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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

February 2024

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FEBRUARY UPDATE

At 0.3%, All Property annual total return eked into positive territory in January 2024 for the first time since October 2022. Negative yield impact continues to offset almost all the positive gains from rental growth and income return, driven by the ongoing outward shift for Offices. Office capital value growth has now fallen behind Industrials by more than 50% over the past four years. However, some office segments have fared better than others as the occupier footprint continues to adjust to the shift to remote working patterns. This month's Spotlight focusses on Central London.

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

52%
Difference in cumulative capital value growth for Industrials over Offices Jan 20 – Jan 24

0.3% ▲
Jan 24 All Property annual total return

1.8% ▲
2025 GDP growth forecast

2.1% ▼
2025 average CPI inflation forecast

3.5% ▼
End-2025 Bank Rate forecast

3.5% ▼
End-2025 10-year government bond yield forecast

Office capital value growth has fallen behind Industrials by more than 50% over the past four years

At 0.3%, **All Property** annual total return eked into positive territory in January 2024 for the first time since October 2022. Negative yield impact continues to offset almost all the positive gains from rental growth and income return, driven by the ongoing outward shift for Offices. Sector differences in cumulative capital value growth in the four years covering the pandemic are stark. **Retail** capital values were broadly unchanged by the end of the period, boosted by Retail Warehouses and the segment's lower rental declines and periods of positive yield impact - whereas shopping centre returns have been a drag on the sector. **Industrial** capital values are up by over a third, despite being at the sharpest end of asset repricing in late 2022.

UK **Offices**, however, have lost almost a fifth of their value so far and it is now the only sector where yields continue to drift out noticeably. Yields arguably should have corrected more meaningfully over the pandemic, but the dearth of transaction activity at the time created significant ambiguity for valuers. The occupier footprint of the office market continues to adjust to the shift to remote working patterns as more leases come up for renewal.

Secondary stock and more fringe locations have taken the brunt of the negative impact. Meanwhile, Central London take-up in Q4 was the largest since Q4 2018 (see this month's Spotlight). However, it is worth noting that much of this is still likely to represent increased churn rather than net demand while firms consolidate space and upgrade to prime locations. Central London vacancy is relatively elevated and likely to continue rising given the strength of the development pipeline. More widely, UK Office rental growth has continued to tick over at an annual rate of 1-2%, in part due to index-linked leases for a small number of office assets that have been moved on significantly with recent strong inflation. However, with lower inflation this contribution is now set to ease.

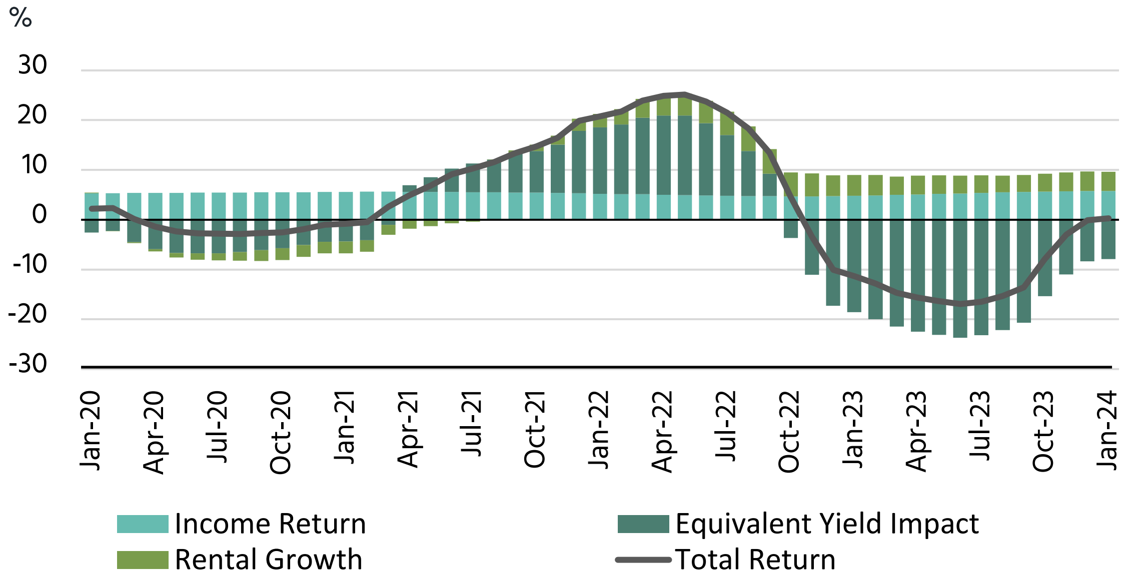
UK **retail** capital values may have held up better than offices over the past four years, but the sector has been subject to longer term decline. Yields have moved out unfavourably compared against other property sectors since as far back as 2016. Retail rents have also reset dramatically. In just the four years since the pandemic shopping centre and high street rents are down by more than a third in real terms, and retail warehouses have dropped by 22%. However, this shift arguably provides a platform at last for some gradual recovery. Indeed, nominal retail rents have largely stabilised recently and there could be some low single digit positive growth in line with the gradual improvement in the consumer sector.

