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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

July 2023

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JULY UPDATE

The June data show the beginnings of another shift down in commercial property capital values for the second half of the year, albeit it is likely to be a much more moderate one than during H2 2022. This is set to impact the different property sectors unequally, however, with offices particularly affected. More positively, the market now expects the rise in the Bank Rate to be shallower than previously expected a few weeks ago, which has given some respite to investors. Investment activity has been subdued and fell for a sixth successive quarter in Q2 2023 from Q1 2021's peak.

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

£7.6bn ▼
Q2 2023 commercial property investment

-1.1% ▼
June 2023 Quarterly All Property yield impact

0.4% ▼
2024 GDP growth forecast

3.6% ▼
2024 average CPI inflation

5.75% ▲
End-2023 Bank Rate

4.1% ▼
End-2024 10-year government bond yield

Shallower expected path for interest rates gives some investor respite

The **All Property** average valuation yield began to edge out again in June, as indicated by the growing negative quarterly yield impact shown in the chart running at -1.1%. We see this as the start of another shift down in commercial property capital values for the second half of the year, albeit a much more moderate one than during H2 2022. This is likely to impact the different property sectors unequally, however, with offices particularly affected.

There has been positive news in the form of the recent core inflation figure for June that came in under expectations, which means that the market now expects the rise in the Bank Rate to be shallower than previously expected. The SONIA forward curve now shows a peak at around 5.75% at the end-year 2023, compared with 6.25% in early 2024 only some weeks ago. This has given some respite to investors, but nevertheless the expectation is that core inflation will stay relatively 'sticky' and interest and debt rates in the UK will stay elevated not just for a longer period, but for longer than in the US and the Eurozone.

Investment activity has been subdued during this period of renewed uncertainty. Quarterly commercial property investment volume fell for a sixth successive quarter in Q2 2023 to only £7.6bn, down from Q1 2021's peak of £22.5bn. In the central London **office** market investor sentiment has been selective but improved towards the end of Q2 as buyers and vendors became more comfortable on new pricing. There is still strong demand for core-plus and value-add assets, but the criteria have narrowed even further on acceptable quality, location and covenant. There has been a shift towards lower lot sizes, partly as a reflection of the difficulty in raising debt and thus all-equity purchases, particularly for these smaller lot sizes, will be more common in H2 2023.

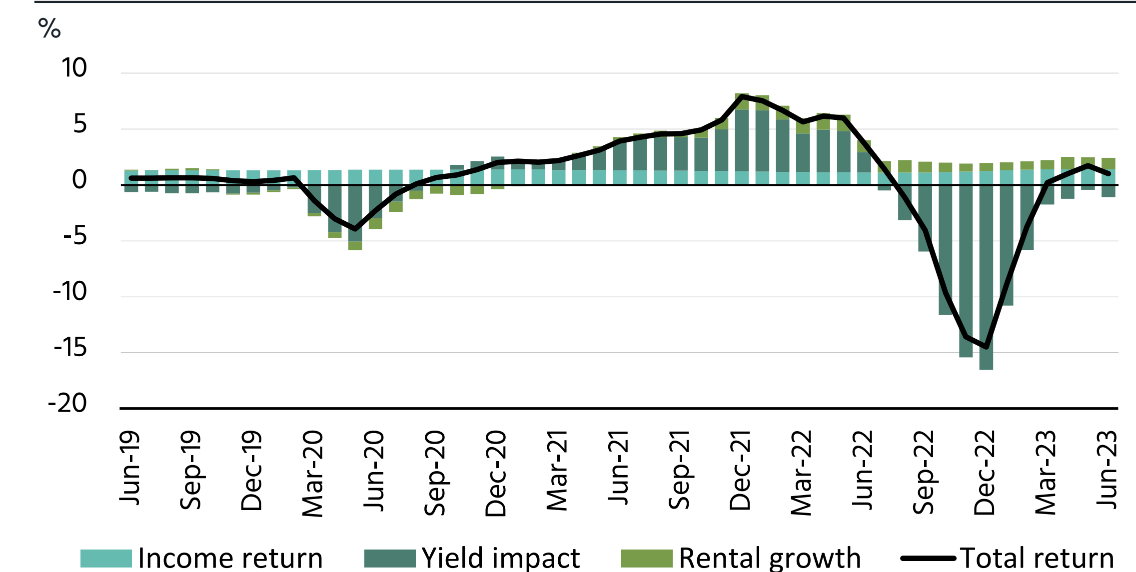
In contrast, **industrial** investment prices have been broadly maintained despite the overarching economic fundamentals. Active investors are looking beyond the short term and typically buying with all-equity. There continues to be confidence in the underlying occupier market, with reversion at a record high. Some investors (notably North American) are bidding quite aggressively on the basis that the reversion will be captured at planned lease events. There is still a significant weight of money targeting UK industrial, particularly the most future-proofed core assets with strong ESG credentials in London and the South East. This is set against the ongoing real lack of suitable investment stock in the market.

