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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

October 2022

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OCTOBER UPDATE

All Property quarterly total return continued to drop further into negative territory and hit -4.1% in September. All major segment quarterly returns were negative but this was particularly driven by industrial. Industrial quarterly total return dropped to -7.1% in a dramatic turnaround after posting +8.4% only four months ago in May. Capital values could fall as much as 25% by the year-end, with a potential -35% peak-to-trough into 2023.

-7.2% ▼
Industrial quarterly total return, Sept 2022

150bps ▲
Prime industrial outward yield shift, May - October

-0.5% ▼
2023 GDP growth forecast

6.0% ▼
2023 CPI inflation forecast

4.6% ▲
2023 unemployment forecast

4.2% ▲
2023 10-year bond yield forecast

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Rapid decline in industrial returns

All Property quarterly total return continued to quickly drop further into negative territory and hit -4.1% in September. All major segment quarterly returns were negative but this was particularly driven by industrial. **Industrial** quarterly total return dropped to -7.1% in a dramatic turnaround after posting +8.4% only four months ago in May.

The radical shift in the cost of debt and subsequent turn in the investment market has been felt most keenly at the lower-yielding end of the market. Indeed, London multi-let, the outperforming darling of UK real estate since mid-2020 which finished 2021 with an astonishing annual return of 42.7% was by some margin the worst performing segment in September, running at a quarterly rate of -9.6%. This reflects an outward yield shift of 44bps since May on the MSCI valuations measure, which is itself lagging the direct market considerably where we estimate yields have softened by 150bps or more.

Industrial capital values have lost around 8% since June on the MSCI measure. This will deteriorate significantly over the next few months and could be at -25% by the year-end and -35% in total peak-to-trough into 2023. This repricing is inevitable but there remains a huge amount of global capital targeting industrial for what is a fundamentally strong income stream. The pandemic boost to logistics occupier demand may have finally eased in Q3 and internet retailers retrenched, but the breadth of modern logistics demand meant that overall take-up was still 20% above the pre-pandemic average. This kind of diversity also points to far more occupier resilience over this downturn than during previous ones and we do not expect headline rents to fall.

In the industrial investment market there has been a clear flight to quality, with the most liquid parts of the market being Greater London multi-lets and high-quality logistics assets of sub-£50m, ideally with a lease event in the next 2-3 years.

Offices have been the underperforming sector during and post pandemic with very low volatility and without an individual subsector like retail warehousing to bolster returns as it has been the case with UK retail. Offices dipped into negative quarterly return of -1.5% in September, which was sufficient to erode the average UK office capital value below its value of two years ago.

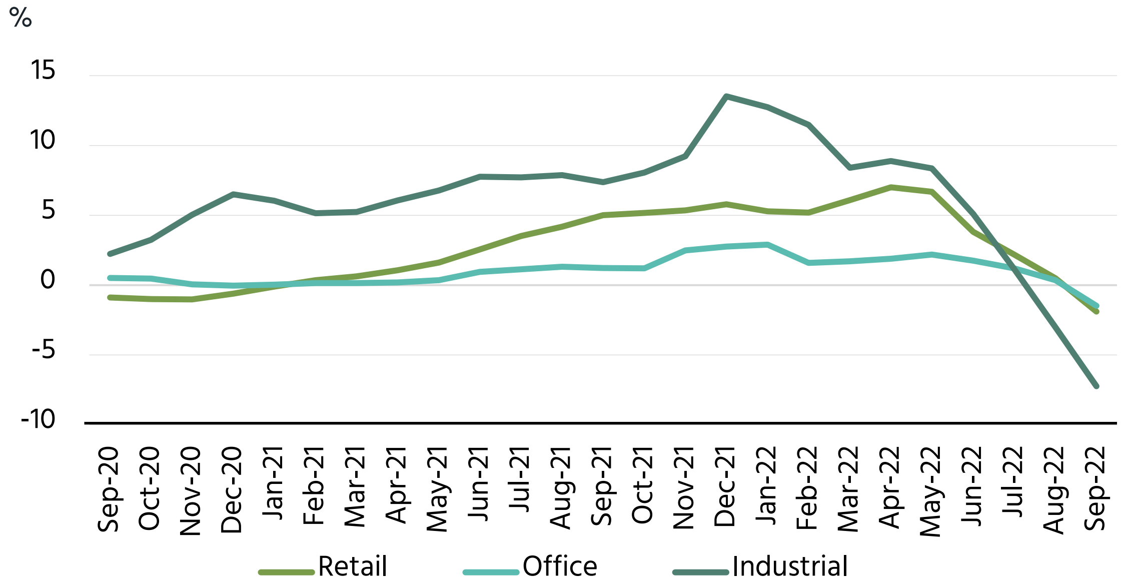
Not only have yields softened but leasing demand also eased in Q3 as occupiers delay decisions where possible and keep a watchful eye on the many uncertainties that lie ahead. The market is increasingly polarised, exemplified by the central London market, where tenant-controlled "grey" space is at a near-record 28% of all availability, with persistent secondary voids. Meanwhile demand for premium office space continues to be robust, and prime supply is increasingly tight. This imbalance at the top end of the market has continued to push up headline rents and shorten rent-free incentives, notably in Knightsbridge and Soho.

