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UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

February 2023

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FEBRUARY UPDATE

Valuations-based equivalent yields across all property segments continued to rise in January but at a significantly more moderate rate than during the record-breaking Q4 2022. This reflects increased investor activity and sentiment in the direct market, where yields have hardened again for some assets. Some of the worst interest rate fears from last September have not been realised, meaning some of the lowest-yielding property assets may have overcorrected while the more thinly traded higher-yielding segments may require further softening to re-establish appropriate relativities.

-11.3% ▼	143bps ▲	-0.4% ▼	6.5% ▼	3.3% ▼	4.2% ▲
All Property annual total return, Jan 2023	All Property outward yield shift, June 22 to Jan 23	2023 GDP growth forecast	2023 CPI inflation forecast	2023 10-year government bond yield forecast	2023 unemployment forecast

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Outward yield shift slows dramatically

Valuations-based equivalent yields across all property segments continued to rise in January but at a significantly more moderate rate than during the record-breaking Q4 2022. The All Property equivalent yield has so far increased 143pbs since its low of 5.1% in June 2022 to 6.6% in January 2023. The underlying cause of the repricing has been the significant change in the interest rate environment, notably the step-change in H2 2022 as shown by the 10-year government bond yields on the chart. The Bank of England base rate has increased at every consecutive Monetary Policy Committee (MPC) meeting from 0.1% in December 2021 to its latest 4.0% in February 2023.

The impact has been felt right across the UK economy and the pattern across property segments has thus been very similar. However, lower-yielding and more liquid assets at the sharp end of the increase in borrowing costs have been affected more significantly - in terms of absolute basis point outward shift and the relatively large impact on capital values off such a low base. Relative segment performance has consequently effectively been reversed. Industrial assets, coming off a massive outperformance of over 40% annual return at mid-year 2022, had the lowest average return of -16.7% in January 2023.

The segment performance overleaf shows that the lowest-yielding London multi-let is now bottom of the pile, with a negative annual return in excess of -20%. Conversely, previously underperforming retail subsectors, such as Leisure and Shopping Centres, now have the least negative returns in the low single digits. In part this is due to the virtue of having a large income component since retail yields have blown out so much over recent years. Also these kinds of assets are relatively thinly traded and it is much less clear where true pricing is really at.

The relative flatness of the office annual total return profile is starkly apparent in the second chart. On the occupier side, post-pandemic office take-up has been reduced by around 20% on average. This compares with industrial's relative success over the lockdowns and its approximately 20% step up of average take-up. Both segments have been affected by increased sub-letting as the economic downturn has now separately taken hold. For industrial the former 'pandemic winners' have retrenched, with the gap in demand filled to some extent by manufacturing; for offices it is the big corporates from the media, tech and finance sectors that are bringing space back.

However, the slowdown in valuation yield softening in January reflects increased investor activity and sentiment in the direct market, where yields have hardened again for some assets. Some of the worst fears from last September have not been realised, with market expectation of the Base rate to reach 'only' 4.5% this year, down from an expectation of around 6.5% only a few months ago.

Arguably the lowest-yielding property assets may have initially overcorrected while the more thinly traded higher-yielding segments may still have some further movements out to re-establish the appropriate relativities. Nevertheless the outlook for exit yields over the medium term is essentially unchanged, with the new higher interest rate environment here to stay.

