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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

October 2023

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OCTOBER UPDATE

The market is past the year anniversary since the “mini budget” that kickstarted a sell-off of UK government bonds, a sharp upward trajectory on the cost of debt and repricing of commercial property. The All Property total return was -13.6% in September and will become progressively less negative over the remaining months of 2023 as the events of late 2022 fall out of the figures. However, the trends for the three major property sectors are different and the rankings of segment performance are changing. Industrial is moving up while offices, notably London City, are moving decidedly down.

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

-0.2% ▼	-18.7% ▼	0.4% ▼	3.0% ▼	4.75% ▼	4.3% ▼
All Property quarterly total return, September 2023	UK office annual total return, September 2023	2024 GDP growth forecast	2024 average CPI inflation forecast	End-2024 Bank Rate forecast	End-2024 10-year government bond yield forecast

UK offices the new poorest-performing sector over the past 12 months

All Property quarterly total return turned negative again in September for the first time since February. The sector posted a -0.2% return, driven by an increasingly negative -2.2% quarterly yield impact. On the occupier side, quarterly rental growth has been relatively stable, particularly given the slowdown in economic activity. Quarterly All Property rental growth was 0.8% in September, which was not far below where it has averaged over the past year.

The market is past the year anniversary since the Truss/Kwarteng "mini budget" that kickstarted a sell-off of UK government bonds and a sharp upward trajectory on the cost of debt to acquire property. Switching to an annual frequency, the All Property total return was -13.6% in September. However, the trends for the three major sectors are different. Retail was the least impacted by the crisis at the end of 2022, with the highest yields going into the volatility, having already softened considerably over the pandemic. A relatively small outward shift for higher base yields has meant that the retail sector has outperformed the other sectors on an annual basis for the past year and returns continue to be relatively stable.

Industrial, in contrast, as the lowest-yielding segment that had benefitted from significant compression over the pandemic was at the sharp end of the repricing. Consequently, annual total returns have been the most negative of any segment over the past year, reaching a trough of -23.1% in June. Prime industrial segments, such as London multi-let, were even more significantly affected, bottoming out at -29.4% annual total return in June. However, as the events of late 2022 begin to fall out of the annual figures, the industrial return has started trending steeply upwards again. Industrial segments have moved back up the individual rankings shown overleaf.

While retail and industrial valuation yields have essentially flatlined so far over 2023, UK offices have more recently experienced yield softening totalling 64bps between May and September, with the average equivalent yield now at over 8%. The annual trend for office returns has thus continued to slide downwards and the sector became the new poorest performer over the past 12 months with a return of -18.7% to September.

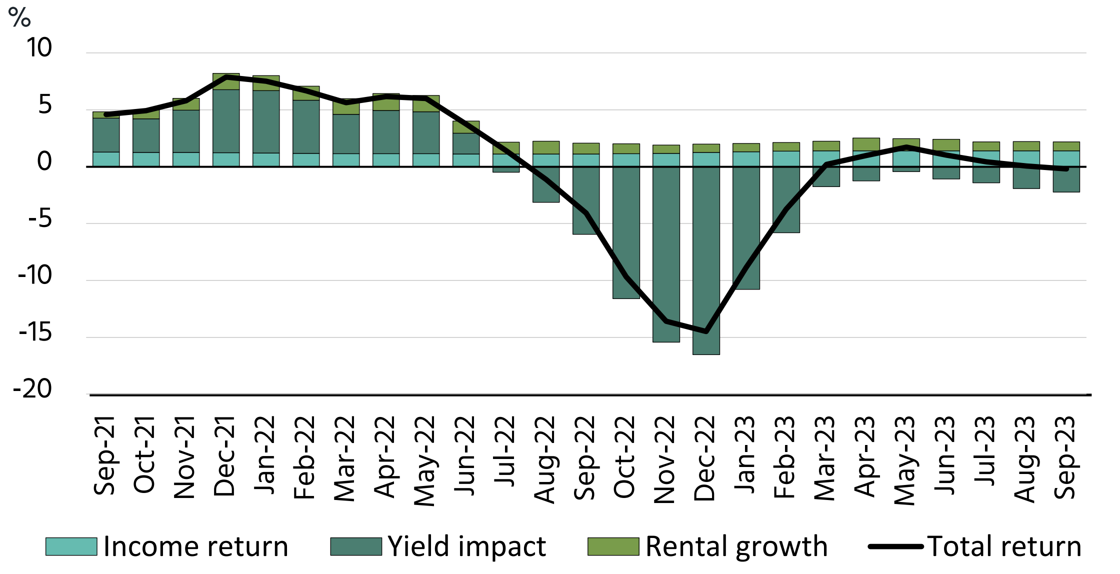
At the segment level, London City offices had the lowest annual total return at -22.7%, and the central London office market features in this month's Spotlight. While the volume of investment transactions increased in Q3 and totalled £1.4bn, the average individual deal size remained low at £48 million. Investment activity in these smaller lot sizes show the prevailing concerns in raising debt for large purchases. However, there are still some well-capitalised investors selectively looking for opportunities in value-add space.