Retail quarterly returns have similarly turned negative, despite the drastic repricing over recent years preceding this current phase of rising interest rates and consumer recession. However, the scope for negative yield impact is less, given the already very elevated retail yields that also provide significant income return that will help cushion any future negative returns.

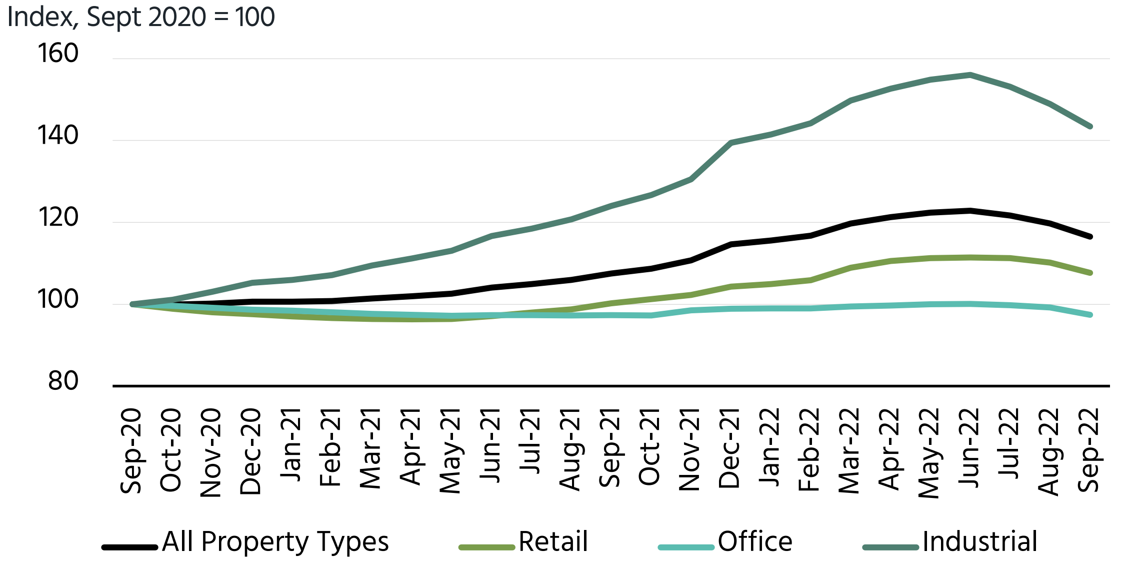
-7.2% ▼
Industrial quarterly total return, Sept 2022

