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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

January 2023

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JANUARY UPDATE

The UK commercial property market finished the year in dramatic fashion, with annual total return sliding precariously to -10.1% in December after peaking at over +20% in the summer only a few months earlier. The current repricing may have pipped the global financial crisis in terms of speed, but the duration is expected to be much shorter and overall size notably smaller. With market pricing already at or near the bottom there is less impetus for those looking to disinvest and self-perpetuate the downswing any further. This points to a more optimistic outlook for 2023 despite the recession.

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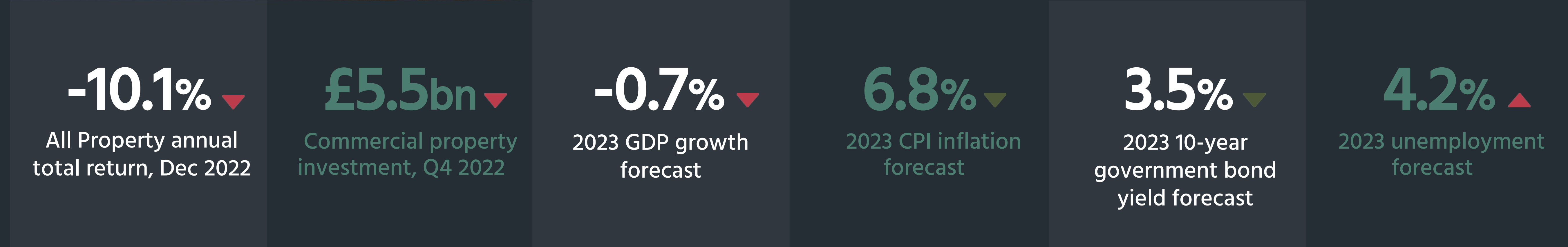
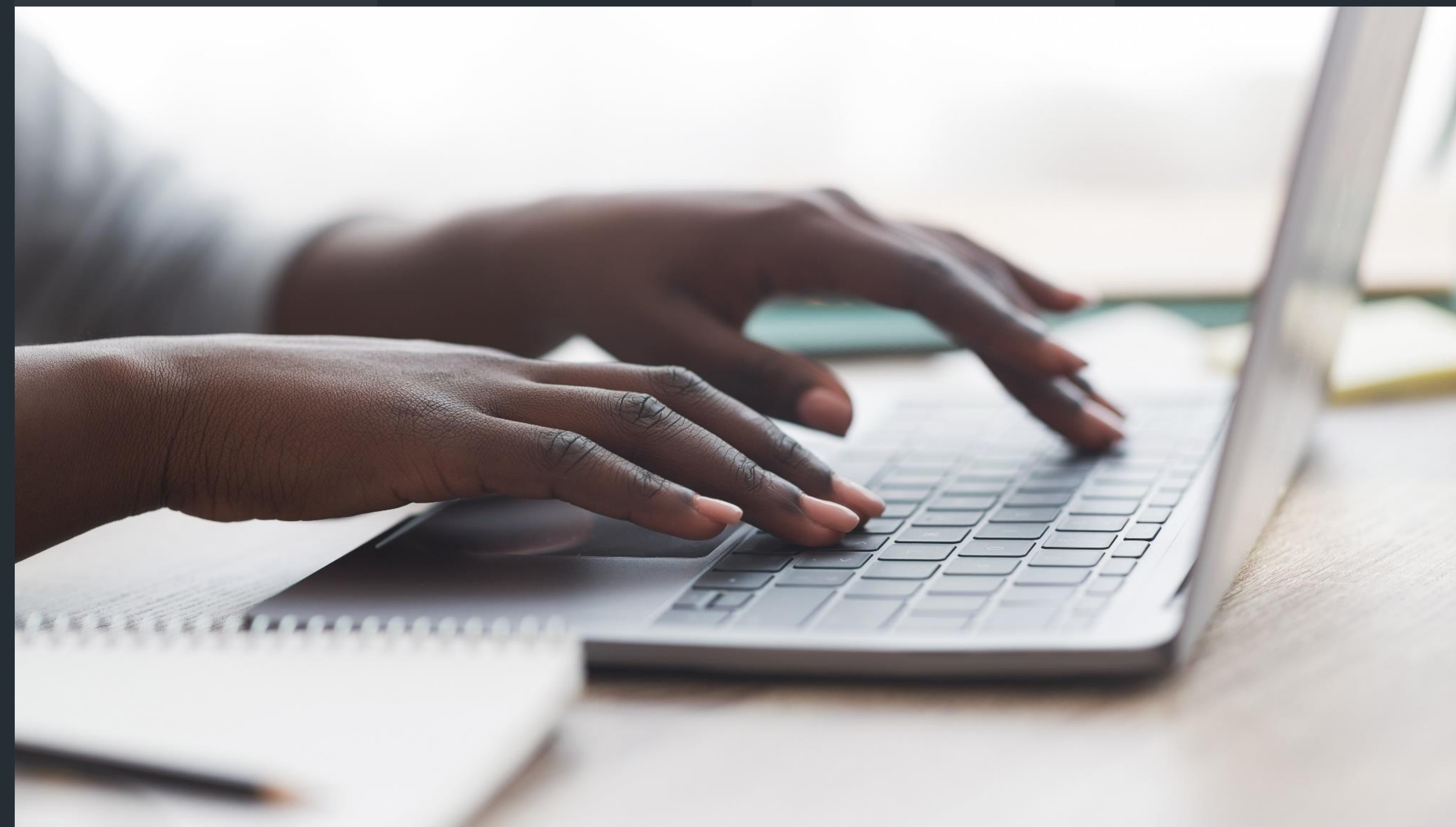