-11.3%▼

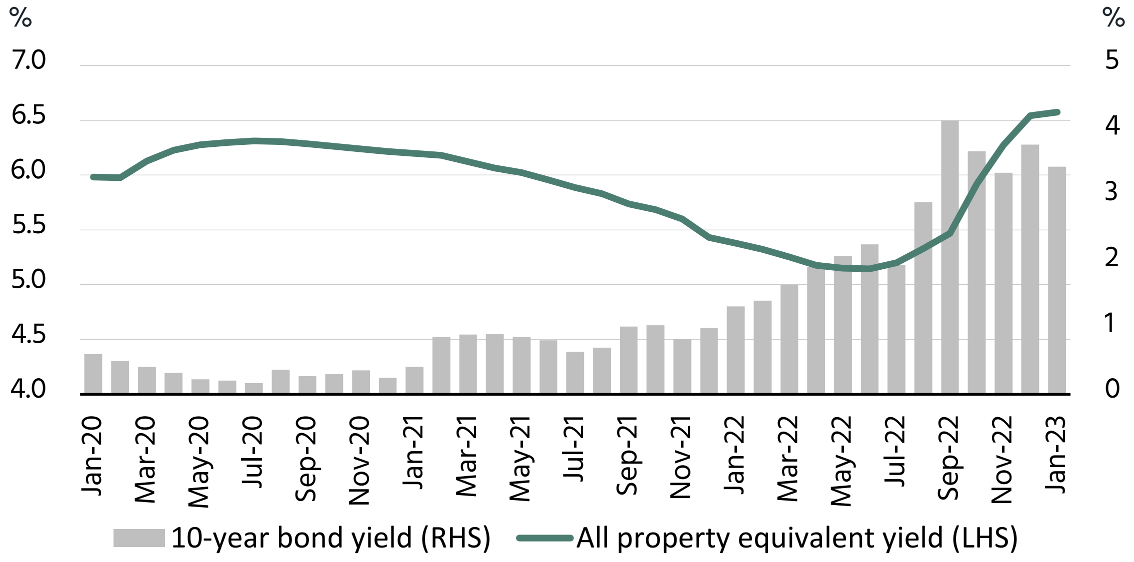
All Property annual total return, Jan 2023

143bps▲

All Property outward yield shift, June 22 to Jan 23

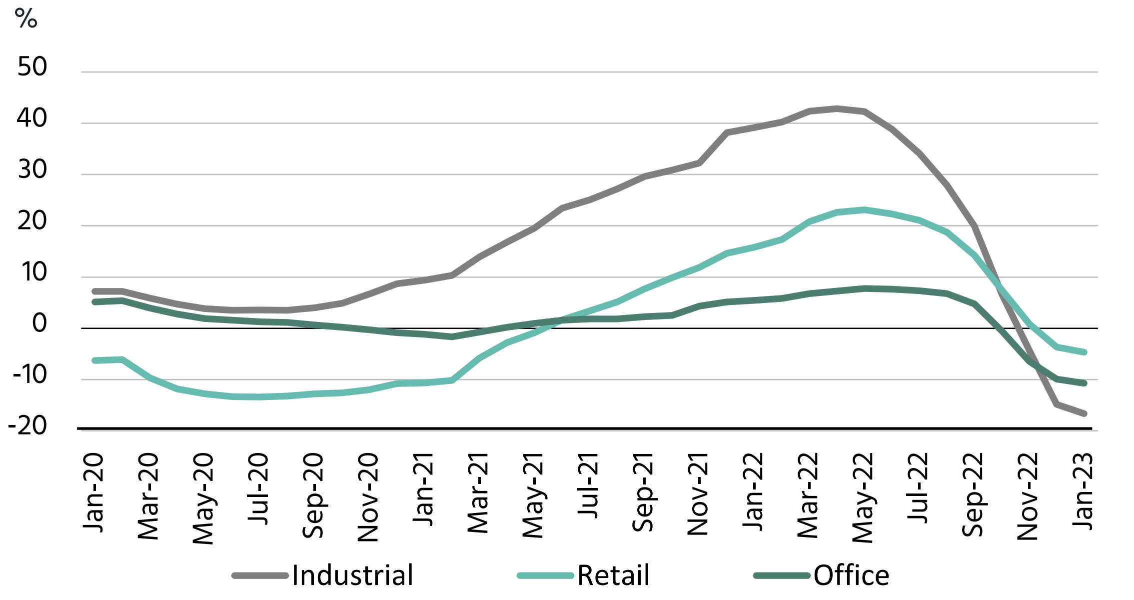
All Property equivalent yield and 10-year bond yield

