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IN BRIEF
UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

February 2022

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FEBRUARY UPDATE

There may be some warning signs for the UK economy, but All Property annual total return sailed past 20% in January for the first time since November 2014. Besides the positive drivers from industrial this reflects the absence of the drag from retail that has been a feature for so many years. Shopping centre annual total return finally crossed into positive territory of +1.0% in January. Meanwhile London offices in January had the highest monthly volume of investment transactions on record.

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20.7% ▲	1.0% ▲	3.8% ▼	5.8% ▲	1.6% ▲	4.0% ▼
All Property annual total return	Shopping centres annual total return	2022 GDP forecast	2022 CPI forecast	2022 10-Yr bond yield forecast	2022 Unemployment rate forecast

Shopping centre return turns positive as All Property sails past 20%

All Property annual total return continued trending upwards into the first month of 2022 and crossed the 20% threshold for the first time since November 2014. Massive amounts of positive yield impact continue to drive the return, and this is also increasingly being supported by positive rental growth.

Besides the positive drivers from industrial, this reflects the absence of the drag from **retail** that has been a feature for so many years. **Shopping centre** annual total return crossed into positive territory of +1.0% in January for the first time since October 2018 and reversed the deeply negative -22% annual return from a year earlier. Indicative of the deep underlying difficulties for the sector it is now relatively cheap, with attractive yields for the right assets and investors. Shopping centre capital values in January were less than a quarter of the value of the same assets pre-financial crisis in 2007. Having never properly recovered, capital values fell a further 44% over the year running up to and during the covid pandemic.

There has been a flurry of shopping centre investment activity recently after a real dearth of transactions. Key recent deals include Silverburn in Glasgow and Bluewater in Dartford going for £140m and £172m respectively in December. But in what will already be one of the largest deals of 2022, LaSalle Investment Management parted with £600m in January for Cheshire Oaks in Ellesmere Port and Swindon Designer Outlet, bought from Nuveen Real Estate.

Across other sectors, **London offices** had in January the highest monthly volume of investment transactions on record. The top six deals so far in 2022 totalled £1.8bn and includes Google's 41 Central St Giles purchase for £762.5m. The chart shows how over the past year London annual total return has pulled away from assets outside of the South East. The underlying occupier market has shown some sustained activity with the various relocation and consolidation plans of large corporates being put into place, which has bolstered investor confidence. Take-up in Q4 increased again and was back on a par with the long term average.