A weak finish to 2022 but a more optimistic 2023 in prospect despite the recession

The UK commercial property market finished the year in dramatic fashion, with annual total return sliding precariously to -10.1% in December after peaking at over +20% in the summer only a few months earlier. This has been the swiftest correction for commercial property in history, with the most negative monthly total return ever of -6.4% in October that attenuated somewhat in November and December to -5.5% and -3.3%. This brought the Q4 2022 total return in at an estimated -14.5%, which was also the most negative quarter on record. The current repricing may have pipped the global financial crisis in terms of speed, but the duration is expected to be much shorter and overall size notably smaller.

The outward yield movement driving the downturn has been in response to the sharp increase in the cost of debt as the interest rate environment has become substantially more hawkish. The impact has been most keenly felt in the lower-yielding and liquid segments, particularly industrial. In some respects this rapid pace has arguably been a good thing in that it demonstrates the liquidity and transparency of these markets that is reflected also in the relatively responsive adjustment to valuation yields.

In the direct industrial market the most intense phase of uncertainty where many deals collapsed or were at least heavily renegotiated was immediately after the disastrous “mini budget” in late September. But by November prime pricing had largely stabilised, charting a total peak-to-trough outward shift of around 175-200bps. Since most commentators consider market pricing to already be at or near the bottom now there is less impetus for those looking to disinvest and self-perpetuate the downswing any further.

Recent sales have been either redemption-led or pension funds looking to strategically reduce exposure to real estate. The Q4 completed transactions volume reflects earlier conditions and the first estimate is that it was only £5.5bn. This will inevitably be revised upwards but is nevertheless very subdued, the lowest since Q2 2020 and almost 60% below the 5-year quarterly average.

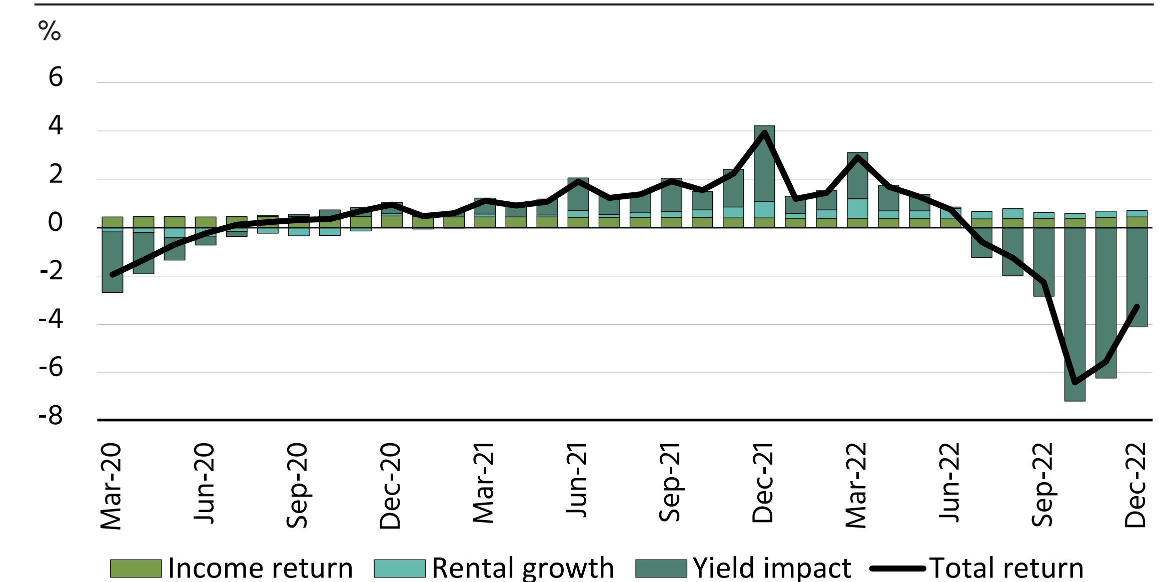
However, current activity is more buoyant - investors have come back into the market now that there is less perceived uncertainty and prices and competition are lower than at the peak of the market. There are typically 3-4 underbidders on a given prime asset sale now, which is much stronger than a couple of months ago but compares with around 10 potential buyers to an asset only a year ago. It is therefore still undoubtedly a buyer’s market with the opportunity typically to focus on the better quality assets.