Industrial rental growth is cooling (from a high base) while void rates tick up (from record lows) and the outlook is still for relatively subdued but positive ERV growth - see this month's Spotlight for more detail on prime logistics. In the smaller multi-let format the realisable development pipeline is minimal and further underpins headline rents. In contrast, central London' office market faces a large wave of new development in H2 2023 in the form of construction overhangs and several comprehensive refurbishments, which will push availability higher. The occupier market here has polarised further between the best-in-class and the rest, with wide variations by submarket.

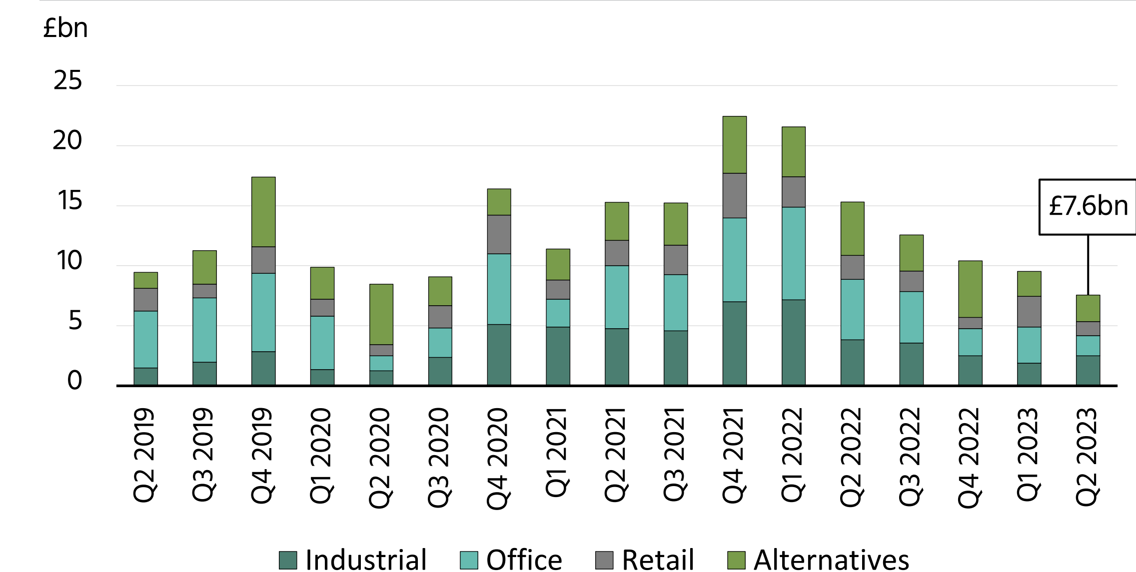
£7.6bn
Q2 2023 commercial property investment

-1.1%
June 2023 Quarterly All Property yield impact

All Property quarterly total return and components
Source: MSCI, Gerald Eve



Commercial property quarterly investment by major sector
Source: RCA, Gerald Eve



UK property segments

UK economy

UK GDP fell by 0.1% month-on-month in May as expected following the extra bank holiday for the King's coronation. However, this bank holiday had a less negative impact than in June and September 2022 where growth fell by 0.7% on each occasion. This paints some positives for economic activity, which will also be helped in the second half of the year following further wage settlements that will avoid potential strike disruption. Nevertheless, the strength and more specifically the durability of wage growth, inflation and subsequent further Bank rate increases means Oxford Economics has reined in its expectations for GDP growth for 2024 to only 0.4% as the lagged impacts of monetary policy tightening are increasingly felt.