150bps ▲
Prime industrial outward yield shift, May - October

Quarterly total return by sector
Source: MSCI

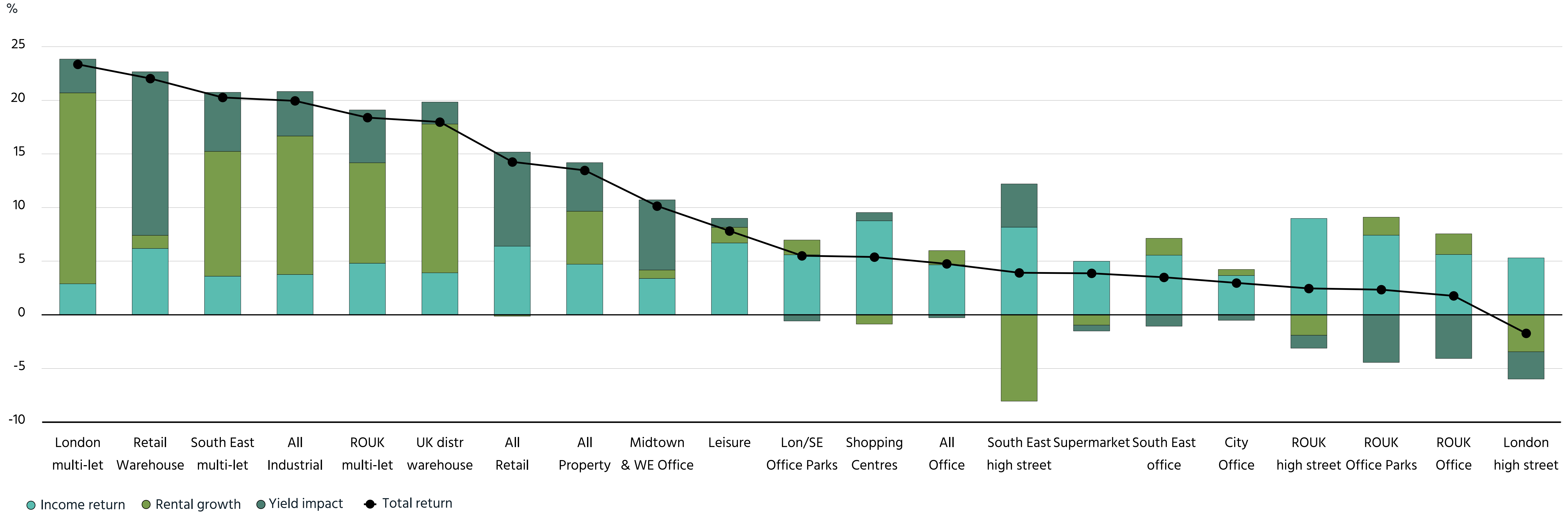


Capital values by sector
Source: MSCI



UK property segments

12-month return to September 2022
Source: Gerald Eve, MSCI



UK economy

UK GDP fell 0.3% month-on-month in August, and leading indicators suggest that economic activity will have likely fallen overall in Q3. The UK might already be in recession, though an official contraction in Q4 is needed to officially confirm this. Oxford Economics has again cut its forecast for annual GDP growth for 2023 now to a contraction of 0.5%.

Turbulence in the financial markets has eased significantly following the various policy U-turns and the appointment of Rishi Sunak as prime minister. November's Autumn Statement promises substantial fiscal tightening across all government departments. This all points to a deeper recession in late 2022 and over 2023 but a potentially lower trajectory for interest rates. Market expectations in late September were for base rates to peak at over 6% in 2023, which has now reduced to around 5%. The majority opinion now is that the MPC will raise rates by 75bps to 3% at the November meeting.

There is nevertheless still a fine line to tread. Business sentiment for services has joined manufacturing indicating contraction and cited somewhat lessened cost and price pressures. But the unemployment rate fell to a new post-1974 low of 3.5% in August and regular annual pay growth increased to 5.4%, the highest rate on record outside of the pandemic period.

The CPI inflation rate increased again to 10.1% in September. This high and sustained period of expected price rises has become very much embedded in the national psyche, increasing the possibility of a domestic wage-price spiral which have historically been shown to be stubborn to shake off. The decision to replace the cap on household energy bills next April with more targeted support will make forecasting inflation harder. And despite a small recent rally the pound remains undervalued, which will bring further imported inflation.

Retail sales fell 1.4% in the month to September and were down 6.9% on a year ago. This was the lowest level for 19 months, and Q3 was the fifth successive quarterly drop. All segments were affected, notably household goods store spending, which was down 17.6% on a year ago. The outlook continues to be poor, with the national insurance contribution cut likely to reversed and tax thresholds frozen. Meanwhile higher mortgage rates will reduce disposable household incomes as fixed rates expire. The negative wealth effects from an estimated 15% fall in house prices will be a further drag on spending.

