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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

September 2023

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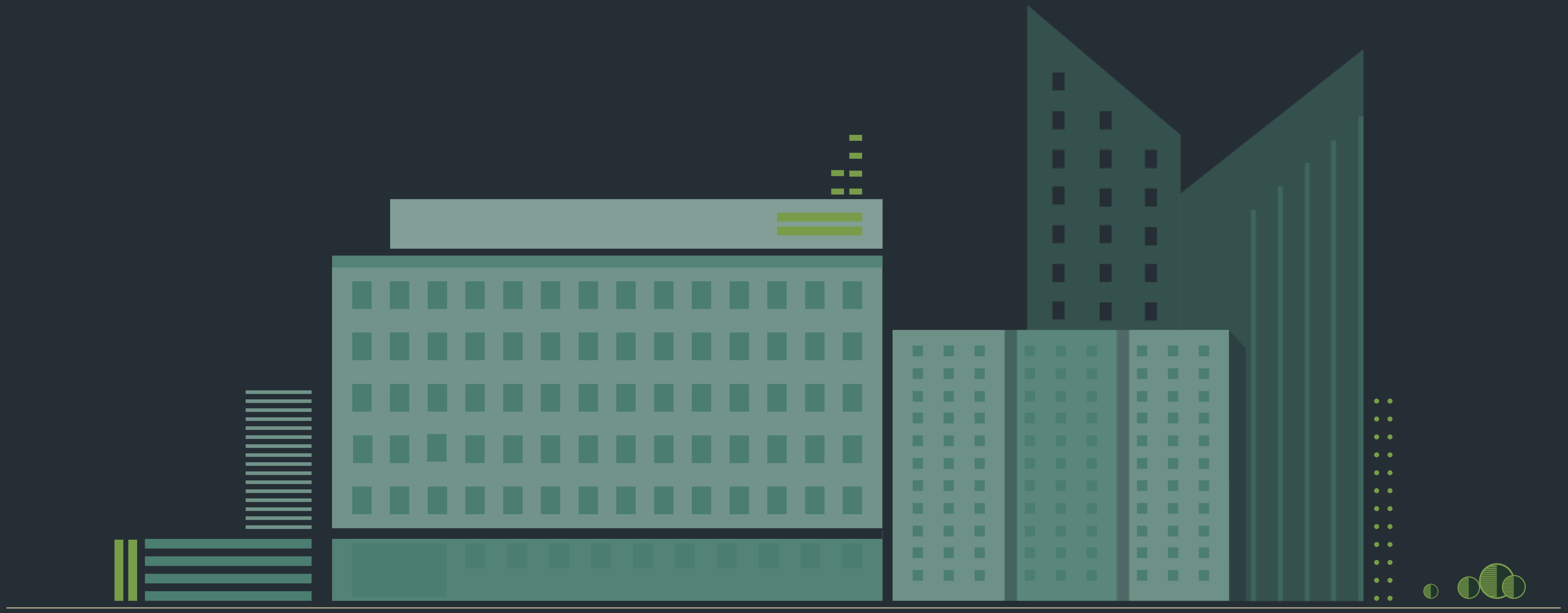

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SEPTEMBER UPDATE

The Bank of England's narrow vote to maintain the Bank Rate at 5.25% in September after 14 consecutive rises has been a boost to the investment market. The consensus is that we are now at the peak of the current rate cycle, albeit for a sustained period. Nevertheless, the price correction for some segments will continue, notably for offices and some secondary markets across all sectors. Broadly though, most UK sector valuation yield profiles continue to be remarkably flat, with only very minimal outward drift and an All Property quarterly total return of effectively zero in August.

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

0.05% ▼
All Property quarterly total return, August 2023

58bps ▲
UK office outward yield shift in 2023

0.4% ◀▶
2024 GDP growth forecast

3.0% ▼
2024 average CPI inflation forecast

4.75% ▼
End-2024 Bank Rate forecast

4.3% ▼
End-2024 10-year government bond yield forecast

Interest rates peak but the price correction continues in some segments

All Property quarterly total return edged down again from 0.4% in July to only 0.05% in August. Performance has been relatively stable in recent months, with only moderate outward yield drift overall compared with late 2022. The sector predominantly driving this outward drift continues to be offices.

Office yields moved out a further 10bps in August to total 48bps so far in 2023. Consequently, offices are the underperforming sector and quarterly total return was running below the other sectors at -4.2% in August. London offices were noticeably impacted in August and the City yield has softened by over 100bps so far this year. In a global context, London is considered to be ahead of its key centre counterparts in absorbing this price correction. This might present greater interest from overseas investment early in 2024, especially if sterling remains relatively cheap.