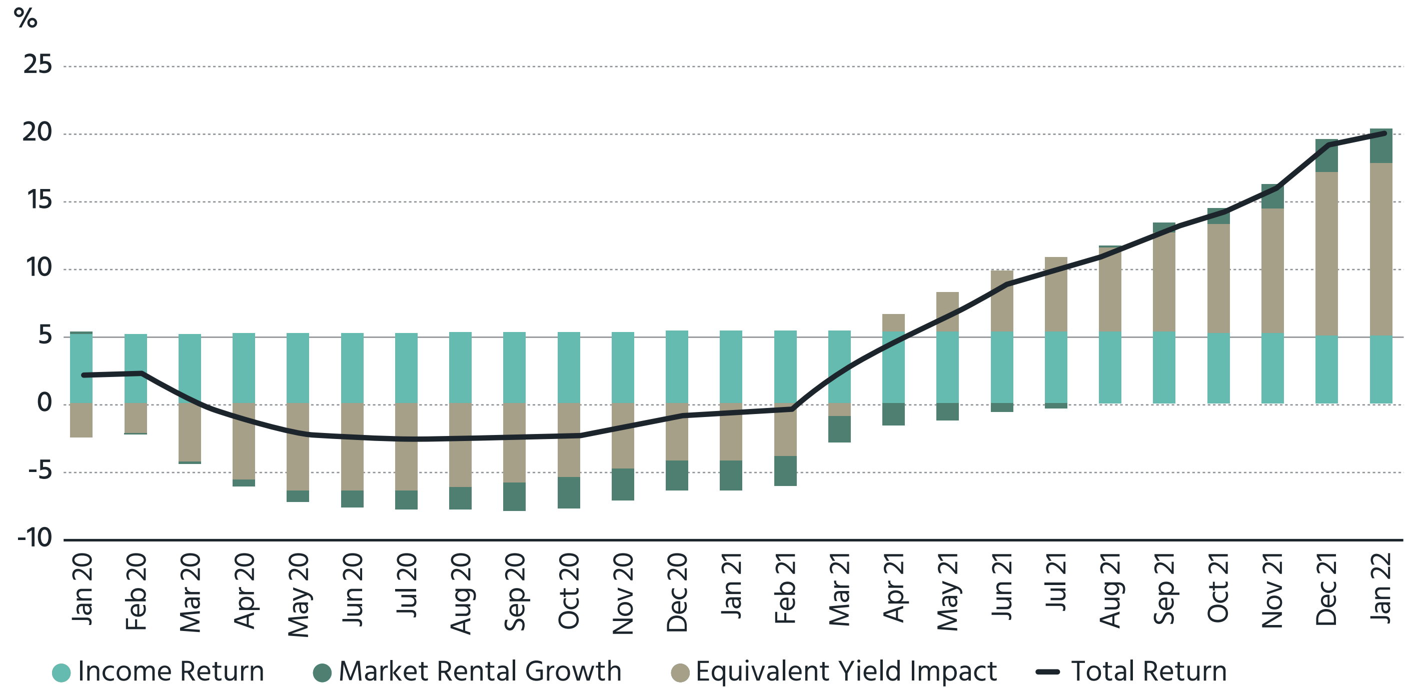
The record headline rents for **industrial** have led to some nervousness as to whether these kinds of rents are sustainable and if there is still scope for further growth. However, the longer term view in real terms suggests there remains further headroom. The greater test will be on yields as the interest rate environment heats up and the risk premium narrows to levels not seen since before the financial crisis. We expect industrial investment volumes to be strong again this year as various owners take profits while the ongoing global weight of capital seeks to get cash invested.

