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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

June 2023

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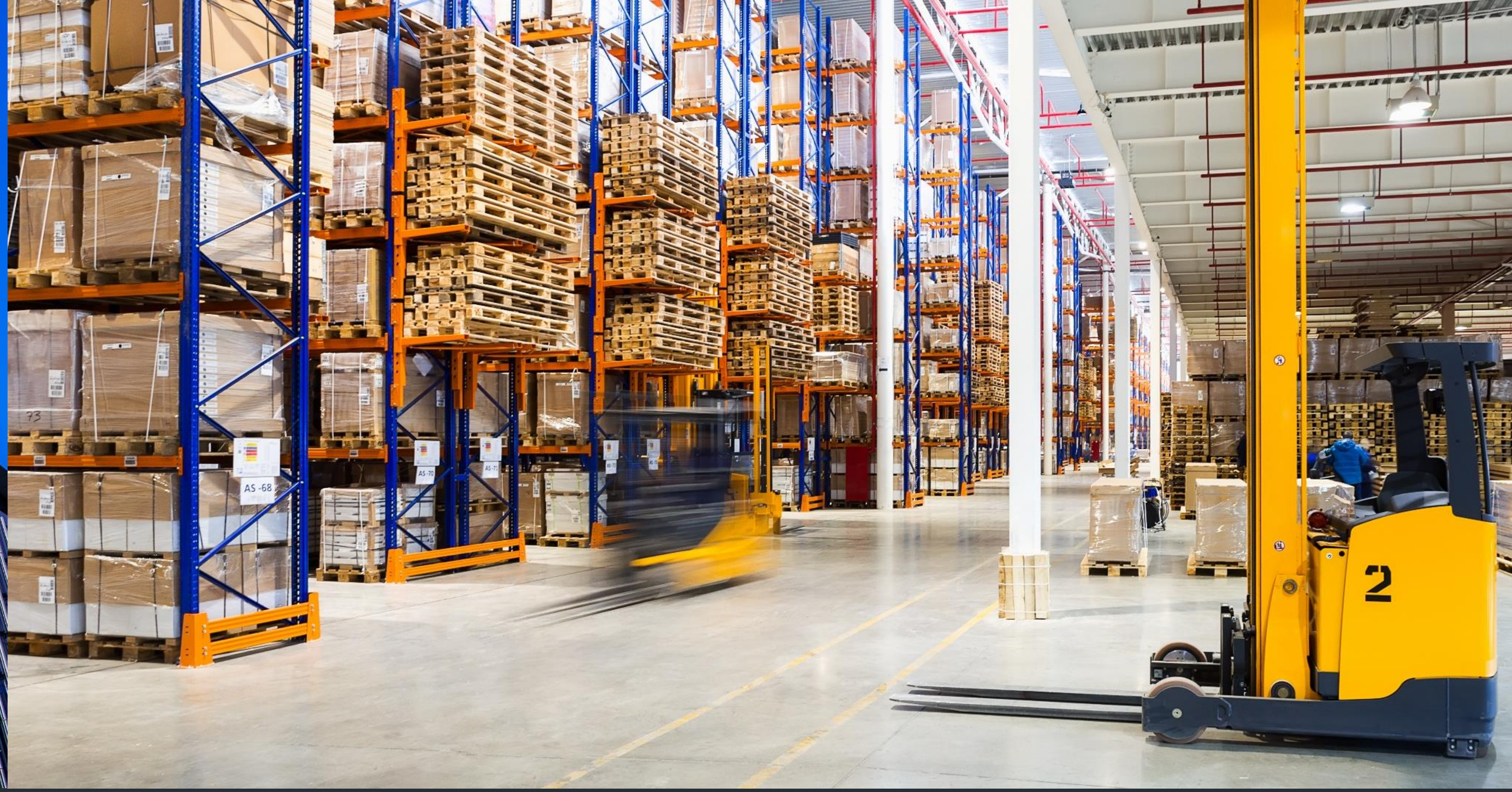
JUNE UPDATE

Valuation yields across all sectors continued to plateau in May and have effectively been unchanged for the entirety of 2023. The outlook for the real economy has been downrated given the more hawkish outlook for interest rates, which will present challenges for most occupiers across all segments. However, the lack of development supply will help underpin rents in some instances. A lack of trades makes it difficult to point to transactional evidence yet, but the sharp rise in the cost of debt means All Property yields are forecast to soften a further 50bps this year and generate a second year of negative total return.

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



1.7% ▲
All Property quarterly total return, May 2023

10.58% ▲
Potential peak all-in cost of debt for commercial property

0.8% ▲
2024 GDP growth forecast

3.6% ▼
2024 average CPI inflation

5.75% ▲
End-2023 Bank Rate

4.0% ▲
End-2024 10-year government bond yield

All Property set for a second year of negative total return

Valuation yields across all sectors continued to plateau in May and have effectively been unchanged for the entirety of 2023 after their outward shift at record speed in late 2022 . With yield stability, quarterly total return has mostly turned positive across the segments after posting deeply negative figures at the end of 2022 and into early 2023. All Property quarterly total return was 1.7% in May, while on an annual basis the figures continue to drift downwards, with All Property total return at -16.3%.

