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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

March 2023

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MARCH UPDATE

Yields in the direct market have tightened again for many of the lower-yielding assets now that some of the worst fears for the path of interest rates are no longer expected and the outlook for the UK economy is more sanguine. The availability and cost of debt has improved and investors have increasingly returned to the market, keen to deploy pent up investment capital in advance of anticipated price growth. Risks nevertheless remain amid economic stagnation and double digit inflation that are yet to resolve and will impact both investment and occupier markets.

Read more for the most recent occupier and investment updates, economics data and property forecasts.

-12.8% ▼
All Property annual total return, Feb 2023

25bps ▼
Prime industrial inward yield shift, Q1 2023

0.0% ◀▶
2023 GDP growth forecast

6.1% ▼
2023 CPI inflation forecast

3.3% ▼
2023 10-year government bond yield forecast

4.1% ▲
2023 unemployment forecast

Prime yields in the direct market reverse their 2022 'overcorrection' but risks remain

All Property annual total return edged down further in February to -12.8%, an incredible drop from the +13.5% annual return six months ago and a recent peak of +25.1% in May 2022. However, the rate of decline has slowed tremendously so far early in 2023. All valuations-based property sector yields continued to move out in January and again in February, but at a markedly slower rate than over the back end of 2022.

The correction to commercial property pricing following the step change in borrowing costs in 2022 is now more nuanced. It reflects the fact that yields in the direct market have tightened up to 50bps again for many of the lowest-yielding prime assets where liquidity is highest. For prime industrial prices were around 25bps keener on average in Q1. Thus the 'concertina effect' in 2022 as lower valuation-based yields moved out more quickly than their more secondary counterparts will be unwound in 2023 and segment relativities re-established.

The availability and cost of debt has improved now that some of the worst fears for the path of interest rates are no longer expected and the outlook for economic activity is more sanguine. Investors have increasingly returned to the market, most recently the institutions. Momentum is building given the weight of pent up investment capital and the perception and urgency of those with cash to deploy in advance of anticipated price growth over 2023.

The current issue in the investment market is the lack of suitable product since most owners that do not need to sell are choosing to hold. This relative scarcity means that quality assets have generated strong interest and multiple rounds of bidding. There remains a focus on modern assets with strong ESG credentials. However, in the more liquid sectors such as industrial appetite has now also returned further up the risk curve, which includes core-plus and value-add assets.

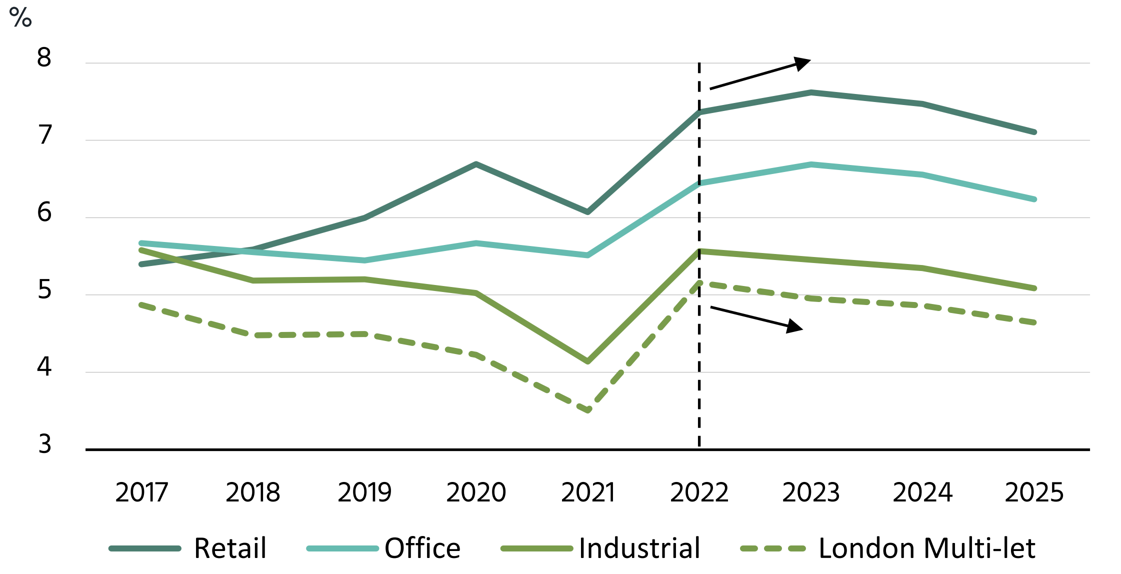
Risks nevertheless remain amid economic stagnation and double digit inflation that are yet to resolve and will impact both investment and occupier markets. Expectations that debt costs will continue to come down over 2023 may be overly optimistic given the many upside risks to inflation. Interest rates will quite feasibly remain high over the medium term and maintain debt at the new more expensive rate. Some private equity buyers are currently seeking to buy with all-equity with the expectation to 'gear-up' in around 18 months once the debt market improves, or accept deficit financing for a short period. However, this timeline could easily be twice as long, causing prices to soften again if investors cannot hold out.