20.7% ▲
All Property annual total return

1.0% ▲
Shopping centres annual total return

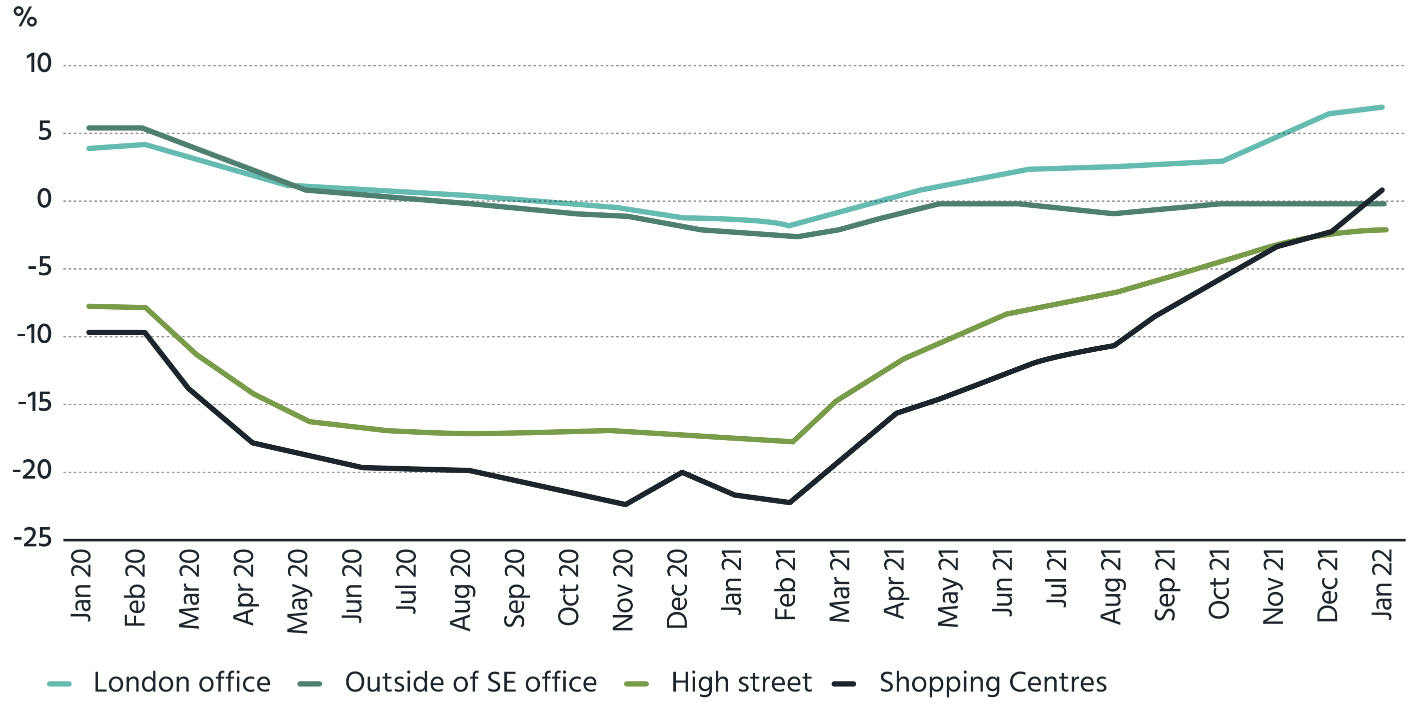
All Property annual total return and components