The outlook for the real economy has been downrated given the more hawkish outlook for interest rates, which will present challenges for most occupiers across all segments. So-called 'pandemic winners' - typically in the industrial sector - had in places overstretched on taking new space during covid, while the pandemic causalities - typically in the retail and offices sectors - are still in some cases adapting to the revised economic and societal circumstances they now operate in. All occupiers continue to be impacted by mounting operational cost pressures, and while inflation rates may be on the way down, progress has been sluggish. Part of these increased costs include the step up in business rates in April and strong passing rental growth in those stronger-performing segments where rental reversion is high.

There has been a broad slowdown in occupier activity, evidenced by reduced take-up and increased sub-letting, while positive rental growth has also cooled. More positively though, despite the erosion of real household incomes, the retail sector is out of recession. Manufacturing output continues to fall and sentiment is relatively weak, but occupier demand for industrial has picked up some of the slack left by online retailers. Meanwhile there is activity in prime office markets even if secondary segments have insufficient post-pandemic demand and EPC regulatory issues to contend with. More broadly, capital values at or below land plus replacement cost will limit new development in markets and help underpin rents.

In the investment market, the unchanged valuation yields and lack of transactions in 2023 belie greater potential upcoming volatility. The estimated all-in cost of debt is calculated here as the average lending margin and arrangement fee plus SONIA. This has more than doubled following 13 consecutive Base Rate rises, most recently the 50bps increase to 5.00% in June. The renewed step-up in interest rate expectations has impacted investor sentiment and means the potential cost of debt is projected to peak at an incredible 10.58% by end-2023 – in excess of most property segment equivalent yields.

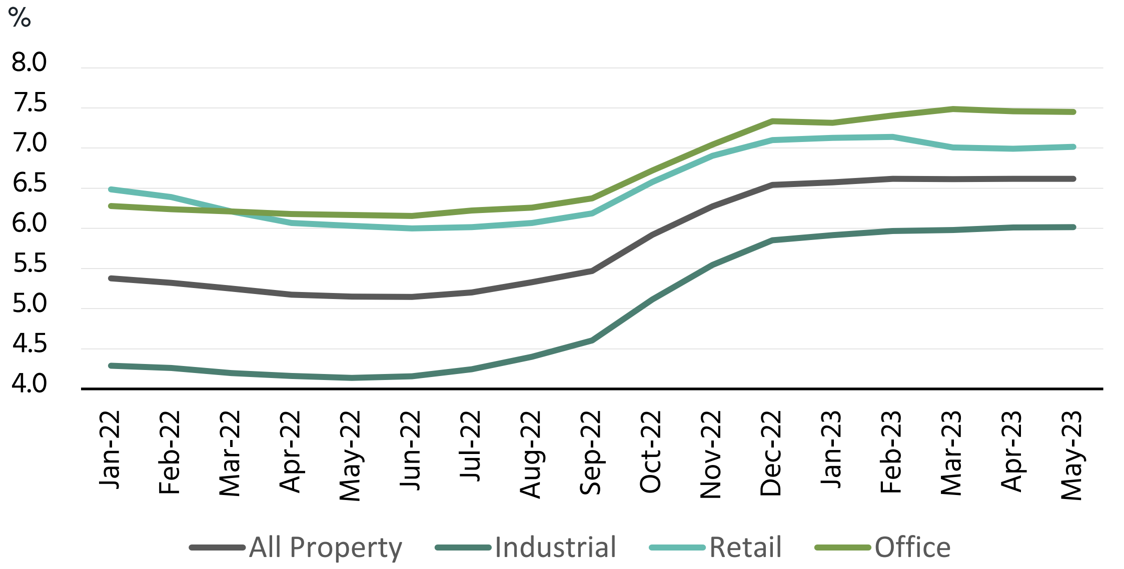
However, it is currently difficult to point to transactional evidence on changes to pricing, given the lack of investment stock in the market. There's still a significant weight of money targeting UK commercial property, with industrial typically the favoured option. And while current yields are low in the context of all-in debt costs, some investors are looking beyond the short-term volatility and buying with all-equity in anticipation of rates potentially beginning to fall in 2024.

Equilibrium yield modelling suggests that the spread between where yields are and where they 'should' be has widened again. Thus the recent yield peak looks to have been an inflection point and modelled yields are set to soften a further 50bps this year. This means another year of negative yield impact for commercial property in 2023, though this is expected to be less than half of the magnitude of 2022.

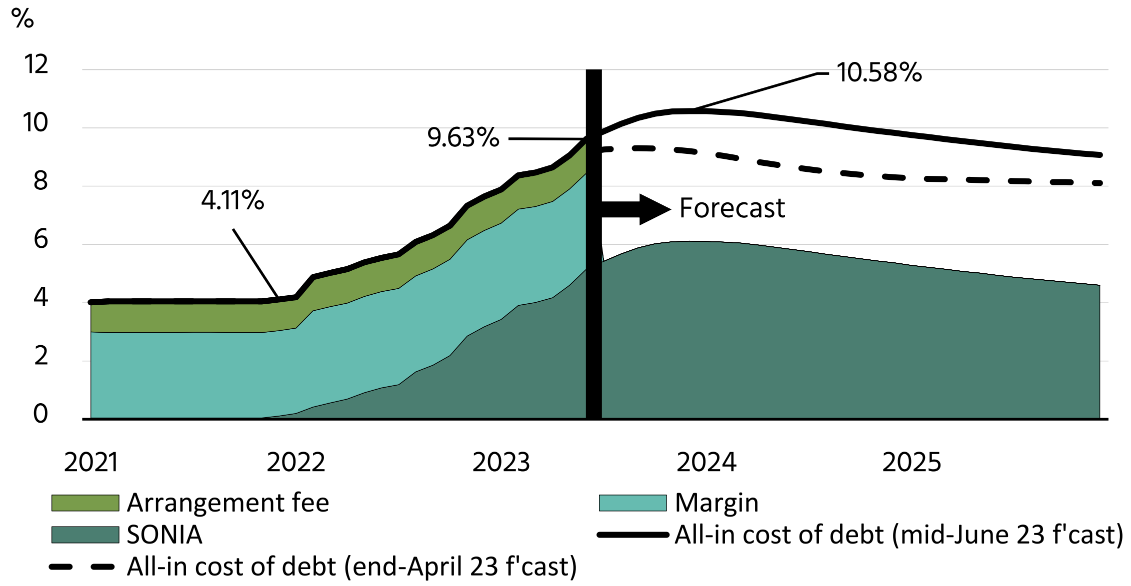
1.7% ▲
All Property quarterly total return, May 2023