Following the 50bp increase in the Bank rate to 5% in June, the subsequent headline inflation figure came in slightly below expectations in a drop from 8.7% to 7.9% - driven not only by lower by energy and food inflation but also domestic core inflation that will dictate the future path of the Bank Rate. Labour market tightness has broadly been maintained, as has much of the momentum of private sector wage growth, but expectations are that the Bank Rate will now increase at a more moderate pace than previously thought – starting with a likely hike of 25bps rather than 50bps in the early August MPC meeting. Moreover, the current SONIA forward curve has a peak of 5.75% by end-2023 compared with 6.25% in early 2024 a month ago.

Monetary policy operates with a lag of up to two years so most consequences of the tightening on the economy are yet to be realised. The retail sector continued its expansion in June, with sales volume growth of 0.7% on the month. However, the broader unsupportive fundamentals gained some traction with households and consumer sentiment dipped in July after steadily improving over the past six months. Strains are also showing in the housing market, with Nationwide reporting that prices are falling at their fastest rate since 2009 and in June were down 3.8% on a year ago.

Sentiment has also slipped further in the corporate sector, notably manufacturing where survey data are consistent with a deeper foray into contraction territory. Output has fallen and new business indicators weakened on the back of increased uncertainty on the impacts of increased interest rates domestically and overseas. Meanwhile the end of pandemic and energy-related stimulus combined with a range of tax increases mean that back-loaded fiscal policy will tighten substantially over the next five years, not dissimilar in magnitude to post-GFC austerity.

0.4% ▼
2024 GDP growth

4.1% ▼
End-2024 10-year government bond yield

3.6% ▼
2024 average CPI inflation

5.75% ▲
End-2023 Bank Rate

The monthly monitor

Source: Bank of England, IMF, ONS

Indicator	Two-year trend	Latest month
GDP annual growth		-0.4%
Unemployment rate		4.0%
Consumer confidence		-24.0
Retail sales growth		-1.0%
Retail sales % online		24.9%
Manf output growth		-1.2%
Brent crude (USD/bbl)		75.41
Gold (USD/oz)		1,920
FTSE-100		7,532
CPI inflation		8.0%
10-year bond yield		4.4%
EUR/GBP		1.17
USD/GBP		1.27

Jun-21 Jul-21 Aug-21 Sep-21 Oct-21 Nov-21 Dec-21 Jan-22 Feb-22 Mar-22 Apr-22 May-22 Jun-22 Jul-22 Aug-22 Sep-22 Oct-22 Nov-22 Dec-22 Jan-23 Feb-23 Mar-23 Apr-23 May-23 Jun-23

Two-year trend | Latest month

Spotlight on... UK prime logistics

The UK logistics market continues to cool after the heat of the pandemic, with most metrics having softened or flatlined in Q2. Take-up of 9.8m sq ft in Q2 was down 16% on Q1 and was the weakest quarter since Q4 2017. The volume traded in Q2 was 27% below the 10-year quarterly average. Sub-lets and assignments are proving popular with occupiers. The fact that these types of units are fitted-out and often offer cheaper accommodation than D&B options are attractive to occupiers keen to make cost savings.

Manufacturers were relatively active in Q2, with green energy production, automotive, pharmaceutical and house building & construction firms all making commitments. Some of this demand can be attributed to nearshoring operations and improving supply chain resilience, but some is also due to the natural churn of lease events. 'Services' occupiers were active too, including telecoms, film & TV, data centres and environmental waste occupiers. In contrast, dedicated internet retailers substantially slowed acquisitions in Q2.

The overall rate of availability increased again from 4.7% in Q1 to 5.4% in Q2. This represents around 50m sq ft of total space now available, with the increase due to a combination of additional delivered spec-built stock and an upturn in marketed sub-lets and assignments. Several occupiers are reworking post-pandemic supply chains and choosing to sub-let surplus space. Sub-lets or assignments are were estimated to account for 14% of availability in Q2, up from around 10% in Q1 and above the long-term average of 5%. The overall quality of available buildings is high and around 60% of all marketed space is either new or refurbished.

Following a period of unprecedented growth, prime rents increased on average 0.1% in Q2 and were 6.1% higher than a year ago - a more 'normal' rate of annual rental growth. We nevertheless remain confident in the structural tailwinds supporting the sector and still anticipate continued (albeit more moderate) rental growth.