Source: MSCI



Annual total return by sector

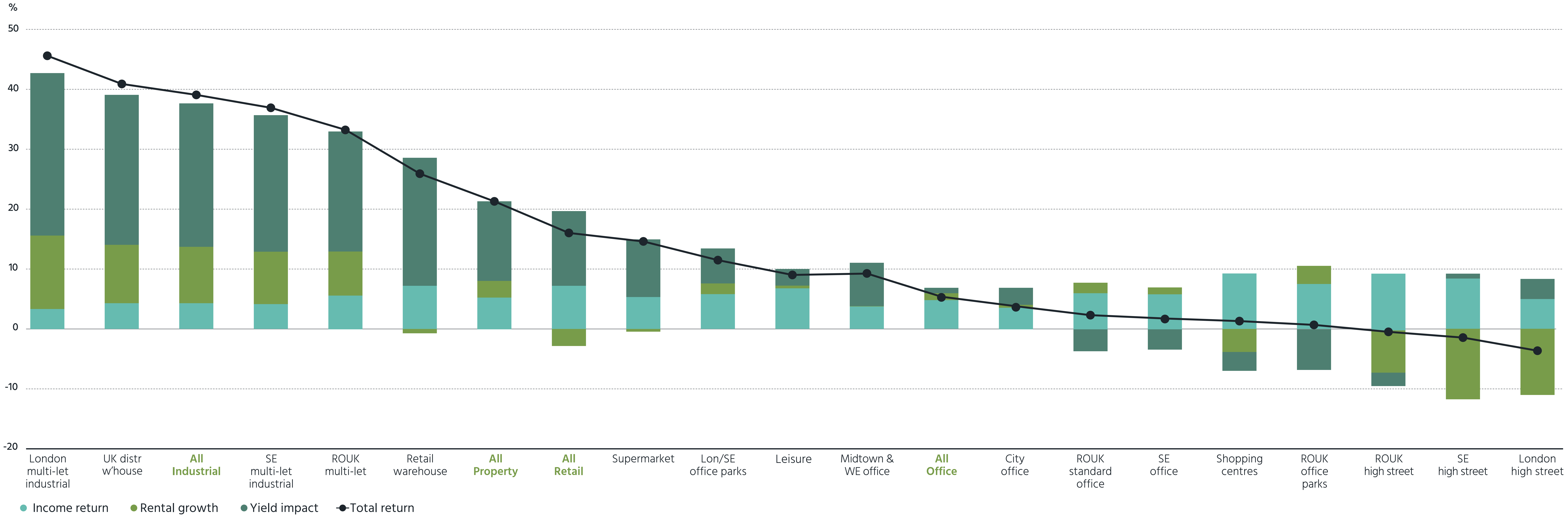
Source: MSCI



Segments

12-month return to January 2022

Source: MSCI



UK economy

The UK economy shrank month-on-month in December as expected, but by only 0.2% – underlining the relatively minimal impact of the Omicron covid variant. The sharp drop in social consumption was offset to some degree by an uptick in the already sizeable health spending on testing and vaccinations. Moreover, output from the construction sector increased 2% in December. However, increased requirements to self-isolate only added to supply chain bottlenecks in the manufacturing sector, where output remains below where it was at the end of 2019.

The key factor though of course is inflation. CPI inflation was 5.4% in December, and elevated global goods prices, the continued rising oil price and the 54% rise in the energy price cap amongst other elements are set to push UK inflation to around 7.5% by April. This sharp increased cost of living has dented consumer sentiment and in January it dropped to the lowest level in the last year. In particular, the outlook for the next 12 months was more pessimistic, with national insurance contributions and expected mortgage rates on the rise. The intention to make major purchases fell while the desire for precautionary saving increased. Consequently Oxford Economics, which was relying on a consumer-led recovery for 2022, has slashed its forecast for GDP growth this year to 3.8%, down from 4.5% last month.

The Bank of England raised interest rates from 0.25% to 0.5% in February and Oxford Economics expects the year to end at 1.25%. Job vacancies continue to trend upwards, and it is this tight labour market with the threat of wage increases entrenching inflation that is forefront in the MPC's concerns.

Meanwhile, monthly retail spending growth actually enjoyed an uptick in January, driven by spending on household goods. This is a volatile series though and spending remains almost 6% below where it was in April 2021. The online proportion remained high at over 27% of all retail spending, which suggests that the accelerated change in shopping habits brought about by the pandemic lockdowns has stuck and we are on a new growth path for e-commerce that has several more years to run at least before saturation.

