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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

July 2022

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JULY UPDATE

The economy is mired in negative uncertainty and this was reflected in the Q2 commercial property investment volume, which was the second lowest in 10 years. Equivalent yields on some of the keenest priced property segments moved out in June for the first time since the onset of the covid pandemic and a further outward shift in pricing in H2 is broadly expected to offset gains in H1. The investment market has fundamentally shifted in line with increased cost and reduced availability in debt markets. Many investors have adopted a 'wait and see' approach over the summer and a period of subdued activity is in prospect.

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

3.36% ▲
London multi-let equivalent yield

£8.0bn ▼
Q2 commercial property investment

0.8% ▼
2023 GDP forecast

6.0% ▲
2023 CPI forecast

2.4% ▲
2023 10-yr bond yield forecast

4.2% ▲
2023 unemployment rate forecast

Second lowest investment volume in 10 years as yields drift out and a subdued summer in prospect

Equivalent yields for **London multi-let industrial** - the highest performing and lowest yielding commercial property segment – moved out in June for the first time since 2020. Performance for the segment peaked at an incredible 51.7% annual total return in May. Inward yield shift alone has contributed a cumulative +41% uplift to capital values since the start of the covid pandemic in March 2020 and an astonishing +76% since the Brexit referendum result in June 2016. This is symptomatic of a wider trend for **industrial**, notably distribution warehouses, over the same period.

However, the investment market has fundamentally shifted in line with increased cost and reduced availability in debt markets, both in the UK and USA, which has reduced potential purchasers, notably debt-backed private equity. There is still confidence in the underlying occupier market, voids are low and prime rental growth outperformed expectations in H1. But the investor buyer pool has unavoidably narrowed and bidding on any one asset has thinned out. This drop in competitive tension has knocked the 'froth' off prices and caused prime yields to soften, typically by around 50bps. Interestingly, this change has been sufficient to very quickly impact the valuation yield, which typically acts with a smoothing time lag.

The slowdown in investment activity has been felt across all property sectors and rippled up the risk curve. Q2 commercial property investment came in at £8bn – less than half the Q1 figure and the lowest in 10 years, not including the Q2 2020 onset of the covid pandemic. There remain some buyers who see this situation as an opportunity – pricing is lower than it was 3-6 months ago and the competition is lower. Typically though investors have less conviction, and many have adopted a 'wait and see' approach over the summer.

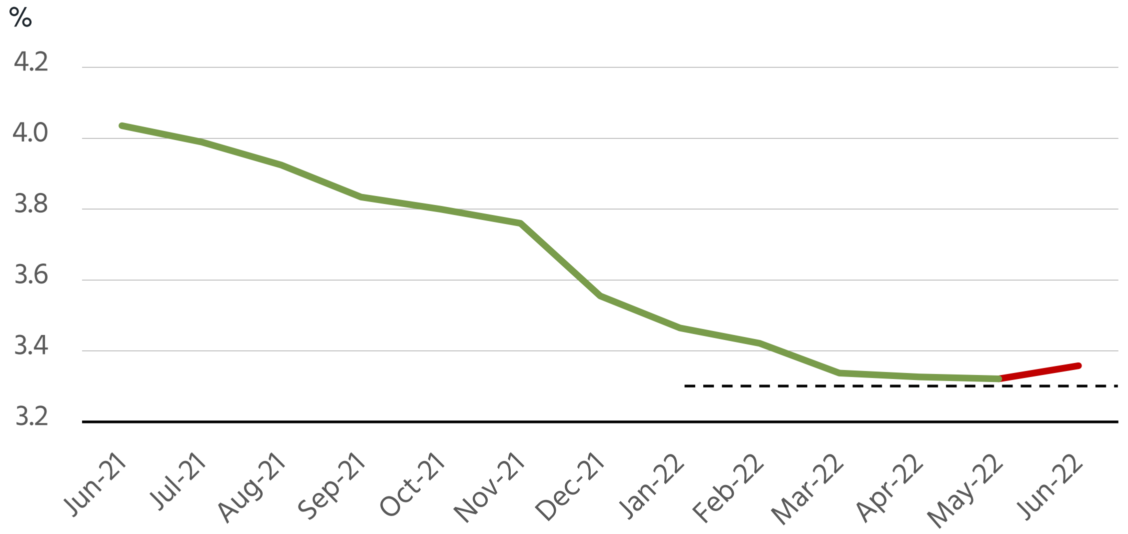
There is a relatively quiet summer ahead for both the occupier and investment market for **offices** also. In central London all-grades rents edged up only 0.2% in Q2 but this hides significant polarisation between the best-in-class assets and the rest of the market. Grade A rents in six out of the 16 London submarkets increased between 6-8% in Q2, with the strongest growth in Mayfair & St James' and Soho. Moreover, occupier take-up ticked up again and was the highest since Q4 2019. However, occupier sentiment now points to a slowdown over the coming months while there is such uncertainty and downside risk in the economy. Investment into London offices was down 60% in Q2 and this hiatus is forecast to persist until at least the autumn. A large majority of what did transact in Q2 came from overseas and APAC in particular to take advantage of the current weakness of sterling.