Occupier demand from dedicated internet retailers has slowed sharply from the pandemic peak. However, **e-commerce** will continue to be a structural driver of demand for logistics space. The price transparency on offer by these retailers is a key USP whilst inflation is high. There will also be retailers upgrading to better quality accommodation or late adopters that will be net positive for logistics demand. In addition, many occupiers are looking for cost-effective avenues to de-risk supply chains. This has entailed **nearshoring** operations closer to domestic markets and increasing inventory levels, both of which will be positive for warehouse demand.

PRIME LOGISTICS Q2 2023 KEY STATISTICS

9.8m sq ft ▼
Take-up

5.4% ▲
Availability rate

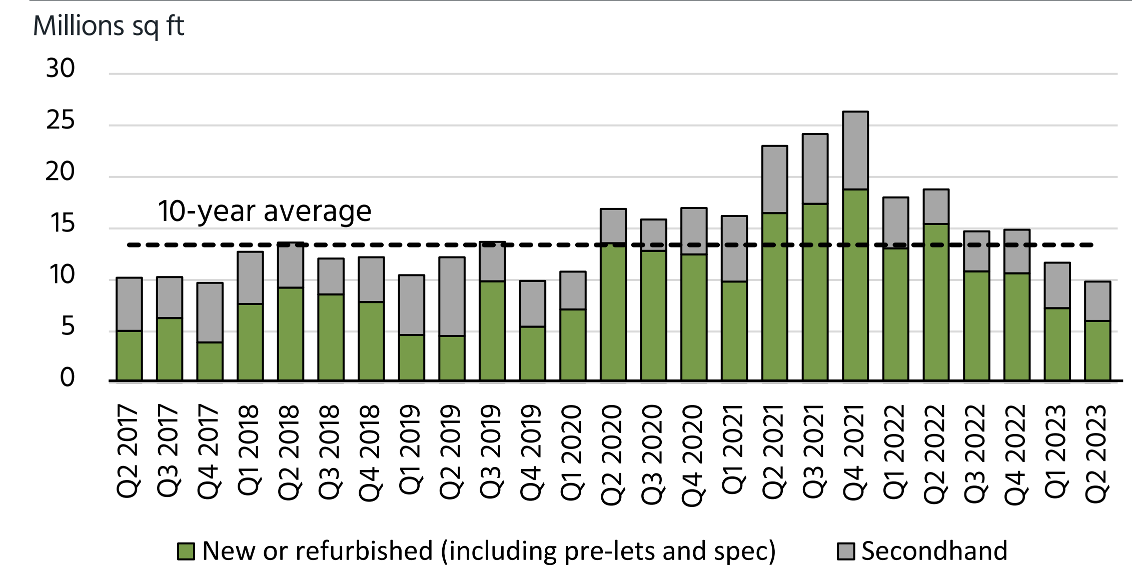
2.8% ▲
New or modern availability rate

0.1% ▼
Prime rental growth

3.0m sq ft ▼
Speculative development starts

0bps
Prime yield shift

UK logistics quarterly take-up by quality
Source: Gerald Eve



UK logistics availability rate
Source: Gerald Eve

Outlook

The recent downgrade in economic growth prospects for 2024 points to a trajectory of elevated UK bond yields, swap rates and commercial debt costs for a longer duration than previously expected. We expect commercial property yields to be impacted and All Property return to be negative for a second successive year. Negative yield impact is forecast to be only around half of the rate of 2022. The current correction may be quite gradual and be drawn out into early 2024 while there is weight of money and transaction volumes remain thin. Nevertheless, we anticipate that annual total return will turn positive again in 2024.