Broadly though, most UK sector valuation yield profiles continue to be remarkably flat, with only very minimal outward drift. This stability has been driven by the prime end of the market, where yields have effectively held constant all year. Investment activity continues to be relatively low and the weight of money targeting UK real estate (notably industrial) means that these kinds of assets can be acquired with all-equity.

Secondary pricing has been more significantly impacted and yields have softened in 2023, particularly over the May-June period for industrial when interest rate expectations were at a peak and anticipated to reach as much as 6.5% by early 2024. Secondary offices continue to be impacted, with the broader price correction compounded by the shift in working patterns and drop in aggregate occupier demand along with sustainability requirements that could render many offices unlettable.

The additional challenge for secondary assets is that typically the investors targeting them have a greater exposure to the debt market, where pricing remains a challenge. Moreover, lenders have concerns around these types of assets and not only price in a significant amount of capex for EPC refurbishment, but they have also become increasingly involved to ensure this is carried out.

The unexpectedly soft economic data and more moderate inflation figure that allowed the Bank of England to maintain the Bank Rate at 5.25% in September after 14 consecutive rises has been a boost to the investment market. The consensus is that we are now at the peak of the current rate cycle, albeit for a sustained period. Property equities were positively impacted by the decision.

At a sector level, the dominant outperformance of **Industrial** is starkly apparent. This relatively lower-yielding sector was the most negatively impacted by the correction in late 2022. But as we move further beyond that period, Industrial is the strongest sector over virtually any time horizon. Industrial has re-established its outperformance over the past three months and the 10-year annual average return is an incredible 13% - more than double the 5.6% recorded for offices and more than three times the 3.0% achieved by retail. See this month's [Spotlight page]for more detail on the industrial occupier market resilience.

0.05%

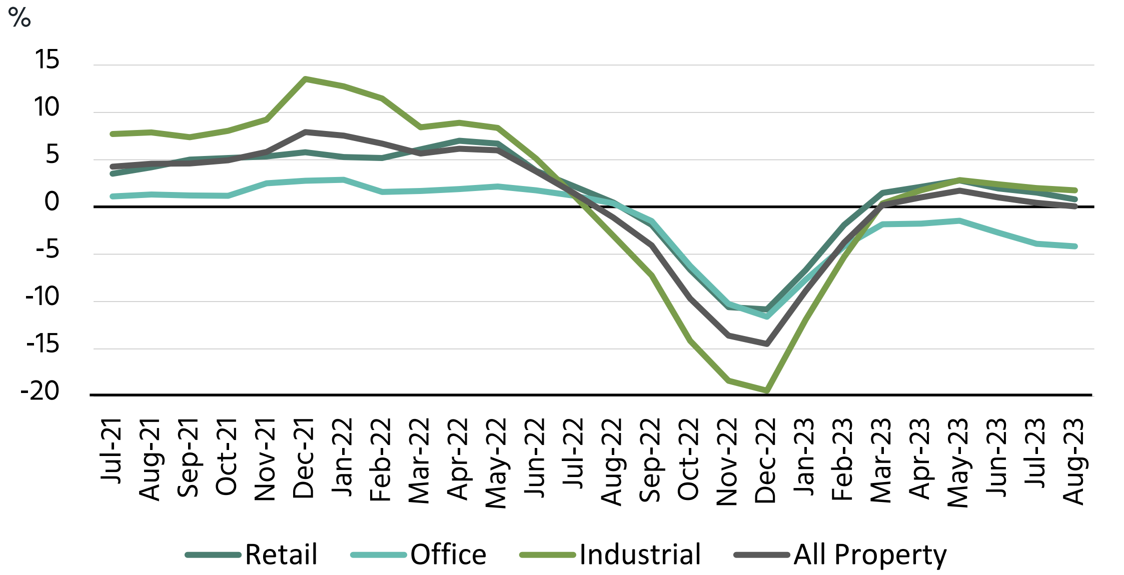
All Property quarterly total return, August 2023

