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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

December 2022

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DECEMBER UPDATE

After an initial delay showing up in the figures this summer, the repricing in commercial property valuations in the final months of the year continues apace. All Property annual total return turned negative in November, to -3.4%. Participants in the direct investment market suggest that the pricing correction is at or near its trough, with potential buying opportunities in 2023. However, the significant shift in the commercial property investment market will now dovetail into a recession in the real economy and present further risks and uncertainties for occupier markets.

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

0.8% ▼
Retail annual total return, November 2022

-4.4% ▼
Industrial annual total return, November 2022

-0.9% ▼
2023 GDP growth forecast

7.5% ▼
2023 CPI inflation forecast

3.3%
2023 10-year government bond yield forecast

4.4% ▲
2023 unemployment forecast

All Property annual return turns negative

After an initial delay showing up in the figures this summer, the repricing in commercial property valuations in the final months of the year continues apace. The All Property average equivalent yield moved out a further 35bps in November after softening 45bps in October. This takes the total outward movement for all grades of all commercial property to 112bps since May.

This was sufficient to turn the All Property annual total return negative in November, to -3.4%. This was the first negative figure since February 2021, which was under very different circumstances during the pandemic when industrial was performing strongly and retail was really feeling the brunt of the lockdowns. November marked the *most* negative All Property annual total return since November 2009 and clearly this figure is going to fall much further. We predicted -11% for the full year 2022 earlier this year and this still remains a plausible prospect.

Investment returns for all property segments are arching steeply downwards as the yield shift wipes capital value. The steepest gradient has been for the lowest-yielding assets, such as industrial. All-grades industrials has now moved out a total of 141bps. In the direct market, prime yields typically softened a further 25bps in Q4, taking the total outward movement to around 175bps, though pricing was thought to have stabilised by mid-November.

Incredibly, retail is now the main property sector with the strongest annual total return. Historically this would mean returning to 2010 for when this was last the case. However, this is simply a reflection of how far retail yields have already moved out in recent years and the relatively smaller impact a nominal shift will now make, plus the typically very elevated income return on a typical retail unit.

Participants in the direct investment market suggest that the pricing correction is at or near its trough. If this is the case it could present considerable buying opportunities in 2023. The fund sell-off driven by redemptions continues, but so far this has been orderly. Some further investors will run into problems refinancing debt in 2023, which may force some more into selling.

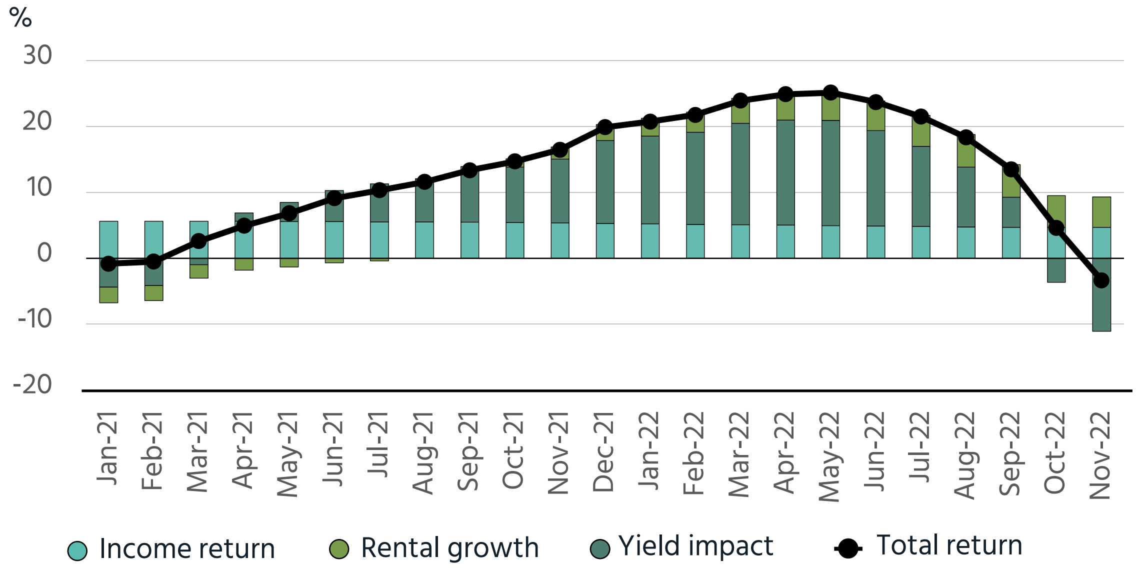
The significant shift in the debt markets and thus the commercial property investment market will now dovetail into a recession in the real economy and present further risks and uncertainties for occupier markets. There are pressures on occupiers from a variety of directions, not just in slowing demand but in the form of increased costs on energy, materials, labour, shipping, currency and add to that a significant hike in business rates (as much as +40% in some cases) in 2023. Leasing activity has broadly slowed down as occupiers have paused to take stock of the impact on their future operating markets.