10.58% ▲
Potential peak all-in cost of debt for commercial property

Equivalent yields by sector
Source: MSCI, Gerald Eve

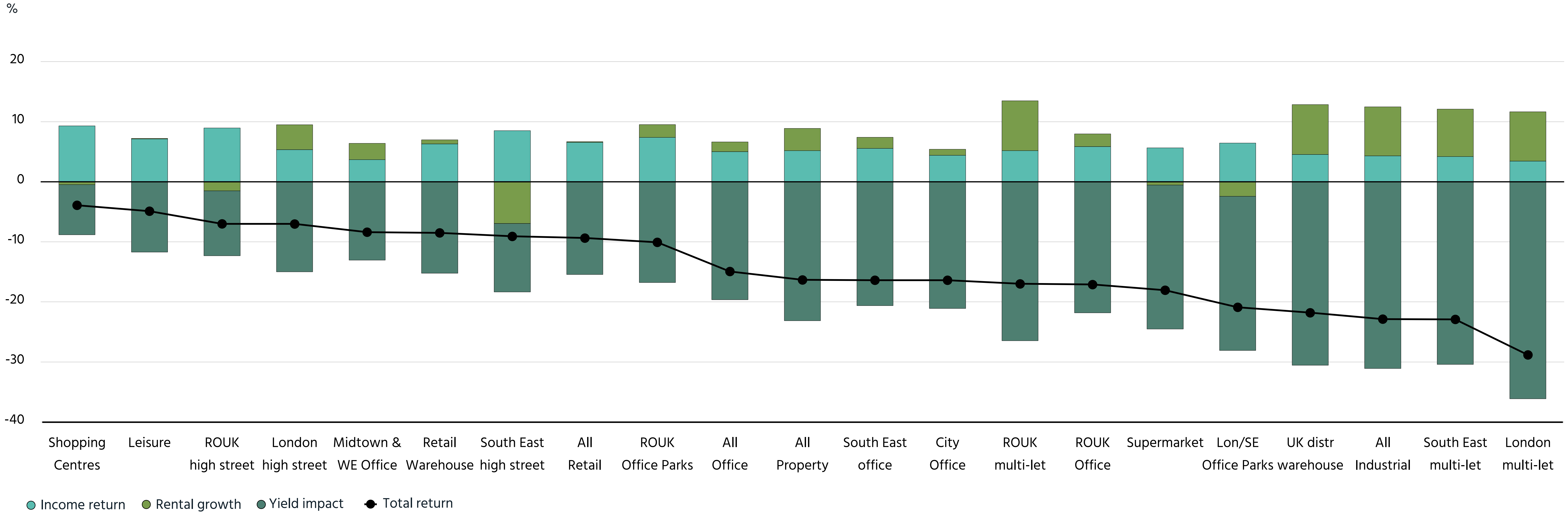


All Property all-in cost of debt and components
Source: Gerald Eve, Bayes Business School, Chatham Financial



UK property segments

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



UK economy

UK GDP increased by 0.2% month-on-month in April following a decrease in March, and the economy continued to effectively flatline as it has over the rest of the first half of 2023. Some of the stronger elements in April were related to activity in the consumer sector, such as accommodation and food, car sales, and retail spending. Consumer confidence has been relatively upbeat, given the fall in energy prices and ongoing strength in the labour market. In contrast, manufacturing output fell by 0.3% and was 0.8% lower than a year ago.

A much more hawkish outlook for monetary policy has cut Oxford Economics' forecast for annual GDP growth to 0.4% in 2023 and 0.8% in 2024. Risks are also skewed to the downside, with numerous other forecasters predicting that the necessary path for monetary policy to bring core inflation under control will push the economy into recession next year.

The Bank Rate increased 50bps to 5% in June after CPI inflation surprised again on the upside in May and remained at 8.7%. Having initially been caused by external energy price rises UK inflation is now being driven by second-round domestic private sector pay growth and services inflation. Job vacancies and recruitment difficulties in the labour market are set to continue to remain tight despite flatlining GDP, given the ongoing increase in the number of people reporting they are unable to work due to long-term sickness.

While energy prices will continue to fall and food price inflation should begin to cool, sticky core inflation means Oxford Economics expects CPI inflation to end 2023 at around 5% and not return to the 2% target until early-2025. The forecaster also expects the Bank Rate to peak at 5.75% by the end of the year, but the market SONIA forward curve is more pessimistic, with an implied peak of 6.25%. This is possible and would be consistent with pushing the economy into recession.

