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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

April 2023

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APRIL UPDATE

The All Property average equivalent yield tightened in March and turned monthly total return positive for the first time since June 2022. It marks a peak-to-trough 147bp outward shift in yields that has taken 29% off capital values following the recent step up in interest rates and borrowing costs. Investment transactions remained low in Q1 as a hangover from weak Q4 activity last year. But investor sentiment and activity is much improved, and the weight of global capital set against limited investment supply has sharpened prime asset prices again.

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

£9.0bn ▼
All Property investment, Q1 2023

147bps ▲
All Property outward yield shift, June '22 – Feb '23

0.3% ▲
2023 GDP growth forecast

6.2% ▼
2023 CPI inflation forecast

3.3% ▼
2023 10-year government bond yield forecast

4.0% ▲
2023 unemployment forecast

All Property valuation yields reach a peak

All Property monthly total return turned positive in March for the first time since June 2022. On an annual basis, total return continued to fall more deeply into the red at -14.7%. This spans a sector range of only -7.9% for retail through to a huge -21.1% for industrial. Indeed, the 'best' performing segments overleaf are UK Shopping Centres and Leisure by virtue of the sharp repricing of stronger segments, such as London and South East Industrial. However, this new hierarchy is likely to be only temporary now that yields appear to have topped out in February.

The All Property average equivalent yield moved in slightly in March and generated some positive impact for capital values. It signals the effective end of the recent outward shift in yields following the step up in interest rates and borrowing costs that started in 2022. The All Property yield bottomed out at 5.15% last June and reached 6.62% in February, which was its highest since August 2014. Property yields may have moved out more rapidly than even during the financial crisis, but over this relatively short duration the peak-to-trough impact on capital values was only around 29%, compared with the staggering 74% over 2007-09. Moreover, the recent actual capital value fall was only around 17%, given the strong rental growth (primarily for industrial assets).

This repricing trajectory of valuation yields is an aggregated and smoothed version of what has been seen with greater volatility and responsiveness in the direct market. Yields initially pushed out more aggressively and have now come in over the past two months for lower-yielding assets such as industrial, but continue to drift out for others as segment relativities re-establish themselves. The average retail yield is now similar to where it was back in mid-2010, such has been the preceding yield drift since 2016. The current all-office yield is also back to 2013 pricing. In contrast, the average industrial yield, with rapid inward shift in recent years is back only as far as late 2017. Rental growth has been so strong in the interim that industrial capital values have lost even less ground and have fallen only to mid-2021 values.

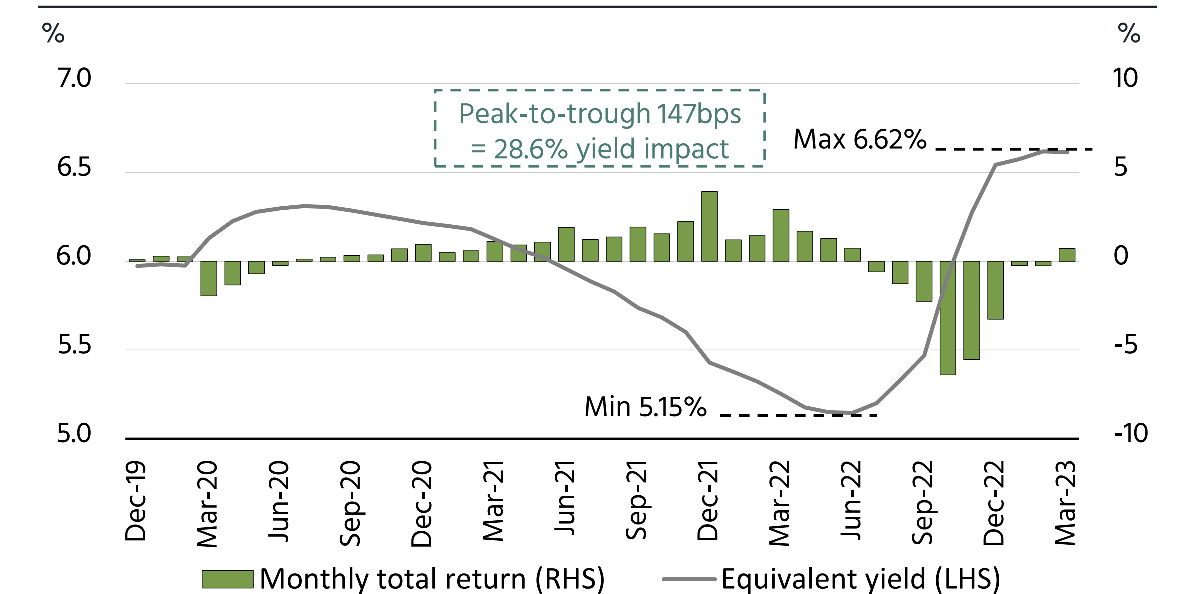
Despite the pricing rally for some prime assets in the direct market, investment volumes remained subdued in Q1 at £9.0bn. This was 58% below the £21.5bn that transacted a year ago in Q1 2022, with quarterly volumes having successively declined since then. However, transactional weakness was a reflection of ongoing muted activity in Q4 2022, with a limited number of deals under offer that could mature into completed transactions in Q1. The meaningful increase in investor sentiment and activity only really gained traction in the second half of Q1 and thus the current volume of stock either under offer or that has exchanged points to an increase in transactions volume in Q2.

