IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

November 2022

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NOVEMBER UPDATE

Valuations data are now rapidly catching up with the unprecedented shift in the direct investment market. Outward yield shift was sufficient to generate an all-time record low -6.4% monthly total return in October. The key question now is where property yields will peak, how quickly this will occur and when and by how much they will potentially fall back again once the recession has worked its way through and inflation has fallen out of the figures. We look to answer this in some detail in a special Spotlight feature this month.

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

-6.4% ▼	98bps ▲	-0.9% ▼	7.6% ▼	3.5% ▲	4.4% ▲
All Property monthly total return, Oct 2022	Industrial outward yield shift, May - October	2023 GDP growth forecast	2023 CPI inflation forecast	2023 10-year government bond yield forecast	2023 unemployment forecast

Most negative All Property monthly total return on record

Commercial property valuations data are now rapidly catching up with the unprecedented shift in the direct investment market that has taken place so far in H2 2022. Yield impact across all property segments have turned sharply negative and total returns are falling at an increasingly volatile and unpredictable rate. This has already taken 12% off the value of all UK commercial property in the three months to October.

The All Property average equivalent yield moved out 45bps in a single month in October, which contributed to an astonishing -6.4% monthly total return. This is the most negative figure on record, greater even than any individual month during the global financial crisis. The current data are all the more remarkable given that only 10 months ago in December 2021 the monthly total return was the highest ever recorded at +3.9%, driven by stellar performance for industrial.

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. The industrial average equivalent yield has moved out 98bps since May, whereas retail and office have each shifted 55bps. Page 4 overleaf shows the relative returns by segment in the 12 months to October. London multi-let has finally been displaced from the top spot after 26 consecutive months. The industrial subsectors generally still sit relatively strongly against other property segments given the very significant amount of rental growth over the past 12 months. However, this will increasingly fall out of the figures, with negative yield impact taking precedent and industrial will move further down the order.

Ironically, now that the valuations data are at their most acutely negative the direct market is showing some signs of stabilisation. There are more potential buyers than a month ago after the period of so-called "price discovery" and now that the more extreme financial market volatility has eased. The fund sell-off driven by redemptions continues, but so far this has been orderly. The pension funds are also selling and there is likely to be more refinance-led distressed sales in the coming months.

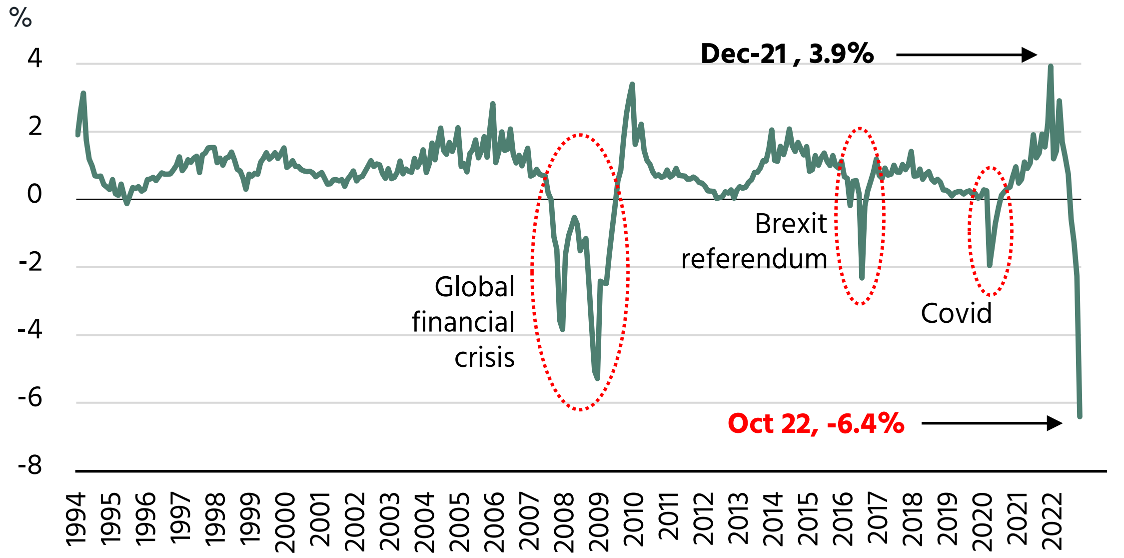
Ultimately though, the key shift in interest rate expectations has essentially now happened and though the recession is expected to be long, it is likely to be relatively shallow. The industrial (and arguably also office) occupier markets have shown themselves to be relatively resilient against negative shocks and our view is that headline rental growth will not turn negative. Moreover, the cost and lack of availability of development materials will minimise the future supply pipeline.

This will help give potential buyers with appropriate finance that have been waiting on the sidelines the confidence to act. We expect this to drive a UK yield trajectory that peaks next year, as shown in some detail on our special Spotlight section this month.

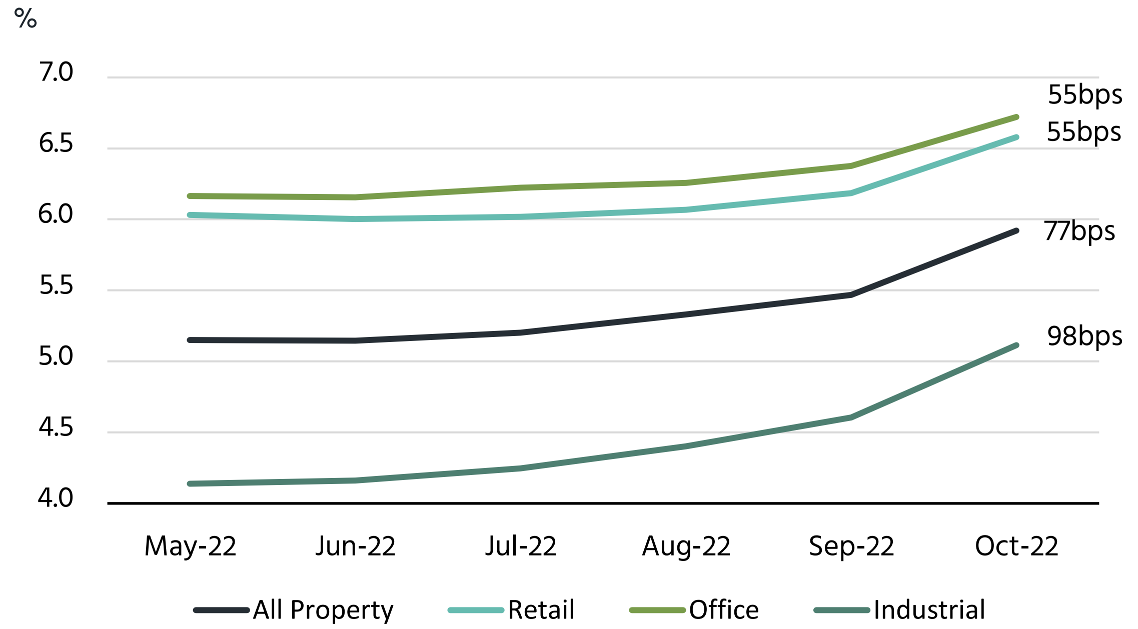
-6.4% ▼
All Property monthly total return, Oct 2022

