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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

August 2023

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AUGUST UPDATE

All Property quarterly total return edged down from 1.0% in June to 0.4% in July following a further tick up in the average commercial property equivalent yield. The steep rise in interest rates has been met with a relatively more moderate increase in property equivalent yields despite their moving out at a record rate in Q4 2022. Retail and industrial valuation yields have been relatively stable so far over 2023, with only office pricing drifting and moving out more sharply in the last two months.

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0.4% ▼
All Property quarterly total return, July 2023

48bps ▲
UK office outward yield shift in 2023

0.4% ▼
2024 GDP growth forecast

3.2% ▼
2024 average CPI inflation forecast

5.50% ▲
End-2023 Bank Rate forecast

4.0% ▼
End-2024 10-year government bond yield forecast

Office yields soften further while other sectors remain stable

All Property quarterly total return edged down from 1.0% in June to 0.4% in July following a further tick up in the average commercial property equivalent yield. The top right chart shows the steep rise in bond yields and the relatively more moderate increase in property equivalent yields despite their moving out at a record rate in Q4 2022. Retail and industrial valuation yields have been relatively stable so far over 2023, with only office pricing drifting and moving out more sharply in the last two months.

Not only was the **retail** yield essentially flat at around 7% again in July, but all subsectors such as high street, shopping centres, retail warehouse, supermarket and leisure were similarly unchanged as they have been all year. Retail valuations have lost significant ground against the other property sectors over the past 10 years, though there have been contrasting fortunes for retail warehouses, which have been more suited to societal shifts than the other formats. Nevertheless, yields are still lower than what the current economic fundamentals imply they should be. The retail sector came out of recession earlier in 2023 but the path ahead continues to be uncertain, given that real incomes are still falling, and as higher interest rates increasingly gain traction. Retail rents fell 17.5% over March 2018 to March 2022 and have been flat over the past year with rental growth hovering around zero.

Industrial valuation yields were effectively unchanged in July, but they have been drifting very gradually over 2023, with an increase of as much as 23bps in London multi-let. As the lowest-yielding segment it is arguably the most exposed to increased debt costs, but investors continue to be attracted to the sector. It has relative strength and diversity of occupier income and some of the most future-proofed assets without the more complicated EPC-related hurdles facing the other property sectors. The weight of equity and low transaction volumes is maintaining values.

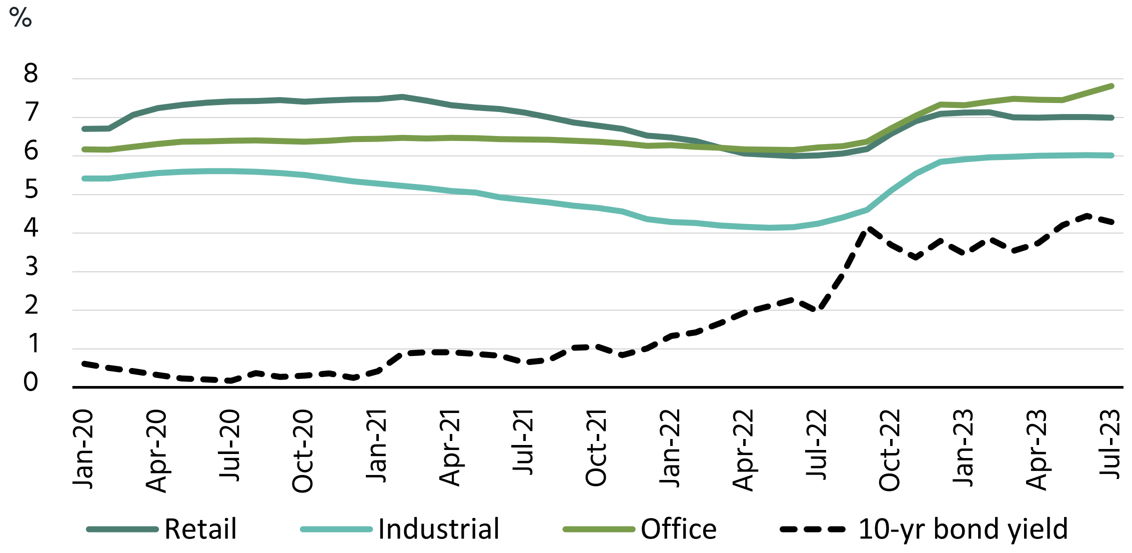
Industrial rental growth has cooled from its recent peak of 13.1% in August 2022 to 7.2% in July, which is nevertheless far stronger than the other property sectors. Despite market rents slowing the average reversion between passing and market headline rents are at an all-time high, meaning that passing rental growth for occupiers on the ground has accelerated and will continue to be high for a sustained period as the reversion is unwound.