3.8% ▼
2022 GDP forecast

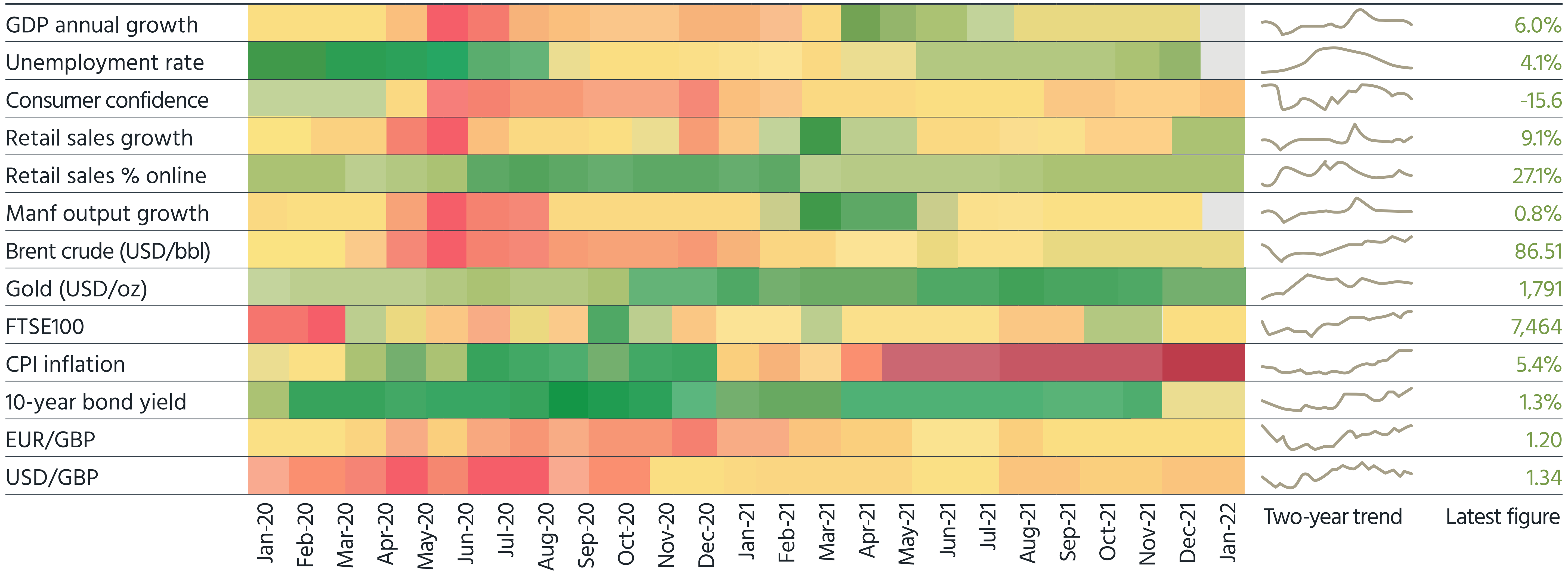
1.6% ▲
2022 10-yr bond yield forecast

5.8% ▲
2022 CPI forecast

4.0% ▼
2022 unemployment rate forecast

The monthly monitor

Source: Bank of England, European Commission, IMF, ONS



Spotlight on...
London offices – ESG to drive a two-speed investment market

A SURGE IN BUILD COST INFLATION

The rate of inflation increased again to 5.4% on the CPI measure in December, the highest in decades. The MPC raised interest rates in response to cost pressures and further base interest rate rises are expected this year. The effect of inflation in the construction industry has been stark. Material price growth and wage growth contributed to a sharp increase in overall build costs in 2021. Annual BCIS build cost growth peaked at 11% in November, well above estimates released earlier last year.

HEIGHTENED COSTS FOR LANDLORDS IN AN ESG POST-COVID WORLD

This has put considerable cost pressure on landlords undertaking new projects or refurbishments to try to cater to post-pandemic demand for best-in-class sustainable space. Both occupiers and landlords are alive to further tightening of regulation around ESG and realise the potential cost of inaction. Tenant preference is heavily geared toward high quality offices with strong environmental credentials, evidenced by recent activity in the leasing market. This will continue to drive further demand for refurbishment as landlords look to bring the emissions and energy usage of buildings up to scratch. Construction price pressures are expected to cool this year, with a forecast of 1.2% annual growth in December 2022, which in turn could stimulate activity to reposition poorer quality stock towards the end of the year.