We anticipate some refinancing-led sales later in 2023 that will help increase the transacted investment volume. If there is a problematic refinancing event the investor may look to sell ahead of time, but could also put money in where possible or come to some arrangement with the lender. Purchases from the last couple of years are likely to be in a technical breach of their LTV ratios. However, banks are unlikely to act unless capital values do not appear to be recovering as we predict they will do from 2024 onwards.

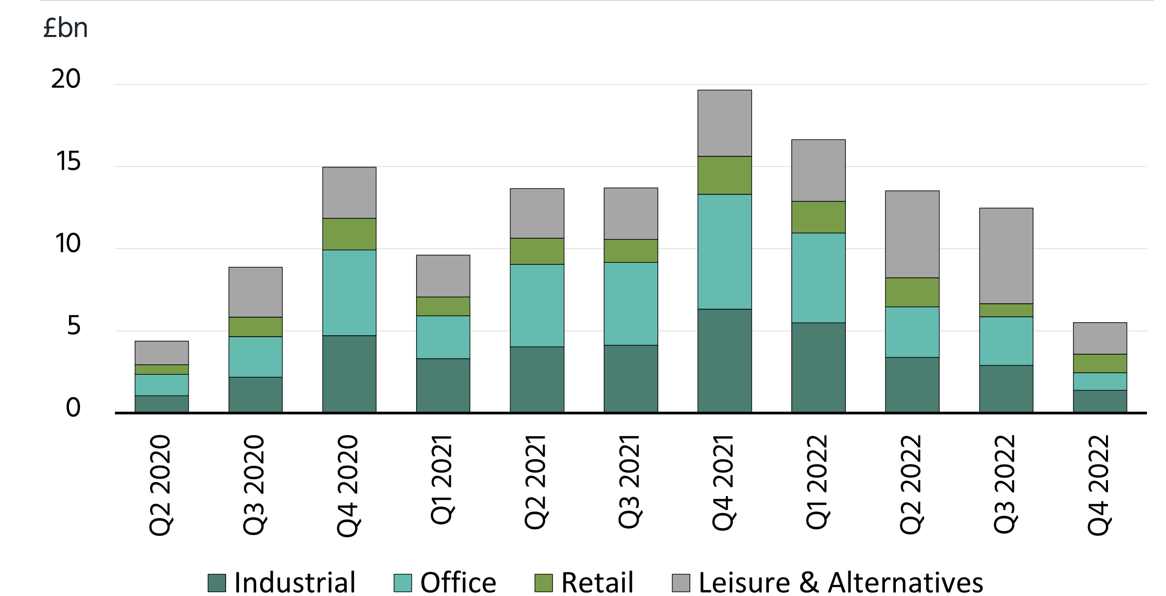
-10.1% ▼
All Property annual total return, Dec 2022