Source: MSCI, Oxford Economics



Annual total return by sector

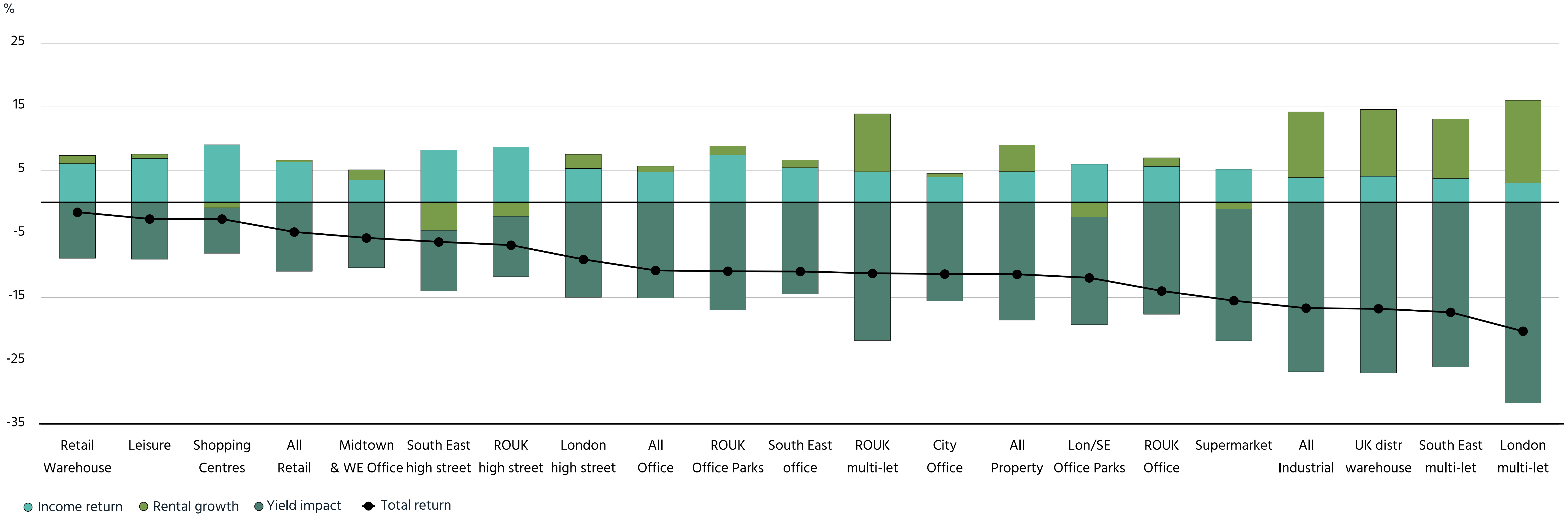
Source: MSCI



UK property segments

12-month return to January 2023

Source: Gerald Eve, MSCI



UK economy

GDP fell by an expected 0.5% month-on-month in December following various industrial action that directly reduced the number of days worked and, in the case of the rail strikes, indirectly hampered commuters and consumers getting to work and to the shops. This means that output was essentially unchanged in Q4 after a contraction in Q3 and thus the UK economy avoided technical recession by the smallest of margins.

More timely and higher frequency business sentiment indicators suggest that output from both services and manufacturing firms have continued to fall so far in early 2023. In something of a contrast, consumer sentiment defied expectations and increased seven points to -38 in February. This was the largest monthly improvement in almost two years and its least negative reading since April 2022.

Households' assessments of their own and the wider UK's current and projected economic situations have improved, which could be accounted for by the news that wholesale global energy prices have fallen sharply. A relatively mild winter for Europe, and China embroiled in covid-related lockdowns has meant that stored gas supplies are high. Consequently the expectation is that the UK energy price cap will fall to £2,300 from July 2023.

UK CPI inflation fell again to 10.0% in January from its recent peak of 11.1% in October 2023, and it is anticipated to continue to fall more sharply over 2023 as a result of strong base effects. Some recently published third party forecasts have put inflation at 2% by 2023 year-end. This current optimism may be short-lived, however. Not only is this view overly optimistic, it does not include the almost certain volatility in inflation that is set to ensue. Core inflation for one, which is of key concern to interest rate setters, is notoriously persistent.