58bps

UK office outward yield shift in 2023

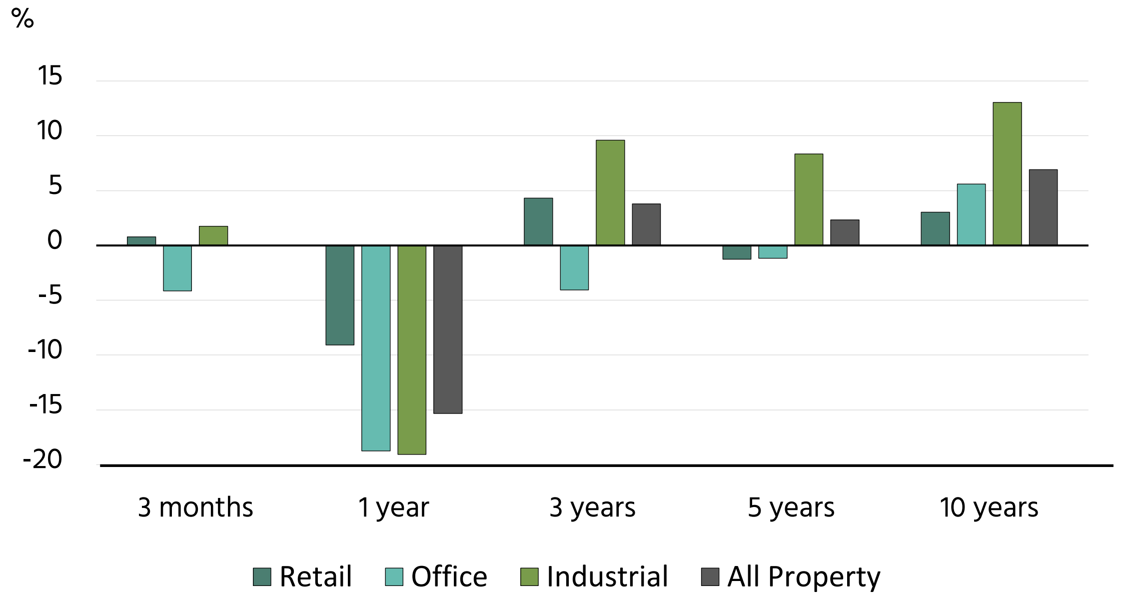
Quarterly total return by sector

Source: MSCI, Gerald Eve



Average annual total return by sector and timeframe

Source: MSCI, Gerald Eve



UK property segments

12-month return to August 2023
Source: Gerald Eve, MSCI

UK economy

UK GDP fell 0.5% month-on-month in July, which reversed all gains from June and was consistent with deteriorating business sentiment and activity indicators. Oxford Economics has revised down its annual GDP growth for 2023 to 0.4% and kept it at this low rate for 2024. Other commentators predict a shallow recession, but the broad consensus is for a sustained period of stagnation ahead.

Global supply chain bottlenecks and energy prices have eased, and that helped bring the UK headline CPI inflation in under expectations to 6.7% in August - though this compares with 3.7% in the US and 5.2% in the eurozone. Domestic core inflation continues to be an issue, though tight labour market conditions have eased further and suggest high wage growth will begin to slow. The unemployment rate increased again to 4.3% in July, up 0.7 percentage points on a year ago, and job vacancies were their lowest since mid-2021. The MPC narrowly voted to keep the Bank Rate on hold at 5.25% in September and end a series of 14 consecutive rate rises. Interest rates may have peaked, but the dampening impact on growth and spending will continue as it feeds through the economy over the next 18 months. Any future rate cuts are not expected until late 2024 and after the US Fed loosens its own policy.

In the business sector, construction firms have been impacted by the fall in housebuilding, services exposed to diminished disposable incomes, and manufacturing activity dented by higher input prices and interest rates set against weakened global trade flows combined with the UK's unique Brexit exporting impediments. Insolvencies have risen sharply to their highest level since the GFC and are forecast to peak in 2024. Survey data suggest that interest rates will reduce business investment by 8% over the coming year. Meanwhile the general election in late 2024 will generate more uncertainty, with some firms set to delay any major decision-making or investment activity until after the results and implications are clearer.

Inflation has fallen below annual wage growth and real incomes have begun to edge up again. Households are feeling notably more optimistic, with sentiment its highest since January 2022 and retail sales ticked up 0.4% in August. This is seemingly unsustainable though, given the numerous headwinds and now that the covid-era savings cushion has largely been spent. Fiscal drag will continue to eat into disposable incomes. And while nominal tax receipts have been bolstered recently, public finances will continue to be strained by local authority deficits, public sector pay, and rises in state pensions.