98bps ▲
Industrial outward yield shift, May - Oct

All Property monthly total return to Oct 2022
Source: MSCI

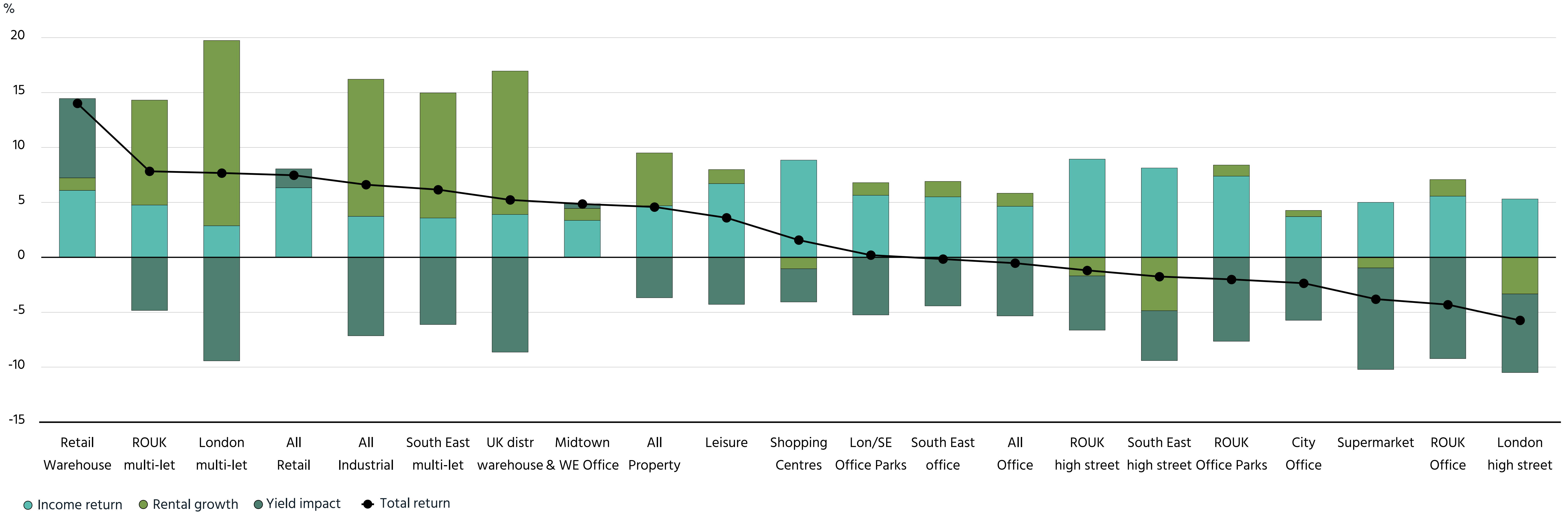


Equivalent yields by sector (and outward shift since May)
Source: MSCI



UK property segments

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



UK economy

UK GDP fell a further 0.3% month-on-month in September, in part due to the extra bank holiday for the Queen's state funeral. The broader, preliminary estimate though is that Q3 GDP fell 0.2% and most commentators, including the bank of England, expect this to be the first quarter of a long recession that could last through the whole of 2023. November's PMI business sentiment surveys again suggest that services and manufacturing output are falling, with a sharp fall in new orders for both consumer and business-facing firms. Oxford Economics has again cut its forecast for annual GDP growth in 2023 to -0.9%.

Most of the detail of the Autumn Statement on 17th November had already been drip fed to the media in the preceding weeks. In total it amounts to a fiscal tightening of £55bn over five years, but very much backloaded to the latter years to avoid compounding the current contraction in economic activity. Numerous nominal tax thresholds have been frozen until 2028, which will generate extra revenue through "fiscal drag" drawing more individuals into paying greater rates of tax, particularly during this period of high inflation. The downside of this from an inflationary/interest rate-setting perspective is that fiscal policy will do little to dampen output in the near term, with the heavy lifting to be done by higher interest rates, currently projected to peak at around 4.5% in mid-2023.

The Bank of England raised rates by 75bps to 3% in November with a further 50bps expected in December. The reversal of most of the Truss/Kwarteng unfunded tax cuts has eased the 10-year bond yield from 4.4% in late September/early October to 3.1% currently. This has fed through to somewhat lower mortgage rates in recent weeks, though homeowners will nevertheless face substantial increases when they come off fixed-rate products over the next few years.

The energy price guarantee will increase from £2,500 to £3,000 from April 2023, which will not only dent consumer sentiment and spending further but add around one more percentage point to headline inflation. The CPI inflation rate increased again to 11.1% in October, the highest rate in 40 years. October will potentially be the peak, but the passthrough effects from the rise in energy costs and the depreciation of sterling are still to fully play out before the typically stickier domestic core inflation is dealt with. Forecasters still widely anticipate high single digit inflation at the end of 2023.