The real driver of the outward yield shift is the wider secondary market. Debt liquidity for secondary office acquisitions has thinned over the course of 2023, with lenders less willing to take on the risk associated with reletting and development. The change to hybrid working patterns has put into question the validity of large swathes of secondary offices just at the time when most of the stock will fall foul of upcoming MEES regulatory deadlines.

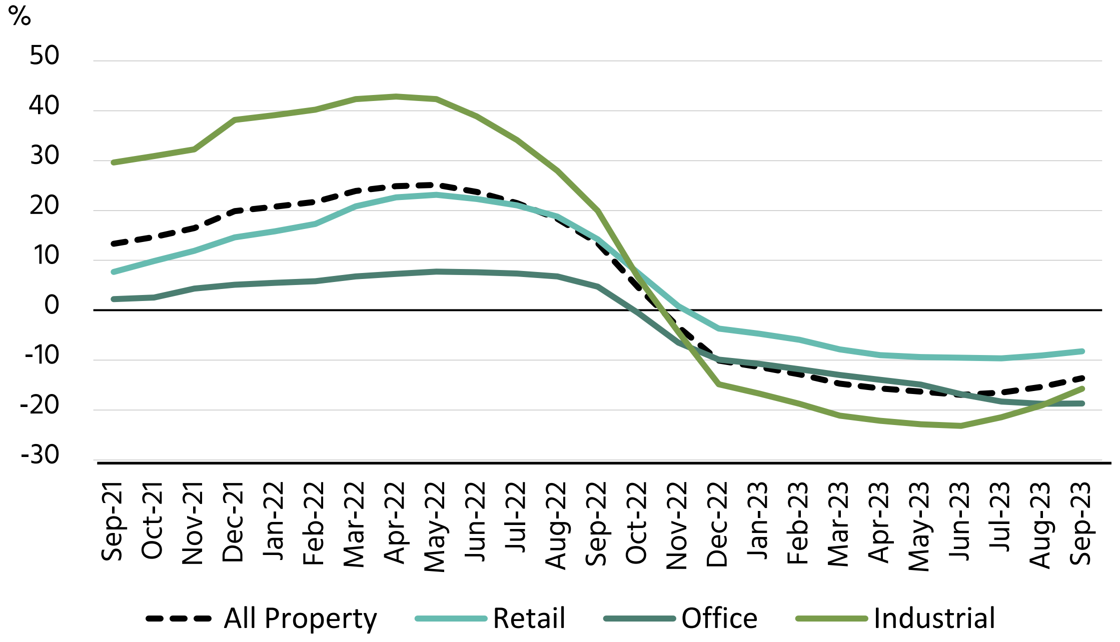
-0.2%▼
All Property quarterly total return, September 2023