There continues to be volatility in retail sales, which in January were only marginally higher than a year ago and more than 5% below where they were two years ago. Consumer sentiment, though still negative, had trended upwards over October to January on the assumption that the worst of the inflation impacts were over and the economy and personal finances would improve. However, this slipped in February, arguably on the realisation that there is still a long road ahead. Online retail spend has returned to its pre-pandemic trend and accounts for just over a quarter of the total. This is forecast to continue trending upwards and capture around a third of all spending by 2027, which will continue to adversely impact physical retail stores.

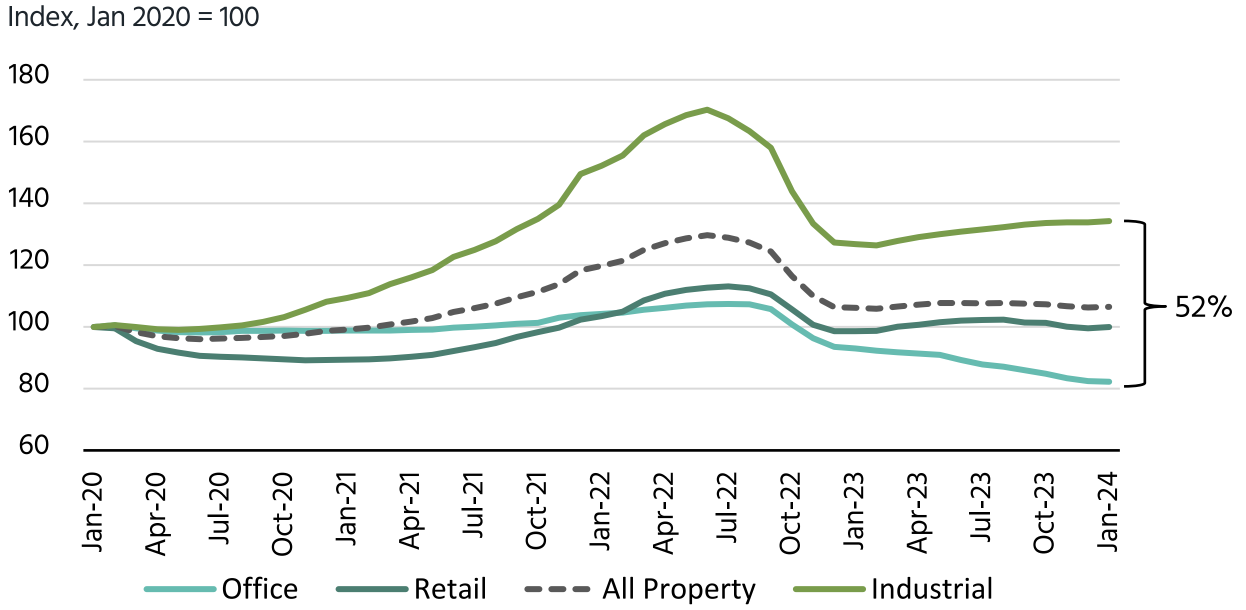
52%
Difference in cumulative capital value growth for Industrials over Offices
Jan 20 – Jan 24