-0.9% ▼
2023 GDP growth forecast

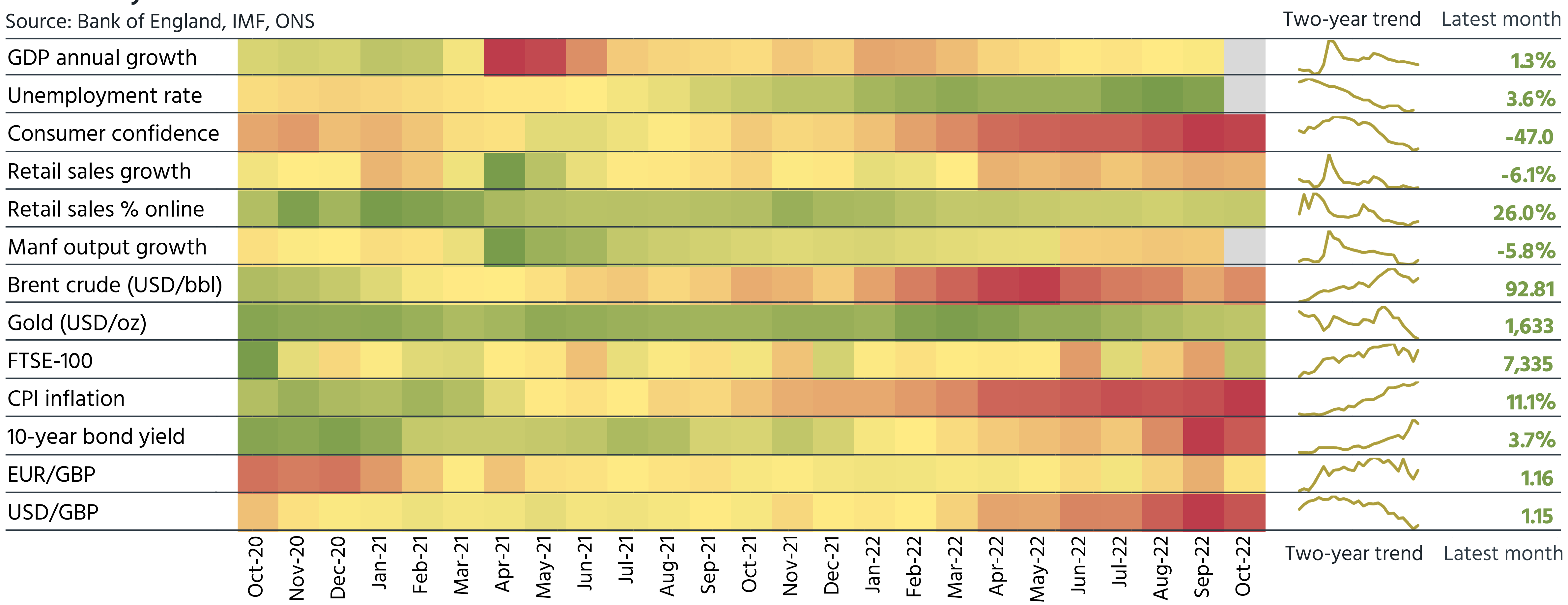
4.4% ▲
2023 unemployment forecast

7.6% ▼
2023 CPI inflation forecast

3.5% ▲
2023 10-year government bond yield forecast

The monthly monitor

Source: Bank of England, IMF, ONS

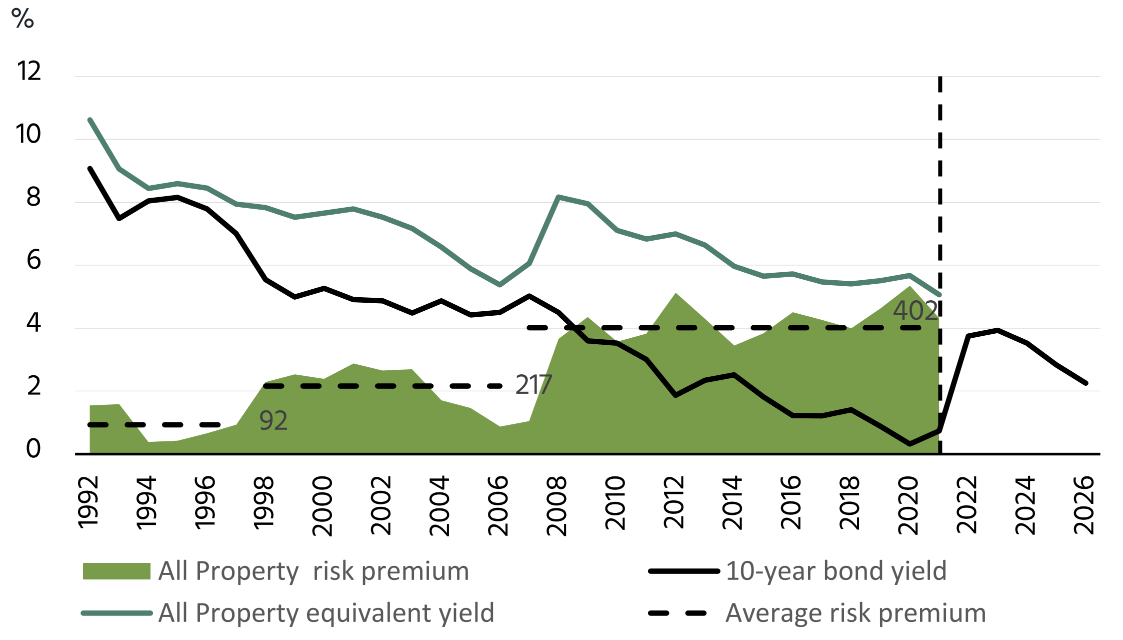


Spotlight on... the future trajectory of commercial property yields

LARGEST EVER UPWARD SHIFT OF INTEREST RATE EXPECTATIONS

The dramatic shift in interest rate expectations has been characterised as much by the extremely rapid rate of change as it has the actual level. The 10-year bond yield is forecast to be 3.75% by end-year 2022, which will represent the largest annual step up on record. Market participants have thus been scrambling to ascertain where property yields will peak, how quickly this will occur and when and by how much they will potentially fall back again once the recession has worked its way through and inflation has fallen out of the figures. Oxford Economics expects a bond yield peak of 3.9% in 2023 with a fall back to 2.25% by 2026. Despite the rapid outward commercial property yield shift, the spread between the All Property yield and the bond yield (the risk premium for holding property) has effectively been neutralised and will need to be re-established over the coming quarters.