£5.5bn ▼
Commercial property investment, Q4 2022

All Property monthly total return and components
Source: MSCI

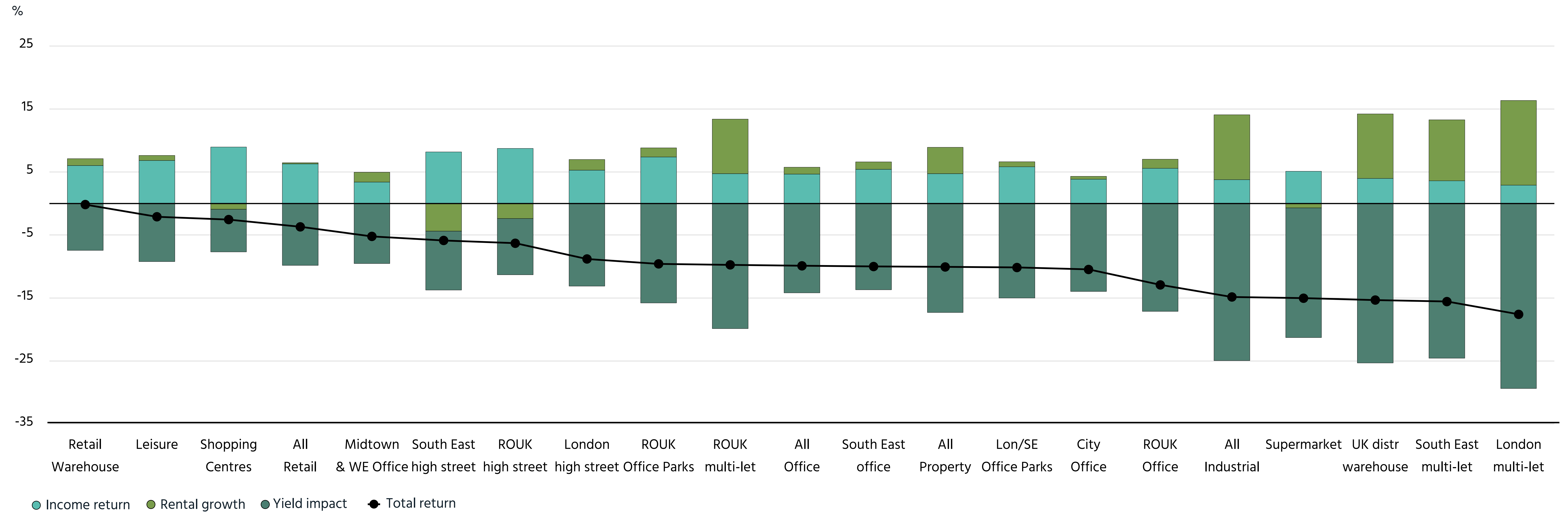


Quarterly commercial property investment by sector
Source: Gerald Eve, Property Data



UK property segments

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



UK economy

UK GDP surprised on the upside and edged up 0.1% month-on-month in November. However, this was arguably just some short term volatility. Business sentiment indicators suggest that output from both services and manufacturing firms continued to fall in December and in fact accelerated downwards in January. Weakened demand continues to negatively impact new orders and crippling energy costs remain at the forefront of business owners' concerns. Moreover, the various industrial action taken across December will have directly reduced the number of days worked and, in the case of the rail strikes, indirectly hampered commuters and consumers getting to work and the shops. GDP in Q4 will thus probably have fallen for a second consecutive quarter and signal a technical recession.

More positively, energy futures have fallen sharply in recent weeks, with the relatively mild winter across Europe leaving gas supplies at record highs. This could help ease rising cost pressures, and survey data suggest that medium term optimism for firms and households has improved on the expectation that inflation has now peaked.

CPI inflation edged down again in December, but still only marginally, to 10.5% from its recent peak of 11.1% in October. Core inflation, which is of key concern to interest rate setters, remains stubbornly persistent. The labour market has showed signs of loosening to some extent, with a fall in vacancies for the seventh consecutive month and redundancies continue to tick upwards. However, the latest ILO unemployment rate data remained at 3.7% and the annual growth in average weekly earnings rose to 6.4% in November, a record high outside of the pandemic period. There will be no MPC meeting in January, but interest rates are thus widely expected to increase by a further 50bp to 4% in early February.

Retail sales fell another 1% in December and are down almost 6% on a year ago. Meanwhile consumer sentiment fell back unexpectedly in January and remains near its record low last September. This was driven predominantly by a worsening assessment of current personal financial situations and the state of the economy. Households will see a further drop in real incomes in 2023 but potentially also a welcome modest drop in domestic energy prices in the second half of the year. Oxford Economics has thus cut its 2023 forecasts for CPI inflation by 0.7ppts to 6.8% and the GDP contraction from 0.9% to 0.7%.

