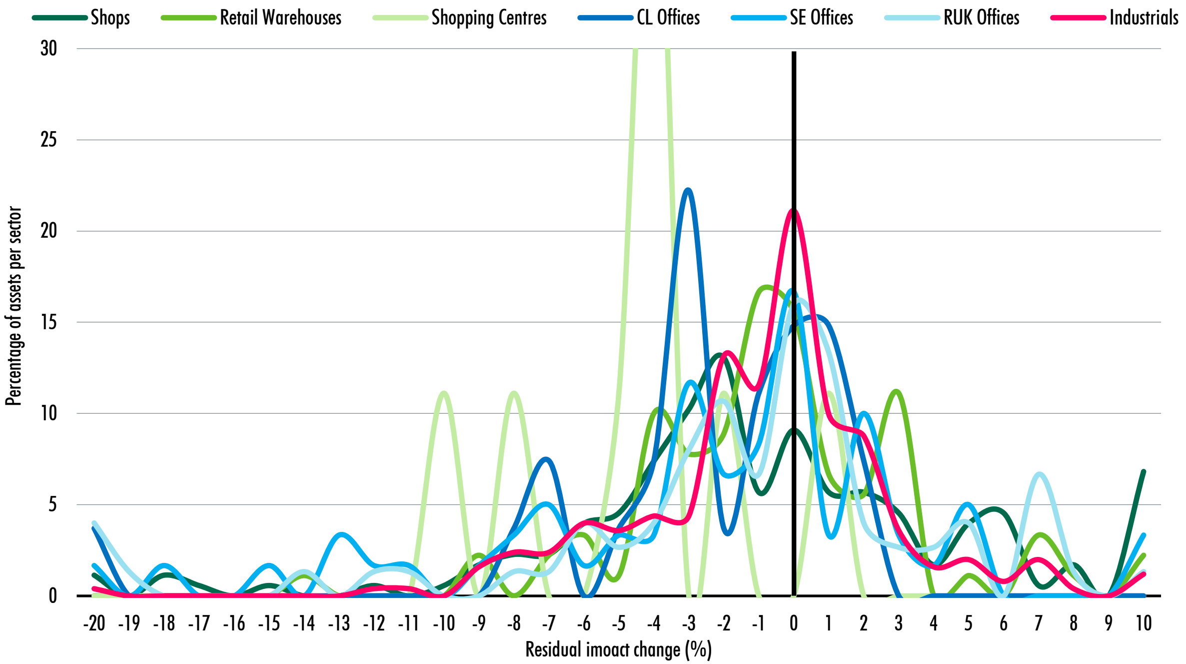
A few broad observations are possible:

- Zero is no longer the most frequent observation for any sector.
- 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, March 2021.

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

Although zero is the most common residual for some sectors, 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.



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).

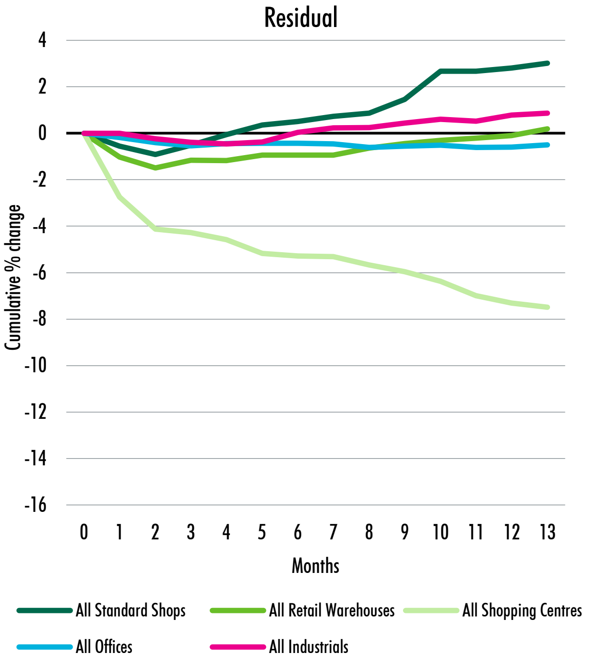
Residual is not often talked about because it is not always that significant. It reflects influences on value that aren't yield or headline rental movement; these could be adjustments to cashflow expectations away from simple moves to headline ERV, including longer void periods, longer rent frees, high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

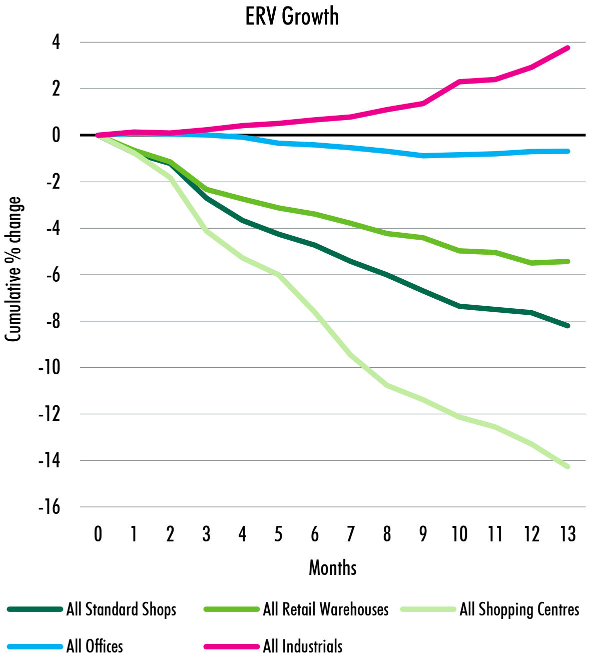
While zero is the most common residual for Industrials and South East Offices, the majority of assets in all sectors have seen non zero change in residual, with around half of assets seeing a residual in the -1% to -8% range.

Source: CBRE UK, Monthly Index, March 2021.

CUMULATIVE ERV GROWTH AND RESIDUAL, SINCE BEGINNING MARCH 2020

After thirteen 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 (negative) residual.





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 is 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, March 2021.

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