In contrast, outward **office** yield drift accelerated in June and July and the sector has shed a total of 48bps so far this year. All UK geographies have been affected, with the diversity of performance between prime and secondary. There is still strong investor demand for core city centre assets, but secondary markets peripheral to urban centres are under pressure, notably in the South East. Secondary offices continue to be impacted by the post-pandemic shift in working patterns and sharp drop in occupier demand. This has been compounded by numerous factors – notably the economic slowdown and the increasingly restrictive MEES deadlines that will render many offices unlettable unless significant capex is used to bring them up to a permissible EPC standard. Meanwhile a glut of new city centre schemes will complete later this year, notably in central London. This is in the form of construction overhangs and several comprehensive refurbishments, which will push availability of this more attractive alternative space even higher.

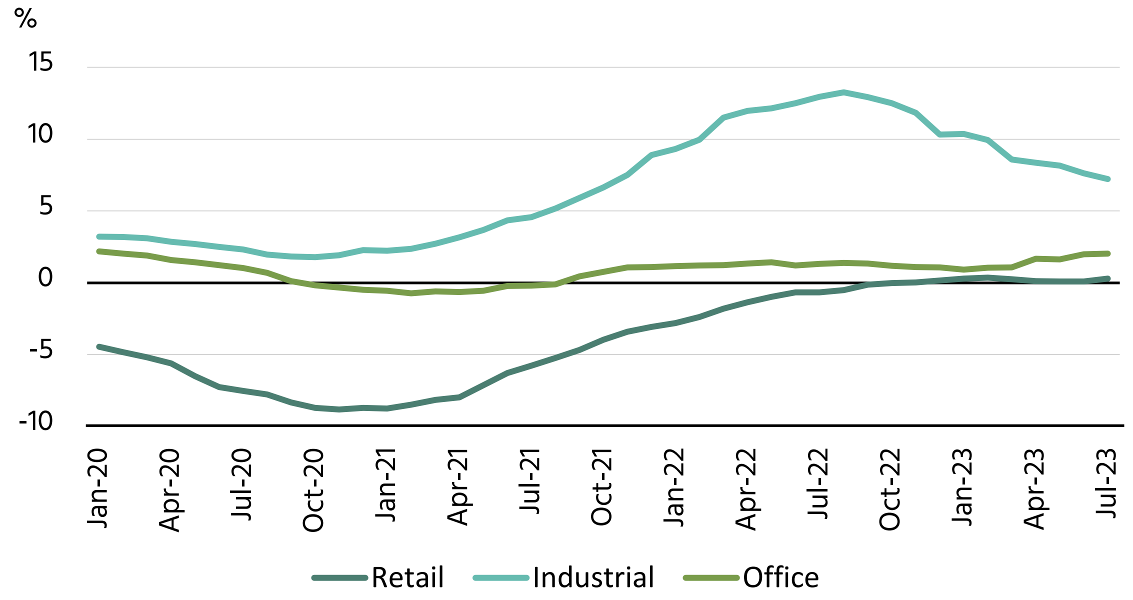
0.4% ▼
All Property quarterly total return, July 2023

48bps ▲
UK office outward yield shift in 2023

Equivalent yields by sector
Source: MSCI, Bank of England



Annual rental growth by sector
Source: MSCI



UK property segments

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

UK economy

UK GDP increased 0.5% month-on-month in June, which exceeded the anticipated bounce following the extra bank holiday in May for the King's coronation. But monthly data are volatile and the temporary surge in pharmaceutical manufacturing that led to June's surprise headline figure belies the wider stagnation of the UK economy, evidenced further by a drop in the composite business sentiment indicators in July, notably the forward-looking components. Ongoing supply shocks from Brexit, Covid and the war in Ukraine, coupled with high inflation, rising interest rates, increasingly restrictive fiscal policy and various industrial action has been described by some commentators as "reminiscent of the 1970s". Oxford Economics forecasts 0.5% annual GDP growth for 2023, falling to 0.4% in 2024.

Headline CPI annual inflation fell to 7.9% in June and 6.8% in July, which gave the Bank of England some respite to increase the Bank Rate by 25bps rather than 50bps in August to 5.25%. However, headline inflation has been driven recently by external factor base effects, such as the fall in energy prices and food inflation. In contrast, core domestic inflation that is so key to monetary policy has shown significant stubbornness. Services inflation increased from 7.2% in June to 7.4% in July and annual private sector pay growth surprised on the upside in Q2 with an increase to 8.2%.