Meanwhile the **retail** sector is in recession but shopping centre and retail warehouse yields were essentially stable in June at 9.60% and 5.64% respectively, while there was 14bps inward momentum to 6.87% for high street. Similarly rents maintained their trend towards stability in June. The significant outward yield shift and drop in rents across the sector going into and then exacerbated by the pandemic provides something of a cushion against further corrections, though transactions will continue to be low.

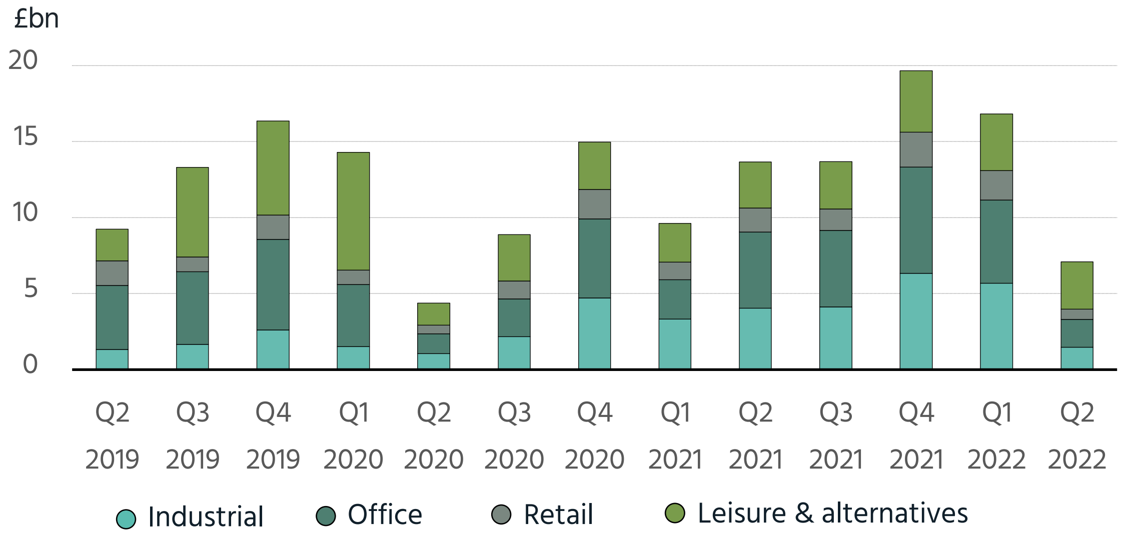
£8.0bn ▼
Q2 commercial property investment