0.4% ◄►
2024 GDP growth forecast

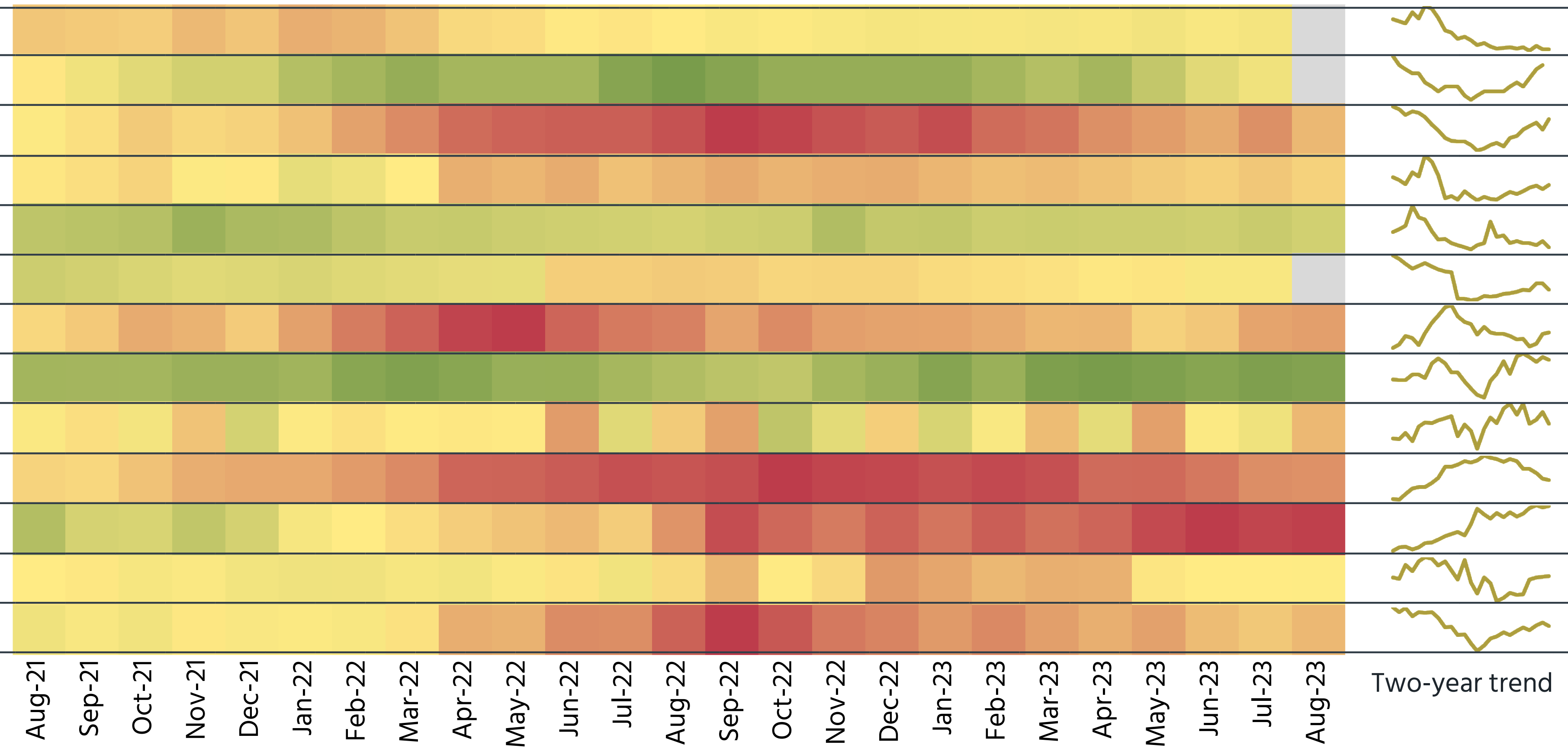
4.3% ▼
End-2024 10-year government bond yield forecast