-0.5% ▼
2023 GDP growth forecast

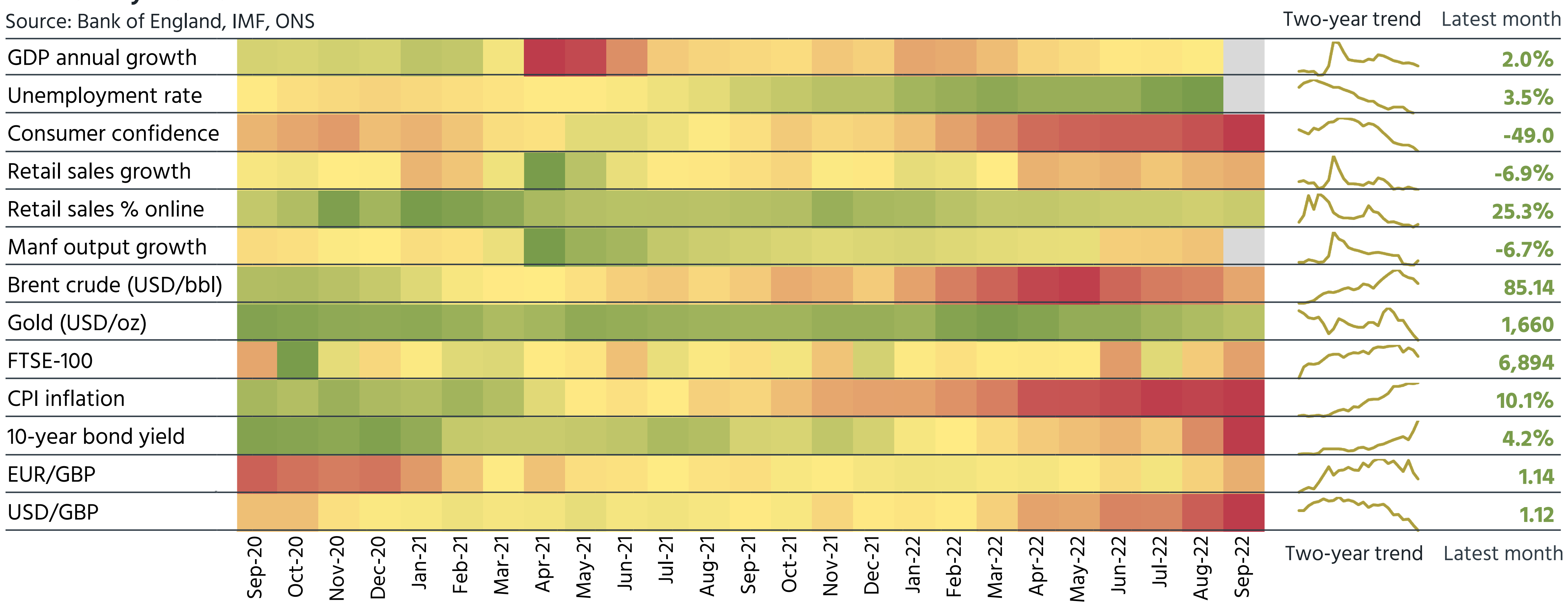
4.6% ▲
2023 unemployment forecast

6.0% ▼
2023 CPI inflation forecast

4.2% ▲
2023 10-year government bond yield forecast

The monthly monitor

Source: Bank of England, IMF, ONS



Spotlight on... UK logistics, occupier costs and rents

RENTAL GROWTH SLOWED SHARPLY IN Q3

There were rent increases recorded in six out of 53 Gerald Eve centres in Q3. This equated to 0.7% prime quarterly rental growth across the UK overall, the lowest since Q2 2020. Typically rents were moved on in deals on speculative buildings in notably active UK locations – Park Royal, Enfield and Swindon for example. These were the exception though in a market where sentiment has softened. On an annual basis, rents have grown 13% so far this year and an incredible 17% since Q3 2021. However, this too represents a drop from the peak 22% annual growth rate in Q2 and this will continue to fall back now. The post-pandemic period of accelerating rents has come to an end. Occupier purchasing power and appetite for new space has weakened, and several occupiers have put acquisitions on hold.