3.36% ▲
London multi-let equivalent yield

London multi-let equivalent yield
Source: MSCI

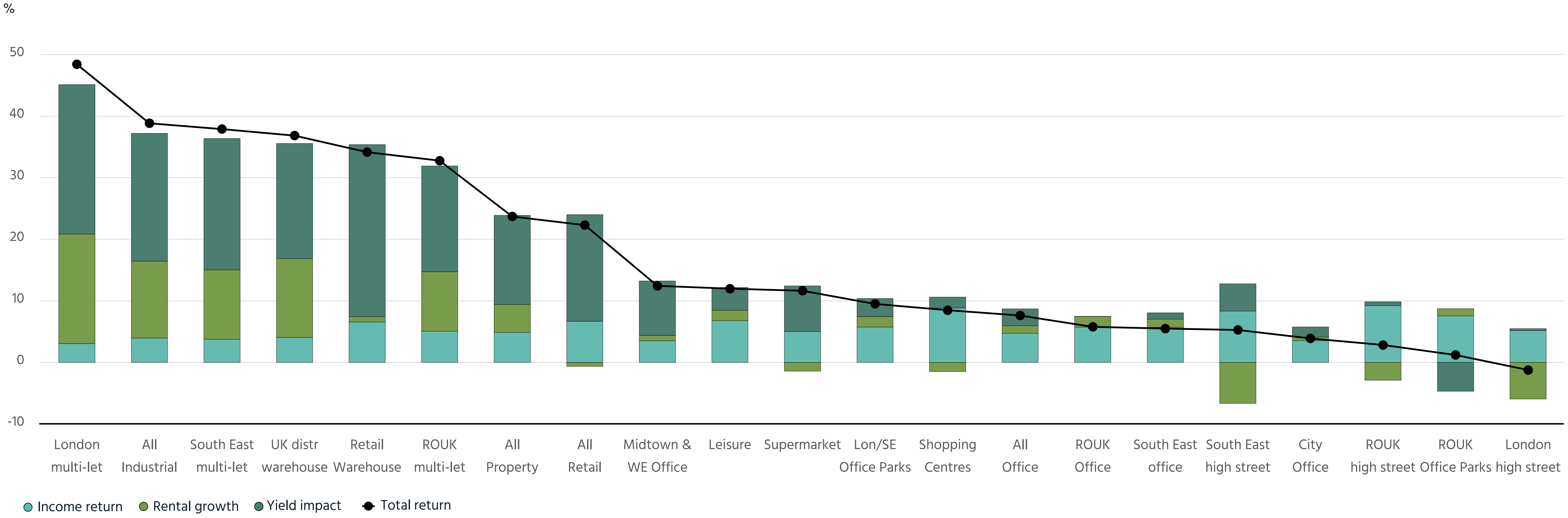


UK quarterly commercial property investment volume by sector
Source: Gerald Eve, Property Data



UK property segments

12-month return to June 2022
Source: MSCI



UK economy

UK GDP increased 0.5% month-on-month in May after effectively stagnating during the previous three months. However, the rise was mainly due to the extra working day caused by the bank holiday shift to the Jubilee in June. Overall, GDP is likely to have fallen modestly in Q2. Oxford Economics has cut its forecast for annual GDP growth for 2023 again by a further 0.5 percentage points to 0.8%, citing further monetary policy tightening and a weakened global backdrop.

UK CPI inflation rose to 9.4% in June, the highest rate since 1982. Petrol prices were the main factor though there is still momentum across a wide range of sectors including elevated global goods and food prices impacted by the conflict in Ukraine. A surge in gas and electricity futures suggests that Ofgem will raise the energy price cap by nearly 60% in October. Consequently Oxford Economics expects UK CPI inflation to peak at nearly 12% in October and fall back only gradually 2023. In part this persistent inflation is due to the weakness of the pound, which is unlikely to reverse while the US Fed continues to hike interest rates more aggressively.

The UK base interest rate increased to 1.25% in June and it is forecast to finish the year at 2%. Sharply rising input costs are of key concern to businesses and high frequency sentiment indicators for services and manufacturing dropped in July to fractionally above the 50 "no-change" mark. This suggests little growth but no contraction either. In contrast, consumer sentiment held steady at a record-low in July in response to the drastic increase in the cost of living and erosion of real incomes. Households will have also felt the effects of the withdrawal of tighter fiscal policy as covid support has been reined in and taxes increased.

Retail sales dropped a further 0.1% in June, which completed two consecutive quarterly falls, signalling recession. The near-term outlook for retailers is challenging whilst the consumer sector is so downbeat. There have been two support packages for energy bills, but anything further is unlikely until the Conservative party elects a new Prime Minister. There are widespread labour shortages and the ILO unemployment rate was maintained at 3.8% in May. There has been a fall in participation since 2019 but some signs that the cost of living might prompt early retirees back into the labour market.