3.0% ▼
2024 average CPI inflation forecast

4.75% ▼
End-2024 Bank Rate forecast

The monthly monitor

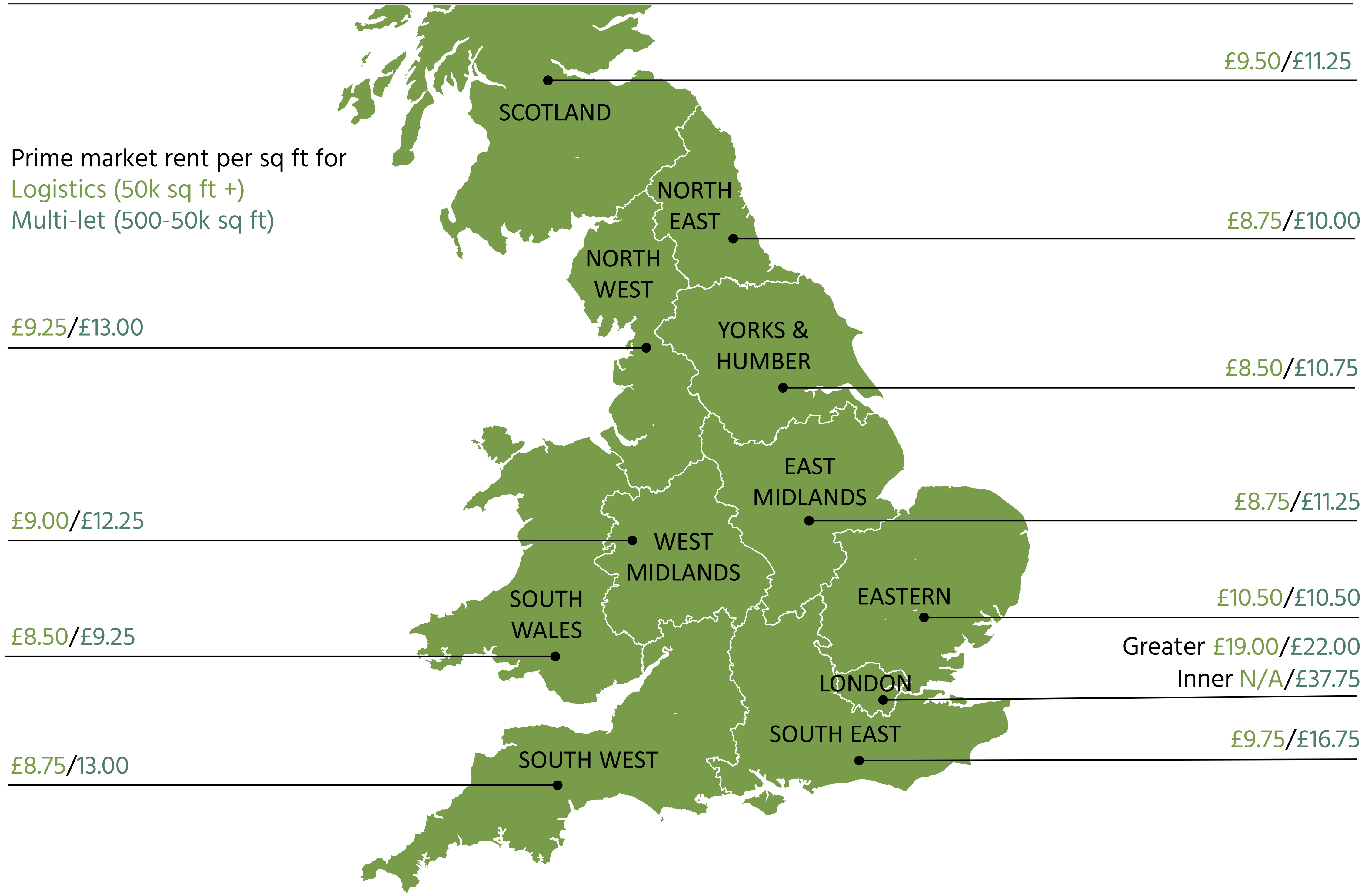
Source: Bank of England, IMF, ONS



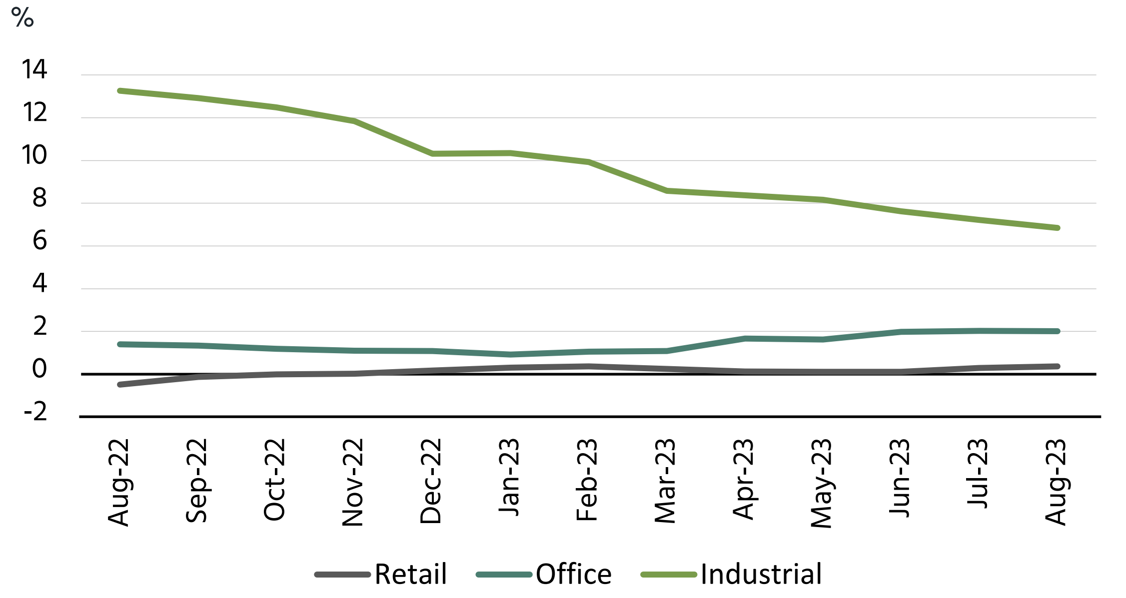
	Latest month
GDP annual growth	0.0%
Unemployment rate	4.3%
Consumer confidence	-21.0
Retail sales growth	-1.4%
Retail sales % online	24.9%
Manf output growth	3.0%
Brent crude (USD/bbl)	86.83
Gold (USD/oz)	1,940
FTSE-100	7,439
CPI inflation	6.7%
10-year bond yield	4.4%
EUR/GBP	1.17
USD/GBP	1.27

Spotlight on... Q3 industrial occupier market resilience

Average prime rent by region, Q3 2023
Source: Gerald Eve



All-grades annual rental growth by sector
Source: MSCI



Industrial rental growth has eased since the frenetic activity of 2021 and 2022 and as the market finds a new post-pandemic equilibrium. Nevertheless, Industrial is far stronger than comparator major property sectors and is the only one with any real continued momentum. Occupier demand has softened - there are fewer Christmas peak requirements from retailers and there have been some longer void periods as landlords hold on for the best headline rents. But supply is limited across many markets, which has either maintained nominal prime rents or continued to move some on in Q3. The relative thinness of market activity and "flight to prime" means the market has been characterised by unequal rental uplift in different, but seemingly similar locations.

Outlook