The UK economy may narrowly avoid technical recession this year but business insolvencies have increased to the highest rate since the aftermath of the financial crisis in 2009. While we do not expect commercial property vacancy rates to reach the heights of previous downturns they have already meaningfully increased recently. In part this is the increase in availability of 'grey space' – previously let space that is now surplus to tenant requirements and has been marketed to sub-let. This has led to some relatively soft leasing deals compared with current market rents by tenants that can cover their rental liability based off historic ERVs. This will negatively impact rent review evidence and is expected to erode market rental growth into 2024.

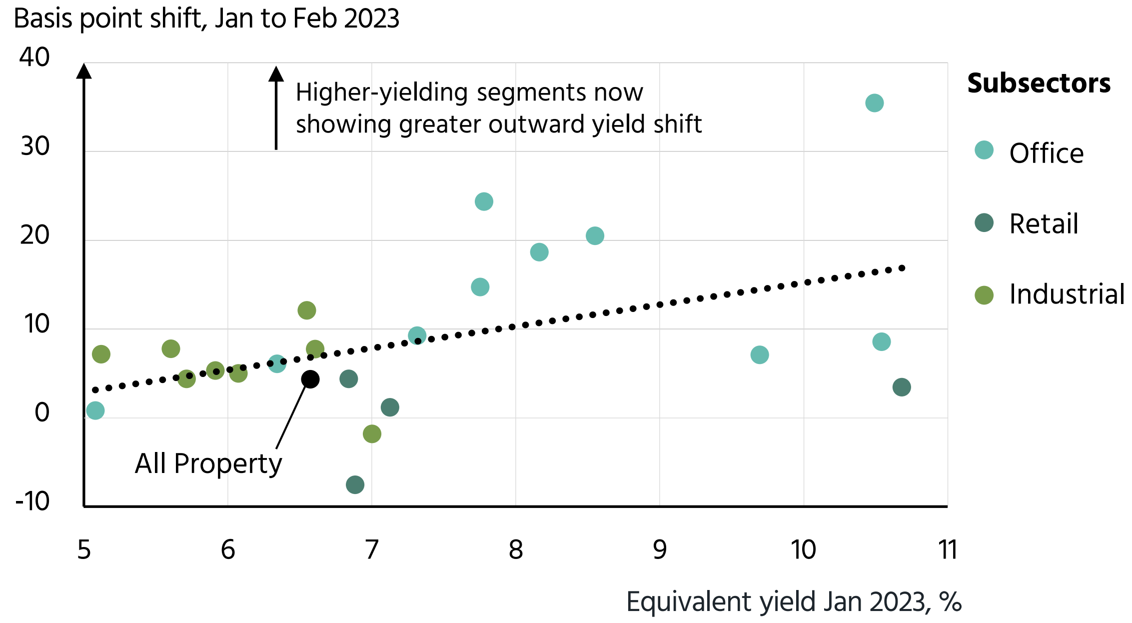
-12.8%
All Property annual total return, Feb 2023