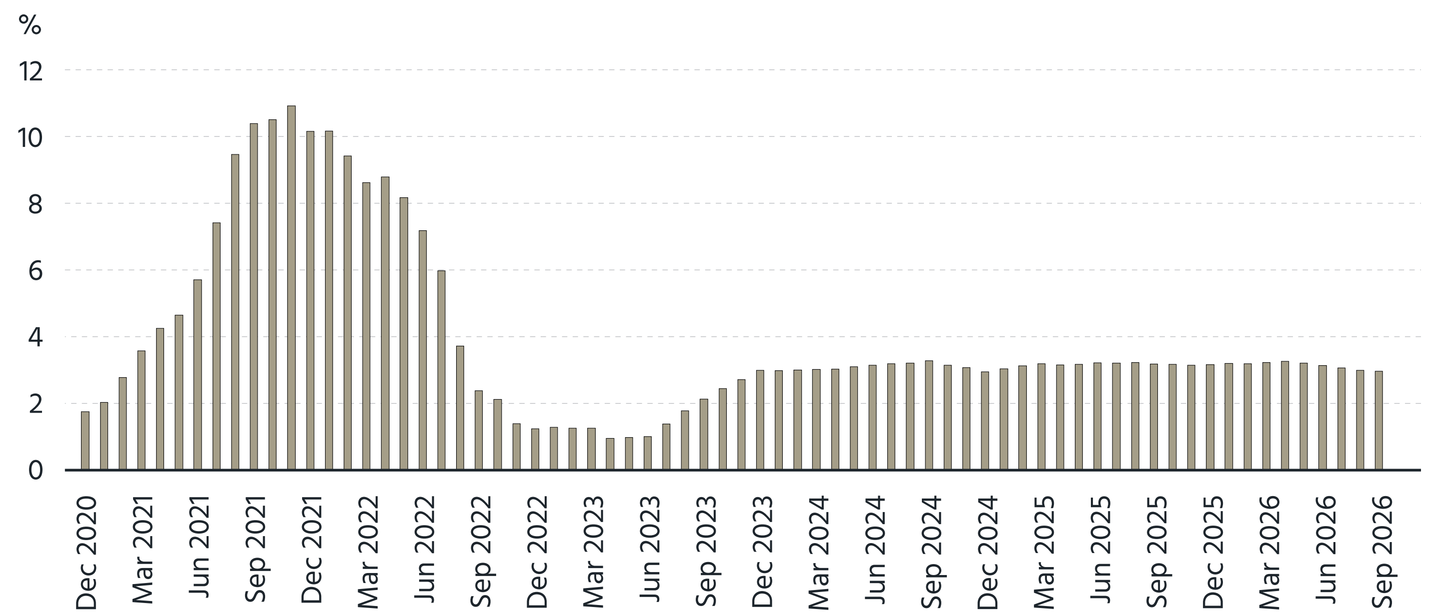
OFFICES WITH WEAK ESG CREDENTIALS TO UNDERPERFORM

Since the beginning of 2020, equivalent yields for tertiary offices in the West End have moved out by 30bps to 4.94%, reflecting a spread of 136bps compared with prime stock. Although the quality of an office is not entirely driven by its sustainability credentials, environmental impact is an increasingly important factor for tenants and will shape letting risk. We expect a similar divergence in yields to occur in other London submarkets this year as the workout and repositioning of poorer quality stock becomes more commonplace.