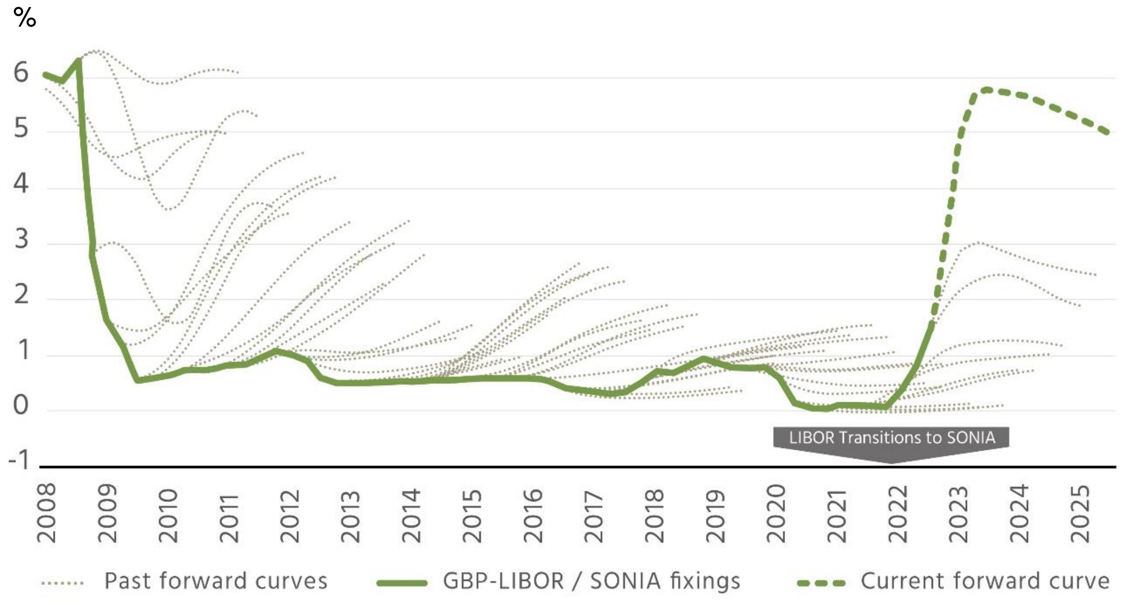
Bond yields, All Property equivalent yield and risk premium
Source: Gerald Eve, MSCI, Oxford Economics



HIGHER INTEREST RATES = LOWER RISK PREMIUM "CUSHION"

Opinions about the exact future bond yield trajectory differ but there is consensus that it will represent a marked shift from the previous 2008-2021 period of ultra low interest rates. What is noticeable about the post-GFC period is the historically large average property risk premium of 402 basis points. Arguably built into the premium during this time was the expectation (and "cushion") that interest rates would revert away from emergency lows over the short-medium term. This is evidenced in the SONIA "hairy chart" below. The fine upward-sloping dotted lines show the various market expectations for interest rates at various points in time. Now with higher actual future interest rates comes a lower expectation of further rises built into the risk premium.

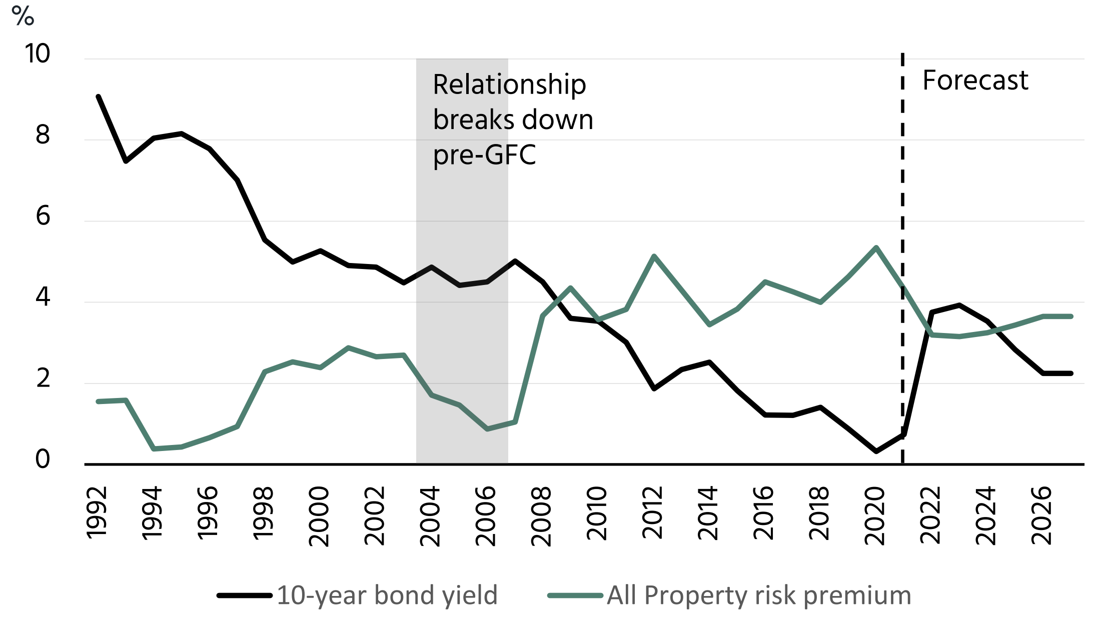
SONIA "hairy chart"
Source: Chatham Financial



NEGATIVE CORRELATION FOR BOND YIELDS AND RISK PREMIUM

Generally speaking, higher bond yields reduce expectations that they will rise further over the medium term, requiring less of a risk premium required to hold commercial property at any given time. Indeed, econometric modelling shows a significant and consistent negative correlation between the 10-year bond yield and the UK property risk premium. With low bond yields there is the expectation/risk of an upward mean reversion that increases the property risk premium and vice-versa. This straightforward relationship was observed only to have broken down in the years preceding the GFC when risk premia fell unjustifiably low. For a given bond yield forecast the model provides a projection for the future property risk premium, which drops to 320bps by end-2022 and picks up moderately to 365bps by 2026.

All Property risk premium vs 10-year bond yield
Source: Gerald Eve, MSCI, Oxford Economics



Spotlight on... the future trajectory of commercial property yields

ALL PROPERTY YIELDS TO PEAK AT 6.55% IN 2023

The future trajectory for both the 10-year bond yield and the commercial property risk premium provide the component parts for the All Property “equilibrium yield”. This is where yields ‘should’ be for the given set of market conditions. However, this historically large step up in the bond yield in 2022 means the market is unlikely to move to the new equilibrium level immediately. There will likely be a transition period where the market lags/catches up with equilibrium – this accounts, for example, for those investors who are cash buyers or have relatively cheaper debt facilities locked in over the medium term. The forecast yield trajectory is shown in the solid black line, which peaks at 6.55% in 2023. It is less volatile than the equilibrium yield in the short term, but both yields converge at 5.9% in the medium term as the bond yield falls and the risk premium rises a little.