There continues to be a flight to quality, with investor appetite focused on modern ESG credentials and strong underlying fundamentals. Realising potential income is key so assets with near-term reversion are particularly in demand, which might give some investors the ability to take on more debt if the cost and availability of lending is more accommodating into 2024 – this, however, is by no means certain. There is a continued weight of global capital, improved appetite from the UK funds, and portfolio activity has been trending upwards. However, the relative scarcity of suitable investment product continues to be an issue since most owners that do not need to sell are choosing to hold, and thus the level of bidding and pressure on pricing for the right kinds of assets is set to continue.

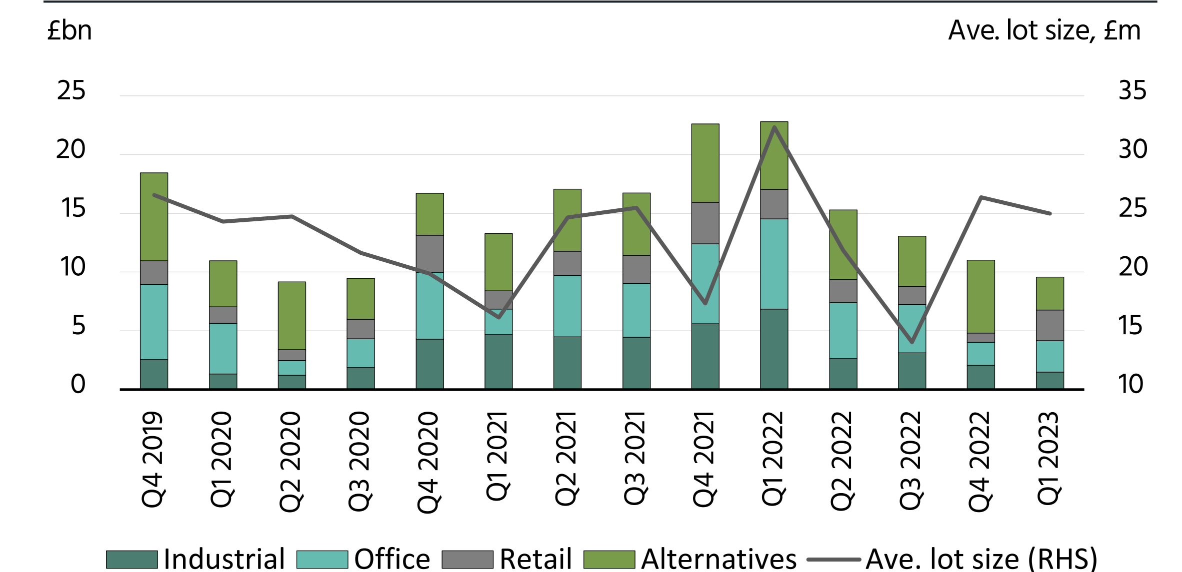
£9.0bn▼
All Property investment volume, Q1 2023