25bps
Prime industrial inward yield shift, Q1 2023

Equivalent yields by property segment
Source: MSCI, Gerald Eve

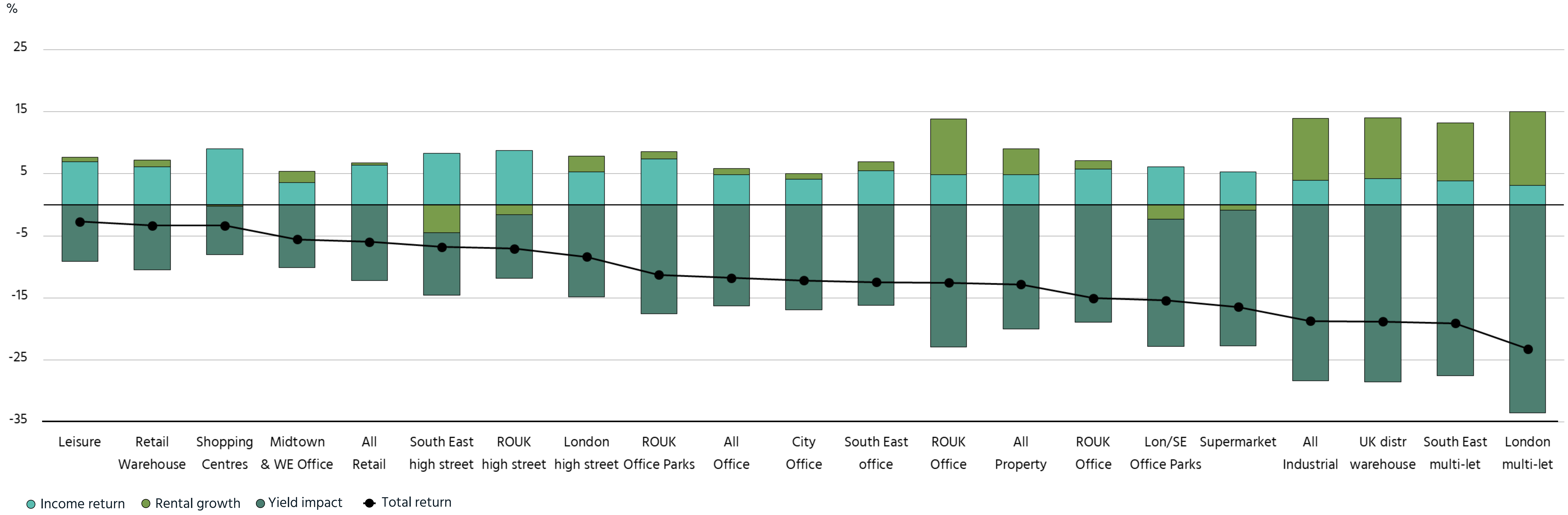


Subsector yields and yield shift
Source: MSCI, Gerald Eve



UK property segments

12-month return to February 2023
Source: Gerald Eve, MSCI



UK economy

UK GDP increased by 0.3% month-on-month in January, reclaiming some of the 0.5% loss in December but leaving total UK output still fractionally below where it was three years ago in January 2020. Widespread industrial action continues to add volatility to the monthly figures, but various disputes now appear to be closer to a resolution and the general outlook for the second half of 2023 is more stable. Oxford Economics now expects GDP to be flat this year, revised up from an anticipated fall of 0.4%.

Wholesale gas prices have continued to decrease, much to the relief of both households and businesses. The GfK consumer confidence indicator was -36 in March, its highest in a year. The negative score still underlies weak sentiment regarding personal finances, given elevated energy and food prices as well as higher interest rates. Business surveys also reported a rebound in activity in February and the lowest input cost inflation since March 2021. Services firms moved into expansion territory with manufacturing still lagging and signalling contraction, despite reporting increased order books.

CPI inflation surprised on the upside and increased to 10.4% in February. More broadly though this has been trending downwards since its peak of 11.1% in October 2022 and is expected to continue to do so over the second half of 2023. The retained government energy price guarantee and falling global wholesale prices means the average household energy bill is set to fall by more than 15% in July.

Real household income is set to recover from H2 2023 but will have fallen by an estimated 1.2% overall this year after a 1.7% drop in 2022. After a difficult couple of years for retailers retail sales data were stronger in January and February, which should be maintained over 2023 commensurate with improving household spending power.

The recent Budget offered extra financial support to households for the short term, which should lower inflation and support economic activity. However, this is still in the context of a significant tightening of fiscal policy over the next five years. Meanwhile base interest rates increased 25bps to 4.25% in March. Risks to inflation remain skewed heavily to the upside, with the tight labour market, relatively resilient economic activity and strong private sector wage growth the critical and problematic factors for whether rate setting has peaked in this cycle and for how long higher rates will persist.