Vacancy rates are still typically moderate to low for most property segments. This has provided an opportunity for some of the "pandemic winners" that may have overreached, such as occupiers in the logistics sector, to sub-let stock back to the market and enjoy a realistic prospect of re-letting.

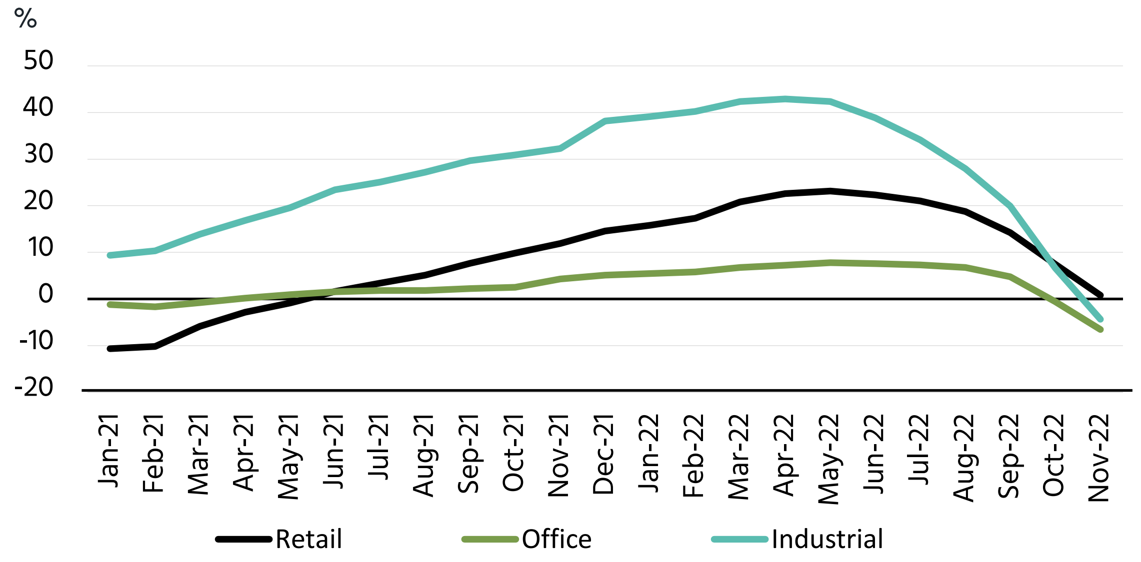
0.8% ▼
Retail annual total return, November 2022