147bps▲
All Property outward yield shift, June '22 – Feb '23

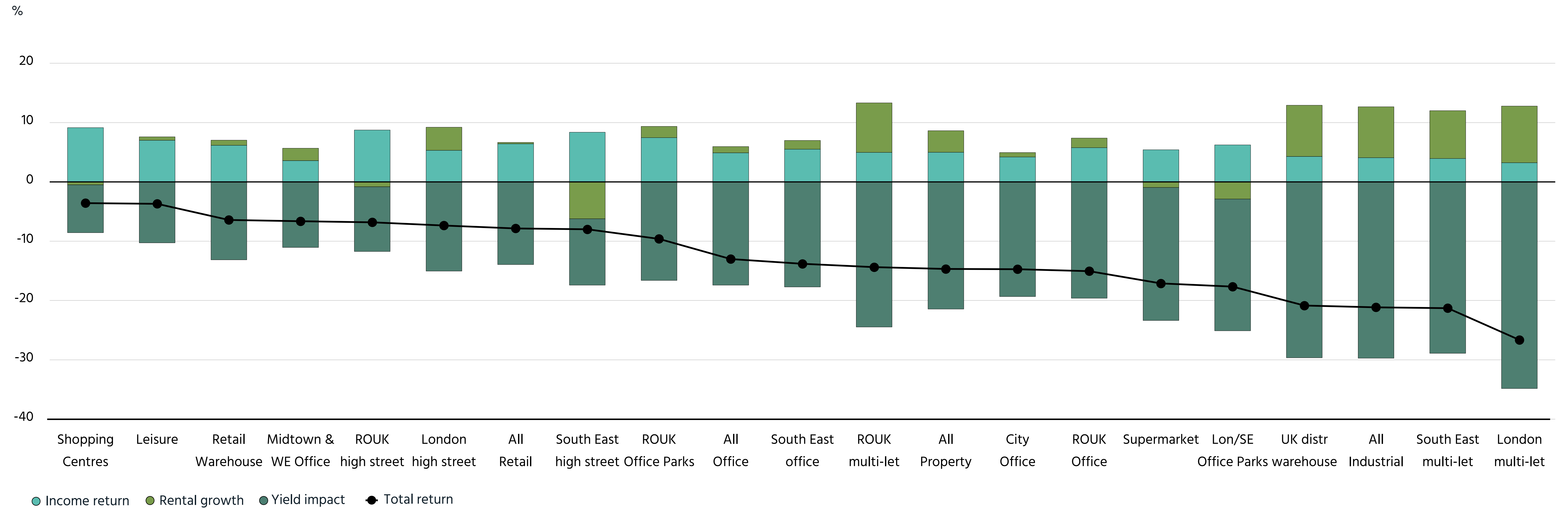
All Property equivalent yield and monthly total return
Source: MSCI, Gerald Eve



Quarterly investment volume by sector
Source: RCA, Gerald Eve



UK property segments



UK economy

UK GDP was unchanged in February, which reflects the current weakness and uncertainty in the economy set against some surprising resilience that has resulted in effective stagnation. Oxford Economics has revised its forecast for 2023 up to 0.3% growth but has downgraded its view for 2024 to 1.3%. Over the short term inflation should start to recede and take the pressure off falling real incomes, but over the medium term fiscal tightness will gain more traction and credit conditions are set to continue to limit the recovery for households and businesses.

Significant and widespread industrial action has added volatility to economic activity since late-2022. In December Royal Mail and railway workers took strike action along with nurses. In February there was the single biggest day of industrial action for more than a decade, which included teachers, civil servants and university lecturers. Some of the disputes have been resolved but some are ongoing, notably in the health sector, and the impacts are set to continue further into 2023.