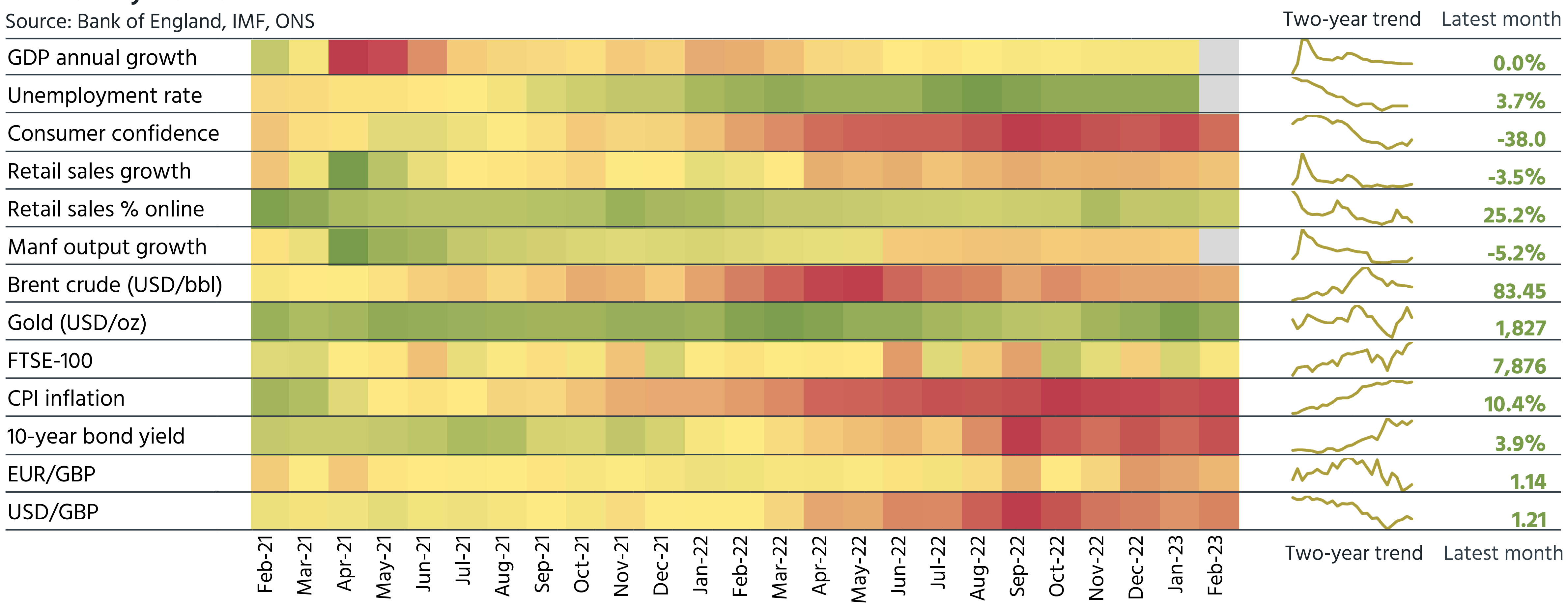
0.0%
2023 GDP growth forecast

4.1%
2023 unemployment forecast

6.1%
2023 average CPI inflation forecast

3.3%
2023 10-year government bond yield forecast

The monthly monitor
Source: Bank of England, IMF, ONS



Spotlight on... the commercial property debt market

The Bank of England has responded to above-trend inflation by raising interest rates in the last 11 consecutive meetings of the Monetary Policy Committee, which has affected all areas of the UK economy. This includes of course asset prices such as commercial property which took a record hit in Q4 2022. Moreover, the impact of monetary policy is expected to have up to an estimated two year lag even after the rate raising cycle has peaked, which it *may* have done this March. One-year SWAPs are currently priced at 4.46%, which suggests a further short term base rate increase from 4.25% to 4.5%.

The recent upswing of the interest rate cycle has caused an unprecedented step up in borrowing costs, most notably after the 'mini budget' in September 2022 that resulted in material financial market volatility. Additionally, and more recently, the failure of Silicon Valley Bank and the purchase of the troubled Credit Suisse by UBS have highlighted the risk of external shocks that could tighten UK and international financial conditions much further - but this is currently relatively unlikely.