The end of pandemic and energy-related stimulus combined with a range of tax increases mean that back-loaded fiscal policy will tighten substantially over the next five years, not dissimilar in magnitude to post-GFC austerity. In the corporate sector, the pandemic triggered a sharp drop in capital spending that has not fully recovered. Some firms amassed significant cash over the pandemic, but many smaller firms have far higher debt than previously and will be more sensitive to interest rate changes. Meanwhile goods exports remain below pre-pandemic levels, in part due to post-Brexit UK-EU trade frictions.

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2024 GDP growth

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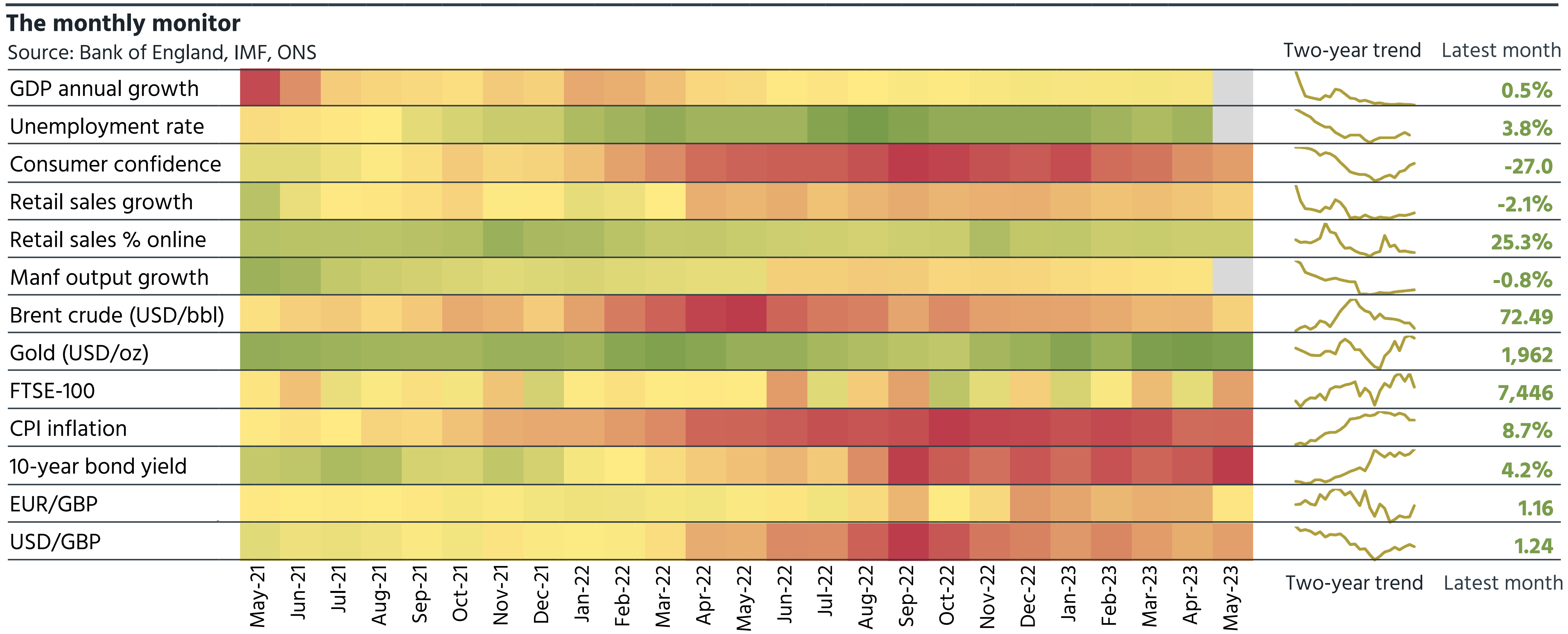


Spotlight on... EPCs and multi-let industrial refurbishments

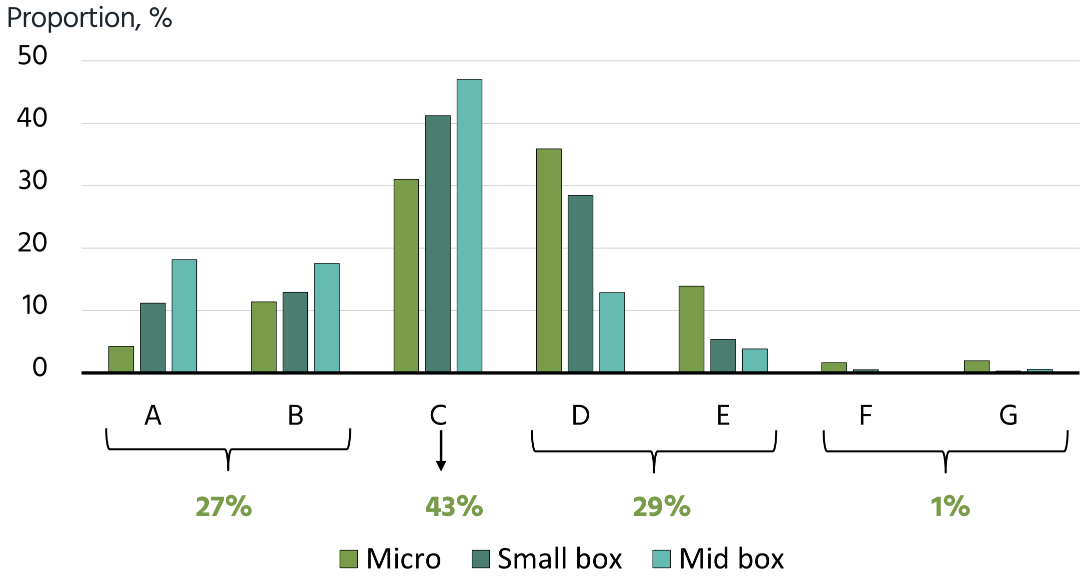
The Minimum Energy Efficient Standards (MEES) dates for compliance. Landlords may not let or continue to let non-compliant units as per below:

APRIL 2023
EPC grades **F&G**

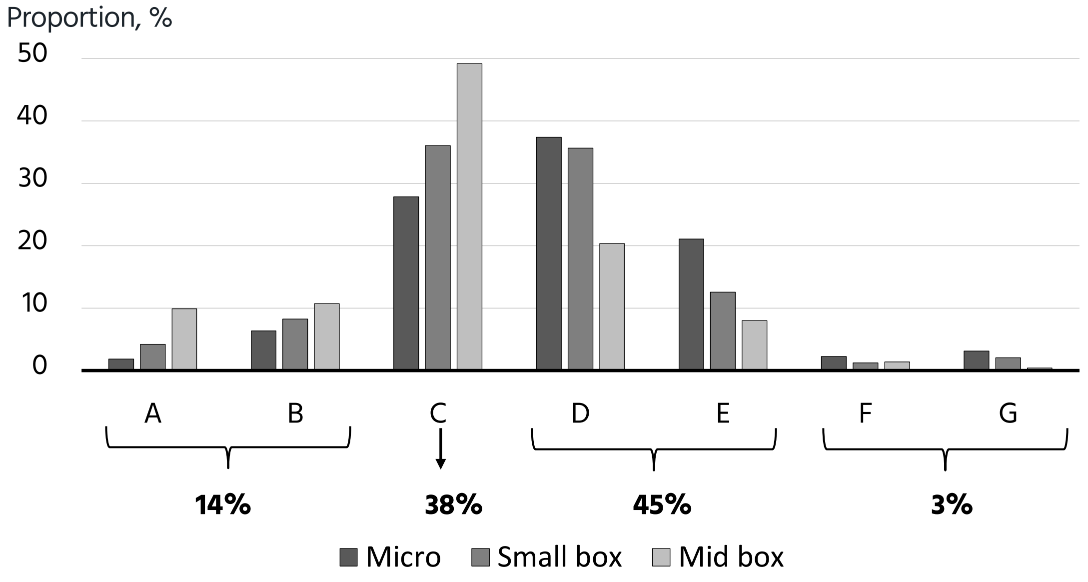
APRIL 2027
EPC grades **D&E**

APRIL 2030
EPC grade **C**

London & the South East multi-let by EPC grade
Source: Gerald Eve



Rest of UK multi-let by EPC grade
Source: Gerald Eve



The Minimum Energy Efficient Standards (MEES) can be fluid and at times opaque. The formulation for how certain attributes in particular combinations qualify for different EPC scores is not made public and can shift from one year to the next. However, the regulatory deadlines opposite have now been established.

The Multi-let EPC distribution spans from A – G and is split here according to major UK geography and by size of unit. The main cluster for both regions continues to be around grades C and D but there have been changes to the landscape since EPC information was introduced in the last Multi-let study with the 2021 data.

Around 1% of the market in London & the South East and 3% in the Rest of the UK at end-2022 were graded EPC F or G. This is down from 2% and 5% last year, respectively. This now represents a tiny proportion of the market that required refurbishment in Q1 this year in order to remain compliant and lettable from April.

The next set of regulatory hurdles for multi-let affect a far greater number of units. All D & E-rated units must be upgraded by April 2027 and all C-rated units must be upgraded by April 2030 to remain compliant. These groups have been whittled down slightly since last year and details of the changes are analysed overleaf. But these grades of units will need sustained attention over the next several years if all regulatory requirements are to be met.

As of end-2022, 30% of London & the South East multi-let floorspace required an upgrade by April 2027, which increases to a much larger 73% needing an intervention by 2030. In the Rest of the UK, these respective figures are 48% and 86% so this will continue to be a key topic for the next several years.