-18.7%▼
UK office annual total return, September 2023

All Property quarterly total return and components
Source: MSCI

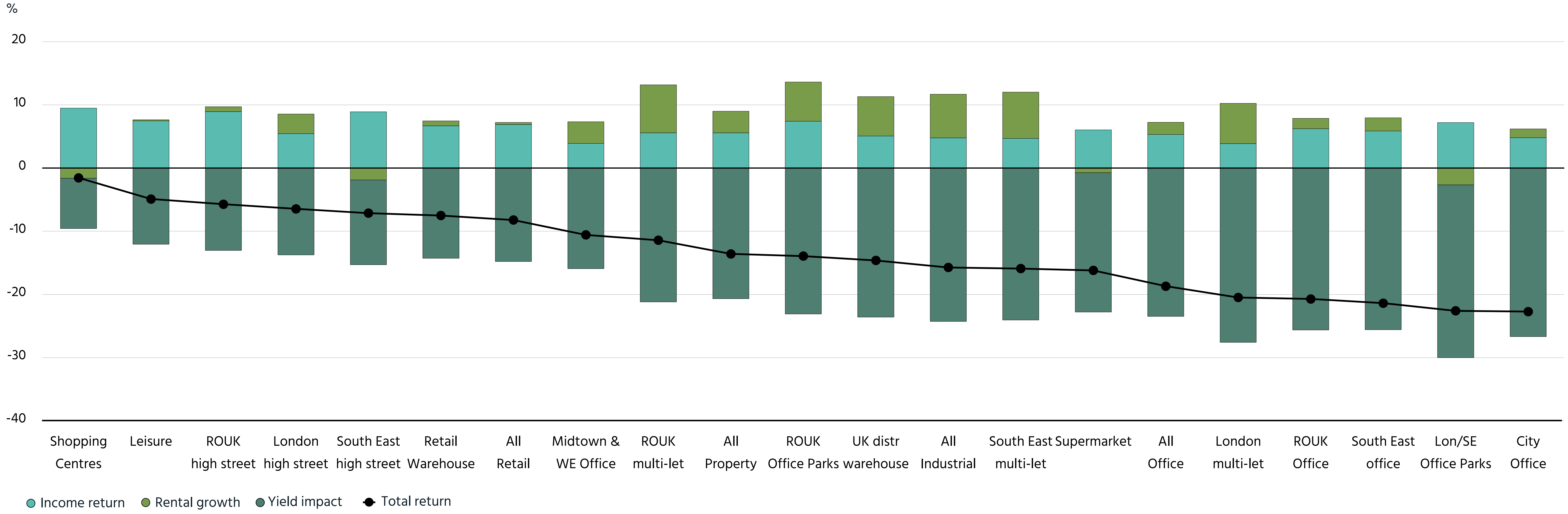


Annual total return by sector
Source: MSCI



UK property segments

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



UK economy

The ONS recently revised its GDP data going back to 2020 following various methodological improvements. While the new figures now suggest that the UK economy had regained its pre-pandemic size by Q4 2021 (rather than still languishing below it in mid-2023) the outlook continues to be challenging. UK GDP recovered only 0.2% month-on-month in August after falling 0.6% in July, so it could potentially contract overall in Q3 despite the extra working day compared with Q2. Oxford Economics forecasts a slowdown to 0.4% annual growth in 2024 while other commentators have predicted a mild recession.

In the manufacturing sector, survey data suggest that input prices fell for the sixth consecutive month in October. Overall sentiment gained some ground but remained in contraction territory while aggregate demand is muted and monetary policy restrictive both at home and abroad. The services sector remains downbeat but more finely balanced between contraction and expansion. More concerningly, output price inflation accelerated as firms sought to limit the squeeze from strong wage growth on operating margins. Retail spending contracted a significant 0.8% month-on-month in September, driven by a drop in demand for household goods. Various confidence indicators also fell sharply in October. Mortgage lending continues to be weak and the MPC's high-for-longer messaging has maintained mortgage pricing despite the recent fall in swap rates now that interest rates appear to have peaked lower than previously expected.

Annual CPI inflation edged down from 6.7% to 6.6% in September. This is a marked fall from the high of 11.1% in October last year as the impact of 2022's steep rise in global energy prices falls out of the data. However, the apparent stickiness at these still-elevated rates in recent months is testament to the extent of the passthrough to domestic services price and wage inflation. Wage growth surprised on the upside again in Q2 and, despite a further loosening in the labour market, these pressures are likely to persist.