ALL PROPERTY NOMINAL CAPITAL VALUE BACK TO 2021 LEVEL BY 2026

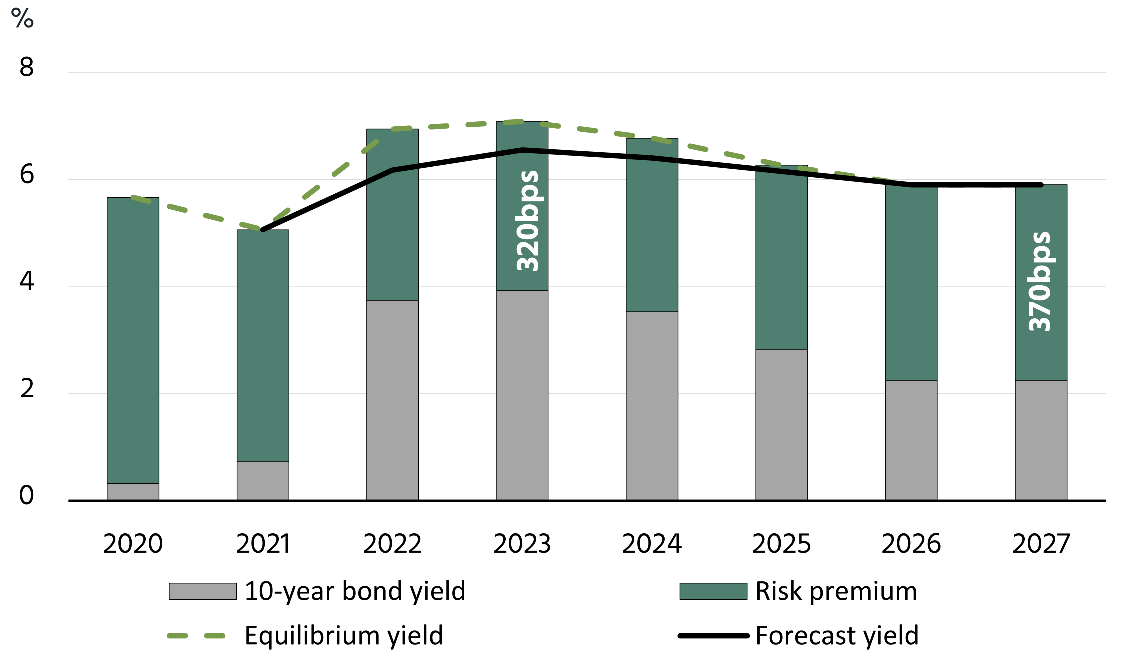
Projected All Property capital values are impacted predominantly by property yields, but are also supported by low, single digit rental growth over 2022-26. The peak in yields in 2023 is set to drive down capital values an estimated 26% from Q2 2022 to 2023. This translates to 17% annually from end-2021 including rental growth. This is notably shallower than the equilibrium yield trajectory but both series converge by 2026 when the capital value has broadly recovered.

However, this method cannot be used directly to calculate individual property segments since the relativities between them have changed over time. Notably, since 2018 industrial has been the lowest-yielding property sector while retail is the highest, in a reversal of hierarchy.

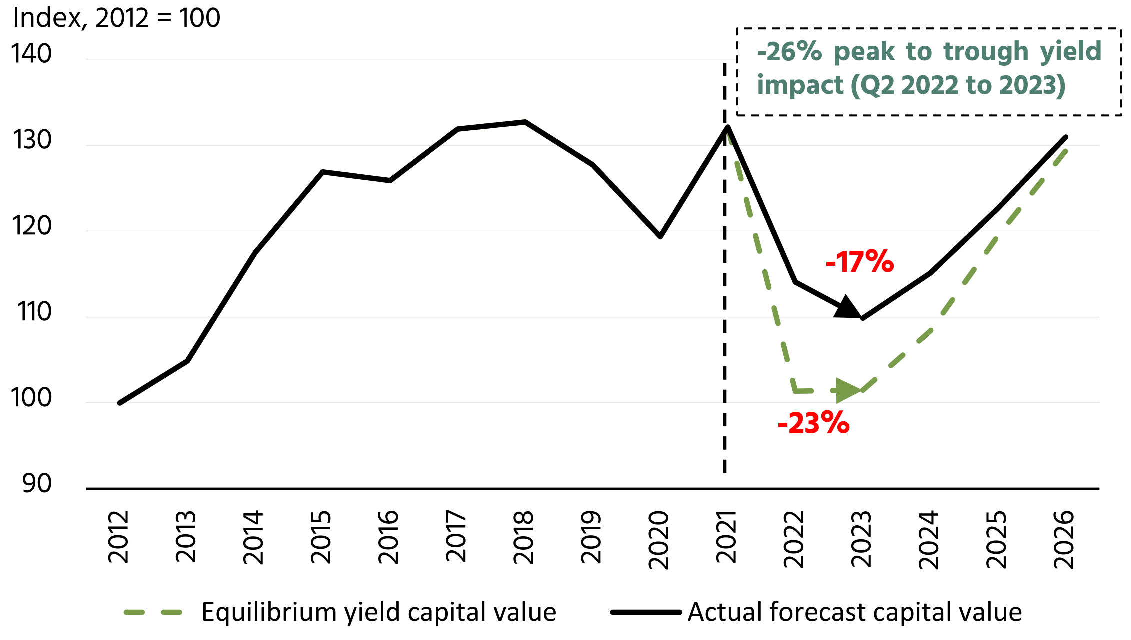
UNLIKE ALL PROPERTY, INDIVIDUAL PROPERTY SEGMENTS HAVE CHANGED OVER TIME

The charts overleaf show the segment relativities against the all-grades All Property risk premium for 1998-2006 versus end-2021. It is clear that modern risk premia for industrial segments are now far lower than their retail counterparts, due in part to the relative changes in the occupier bases and covenant strength as e-commerce has become more established. Thus future risk premia and property yields for individual segments are based off the All Property model but calibrated for modern relativities between property segments. These show that while the industrial yield will peak at a lower level than the other sectors in 2023 it will underperform for in 2022/23 before re-establishing itself as the strongest sector in 2024.