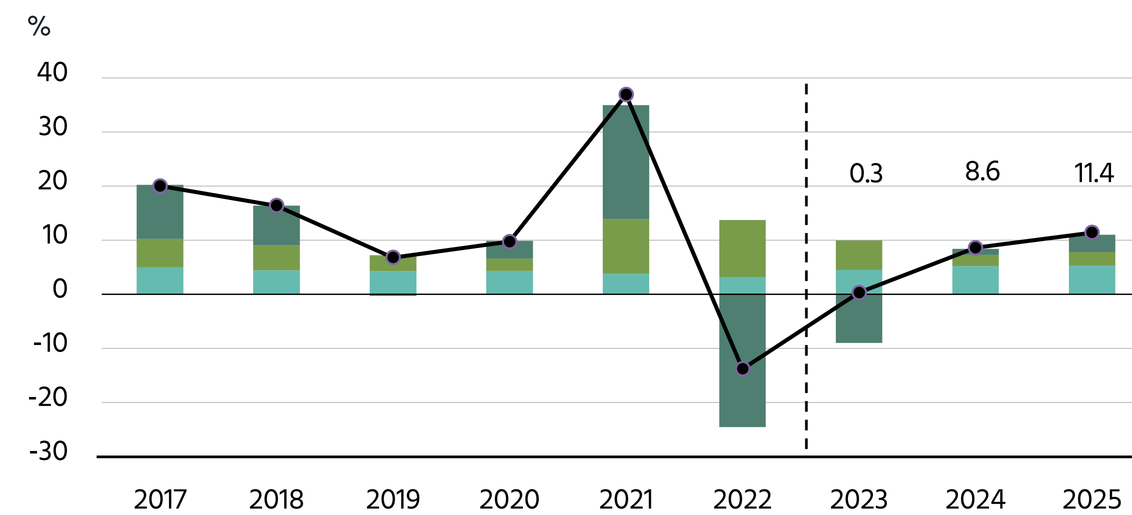
Industrial still sits relatively favourably amongst the other major property sectors. There is a significant global weight of capital targeting the sector set against very limited investment supply, which will help moderate any outward yield shift. Rental growth may have cooled, but this is from very strong rates in 2021 and 2022. Void rates and default rates have ticked up, and subletting has also increased. However, we remain upbeat on the robustness of industrial's diverse occupier base and expect market rental growth to remain positive, helped in part by greater flexibility from landlords.

In contrast, **retail** and **offices** have more structural problems to deal with. **Office** prime/secondary polarisation is set to intensify as alternative working practices allied with EPC obstacles continue to negatively impact occupancy and investment demand for secondary space. Meanwhile real incomes are set to fall further despite strength in the labour market and a moderation in energy bills as ongoing price rises and increased mortgage rates gain traction, which will negatively impact the **retail** sector. The significant capital value falls for retail assets over the last several years should provide a small offsetting cushion in the form of relatively greater income return.

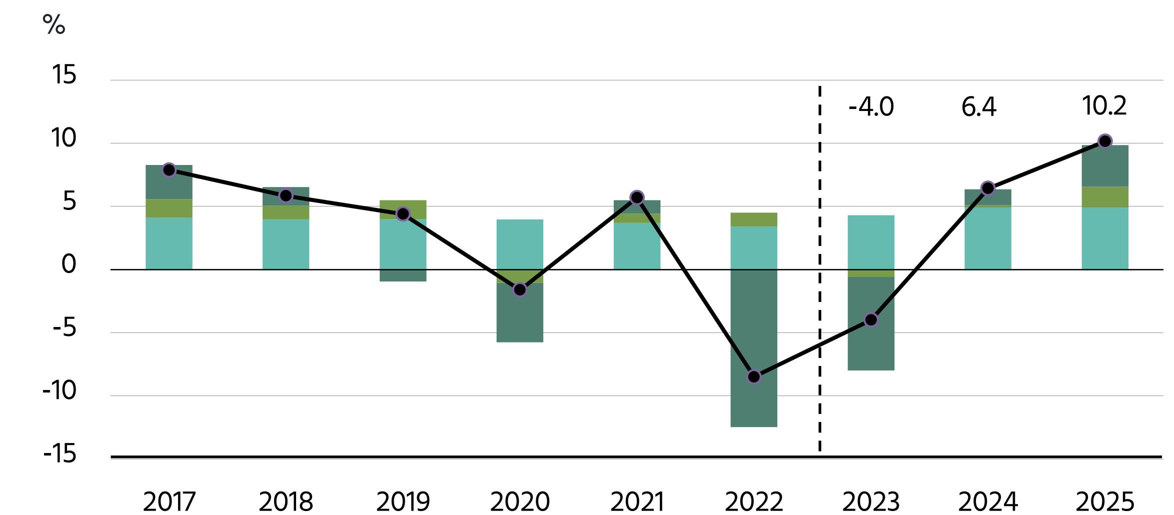
Total return and components by sector, July 2023 forecast