With interest rates likely to have peaked at 5.25% the consensus is that we are in for a sustained period of elevated UK bond yields, swap rates and commercial debt costs. Commercial property yields continue in the main to be below where these economic fundamentals suggest they should be, but current low transactions volumes and weight of equity means that this disequilibrium is set to persist. This is particularly likely for industrial assets, while office values will likely continue softening, driven by weakness in secondary. While the lack of outward yield shift will mitigate negative yield impact in the short term it will also limit positive total returns over the medium term. All Property annual total return is set to be effectively zero in 2023 and rise later in the forecast period as yields stabilise.

There is a significant global weight of capital targeting **Industrial** set against limited investment supply, which will help moderate any outward yield shift. Rental growth may have cooled, but this is from very strong rates in 2021/22. Void rates and default rates are likely to continue to rise and peak in 2024, but well below previous downturns. We remain relatively upbeat on industrial's diverse occupier base and expect nominal rental growth to remain positive.

In contrast, **retail** and **offices** have more structural problems to contend 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 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, September 2023 forecast
Source: Gerald Eve, MSCI

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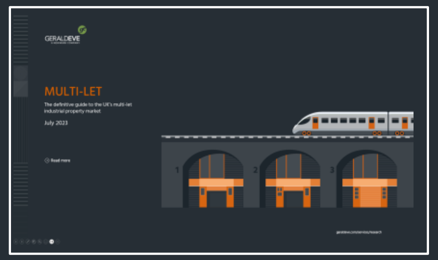

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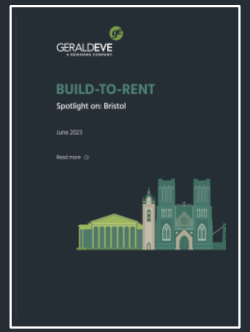
Q2 2023



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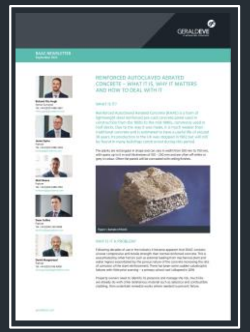
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