There is some small indication of increased slack in the labour market with an increase in the ILO unemployment rate to 4.2% in May, up from 4% in April and the 3.5% trough in July 2022. But the stickiness of core inflation means that the Bank Rate is widely expected to increase by a further 25bps to 5.5% in September, which many now forecast to be the peak of this cycle. Core inflation is likely to be persistent for a sustained period and pay growth will need to return to around 3% and CPI inflation be clearly headed towards the 2% target before there can be a cut to the Bank Rate, which will be well into 2024 at the earliest for the UK and likely after the eurozone and the US.

Retail sales fell 1.2% in July, which was blamed on heavy rain and the uptick in online spending gives some credence to this. Consumer sentiment has been trending upwards over 2023 from record lows despite the ongoing erosion of real incomes, increasing mortgage payments and falling house prices. There has been some renewed optimism now that interest rates are near a peak and the energy price cap has been lowered. However, the path ahead to this winter looks bumpy, evidenced by the record appeals to Citizens Advice on how to handle upcoming fuel bills without government support.

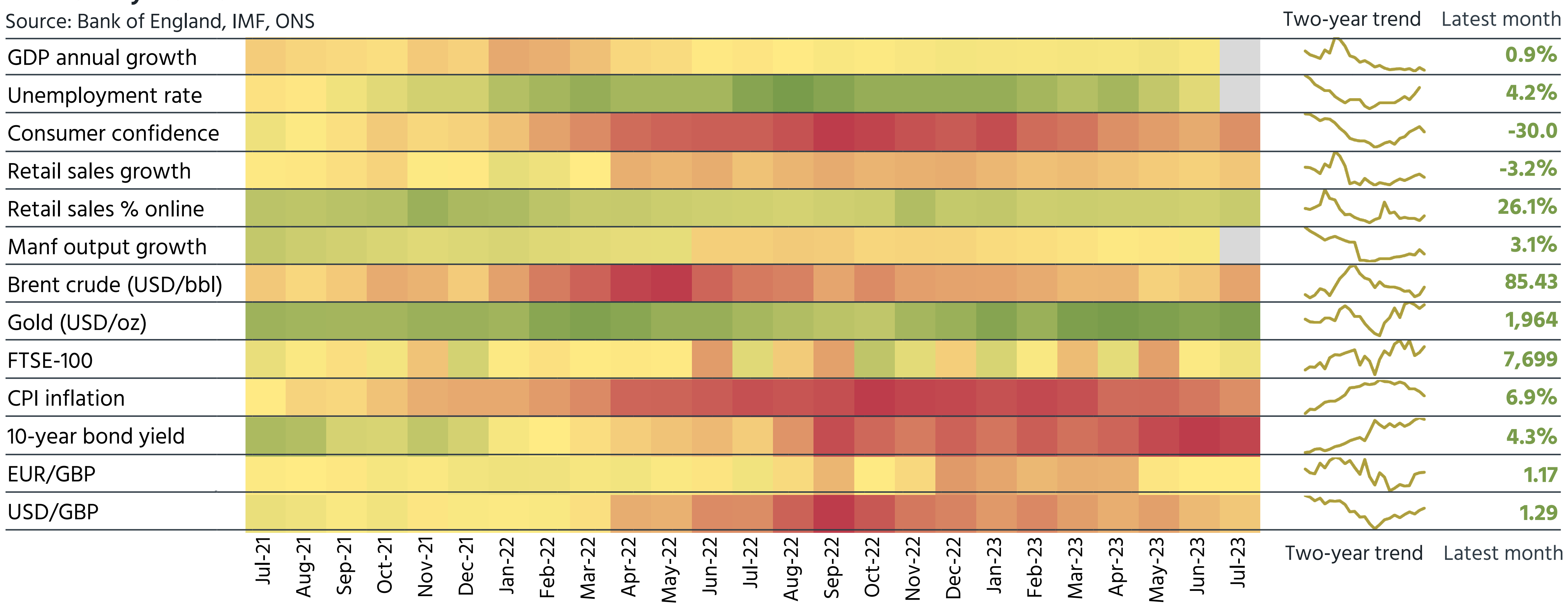
0.4%▼
2024 GDP growth forecast

4.0%▼
End-2024 10-year government bond yield forecast

3.2%▼
2024 average CPI inflation forecast

5.50%▲
End-2023 Bank Rate forecast

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



Spotlight on... central London offices

Occupier take-up was just under 2.2m sq ft in Q2 2023, which was a fall of 8% compared with Q1 and 22% below the five-year quarterly average. Barring the lows of the pandemic in 2020, leasing activity in Q2 was one of the weakest quarters on record since the financial crisis, driven by a dearth of transactions outside anything narrowly defined as the most prime, core assets.