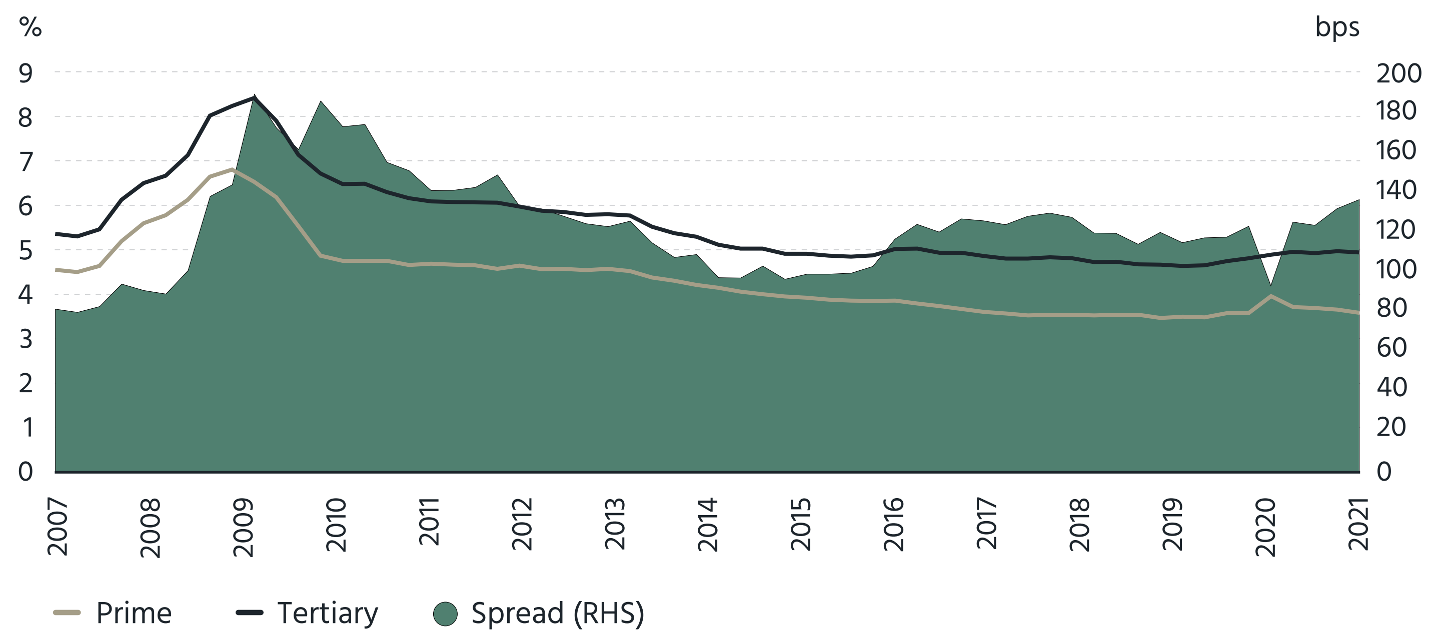
REPOSITIONING TO FIT ESG CREDENTIALS KEY TO PROTECTING RETURNS

In future, for poor quality offices – characterised by older stock, low energy ratings and uninspiring fit outs – it will prove harder to achieve previously-attainable rental profiles. A two-speed market will become more pronounced, with enhanced rental growth for newly delivered, ESG focused best-in-class space, and a brown discount for poorer quality stock. Negative rental growth and capital value declines will drag on returns for this space, coupled with low occupancy rates impacting income return. However, opportunities to protect returns by repositioning poorer quality offices are clear and with more stringent ESG regulations likely, this will prove crucial to secure future pricing and liquidity.

BCIS general build cost index growth
Source: BCIS



West End equivalent yields by quality
Sources: MSCI, Gerald Eve



Outlook

All Property total return is estimated to have exceeded 19% in 2021 and is forecast to slip back to around 10% in 2022. Nevertheless, industrial is set to continue its dominance. Underperforming retail subsectors should switch from negative to positive return in 2022 and the sector overall is likely to continue to outperform UK offices.

The record-breaking return for **industrial** in 2021 will not be repeated in 2022 but the sector is expected to continue to dominate with a return in excess of 14%. The overwhelming occupier demand set against insufficient supply will continue to drive rental growth in 2022. Equally there should be some carry-over of positive yield impact but at a much more moderate rate given the current keenness of investment pricing set against the rising interest rate environment.

Office rents have stabilised in Q4 after slipping back earlier in 2021 with the influx of tenant-controlled space. The polarisation of the best-in-class assets is set to intensify, and prime yields have consequently tightened in London. Landlords and developers are reportedly marketing buildings which will deliver in the next 6-12 months above current market rents as they know competition for new space will be high.

Retail outperformed offices in 2021, driven by retail warehouses. This was the first non-negative return since 2017. In 2022 retail warehouse return should ease but overall retail return is set to outperform offices again as high street and shopping centre pricing stabilise and contribute positively.