0.3% ▲
Jan 24 All Property annual total return

All Property annual total return and components
Source: MSCI

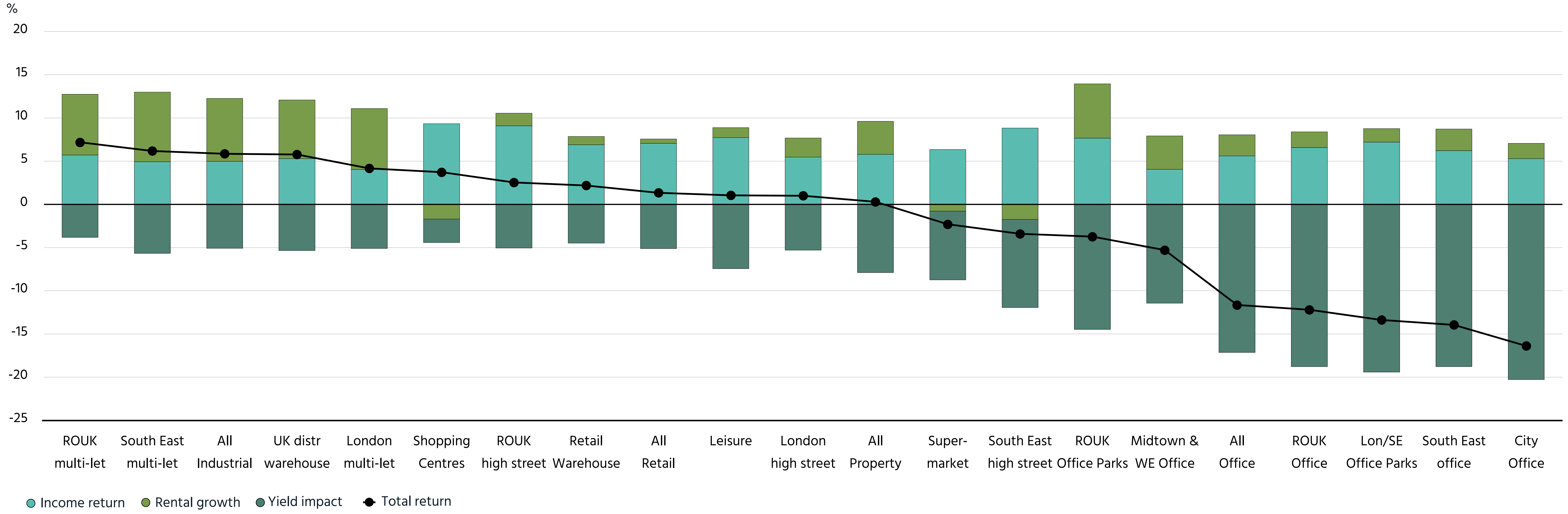


Capital values by sector
Source: Gerald Eve, MSCI



UK property segments

12-month return to January 2024
Source: Gerald Eve, MSCI



UK economy

UK GDP fell by 0.1% month-on-month in December 2023, which contributed to a 0.3% contraction for Q4 overall. This was the second successive quarter of negative growth and thus tipped the UK into technical recession. However, December is likely to be the low point in activity and the 'downturn' is probably already over. Business survey sentiment data suggest that while there continues to be weakness for manufacturers, overall output is in moderate expansion territory in Q1.

The survey data also suggest that input costs increased at their fastest rate for six months in February. This was driven in part by the Red Sea conflict and increased shipping costs for manufacturers, along with ongoing strong service sector wage inflation. Wage growth is softer than it was for most of 2023, but the latest figure came in above expectations and downward momentum appears to have slowed so far in early 2024. Wage growth is still double the pace that would be consistent with achieving the inflation target.

Broader disinflationary forces, notably from the more than 12% drop in the energy price cap in April, mean overall inflation is set to continue to fall to the Bank of England's 2% target over the next few months. But these latest data will maintain lingering concerns over stickiness in core inflation and pay growth, meaning the initial rate cut may not occur until the early summer. Oxford Economics has revised down its forecast of 100bps of cuts this year to 75bps and retained the 100bps in 2025, which will take the Bank Rate to 3.5% by the end of 2025.

The upcoming March Budget will likely contain some small giveaways, but the Chancellor will be all too aware of the tight constraints on the public purse and the punishment dished out by the money markets for the Truss/Kwarteng 'fiscal event' in late 2022. Overall fiscal policy will necessarily continue to be a drag on the recovery over the medium term, irrespective of whichever party wins the 2024 general election.

Lower inflation should support real incomes over 2024 and help develop some modest recovery in household spending. House prices are estimated still to be around 16% overvalued and effective mortgage rates continue to rise while fixed-rate mortgages end and refinancing occurs at higher rates for around 1.5m households by the end of 2024. Prices should nevertheless have a relatively soft landing, given the strength in employment and wage growth, the large proportion of properties without a mortgage and the relatively gradual passthrough of interest rate rises for the ones that do.