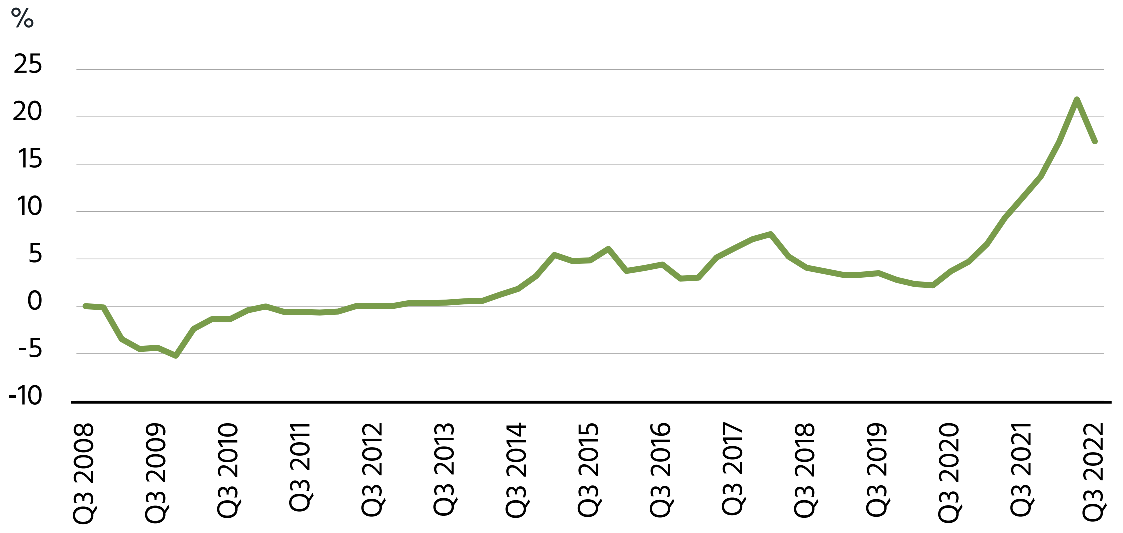
BUSINESS RATE RISES TO ADD TO OCCUPIER UNCERTAINTIES AND COST PRESSURES FROM APRIL 2023

Cost pressures are mounting for occupiers and future order books have been dented by the consumer recession and cost of living crisis. Increased operational, labour and utilities costs along with the higher cost of servicing debt have put increased pressure on already-tight margins for some tenants. Government support for businesses in the form of the energy price cap has been welcomed, but will potentially be short-lived, with relief set to end in March 2023. Uncertainty over this key component of costs for many industrial occupiers will coincide with the certain increase in business rates liabilities, based on the unprecedented period of rental growth in the sector between 2017 and 2021.

BUT LIMITED SUPPLY WILL UNDERPIN HEADLINE RENTS

Developers are conscious of the projected weaker occupier demand pool in 2023 but are equally all too aware of the need to cover their inflated construction costs. Costs will be most problematic for those that bought recently, particularly if debt-backed and facing refinancing issues. Necessarily high rents on newly-developed buildings are likely to continue to set market tone, but occupiers will be less willing and able to pay them. Void rates are currently at historic lows but longer periods of vacancy could result if landlords hold out. For some developers, these increased costs set against sharply softening yields have meant that schemes simply do not stack up financially, which is likely to limit the delivery of future speculative schemes and further help keep a floor under headline rents.

Annual prime logistics rental growth
Source: Gerald Eve



Key dates leading up to the 2023 rating revaluation
Source: Gerald Eve

2021 — **1st April**: Antecedent valuation date for 2023 Revaluation.

2022 — **Autumn**: Anticipated announcement regarding transitional scheme for April 2023 and beyond.

31st December: Latest potential publication date for draft 2023 Rating List.

2023 — **1st April**: 2023 Revaluation start date. Assessments capable of being appealed.