Based on all-in free floating borrowing rates, the cost of accessing debt roughly doubled between January 2022 and January 2023. The all-in rate is comprised of the SONIA reference rate (the interest rate that banks pay to borrow sterling overnight), the lender's margin and a typical arrangement fee.

Interestingly, as it stands the fall in commercial property values thus far has not matched the magnitude the increased cost of borrowing would imply. In principle this could suggest that the asset price correction technically has further to go. This is especially the case for secondary assets - older stock in need of refurbishment, buildings in peripheral locations or those with EPC ratings which do not meet the upcoming regulatory benchmarks.

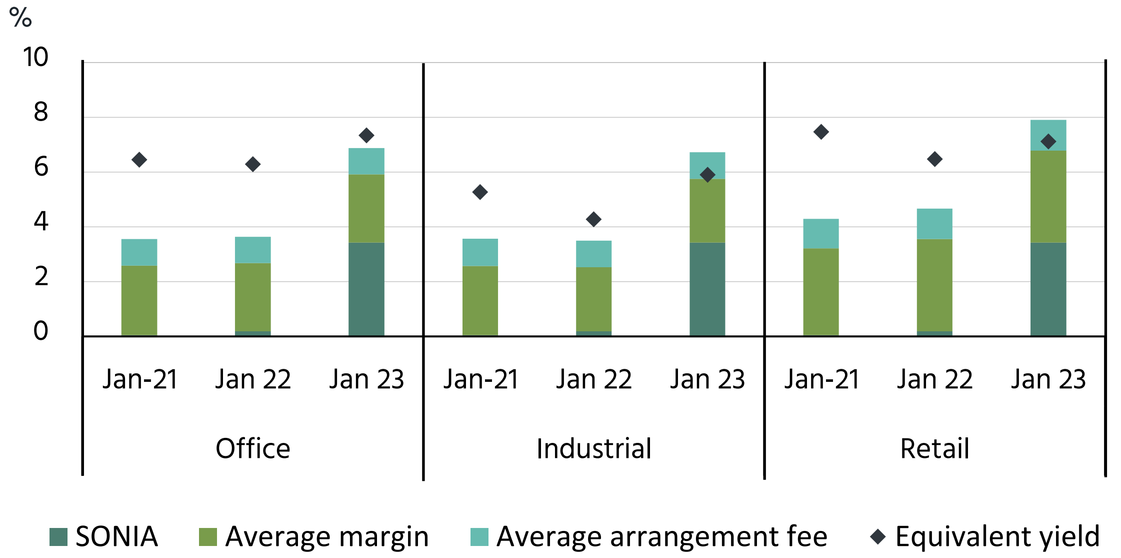
Additionally, purchases made in and around 2018 with five-year financing terms will be coming up for refinance. This will put further stress on property valuations since current property yields will not provide a substantial return above current debt cost and the higher leverage secured when rates were at an all-time low. This may not be financeable in the current market, which could bring more assets to market or equity calls for investors.

The fall in property pricing is nevertheless unlikely to materialise 'fully'. Firstly, during a subdued market, price comparisons are hard to come by, especially when investors are not yet forced into sales. Also any market-induced fall in pricing from sentiment does not occur until buildings are transacted. Secondly, and more importantly, larger specialist and sector-driven real estate investors generally require long term income and asset backing, and typically lock in terms for credit facility drawdowns from lenders. These investors tend to have large cash balances available to deploy, and a 5-6% return remains more attractive than keeping cash on hand.