Spotlight on... EPCs and multi-let industrial refurbishments

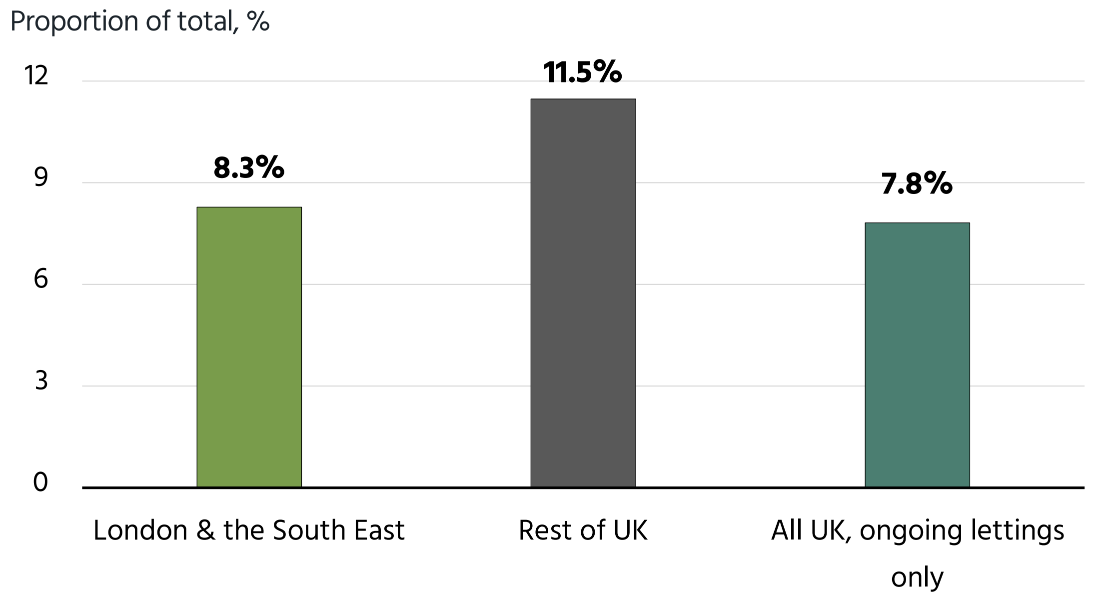
In London & the South East 8.3% of C-G rated floorspace underwent an EPC improvement in 2022. A larger 11.5% of equivalent floorspace was uprated in the Rest of the UK. It is also important to ascertain if units have been refurbished in this way during an ongoing letting since the wording of the MEES regulations is that landlords “may not continue to let” non-compliant units and thus many will have to be improved in this way, with no window of vacancy.

Across UK multi-let 7.8% of units rated C-G with an ongoing letting were improved in 2022, which was only a slightly lower proportion than all multi-let floorspace. This shows that an EPC upgrade for a unit with uninterrupted occupancy and income stream with no window of vacancy is broadly possible for multi-let, which is arguably less doable for the other property sectors.

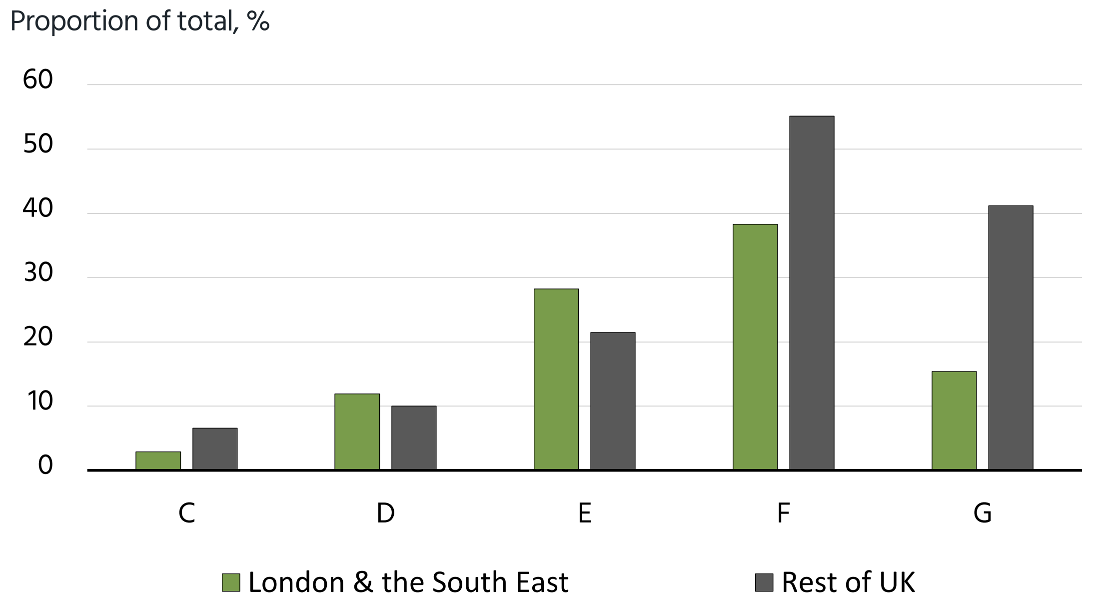
The most common grades to be given an uprating were, unsurprisingly, those rated F and G in 2021. Over 50% of all F-rated floorspace in the regions was uprated in 2022. Floorspace rated D & E face the next regulatory hurdle and between approximately 20% and 30% of EPC E floorspace and around 10% of grade D was uprated in 2022. It is encouraging that multi-let landlords are engaging with this process and means we can look relatively favourably to the next deadline in 2027.

The donut charts show the range of destination EPC grades for the two major UK geographies. The most popular destination grade for London & the South East was EPC grade B, whereas the Rest of the UK was a C. Similarly, the most popular EPC grade destination UK-wide for an ongoing letting in 2022 was a C, which might indicate that this is typically the highest that can be achieved without impacting a sitting tenant too problematically.