Source: Gerald Eve, MSCI

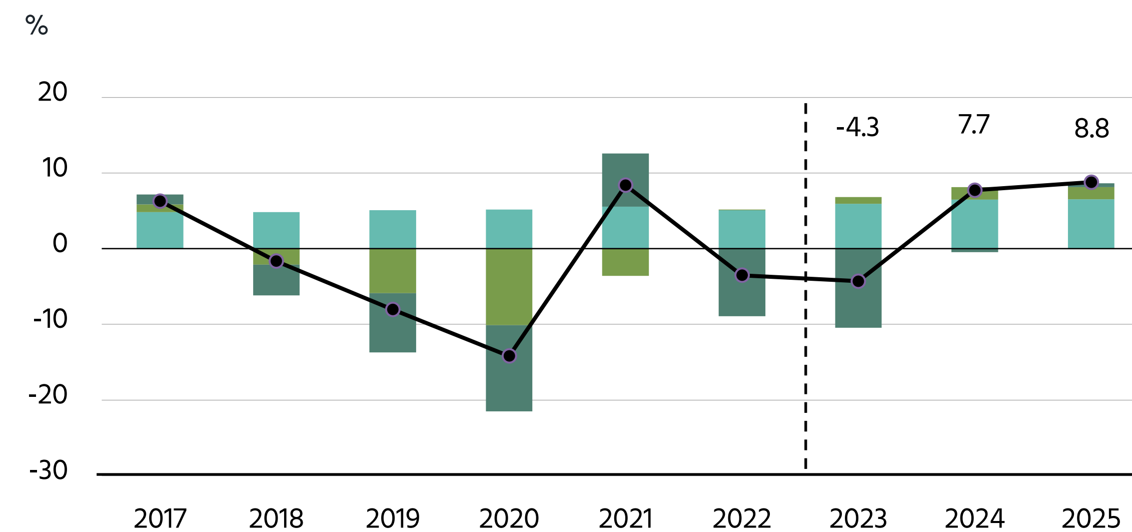
Industrial



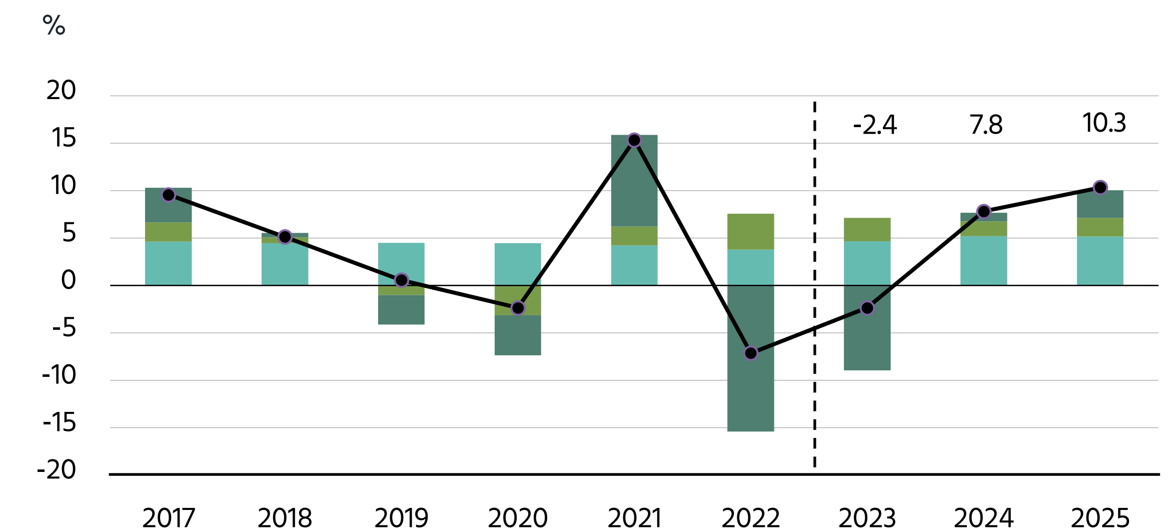
Office



Retail



All Property



Income return · Rental growth · Yield impact · Total return

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Prime Logistics
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London Markets
Q2 2023

South East Office Investment
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Rating update -
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