-4.4% ▼
Industrial annual total return, November 2022

All Property annual total return and components
Source: MSCI

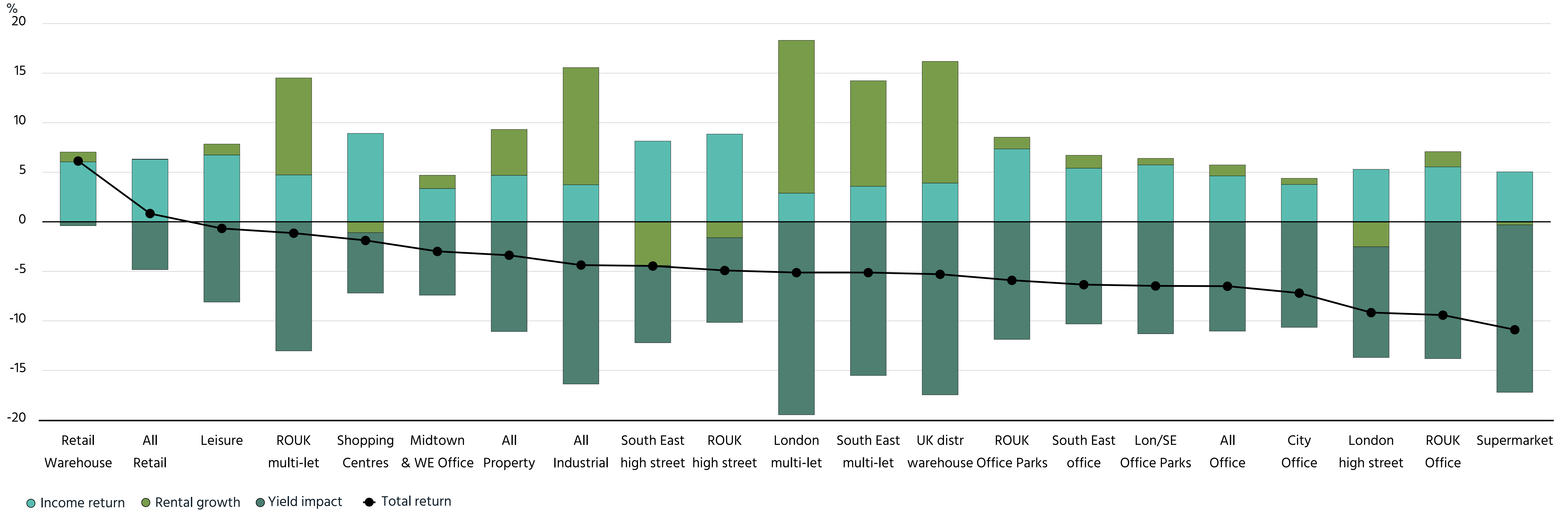


Annual total return by sector
Source: MSCI



UK property segments

12-month return to November 2022
Source: MSCI



UK economy

UK GDP increased 0.5% month-on-month in October, following the dip in output in September due to the extra bank holiday for the Queen's state funeral. However, broader economic indicators for Q4 are indicative of another fall in quarterly GDP that will put the UK officially into recession after its contraction in Q3. December business sentiment data reported a further decline in UK activity. Services and manufacturing firms both reported further falls in new orders, with a notably deepening downturn in manufacturing. This follows data that show manufacturing output was already 4.6% lower in October than a year earlier.

Retail sales fell by 0.4% in November and were 6.2% lower than a year ago. Sales of household goods have been particularly affected, which were 9.1% lower than in November 2021. The GfK Consumer Confidence indicator edged up slightly again to -42 in December 2022. This was the third month of improvement but is in the context of the all-time historic low -49 in September. The component of the index that covers the outlook for individuals' personal financial situation over the next 12 months remained at a record low. Real household incomes continue to fall as inflation strips away value over the last remaining shopping days before Christmas.

The situation is likely to persist well into 2023 as consumer-facing firms see customer spending power further eroded, rising unemployment and higher interest rates. The business sector is also battling headwinds from several sources, including weak demand and high energy costs. Most commentators, including the Bank of England, expect Q3 to have been the first quarter of a long though relatively shallow recession that could last through the whole of 2023.

Annual CPI inflation slipped only fractionally to 10.7% in November and, as expected, the Bank of England increased the base interest rate by 50bps to 3.5% in December. The tightness of the labour market and strong wage growth remains the key concern. Falling output should lower the demand for labour but the ILO unemployment rate ticked up only another 0.1 percentage points to 3.7% in September. Thus interest rates are likely to rise further, peaking at over 4% in 2023. Persistent inflation will keep interest rates elevated and, combined with a tightening fiscal policy, will constrain any recovery in 2024.