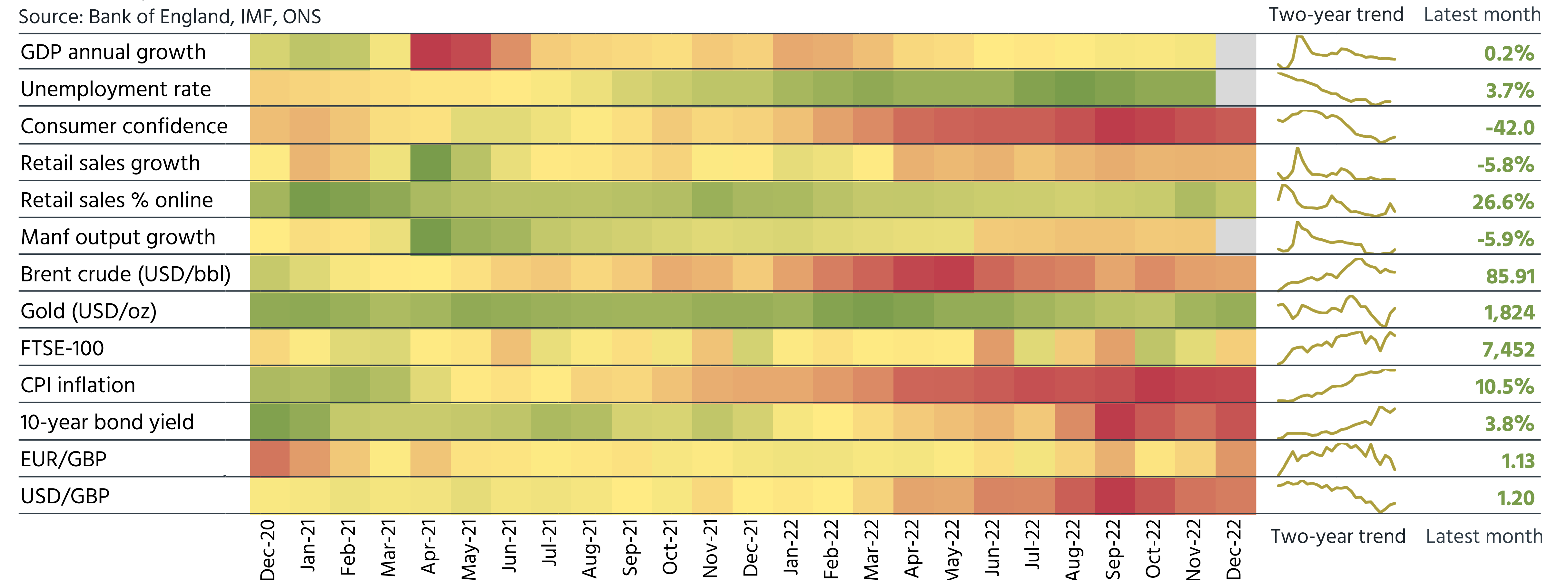
-0.7% ▼
2023 GDP growth forecast

4.2% ▲
2023 unemployment forecast

6.8% ▼
2023 average CPI inflation forecast

3.5% ▼
2023 10-year government bond yield forecast

The monthly monitor



Spotlight on... prime logistics

Read more detail from the report, click here

OCCUPIER DEMAND STABILISES 5% BELOW 5-YEAR AVERAGE

Take-up was just under 15m sq ft in Q4 for a second successive quarter, which is around 5% below the 5-year average. Demand was squarely focused on new stock: pre-lets accounted for 53% and new speculative buildings accounted for 10% of all activity. Secondary space continues to account for a relatively small proportion of demand, given its very low availability and corporate ESG commitments. Occupier take-up for 2022 as a whole was 66m sq ft, 25% down on the record high in 2021. We are now clearly over the pandemic peak in terms of occupier demand, with fewer expansionary deals and critically urgent space requirements than in 2021. Nevertheless, this was second most active year on record.

INTERNET RETAILERS RETRENCH

E-commerce remains a structural driver of demand for logistics but the sector is now starting to feel the impacts of the switch back to pre-pandemic shopping patterns and the retail recession more generally. Weaker consumer demand, slower overseas delivery times and disruptive industrial strike action have all weakened the outlook for both dedicated internet retailers and parcel & post operators this year. Internet retailers accounted for 12% of all activity in 2022, down from the 30% peak in Q2 2021. The expected long (albeit relatively shallow) recession and subsequent weak recovery will undoubtedly pose further risks to internet retailers, especially those linked to discretionary consumer spending.

GREEN ENERGY-LINKED MANUFACTURERS PLUG THE DEMAND GAP LEFT BY INTERNET RETAILERS IN Q4

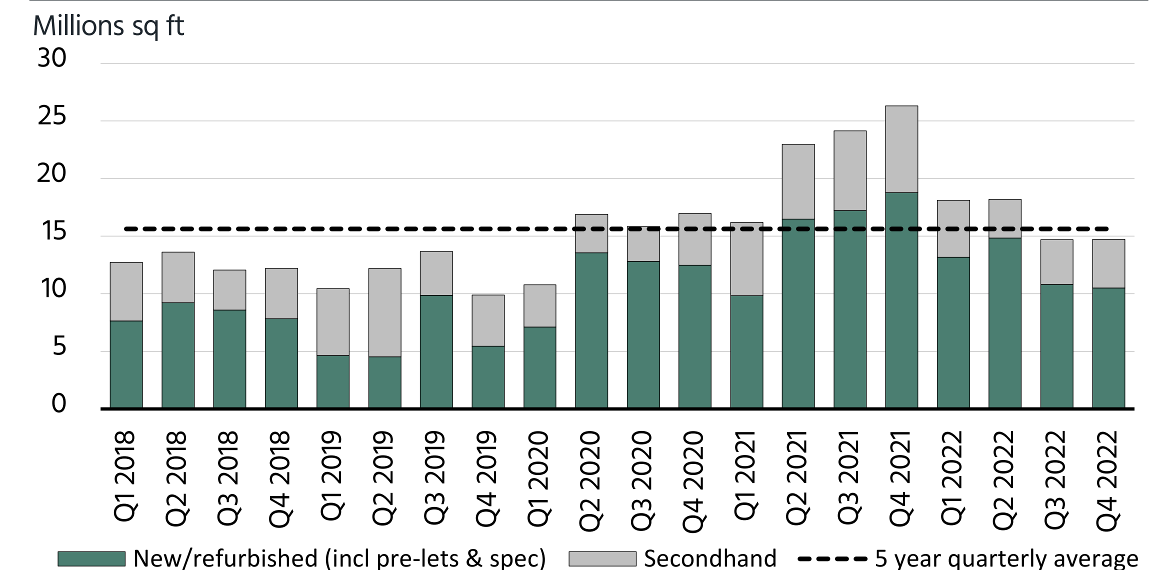
Manufacturers dominated activity in Q4, accounting for 56% of all take-up and nearly all of the exceptionally big box deals over 500,000 sq ft. Activity was driven by occupiers in the green energy production sector – Green Lithium, SeAH Wind and Nissan & Envision AESC all signed pre-lets over 1 m sq ft in Teesside. Other active manufacturing sectors included housebuilding, life sciences and electric vehicle production. Occupiers seeking supply chain resilience and nearshoring operations closer to end markets in order to meet sustainability goals are likely to continue to be acquisitive this year.