Nevertheless, domestic demand appears to be gradually strengthening, despite high inflation squeezing real incomes. The retail sector is no longer in recession having been in broad decline since mid-2021. Consumer sentiment continues to be deeply negative but surprised on the upside again in April. Households are their least pessimistic since February 2022 following the drop in wholesale gas prices and the view that a recession will have been narrowly avoided.

The labour market has softened somewhat over the past six months (the number of vacancies has fallen, for example), but recruitment difficulties and private sector wage growth are very high by historical standards and show little sign of easing in the short term. Business sentiment indicators improved again in April, though there remained a significant margin between services and manufacturing, with the latter still in contraction territory.

CPI inflation has drifted down only gradually from its peak of 11.1% in October last year and defied expectations again to remain in double digits at 10.1% in March. The impact of falling wholesale energy prices will feed through to meaningful base effects on headline inflation in the second half of 2023 but core inflation can be notoriously sticky. The Bank Rate rose by 25bps to 4.25% in March. Concerns over persistent tightness of the labour market and services inflation means a further 25bps increase in May is now likely and has been priced in by the financial markets.

0.3% ▲
2023 GDP growth forecast

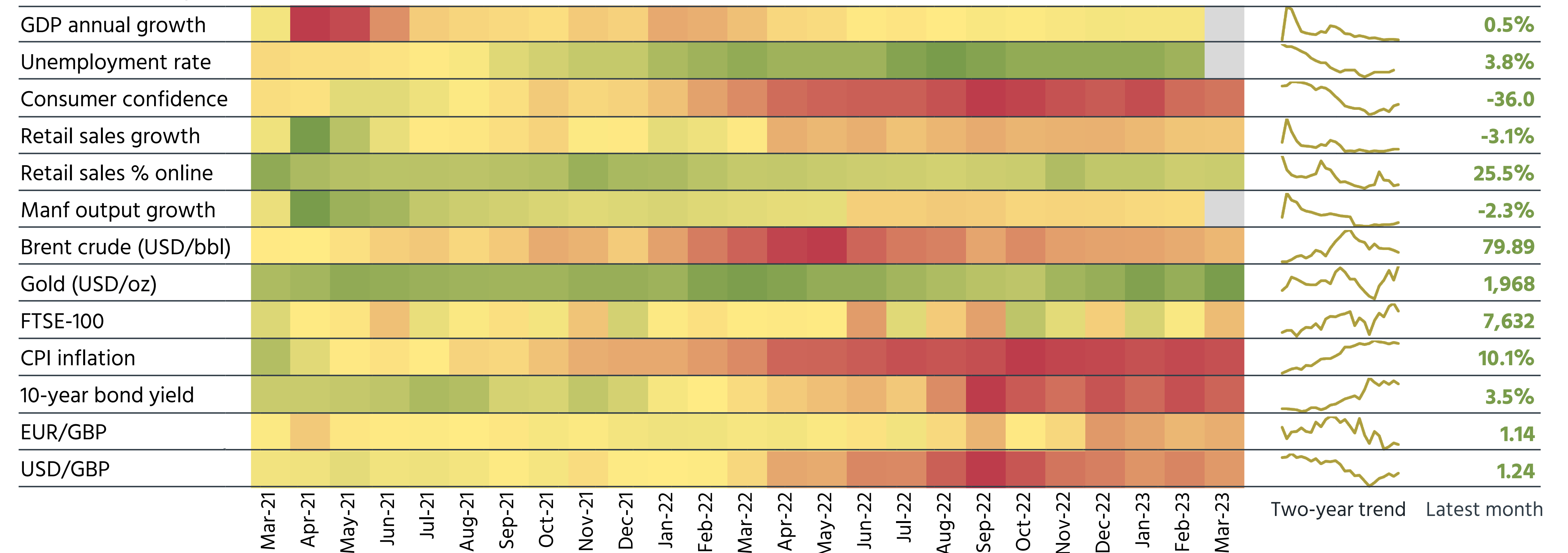
4.0% ▲
2023 unemployment forecast

6.2% ▼
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... UK insolvencies and multi-let industrial defaults