Industrial dispute wage settlements and retrospective pay are unlikely to show up in the figures for another 18+ months' time. Meanwhile China's energy needs are now unencumbered by lockdowns and the geopolitical risk surrounding the conflict in Ukraine is likely to be sustained. Also the winters of 2023 and 2024 and their energy requirements are not guaranteed to be as forgiving. A further 25bps base interest rate rise is expected in March and rate cutting could be years away. Meanwhile backloaded fiscal tightening will gain traction in 2024/25 and be a drag on the economic recovery.

-0.4%
2023 GDP growth forecast

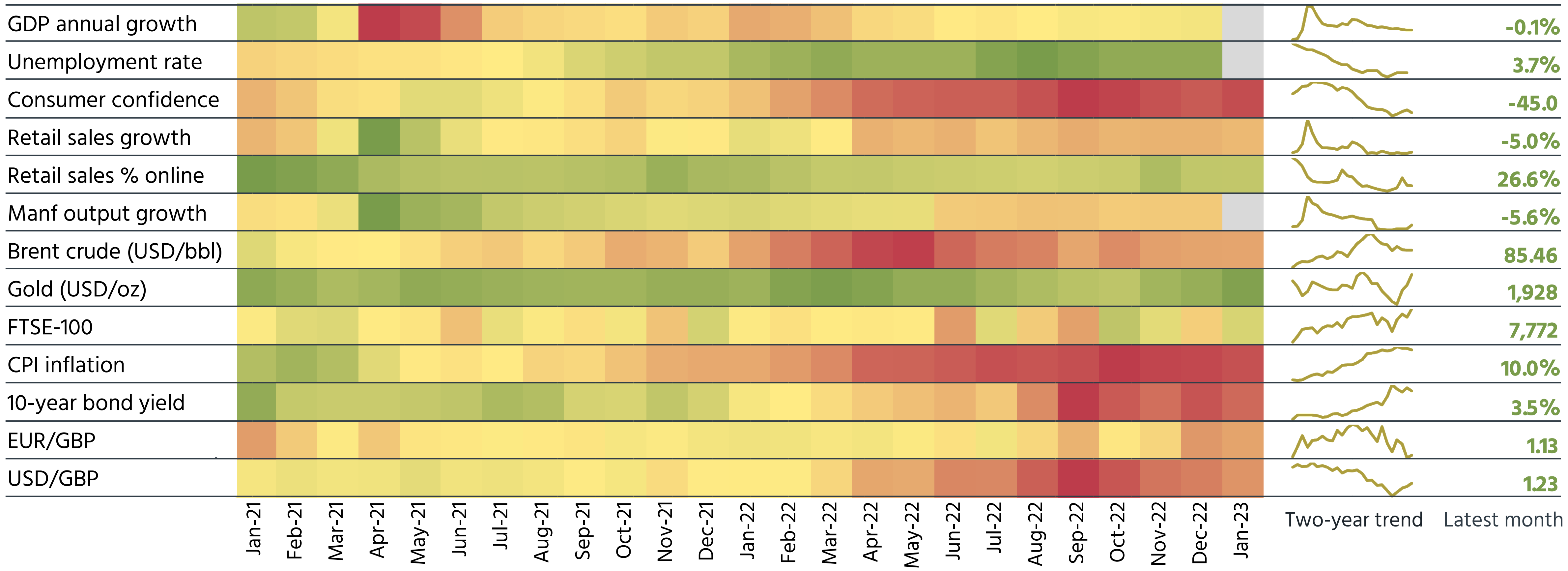
4.2%
2023 unemployment forecast

6.5%
2023 average CPI inflation forecast

3.3%
2023 10-year government bond yield forecast

The monthly monitor

Source: Bank of England, IMF, ONS



Spotlight on... central London offices

Read more detail from the report, click here

London office leasing activity closed out 2022 strongly, with Q4 occupier take-up 10% up on the previous quarter, totalling 3m sq ft. Take-up over 2022 as a whole was 12.1m sq ft - a significant 28% increase on 2021, but still 17% below the pre-covid five-year average.