On the 2nd of November the MPC voted for a second time to keep the Bank Rate on hold at 5.25% after 14 consecutive rate rises between January 2022 and July 2023. Nevertheless, the dampening impact on growth and spending will continue to feed through the economy over the next year or so. In a statement it said it does not expect inflation to return to the 2% target until 2025, though some commentators consider this to be overly pessimistic. Regardless, any future rate cuts are not expected at least until summer 2024 and several months after the US Fed and the Eurozone loosen policy.

0.4% ▼
2024 GDP growth forecast

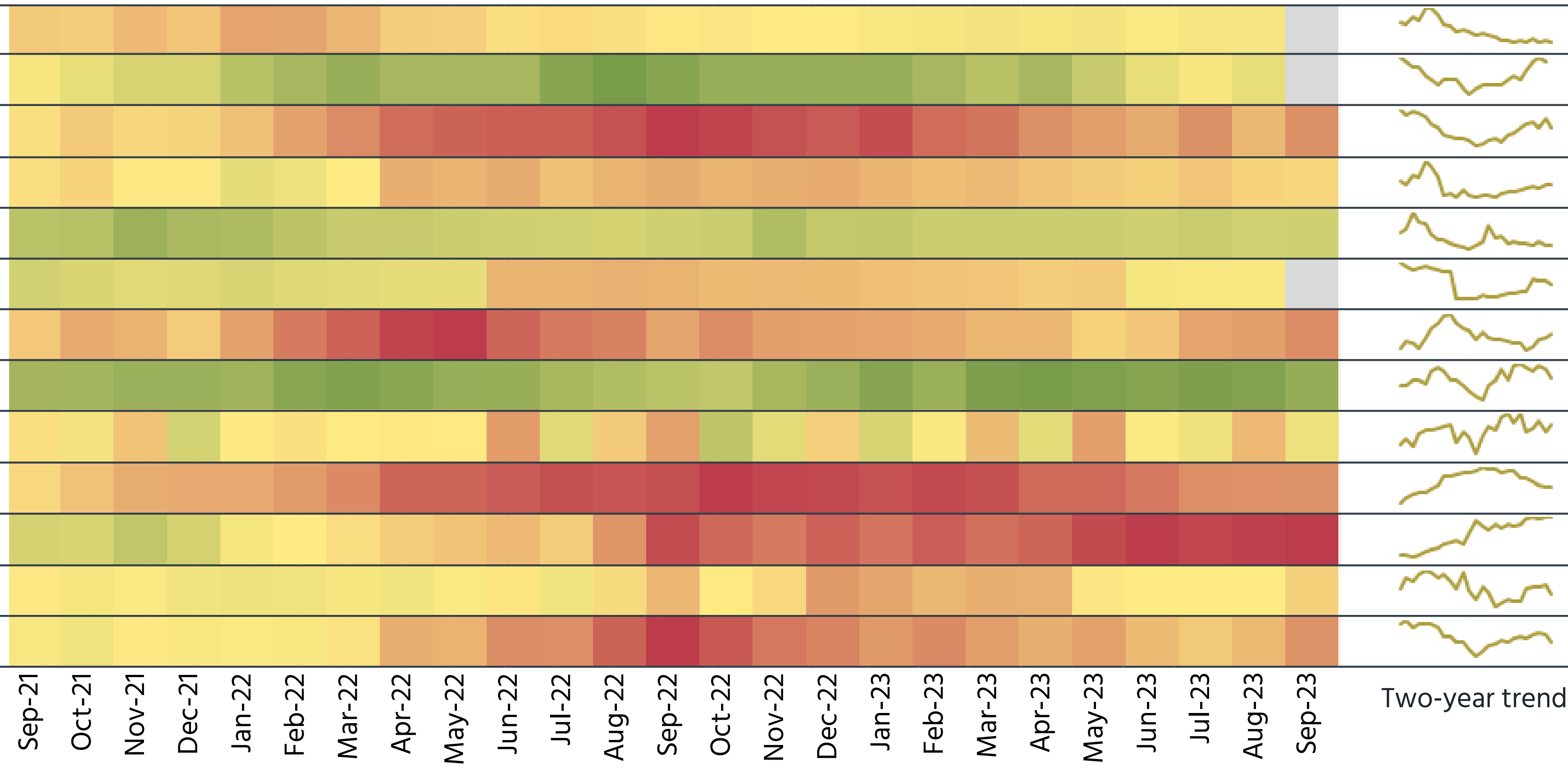
4.3% ▼
End-2024 10-year government bond yield forecast