0.8% ▼
2023 GDP forecast

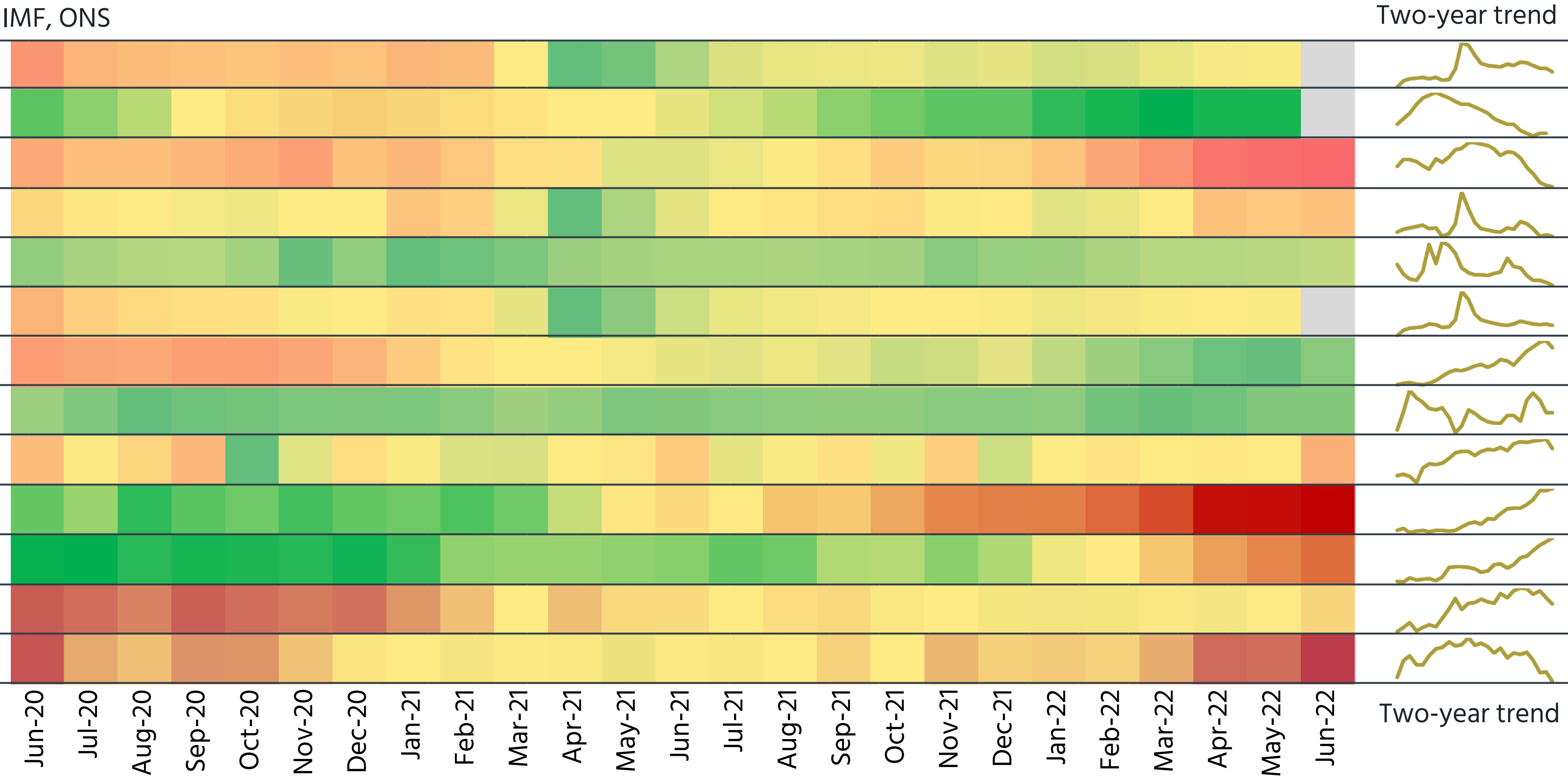
2.4 % ▲
2023 10-yr bond yield forecast

6.0% ▲
2023 CPI forecast

4.2% ▲
2023 unemployment rate forecast

The monthly monitor

Source: Bank of England, IMF, ONS

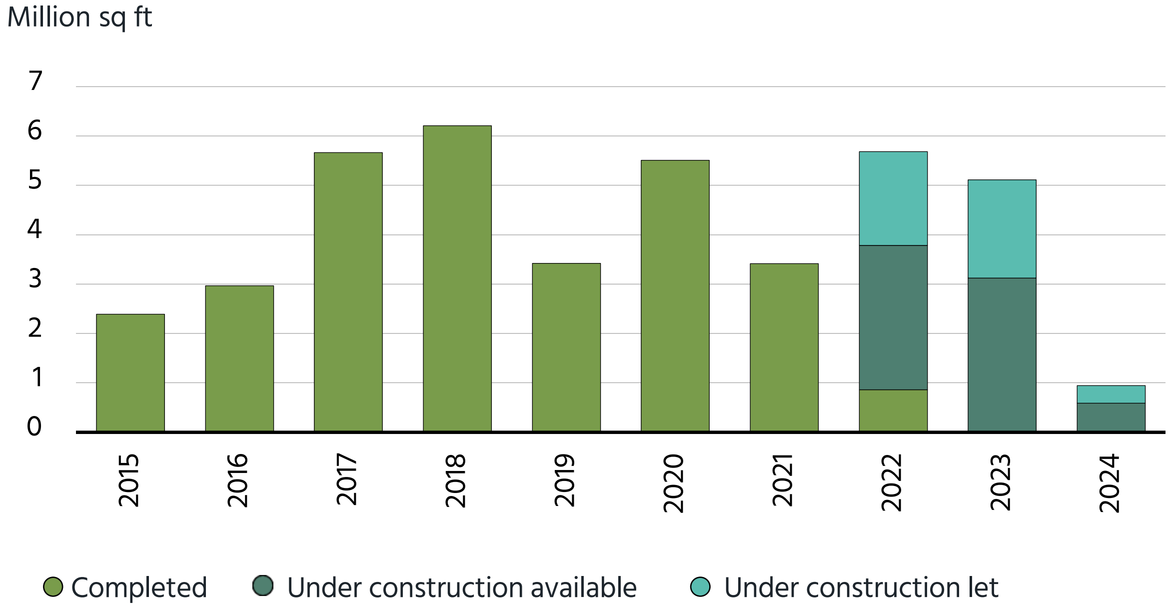


	Latest figure
GDP annual growth	3.5%
Unemployment rate	3.8%
Consumer confidence	-41.0
Retail sales growth	-5.8%
Retail sales % online	24.8%
Manf output growth	2.2%
Brent crude (USD/bbl)	103.92
Gold (USD/oz)	1,837
FTSE-100	7,171
CPI inflation	9.4%
10-year bond yield	2.3%
EUR/GBP	1.16
USD/GBP	1.21