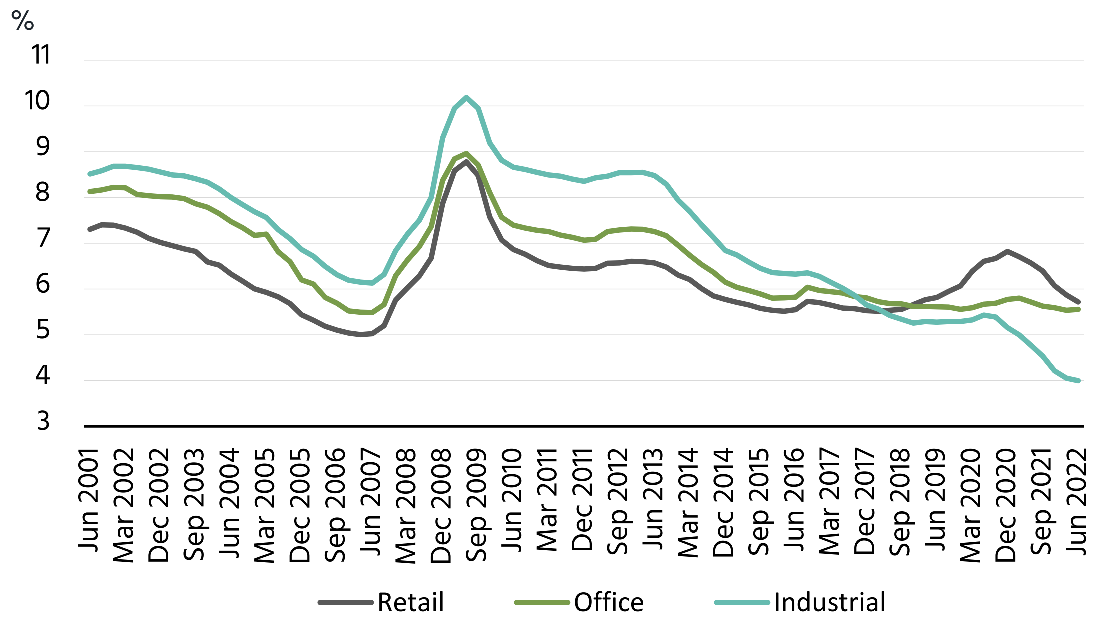
All Property equivalent yield and components
Source: Gerald Eve, MSCI, Oxford Economics



All Property capital value
Source: Gerald Eve, MSCI

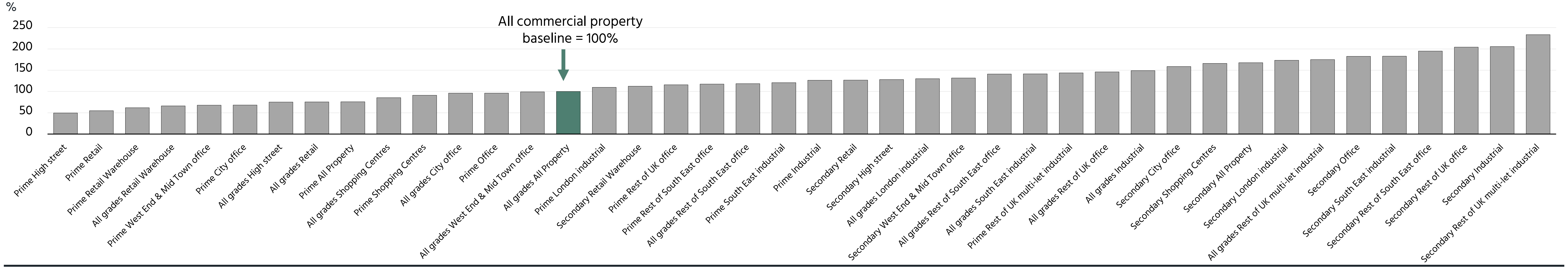


Equivalent yields by property sector
Source: MSCI

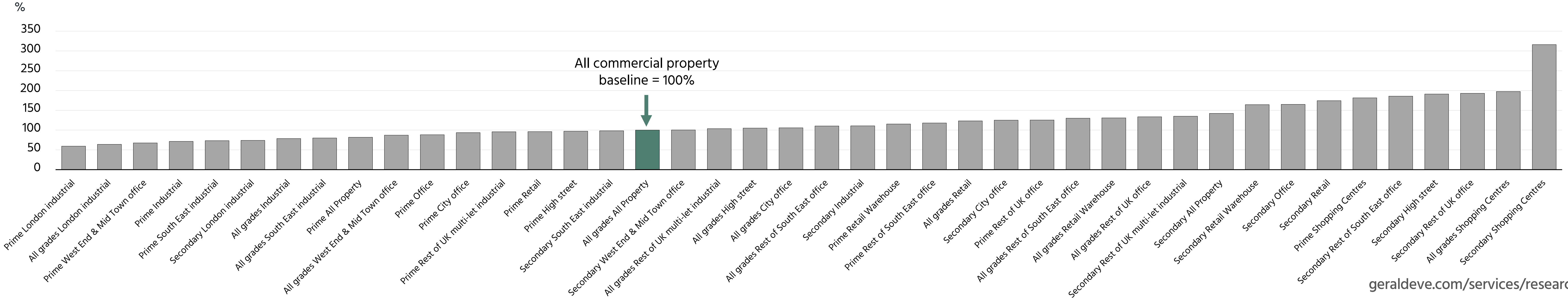


Spotlight on... the future trajectory of commercial property yields

UK property segment risk premium relativities, average 1998-2006
Source: Gerald Eve, MSCI