-0.9%
2023 GDP growth forecast

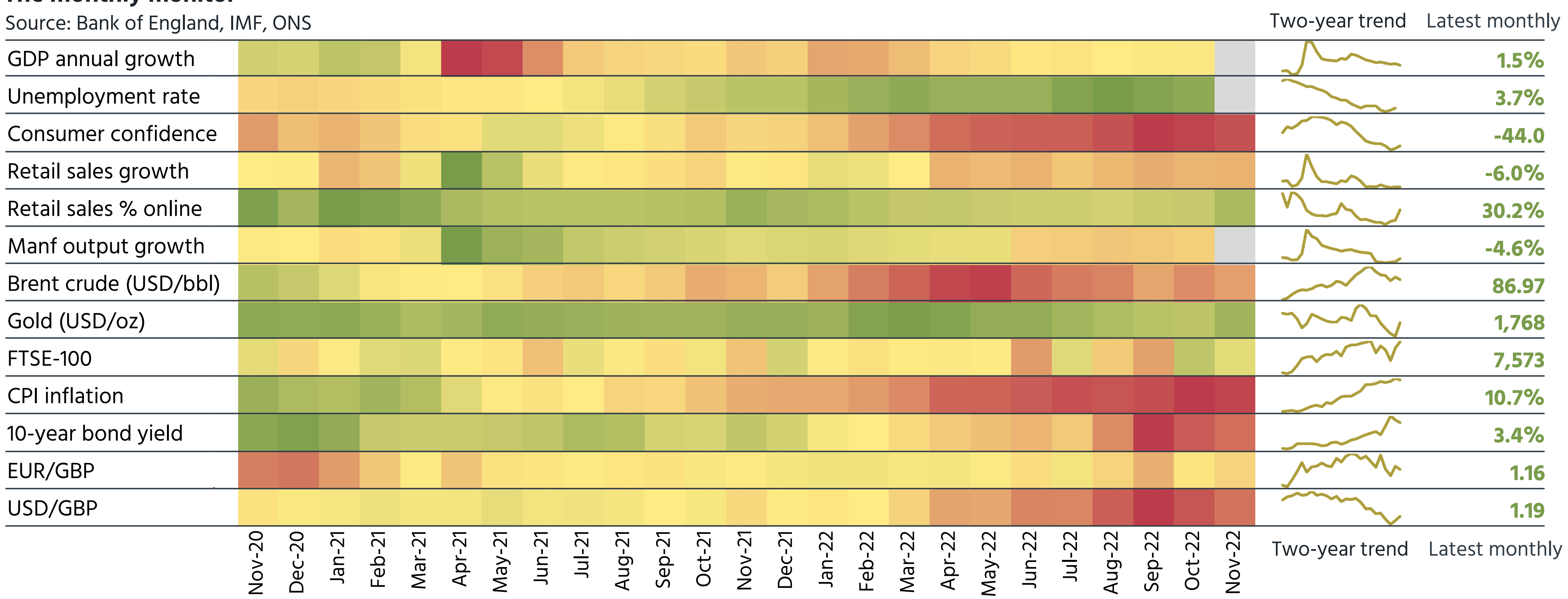
4.4%
2023 unemployment forecast

7.5%
2023 CPI inflation forecast

3.3%
2023 10-year government bond yield forecast

The monthly monitor

Source: Bank of England, IMF, ONS



Outlook

The acceleration of valuation-based outward yield shift in the latter half of 2022 means we expect capital falls that will drive deeply negative 2022 annual returns across various property segments. The direct market correction is arguably now over but there will be further valuations-based yield softening in H1 2023 given how valuations lag market pricing. See our detailed "equilibrium yield" forecasting model set out here.