Subscribe to receive the May update of our Multi-let research, click here

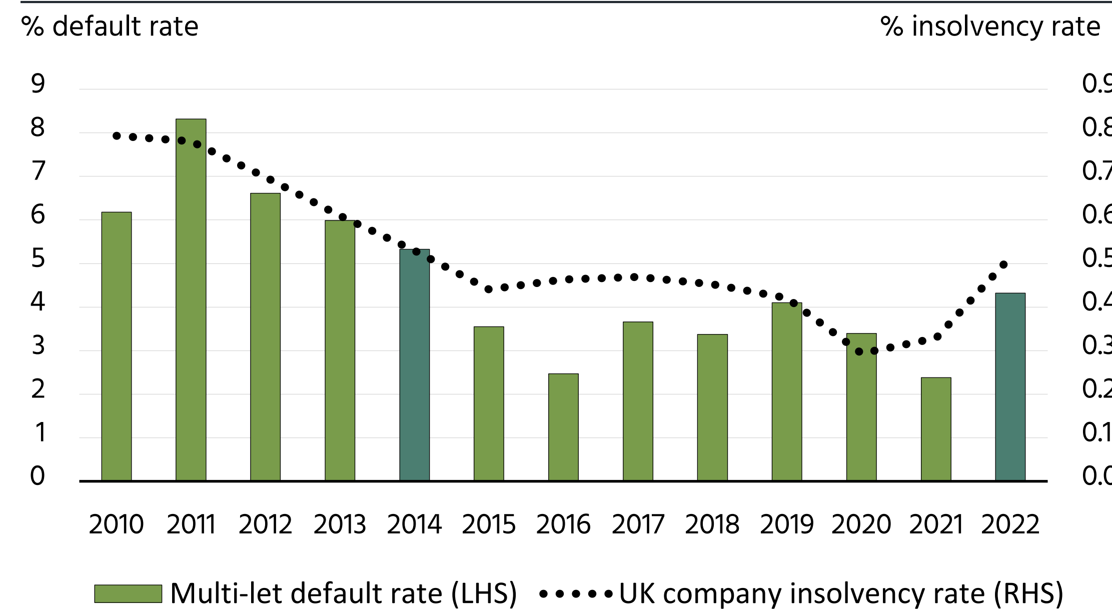
Initial data from our unique syndicated multi-let industrial study shows that the default rate nearly doubled to reach 4.3% in 2022, albeit from a record low in 2021. The 2022 default rate was the highest since 2014 but still far below the kinds of rates recorded after the financial crisis. The recent increase was unsurprising given the rise in the wider UK company insolvency rate following its sharp decline in 2020 amid various covid government support measures. Multi-let void rates increased moderately in both the London & the South East and Rest of UK markets in 2022, but the higher default rate alone was insufficient to drive the change. Churn rates have been similar to previous years but in 2022 led more frequently to void units, particularly in the more heated markets, such as London. This could be attributed to occupier affordability issues but could just as easily be landlord-led in seeking to move tenants on and achieve the full market rent reversion.

The multi-let default rate tracks the wider UK company insolvency rate fairly closely and thus the latter serves as a useful leading indicator. The chart below shows the quarterly rolling average of UK company insolvencies. This gives higher frequency and more timely insight than the annual version but irons out some of the monthly volatility. The trend has been upwards since mid-2021 and suggests there will be a significantly higher annual figure again for 2023. In fact, in March the UK insolvency rate was its second highest in history, fractionally below December 2008. Individual months of data are volatile but this is clearly something to watch very carefully. However, a direct translation to multi-let defaults that would materially impact void rates and ultimately rental growth is not a given. Current anecdote from the market does not suggest that insolvencies and defaults are playing much of a role and the sectoral data might be able to explain why this is the case.