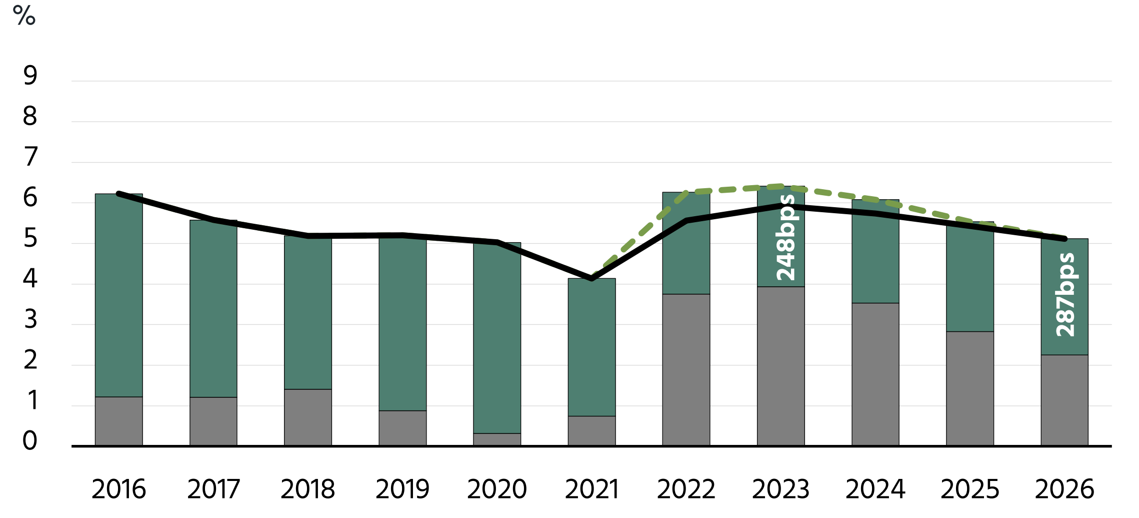
UK property segment risk premium relativities, end-2021
Source: Gerald Eve, MSCI



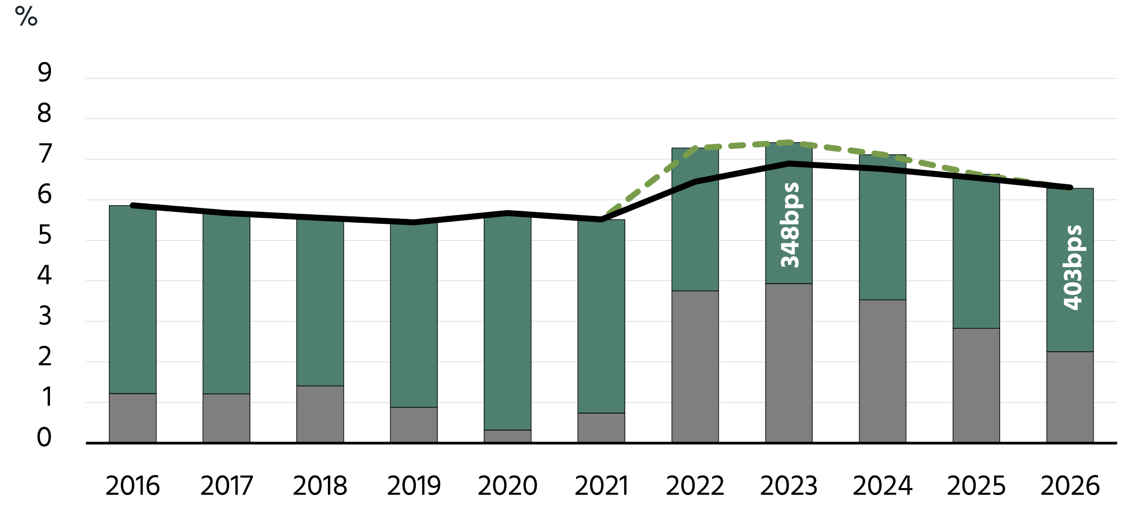
Outlook by sector

Equivalent yield and components

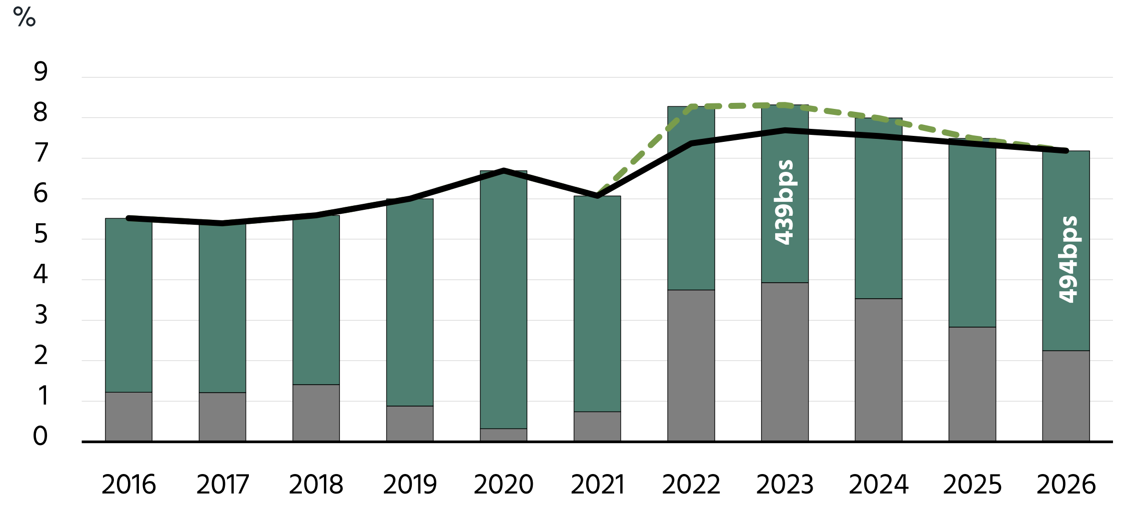
Industrial
Source: Gerald Eve, MSCI, Oxford Economics



Office
Source: Gerald Eve, MSCI, Oxford Economics



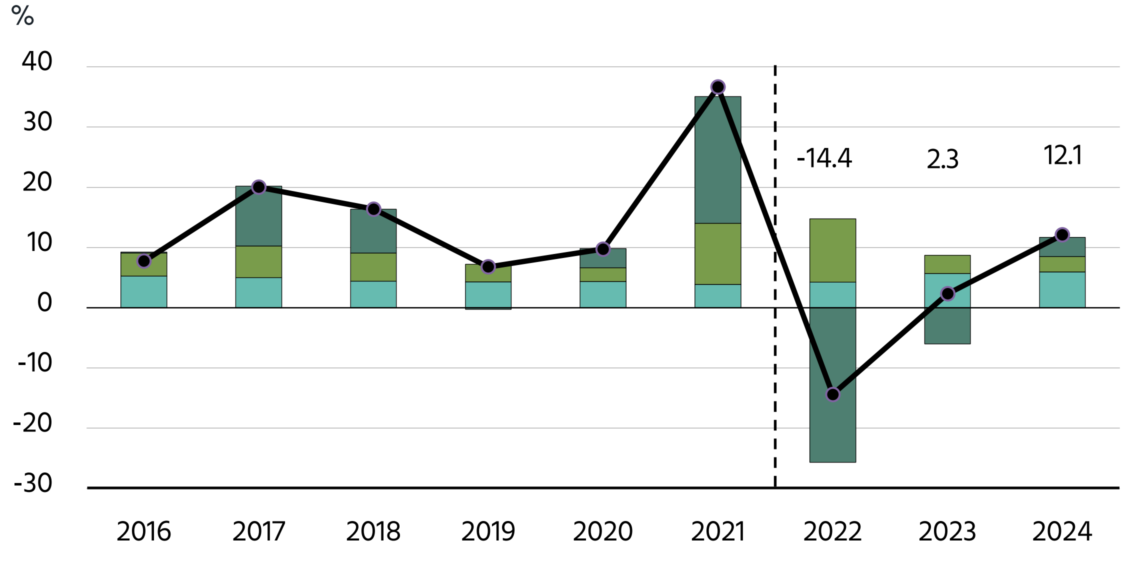
Retail
Source: Gerald Eve, MSCI, Oxford Economics