Total return and components by sector

Source: Gerald Eve, MSCI

Contact

Research

STEVE SHARMAN
Partner
ssharman@geraldeve.com
Tel. +44 (0)20 7333 6271

BEN CLARKE
Partner
bclarke@geraldeve.com
Tel. +44 (0)20 7333 6288

OLIVER AL-REHANI
Senior Research Analyst
oal-rehani@geraldeve.com
Tel. +44 (0)20 7518 7255

Capital Markets

JOHN RODGERS
Partner
jrodgers@geraldeve.com
Tel. +44 (0)20 3486 3467

Agency

MARK TROWELL
Partner
mtrowell@geraldeve.com
Tel. +44 (0)20 7333 6323

Valuation

RICHARD MOIR
Partner
rmoir@geraldeve.com
Tel. +44 (0)20 7333 6281

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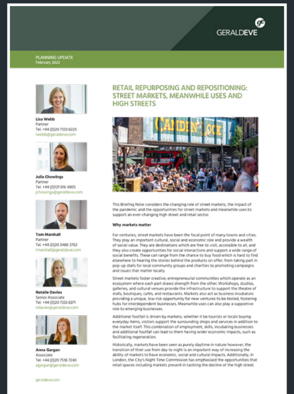
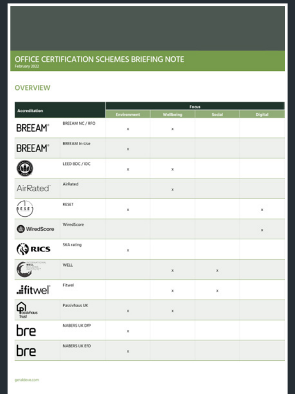
Further Insight

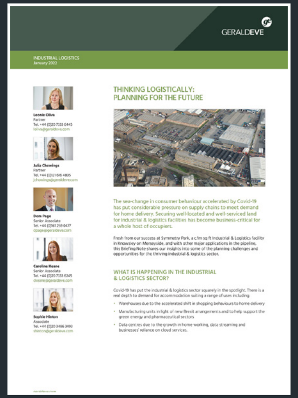


Retail Repurposing and Repositioning
February 2022



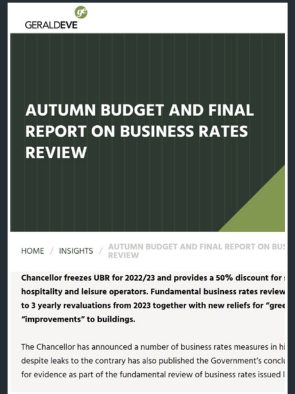
Office Certification Explained
February 2022

London Markets
Q4 2021



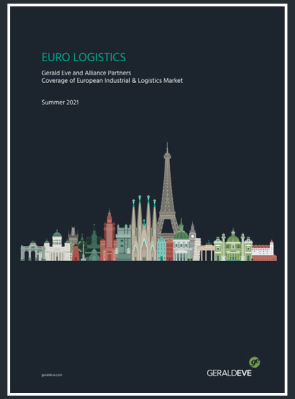
Industrial Logistics
January 2022

Prime Logistics
Q4 2021

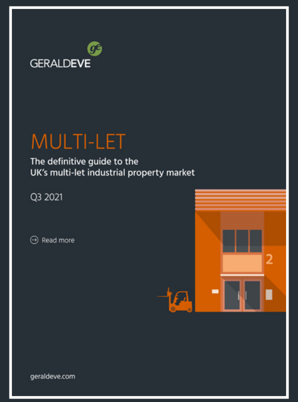


Business Rates Review
November 2021

Manchester BTR
2021

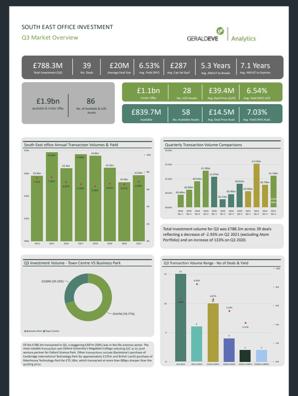


Euro Logistics
Summer 2021



Multi-Let
Q3 2021

Sustainable Retrofit
June 2021



South East Office Investment
Q3 2021

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