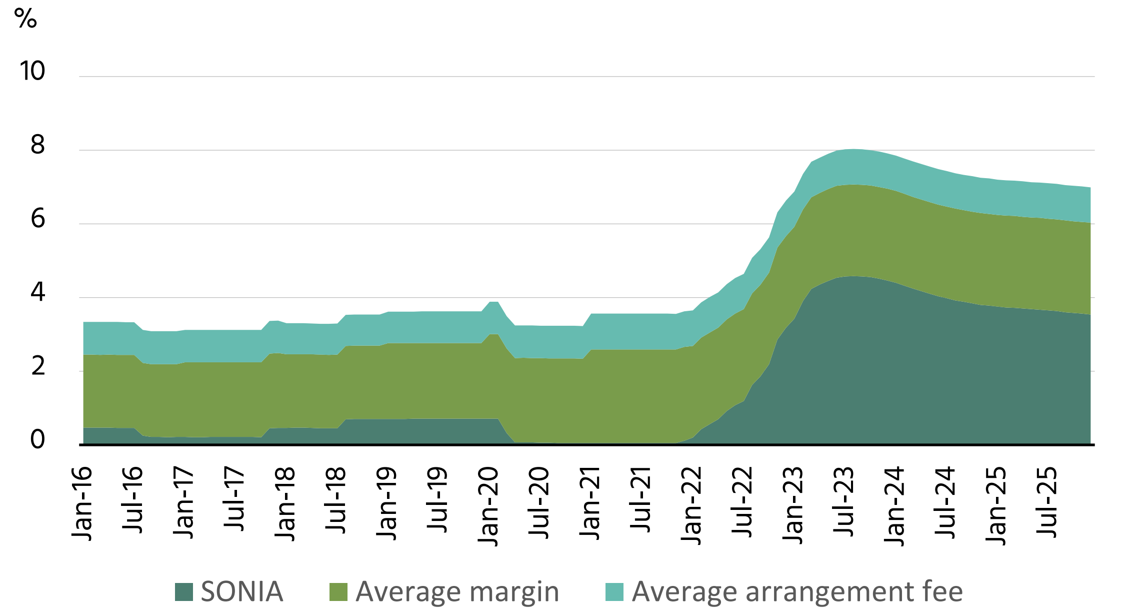
Thus this creates a two-tier market, with investors that have accessed debt at lower interest rates willing and able to pick up assets at discounted prices. However, this will likely mean that leveraged smaller investors and those that can only access debt at the current rate are no longer able to make competitive offers.

The forward SONIA curve suggests that the cost of accessing debt will remain above 7% until the end of 2025, so pricing on secondary assets is expected to be under pressure in the short term. Further fragmentation of the market into pricing segments as debt costs impact different investors and property types will be a key trend over the coming year.

Debt cost by property type vs equivalent yield
Source: Bank of England, Bayes Business School, Chatham Financial, MSCI



SONIA forward curve and projected all-in debt costs
Source: Bank of England, Bayes Business School, Chatham Financial