THE OUTLOOK REMAINS CAUTIOUSLY OPTIMISTIC

Occupier demand is likely to settle at 10-20% above pre-pandemic volumes, with green energy production and onshorers key drivers. Availability is set to rise somewhat as speculative developments complete and cost-cutting measures return unwanted buildings. However, the market will continue to be defined by a lack of supply, given the increased risk and cost associated with development set against reduced industrial capital values. Those developers with conviction and with tied-in construction costs will start new schemes, but this will not be sufficient to increase availability to anything like the magnitudes of previous downturns. This is all supportive of an ongoing positive rental growth outlook, albeit in the low single digits for the next few years.

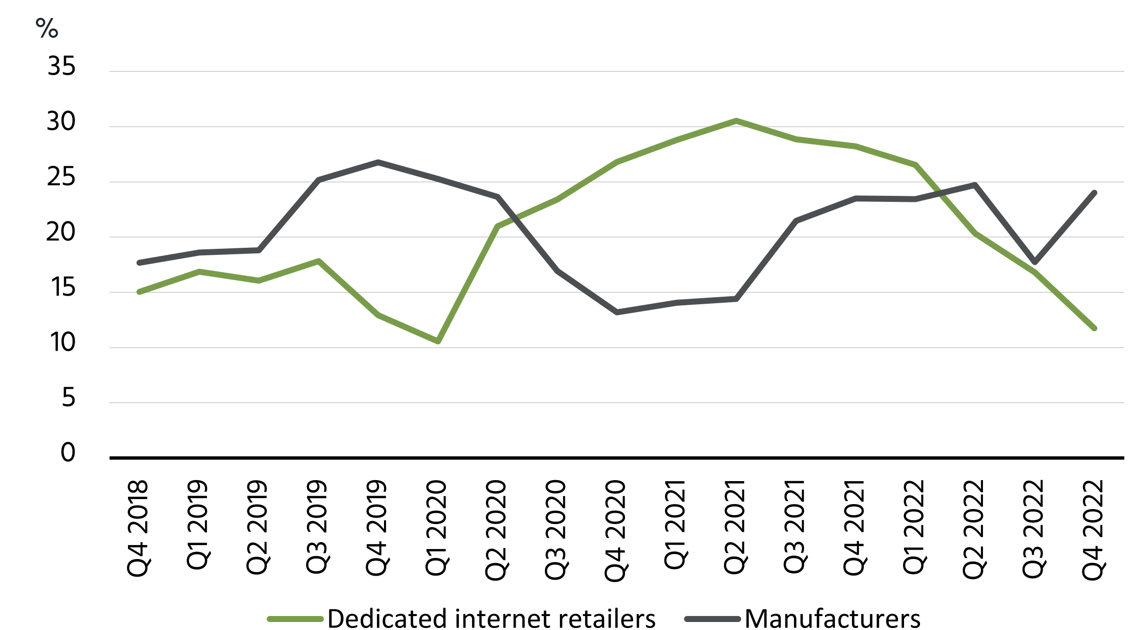
Quarterly logistics take-up by quality

Source: Gerald Eve



Proportion of logistics take-up by business sector

Source: Gerald Eve



Outlook

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. This is now set to dovetail into what looks like a long recessionary period and impact occupier markets.