Grade A rents rose in four submarkets in Q4, with strong demand in the City pushing ERVs from £70 to £75 per sq ft. Covent Garden, Midtown, and Southbank rents also increased. Meanwhile rising availability in Shoreditch has culminated in a downgrade to £65 per sq ft from its £72.50 per sq ft pre-pandemic level.

Availability was broadly stable across central London offices in Q4 overall. However, the quarter marked a record high for tenant-controlled sub-let availability. Estimates show roughly 6.3 million sq ft of "grey space" is on the market, accounting for 29% of overall availability.

Multiple delayed development completions meant that the total for the year was only 2.2m sq ft, a massive 70% below the original estimate for 2022. An enlarged pipeline of 7.8m sq ft is therefore anticipated for 2023. However, going forward increased development financing costs means starts are likely to be muted, at least in the short term.

The recent outward yield shift for central London offices has led to a sharp correction in capital values. MSCI's monthly January 2023 data show a fall of over 11% in the capital value index since September's problematic "mini-budget". We expect office values to continue to drift but bottom out in 2023.

London office investment in Q4 came in at just under £1.6bn. This is one of the lowest quarterly volumes on record, barring the covid-lows in Q2 and Q3 2020. The investment market was markedly subdued with investors in wait-and-see mode amid the financial volatility caused by the "mini budget" in late September.

3.0m sq ft ▲
Take-up, Q4 2022

8.2% ▲
Availability rate, Q4 2022

£1.6bn ▼
Investment volume, Q4 2022

29% ▲
Tenant-controlled space, % of total

Outlook

Investor activity and sentiment is forecast to improve in 2023. Some of the worst interest rate fears from last September have not been realised, meaning some of the lowest-yielding property assets may have overcorrected and these yields will now come in a little. Meanwhile the more thinly traded higher-yielding segments may still require further softening to re-establish appropriate relativities. Consequently the recently reversed sector performance hierarchies will likely reverse back again to the longer-standing order by end-2023.

Industrial still sits relatively favourably amongst the other major property sectors. These are typically the lowest-yielding assets that arguably overcorrected in H2 2022. There is an overwhelming weight of capital targeting the sector (estimated at over £10bn) which is already driving yield compression in the direct market. While we see a relatively lean few years in 2023/24/25 in the occupier market 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 this fundamentally robust asset class that is relatively well placed to deal with upcoming challenges.

In contrast, **retail** and **offices** have more structural problems to deal with in addition to the economic malaise. **Office** prime/secondary polarisation is set to intensify while new development is restricted and hybrid working continues to impact occupancy of secondary space. The sector is due a broad occupier slowdown over the medium term while the global economy faces ongoing challenges. The significant capital value falls for **retail** property over the last several years should provide a small offsetting cushion for performance. Income will be the key positive driver of returns 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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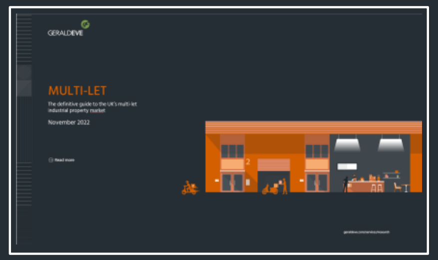

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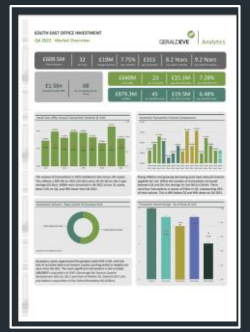
December 2022

Prime Logistics
Q4 2022

London Markets
Q4 2022



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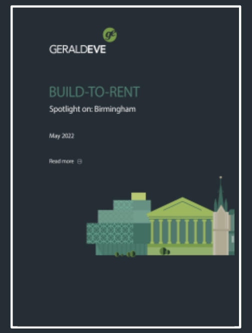

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