3.0% ▼
2024 average CPI inflation forecast

4.75% ▼
End-2024 Bank Rate forecast

The monthly monitor

Source: Bank of England, IMF, ONS



	Latest month
GDP annual growth	0.5%
Unemployment rate	4.2%
Consumer confidence	-30.0
Retail sales growth	-0.9%
Retail sales % online	25.3%
Manf output growth	2.8%
Brent crude (USD/bbl)	92.20
Gold (USD/oz)	1,848
FTSE-100	7,608
CPI inflation	6.6%
10-year bond yield	4.4%
EUR/GBP	1.15
USD/GBP	1.22

Spotlight on... central London offices

Download the Q3 report, click here

Take-up increased to 2.9m sq ft in Q3 2023, which was 30% more than Q2 and 5% above the five-year quarterly average. Most transactions were for high quality accommodation that will meet all EPC regulations to 2030. The development pipeline is strong and pre-letting accounted for nearly a fifth of total take-up.

Mayfair & St James's and the City have relatively resilient demand and restrictive supply at the top end of the market and were the only areas to record an increase in Grade A rents in Q3. The West End is expected to outperform the other segments, though rental growth anywhere will be in low single digits.

The overall availability rate was effectively unchanged at 9.1% in Q3. The uptick in take-up was not enough to offset new refurbishments and developments brought to market. Furthermore, there are signs that availability in some subsectors may increase further through break options on leases signed pre-Covid.

An estimated 1.5m sq ft of new developments completed in Q3 across 11 schemes, bringing the expected 2023 total to 3.8m sq ft. Completion dates slipped with nearly 1m sq ft pushed to Q4, and 0.5m sq ft pushed to Q1 2024. Speculative developments may face further delays on the back of increased financing margins.

Refurbishment and redevelopment activity has increased across central London offices. This is due to the increasing costs of new-build developments and/or requirements to improve the environmental credentials of standing stock.

The volume of investment transactions increased in Q3 and totalled £1.4bn across 29 transactions. This was an increase of 50% on Q2 but still 40% below the 5-year quarter average. Office yields have moved out over 2023 more than any other major property sector and office total return was -14% in September.

2.9m sq ft ▲
Take-up, Q3 2023

9.1% ▼
Availability rate, Q3 2023

£1.4bn ▲
Investment volume, Q3 2023

-14% ▼
Central London offices, annual total return, Sep-23

Outlook

With interest rates likely to have peaked at 5.25% the consensus is that we are in for a sustained period of elevated UK bond yields, swap rates and commercial debt costs. Commercial property yields continue in the main to be below where these economic fundamentals suggest they should be, but current low transactions volumes and weight of equity means that this disequilibrium is set to persist. This is particularly likely for industrial assets, while office values will likely continue softening, driven by weakness in secondary. 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 later in the forecast period as yields stabilise.

There is a significant global weight of equity targeting **Industrial** set against 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, October 2023 forecast
Source: Gerald Eve, MSCI

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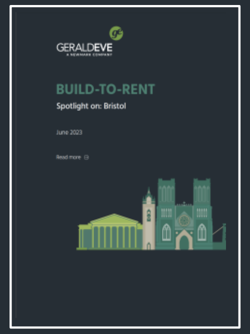
Prime Logistics
Q3 2023

London Markets
Q3 2023



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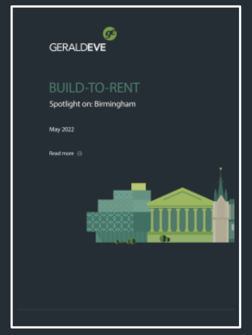

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