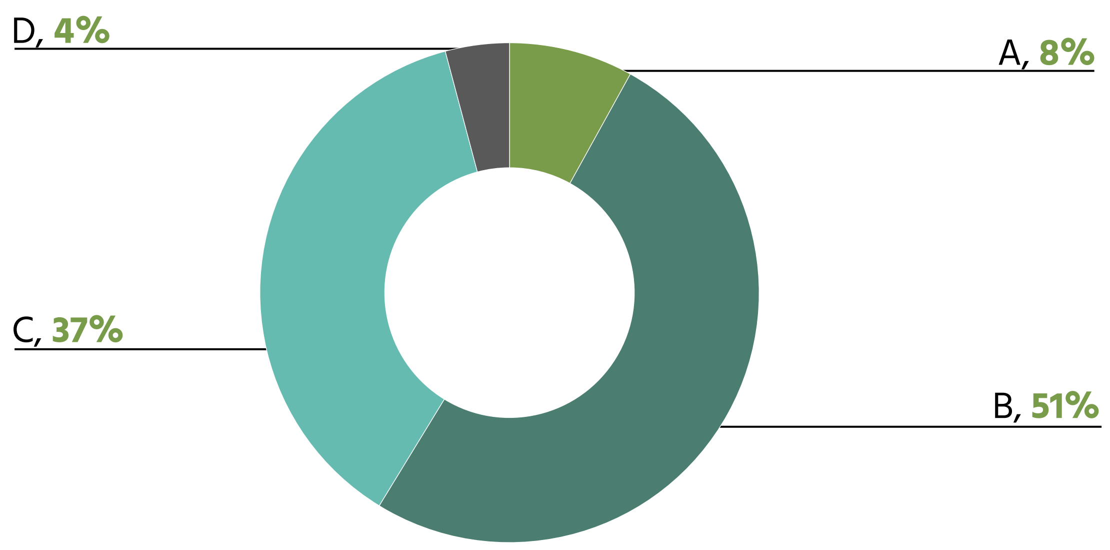
Proportion of floorspace uprated, 2021 EPC grade C-G
Source: Gerald Eve



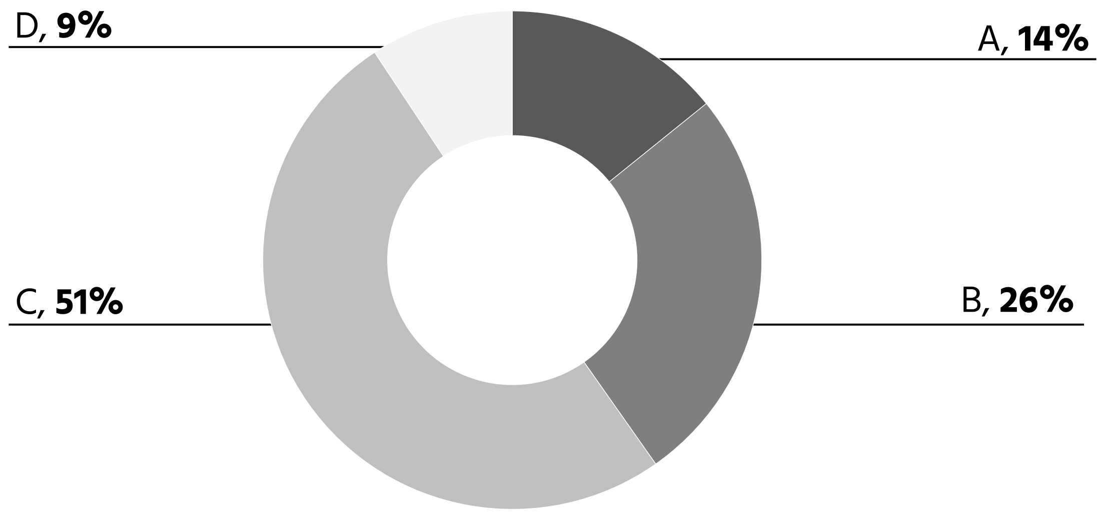
Proportion of floorspace uprated, by 2021 EPC source grade
Source: Gerald Eve