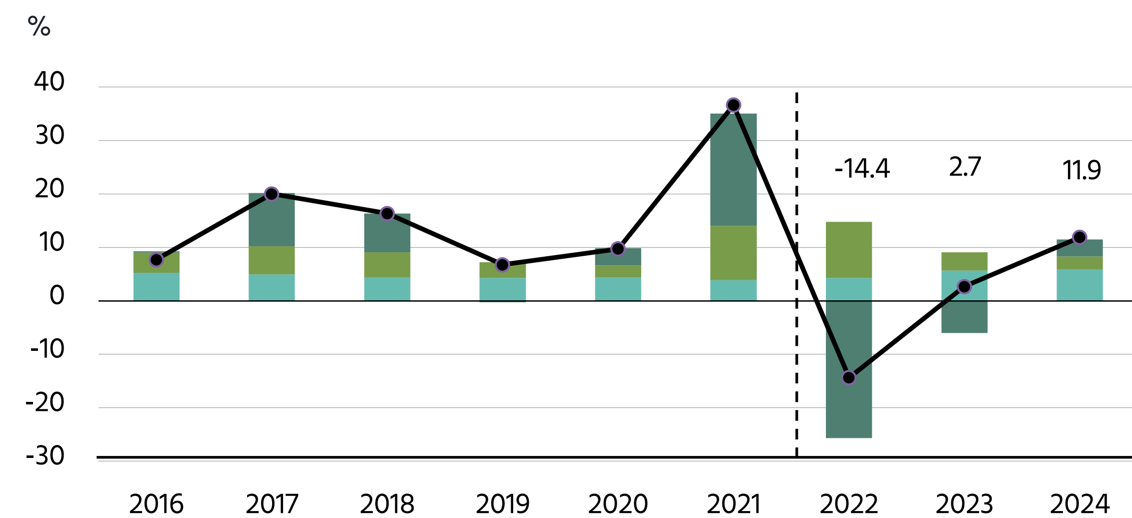
Industrial still sits relatively favourably amongst the other major sectors. While we see a relatively lean few years in 2023/24/25 we do not expect industrial void rates to rise to the point where rental growth will turn negative. The challenging economic backdrop will be a test for a fundamentally good asset class that is relatively well placed to deal with things like the new EPC regulations. In contrast, retail and offices have more structural problems to deal with over this period along with the economic malaise. Industrial total return will underperform in 2023 before re-establishing itself as the strongest sector in 2024.

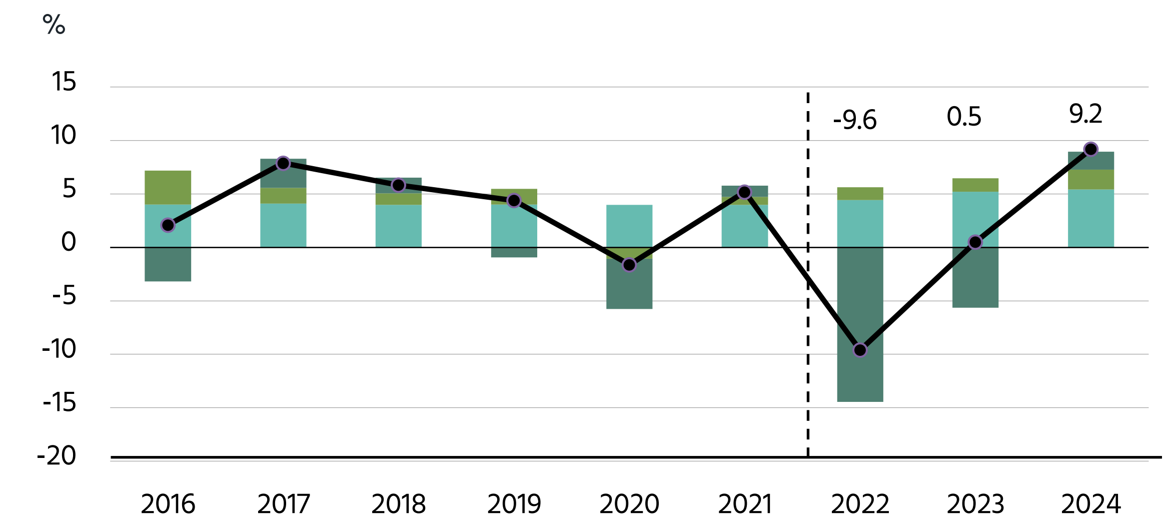
The **office** market is polarised between the highly desired and undersupplied best-in-class stock versus the rest. This is set to intensify since development timescales will be pushed out by high cost inflation and lack of availability of materials. There may still be some sporadic upward rent inertia 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 and hybrid working continues to impact occupancy of secondary space.