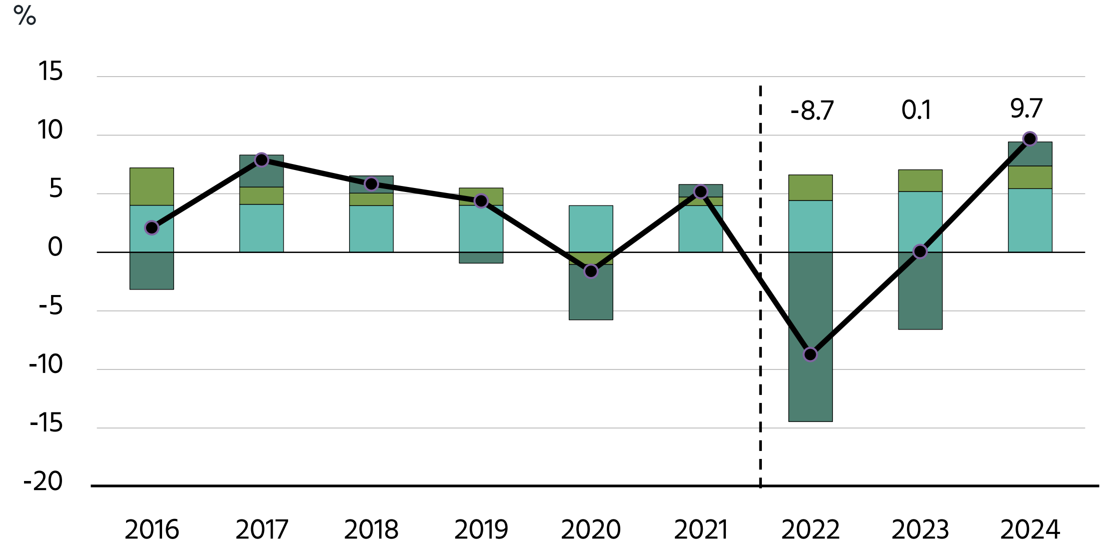
10-year bond yield | Risk premium | Equilibrium yield | Forecast yield

Total return and components

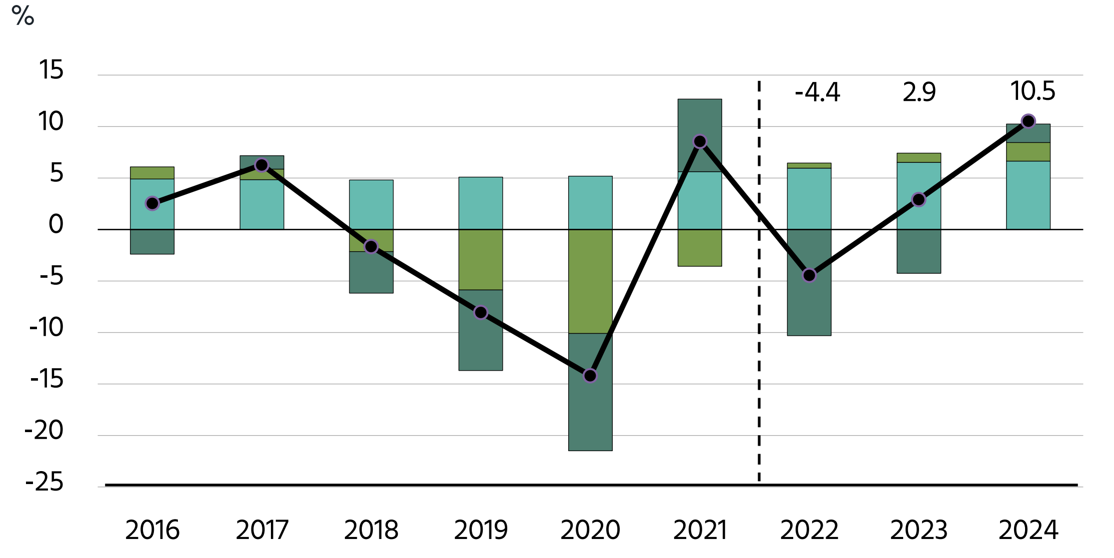
Industrial
Source: Gerald Eve, MSCI



Office
Source: Gerald Eve, MSCI



Retail
Source: Gerald Eve, MSCI



Income return | Rental growth | Yield impact | Total return

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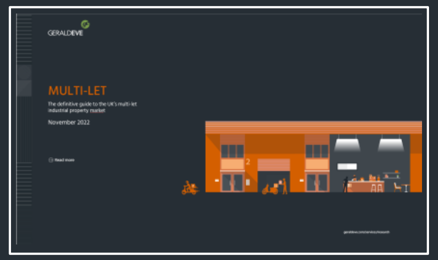

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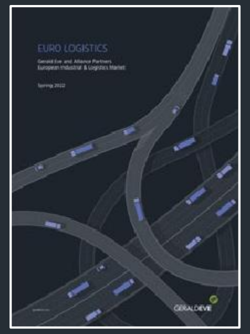
November 2022

Prime Logistics
Q3 2022

London Markets
Q3 2022



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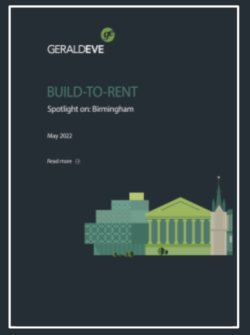

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