London & the South East 2022 uprated EPC grade
Source: Gerald Eve



Rest of UK 2022 uprated EPC grade
Source: Gerald Eve



Outlook

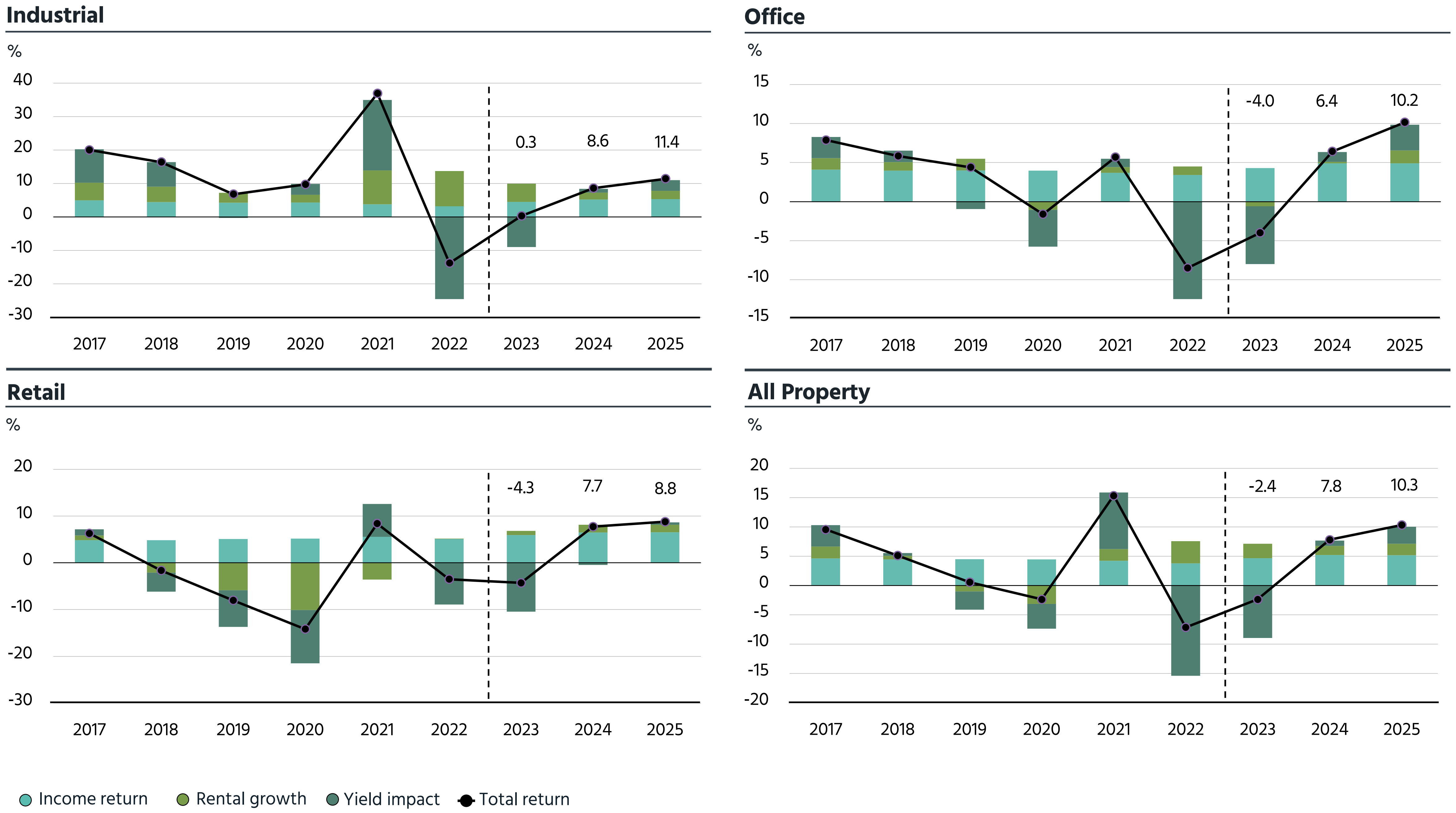
The recent increase in inflation and interest rate expectations points to a trajectory of higher bond yields, swap rates and commercial debt costs - and for a longer duration. Consequently, the outlook has been revised downwards, notably for 2023 where we now expect All Property return to be negative for a second successive year. Yield impact will continue to be negative but is forecast to be only around half of the rate of 2022. We anticipate any further correction to be limited to 2023 and for annual total return across all segments to turn positive again in 2024.

Industrial still sits relatively favourably amongst the other major property sectors. There is a significant global weight of capital targeting the sector set against very limited investment supply, which will help moderate any outward yield shift. Rental growth may have cooled, but this is from very strong rates in 2021 and 2022. Void rates and default rates have ticked up, and subletting has also increased. However, we remain upbeat on the robustness of industrial's diverse occupier base and expect market rental growth to remain positive, helped in part by greater flexibility from landlords.

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 new working practices continue to negatively impact occupancy of secondary space. Meanwhile strength in the labour market and a moderation in energy bills have given households greater optimism about the economy and their own finances, but real incomes are set to fall further as ongoing price rises and increased mortgage rates gain traction, which can only impact the **retail** sector negatively. The significant capital value falls for retail assets 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, June 2023 forecast

Source: Gerald Eve, MSCI



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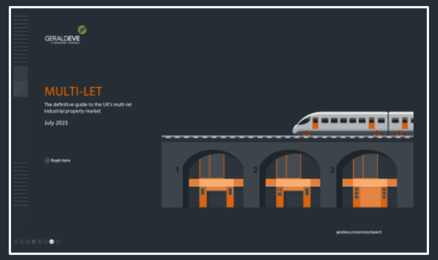
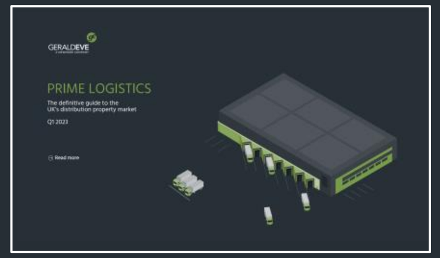
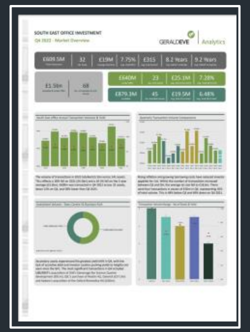


Multi-Let
July 2023



Prime Logistics
Q1 2023

London Markets
Q1 2023



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MEES - EPC UPRATING

MEES - EPC uprating
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RATING UPDATE - NEW RATING BILL ANNOUNCED

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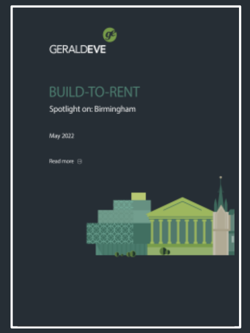

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