Prime grade A rents in a third of the London submarkets increased in Q2. Covent Garden, Marylebone, Fitzrovia and Victoria all edged up by £2.50 per sq ft. Mayfair & St James's had the strongest uplift, rising from £135 to £140 per sq ft, up 3.7% from the previous quarter.

The availability rates in the outperforming submarkets are well below the London average but, in contrast, there were further increases in Canary Wharf, Midtown, and Southbank in Q2. Canary Wharf's office availability rate of just over 18% is the highest London submarket, accounting for almost a third (2.1 million sq ft) of all central London tenant-controlled space for sublet

New office development is expected to increase significantly later in 2023, given the carry-over of delayed work from earlier this year and from 2022. This points to potential further increases in availability in some notably affected submarkets such as Midtown, Shoreditch, and Southbank, where there have been little to no pre-lets on upcoming schemes.

Investment market activity was quiet in Q2, with a total of only £940m across 20 transactions. There were more individual deals than in Q1, but the average size fell markedly from £102m to only £46m. Consequently, the overall volume was down by nearly a half compared with Q1 and was more than 60% below the 5-year quarterly average.

The refurbishment pipeline mostly contains properties with existing EPC grades ranging from B to D, suggesting that landlords are focusing on the most cost-effective projects. There is limited activity for offices with substantially lower EPC grades, which points to an unwillingness to take on substantive upgrades due to high capex costs and an uncertain lettings market.

2.2m sq ft ▼
Take-up, Q2 2023

9.2% ▲
Availability rate, Q2 2023

£0.9bn ▼
Investment volume, Q2 2023

74%
Proportion of refurbishment pipeline with existing EPC grade B, C & D

Outlook

UK core inflation is likely to be sustained and points to a longer period of elevated UK bond yields, swap rates and commercial debt costs. Commercial property yields are below where these economic fundamentals suggest they should be, but current low transactions volumes and weight of equity means that this disequilibrium could persist. This is particularly likely for industrial assets, but office prices are set to continue softening, driven by weakness in secondary assets. While the lack of outward yield shift will mitigate negative yield impact in the short term it will also limit positive total returns over the medium term. All Property annual total return is set to be effectively zero in 2023 and rise in later years as yields stabilise.

There is a significant global weight of capital targeting **Industrial** 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 2021/22. Void rates and default rates are likely to continue to rise and peak in 2024, but well below previous downturns. We remain relatively upbeat on industrial's diverse occupier base and expect nominal rental growth to remain positive.

In contrast, **retail** and **offices** have more structural problems to contend with. **Office** prime/secondary polarisation is set to intensify as alternative working practices allied with EPC obstacles continue to negatively impact occupancy and investment demand for secondary space. Meanwhile real incomes are set to fall further despite strength in the labour market as ongoing price rises and increased mortgage rates gain traction, which will negatively impact the **retail** sector. 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, August 2023 forecast

Source: Gerald Eve, MSCI

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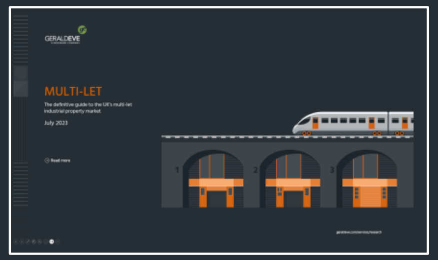

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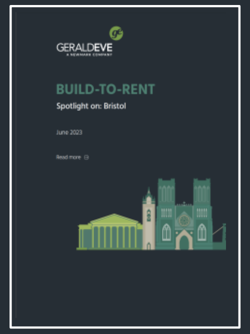
July 2023

Prime Logistics
Q2 2023

London Markets
Q2 2023



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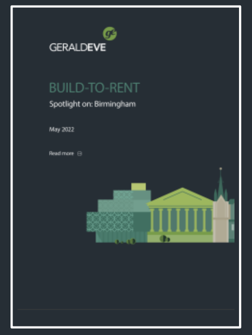

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