Company insolvencies split by sector show no recent trends regarding the proportion attributable to each and have been quite stable over time. The averages shown below reveal a bias towards services/office-based sectors and construction, which accounts for well over half of the total. Multi-let has a diversified occupier base, taking tenancies either derived by or directly for a broader non-traditional range of activities that include leisure, the arts and healthcare. This diversity of demand gives the asset class flexibility and robustness during a slowdown. But in addition the occupier footprint is skewed away from where business insolvencies are most prevalent, with a greater focus on retail & logistics and manufacturing. There is a relatively smaller share of office-based and construction activities, which presents a kind of "best of both" structure, particularly during a time of economic weakness.

UK multi-let default rate and company insolvency rate

Source: Gerald Eve, The Insolvency Service, ONS

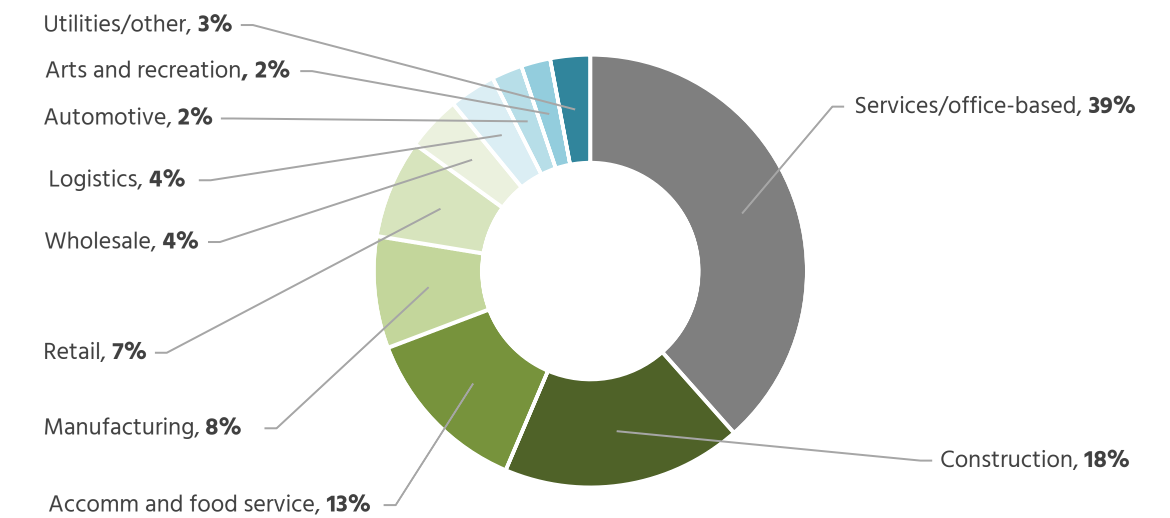


Rolling UK quarterly insolvencies to March 2023

Source: The Insolvency Service, ONS, Gerald Eve

UK 3-year average proportion of insolvencies by sector

Source: The Insolvency Service, Gerald Eve



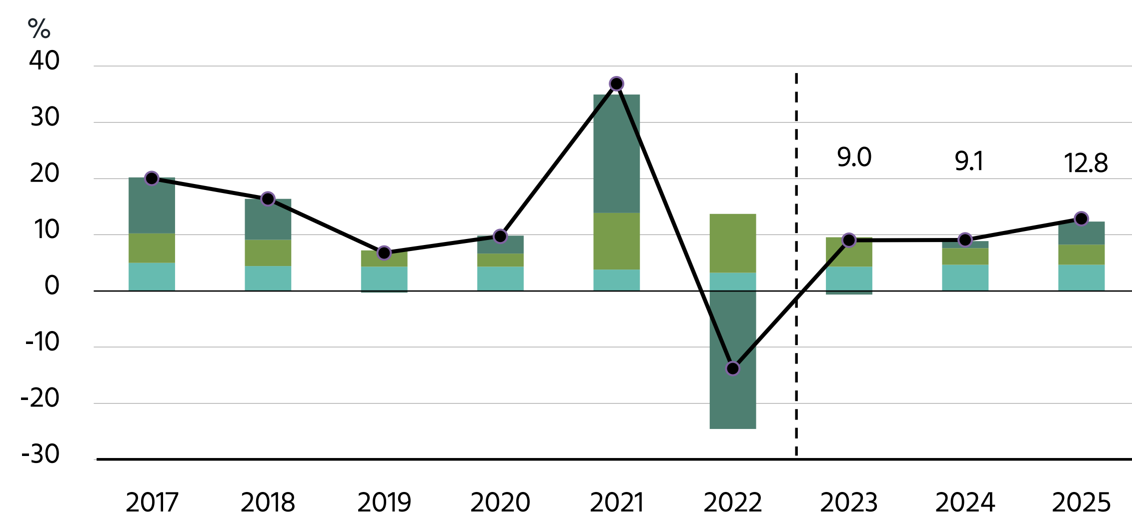
Outlook

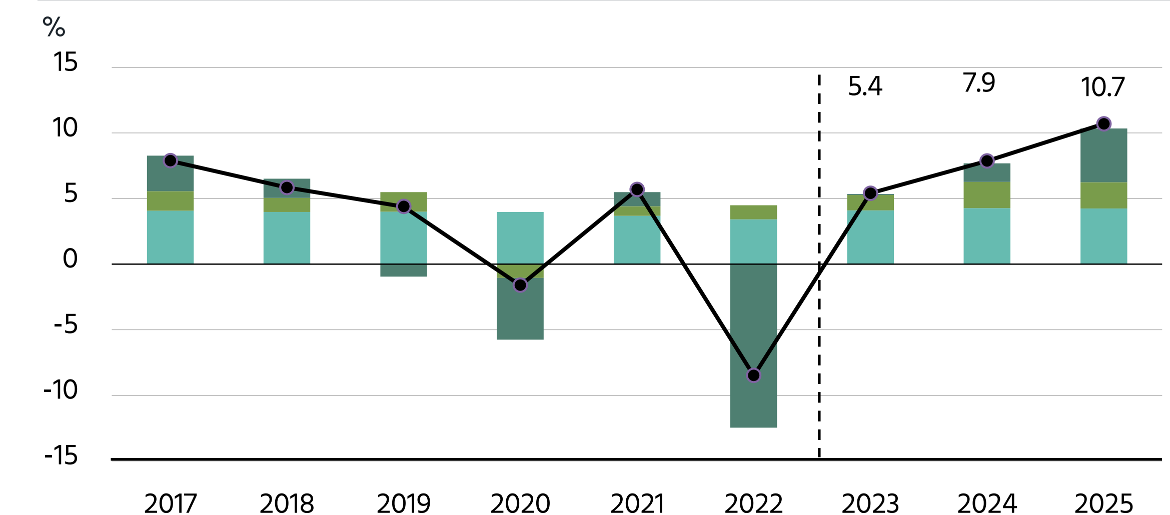
Investor sentiment and activity have broadly improved now that some of the worst interest rate fears from last year have not materialised. However, the outlook has become more hawkish recently and the bond yield assumptions underlying the forecasts are around 50bp higher. The returns outlook has thus been revised down. Moreover, in 2022 the various property segment yields concertinaed together so as this is unwound from 2023 the lowest-yielding property assets (industrial) will outperform the more thinly traded higher-yielding segments (retail) as they re-establish appropriate yield relativities.