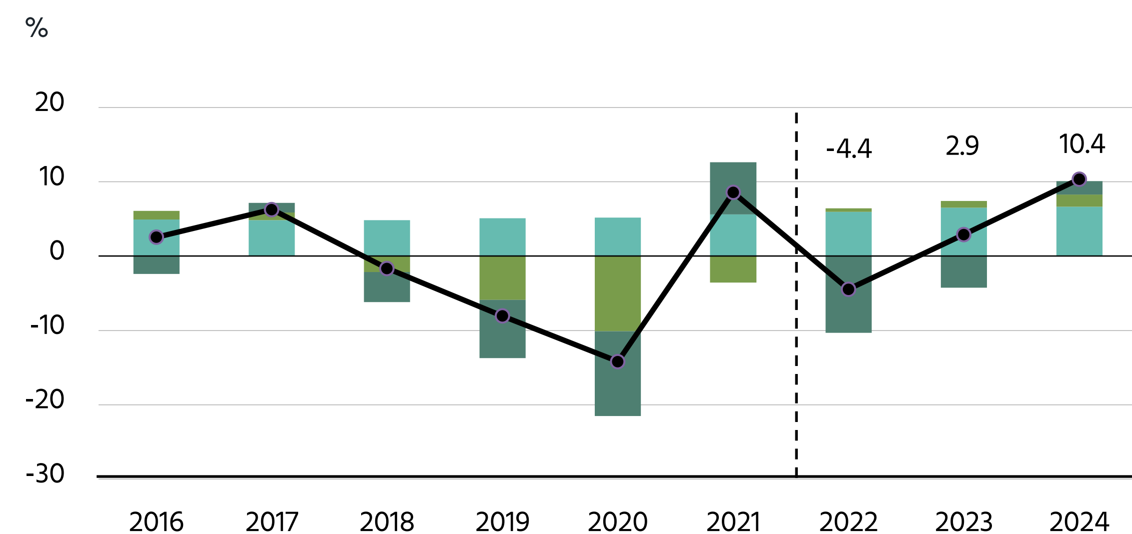
UK households are facing deep challenges and the **retail** sector is in recession. However, the significant value falls for retail property over the last several years should provide a small offsetting cushion. Income will be the key positive driver of performance over the next few years and retail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

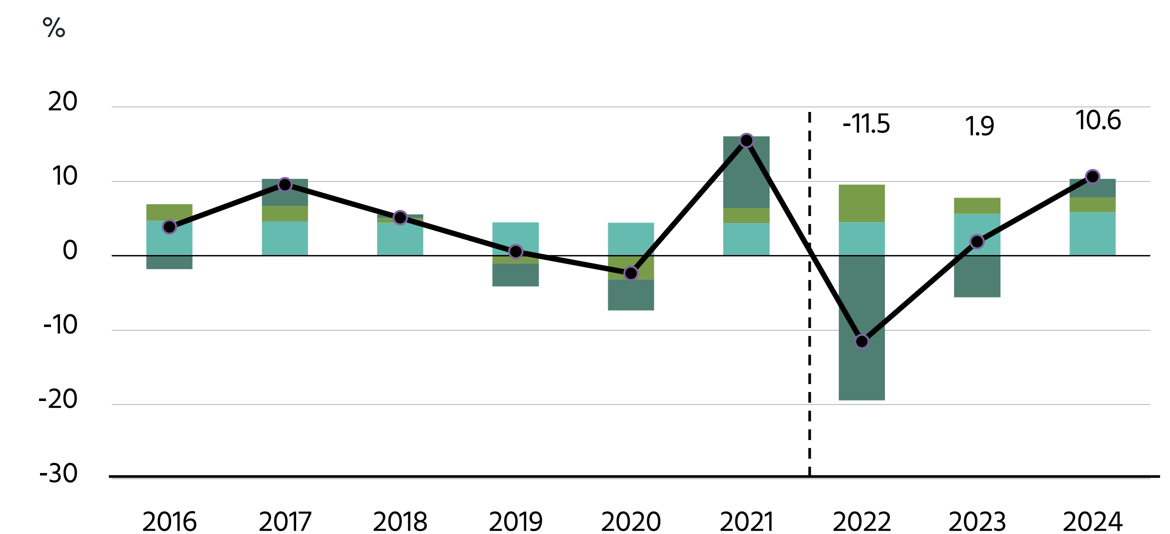
Total return and components by sector

Source: Gerald Eve, MSCI









Income return · Rental growth · Yield impact · Total return

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
Associate
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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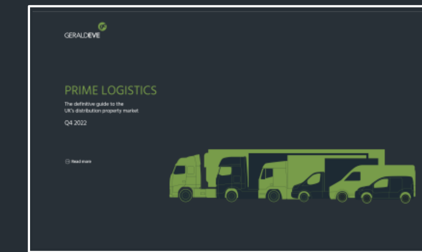
December 2022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