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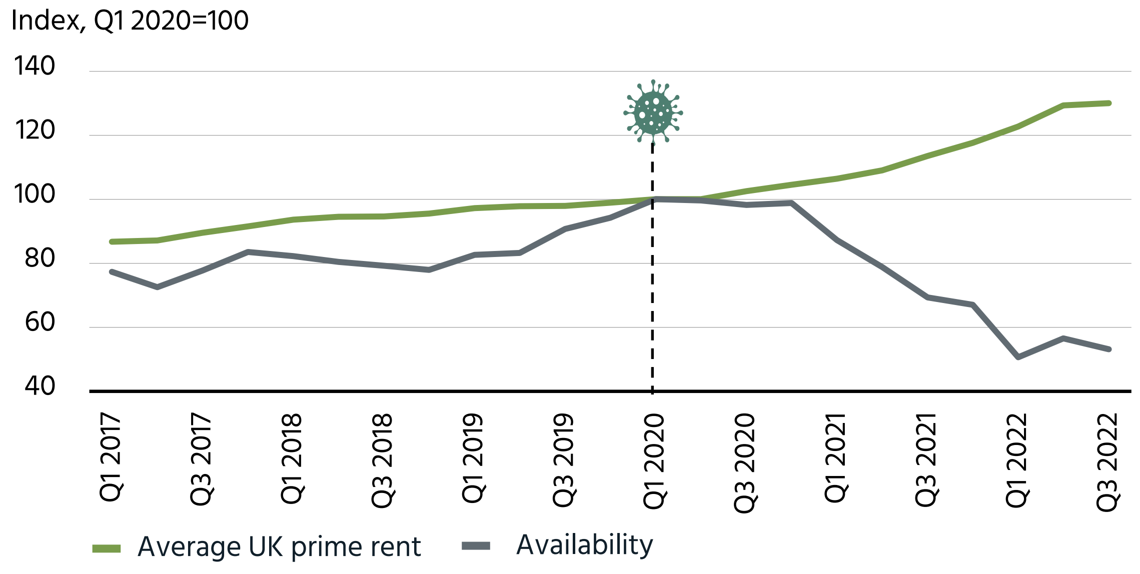
Indexed prime rents and availability
Source: Gerald Eve



Outlook

We have revised our outlook on the outward yield shift in H2 and we now expect capital falls that will be sufficient to drive negative 2022 annual returns across various property segments. The direct market will likely correct quite quickly but there will be further valuations-based yield softening in H1 2023 since valuations lag market pricing. This is likely to generate a negative annual total return in 2023 also.

Industrial is the lowest-yielding property sector and is thus most exposed to rising debt costs. Outward yield shift in H2 will have a dramatic impact on returns in 2022 despite exceptional rental growth recorded in the first half of the year. We expect a return to 'normal' rates of rental growth from 2023 as the market absorbs record levels of reversion. Further outward momentum for valuations–based yields point to another year of negative return.

The **office** market is polarised between the highly desired and undersupplied best-in-class stock versus the rest. This is set to intensify 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 a challenging period.

UK households are facing deep challenges and the **retail** sector is in recession. However, the significant value falls for retail property over the last several years should provide a small offsetting cushion. Income will be the key positive driver of performance over the next few years 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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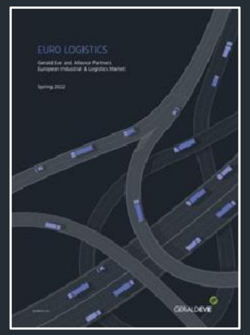
August 2022

Prime Logistics
Q3 2022

London Markets
Q3 2022



Euro Logistics
Spring 2022

Carbon Offset Contribution - London Benchmarkg
August 2022

Rating Update - Autumn 2022
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Whole life carbon Optioneering
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A life sciences lease of life: Adaptive repurposing
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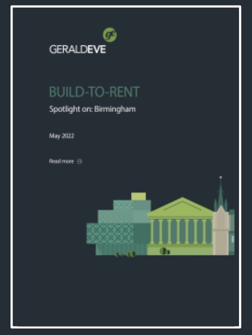

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