Spotlight on... central London office development

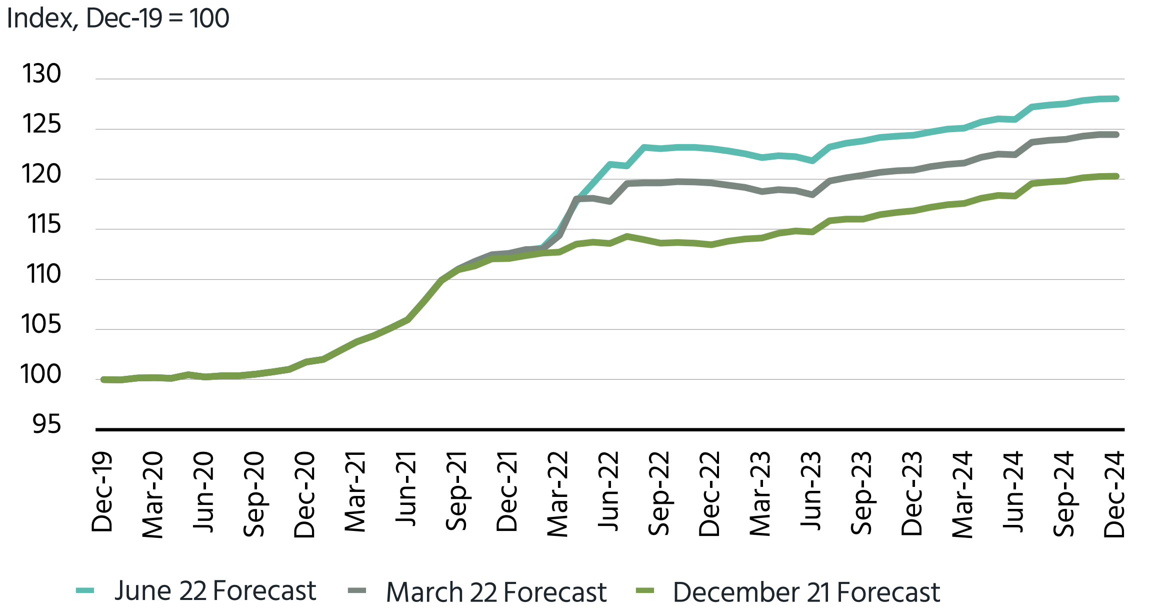
London office development pipeline

Source: Gerald Eve



BCIS general build cost index

Source: BCIS



> Developers are conscious of the heightened expectations of office occupiers on environmental performance, well-being and sustainability. It is also apparent that space with these attributes are in very tight supply, especially in the West End. For existing sites that have the potential to provide this space, developers are still looking to proceed despite the challenges of build costs. However, they are mindful of what is a restrictive and increasingly challenging regulatory climate, especially where major physical change, as opposed to cosmetic enhancements, are proposed.
>
> **James Wickham, Partner**

Several new developments continue to lag original delivery schedules, with schemes such as Ilona Rose House and Paddington Square originally cited for practical completion in the latter stages of Q2 now expected to complete in late July or August. This is happening across London and the various postponements mean it is now highly likely there will be a material reduction in the 7.7m sq ft of completions for 2022 that was expected earlier this year. There is an estimated 4.8m sq ft left to complete in 2022, with only just over 850,000 sq ft completed by the half-year point.

Only half a million sq ft completed in Q2 across five schemes, the largest of which was Derwent's 209,000 sq ft 1 Soho Place. The recent high volume of pre-let take-up has fed through into this year's pre-let development figure, which now stands at 40% of all stock under construction. For 2023, the pipeline is for 5.1m sq ft, of which just under 2m sq ft is pre-let. There is increased appetite for developers to take on full-scale refurbishments, as opposed to ground-up developments that have the faster growing build costs of the two.

Build cost inflation continues to rise, with further upward revisions to forecasts. Typical build costs in 2022 and 2023 are expected to be a further 1.7% and 2.9% above the March-22 forecast. For refurbishments, particularly brown-to-green, costs have increased markedly, with some schemes reporting an increase to an average £400 per sq ft, compared with an average £300 per sq ft a year ago. Despite the stark increase, comprehensive refurbishments remain cheaper than ground-up schemes. This will change the pipeline over the coming two years, with developers and landlords being increasingly selective on office developments and refurbishments.

Outlook

We expect outward yield shift in H2 to largely offset the inward yield undershoot in H1 across various property segments. Typically those with stronger yield impact in H1 are lower-yielding and more susceptible to the increased cost of debt. Consequently the overall annual yield impact for all sectors in 2022 is likely to be quite minimal. After some years of divergent returns sector performance will be similar from 2023 and driven by income.

Industrial is expected to continue to dominate in 2022 with a total return of over 17%. However, this will be driven by rental growth rather than yield impact. Record rental growth momentum carried over into H1 2022 outperformed expectations but we expect a more moderate increase in H2 and a return to 'normal' rates of growth from 2023 as the market absorbs record levels of underrentedness. Returns from 2023 should be more in line with the other sectors.

The **office** market is polarised between the highly desired and undersupplied best-in-class stock versus the rest. This is set to persist since development timescales will be pushed out by high cost inflation and lack of availability of materials. There may still be some upward rent inertia at the prime end in London but broadly a slowdown in occupier activity is expected over the medium term as the global economy weathers an uncertain period.

UK households are facing real challenges and the **retail** sector is now in recession. However, the significant value falls for retail property over the last several years should cushion the sector somewhat from further negative pressures. Income will be the key driver of performance over the medium term and retail assets benefit from high income return, though there is considerable risk.

Total return and components by sector

Source: Gerald Eve, MSCI

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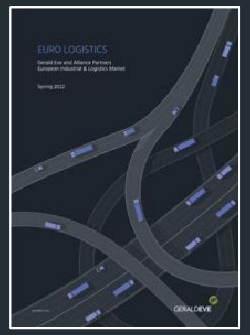
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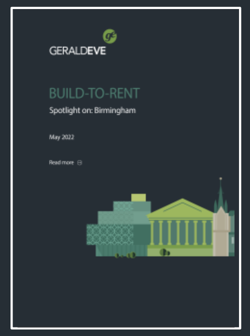
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