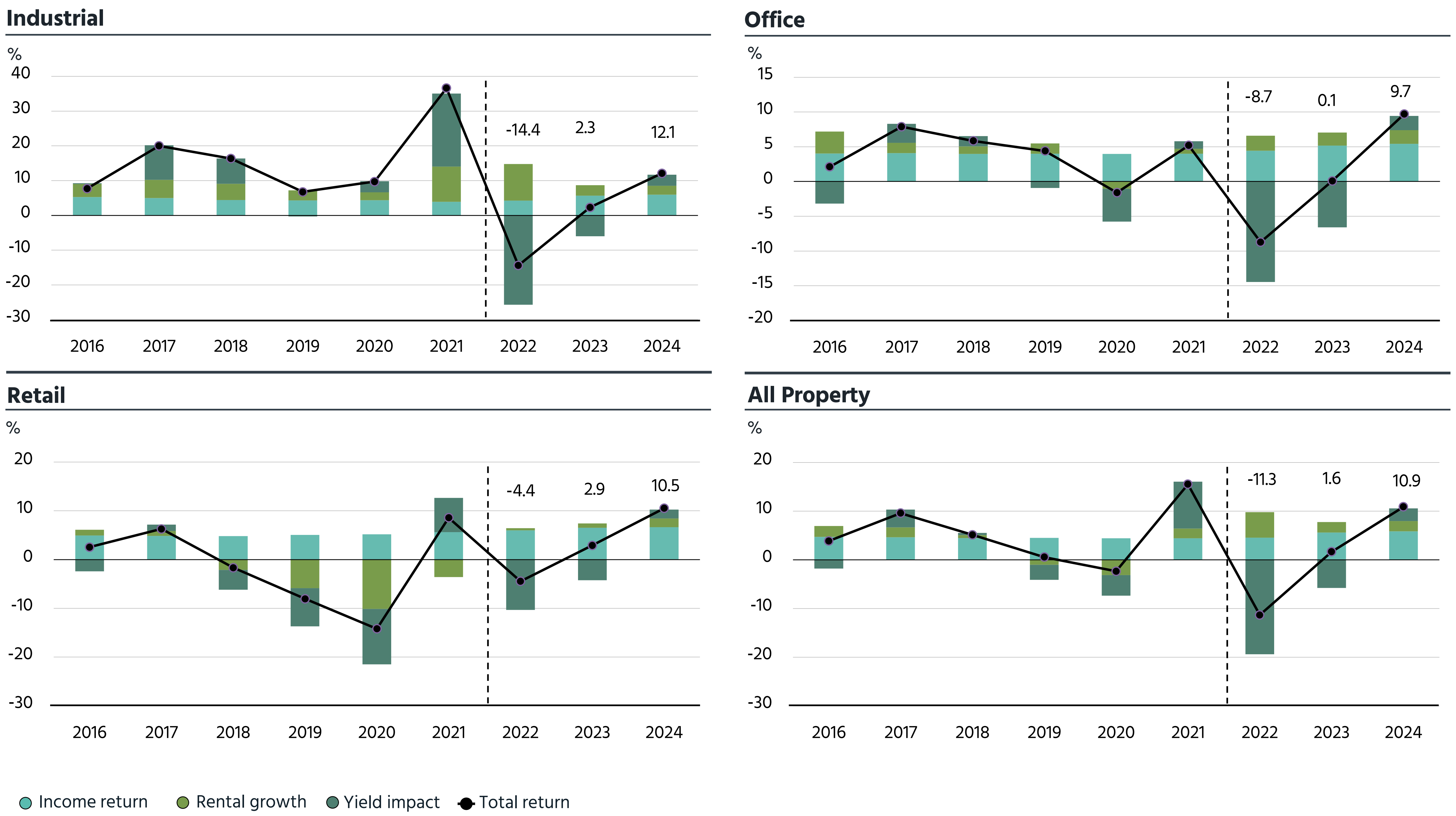
Industrial is the lowest-yielding property sector and is thus most exposed to rising debt costs. Outward yield shift in H2 will have a dramatic impact on returns in 2022 despite exceptional rental growth recorded in the first half of the year. We expect a return to 'normal' rates of rental growth from 2023 as the market absorbs record levels of reversion. Industrial will underperform in 2022/23 before re-establishing itself as the strongest sector in 2024.

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 sporadic 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.

Total return and components by sector

Source: Gerald Eve, MSCI



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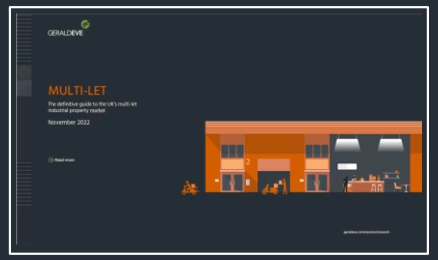
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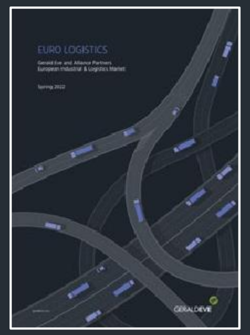
December 2022


Prime Logistics
Q3 2022


London Markets
Q3 2022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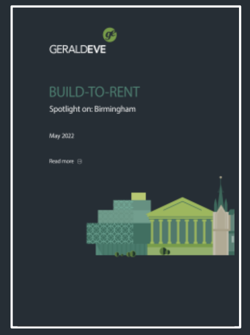
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