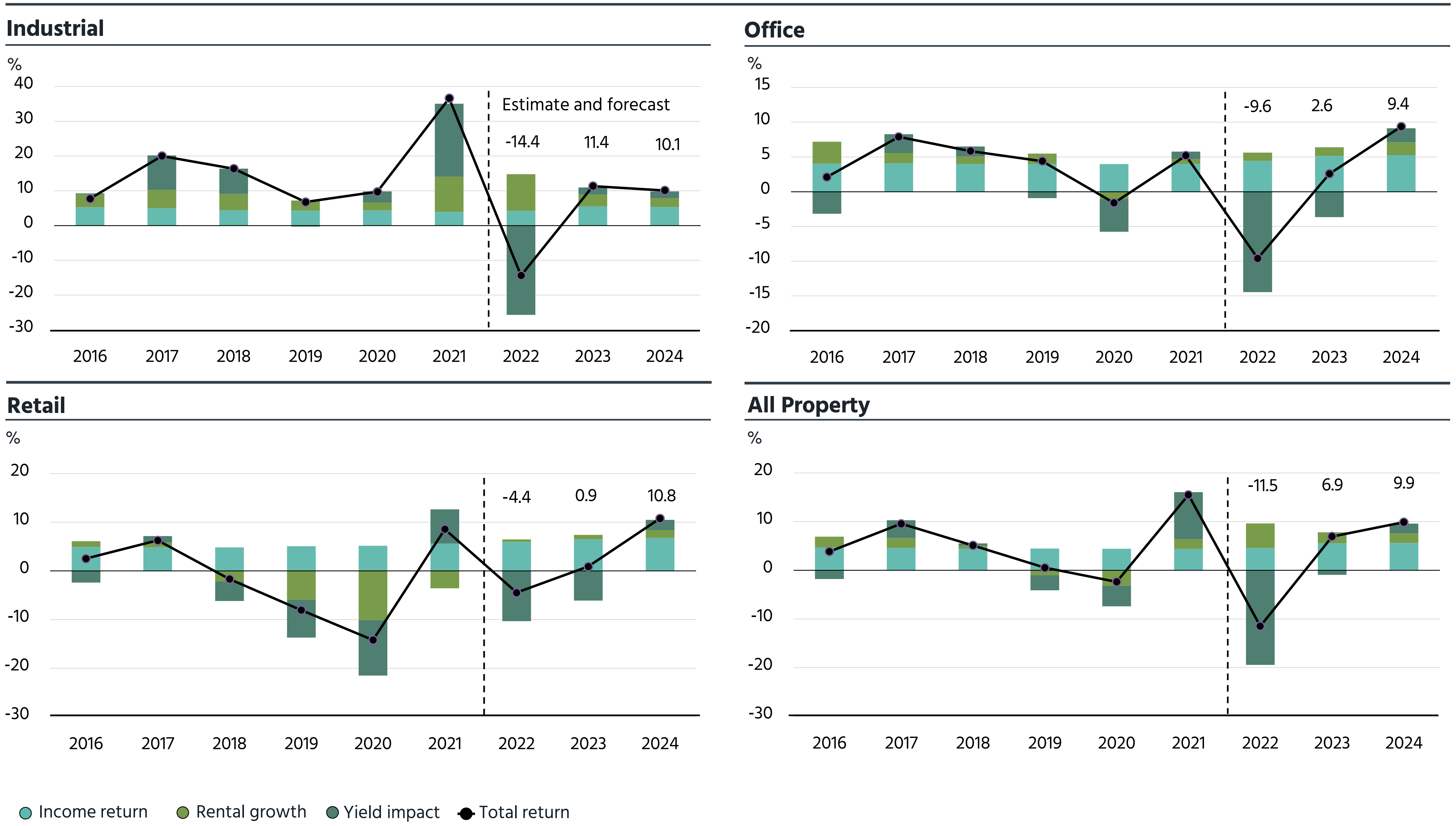
Outlook

Investor activity and sentiment is forecast to improve over 2023. Some of the worst interest rate fears from last September have not been realised, meaning some of the lowest-yielding property assets may have overcorrected and these yields will now come in a little. Meanwhile the more thinly traded higher-yielding segments may still require further softening to re-establish appropriate relativities. Consequently the recently reversed sector performance hierarchies will likely reverse back again to the longer-standing order by end-2023.

Industrial still sits relatively favourably amongst the other major property sectors. These are typically the lowest-yielding assets that arguably overcorrected in H2 2022. There is an overwhelming weight of capital targeting the sector, which is already driving yield compression in the direct market. Strong prime rental growth momentum has been maintained into 2023 across many regional markets in spite of the increased headwinds for occupiers. Void rates may rise somewhat over the short term but we do not expect rental growth to turn negative for this fundamentally robust asset class that is relatively well placed to deal with any upcoming challenges.

In contrast, **retail** and **offices** have more structural problems to deal with in addition to the economic malaise. **Office** prime/secondary polarisation is set to intensify while new development is restricted and hybrid working continues to impact occupancy of secondary space. The sector is due a broad occupier slowdown over the medium term while the global economy faces ongoing challenges. The significant capital value falls for **retail** property over the last several years should provide a small offsetting cushion for performance. Income will be the key positive driver of returns over the next few years and retail assets benefit from high income return.

Total return and components by sector, March 2023 forecast
Source: Gerald Eve, MSCI



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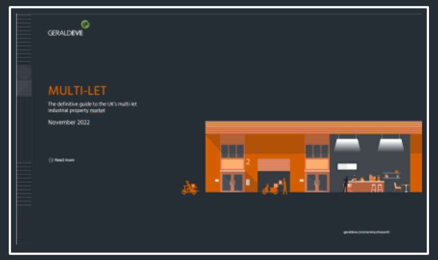

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Q4 2022

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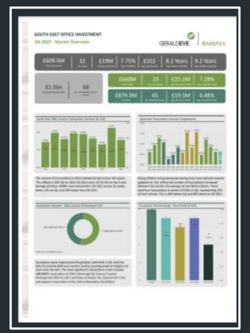
Q4 2022



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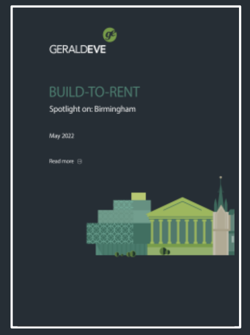

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