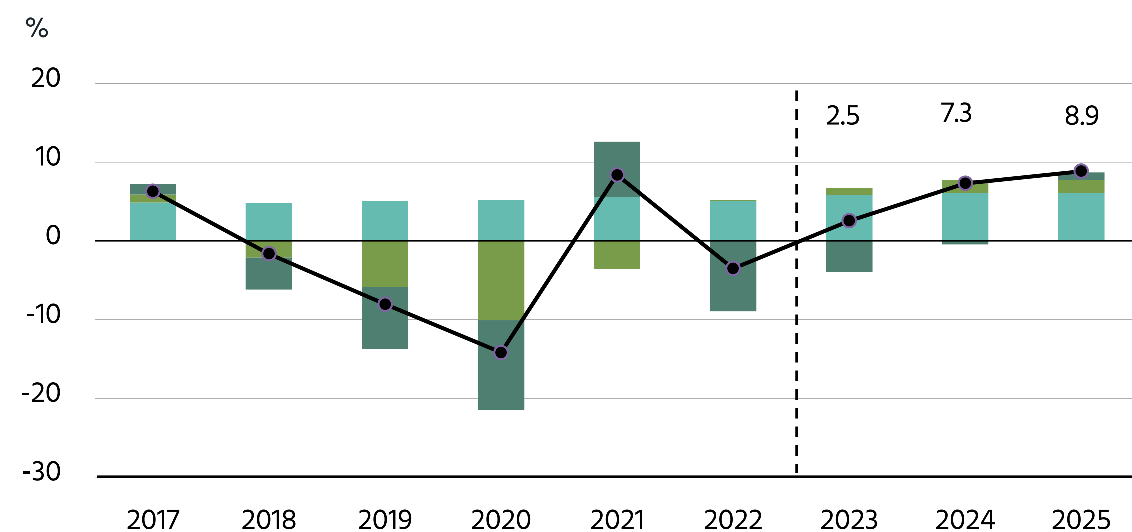
Industrial still sits relatively favourably amongst the other major property sectors. These are typically the lowest-yielding assets that arguably overcorrected in H2 2022. There is a significant global weight of capital targeting the sector, which is already driving yield compression in the direct market. 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 rental growth will remain positive for this fundamentally robust asset class that is relatively well placed to contend with the current economic slowdown.

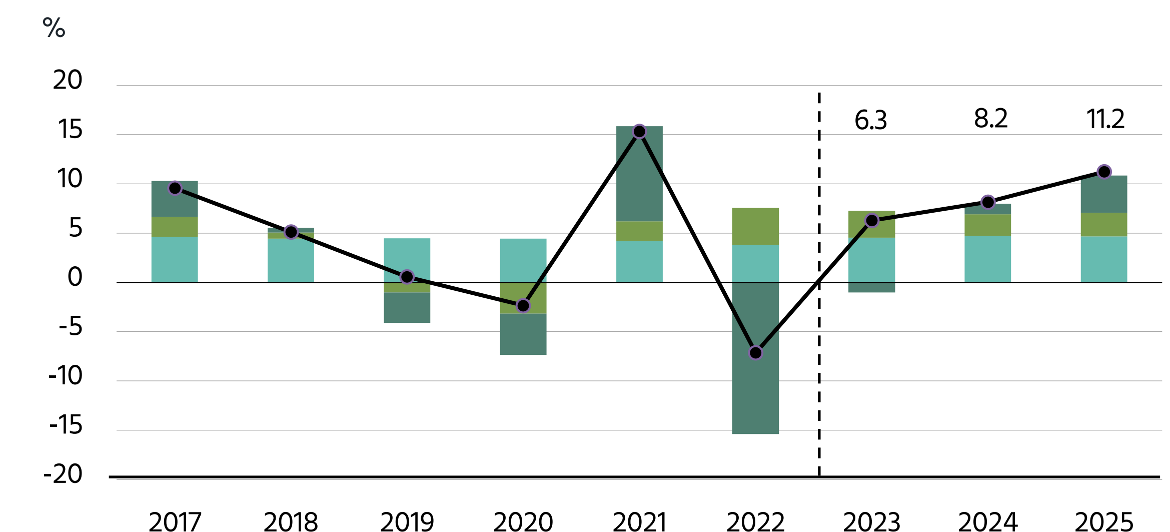
In contrast, **retail** and **offices** have more structural problems to deal with. **Office** prime/secondary polarisation is set to intensify while new development is restricted and hybrid working continues to impact occupancy of secondary space. Tenant demand will remain subdued over the medium term 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 in the form of relatively greater income return.

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









Income return | Rental growth | Yield impact | Total return

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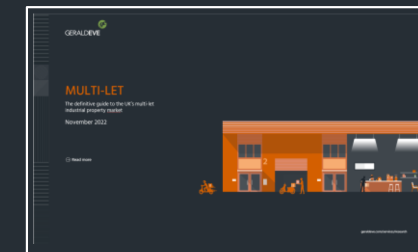
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