1.8% ▲
2025 GDP growth forecast

3.5% ▼
End-2025 10-year government bond yield forecast

2.1% ▼
2025 average CPI inflation forecast

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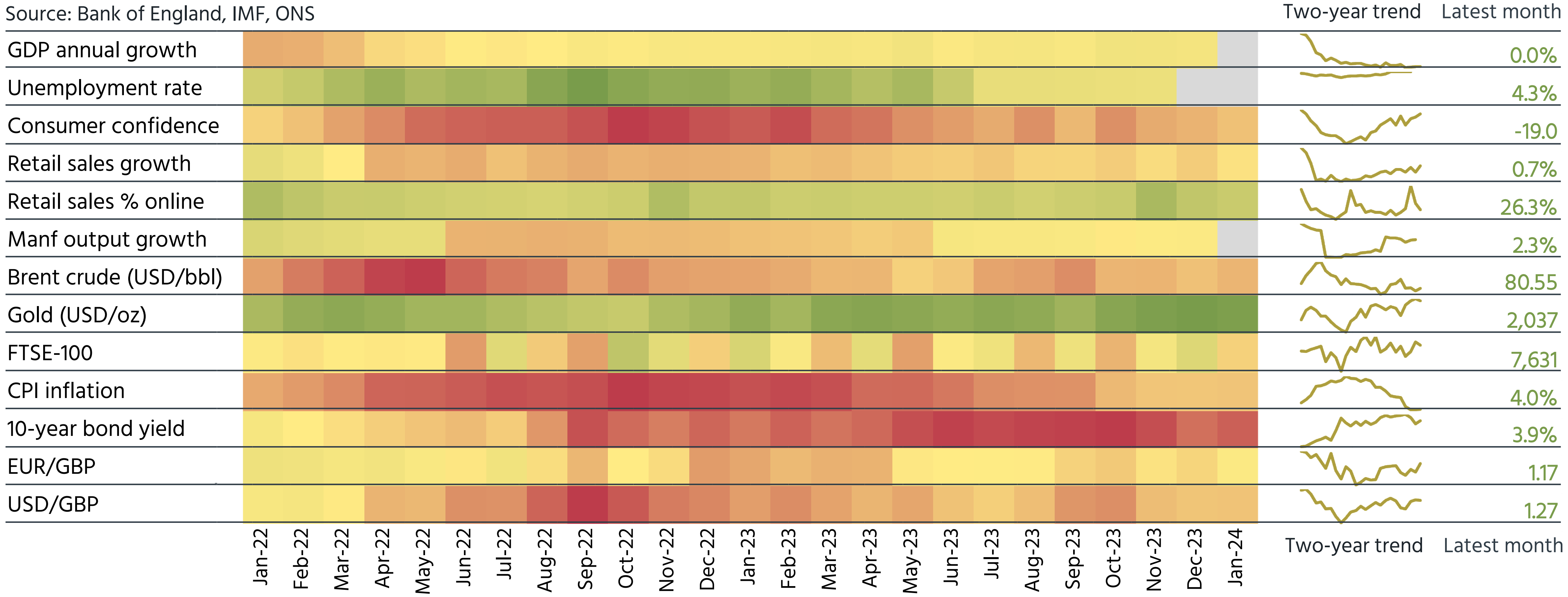
The monthly monitor

Source: Bank of England, IMF, ONS



Spotlight on... central London offices

Read more detail from the report, click here

Take-up in Q4 was 4.4m sq ft, the largest quarterly volume since Q4 2018. Activity in Q4 2023 was skewed by two large lettings by HSBC and Barclays totalling 1.4m sq ft. Excluding these deals, core demand was above the long-term quarterly average.

Grade A rents in Marylebone rose 2.6% in Q4. There is limited Grade A availability in the submarket and quoting rents have risen for good quality space. More broadly, prime rents continue to outpace secondary counterparts across most West End and City core markets.

Availability edged down for the second consecutive quarter to 8.8% in Q4. However, several developments and full-scale refurbishments are in the pipeline, which will likely cause availability to trend upwards over the medium term.

An estimated 2.2m sq ft of new office space completed in Q4 across 12 schemes. The volume of new completions in 2023 was just over 6m sq ft, the second highest on record behind 2018. Material costs are expected to fall for the first time since 2020 which may incentivise developers in 2024.

The volume of refurbishment activity is high, with almost 6m sq ft undergoing improvement. Landlords are undertaking works to meet EPC regulations and in response to occupier requirements for the best quality space.

The volume of investment in Q4 was £1.6bn across 32 transactions. This was an increase of 14% on Q3 but still 27% below the 5-year quarterly average. The total annual volume was £5.8bn in 2023, one of the lowest on record and 42% below 2022.

4.4m sq ft ▲ Take-up, Q4 2023	8.8% ▼ Availability rate, Q4 2023
£1.6bn ▲ Investment volume, Q4 2023	6.0m sq ft ▲ Under refurbishment, Q4 2023

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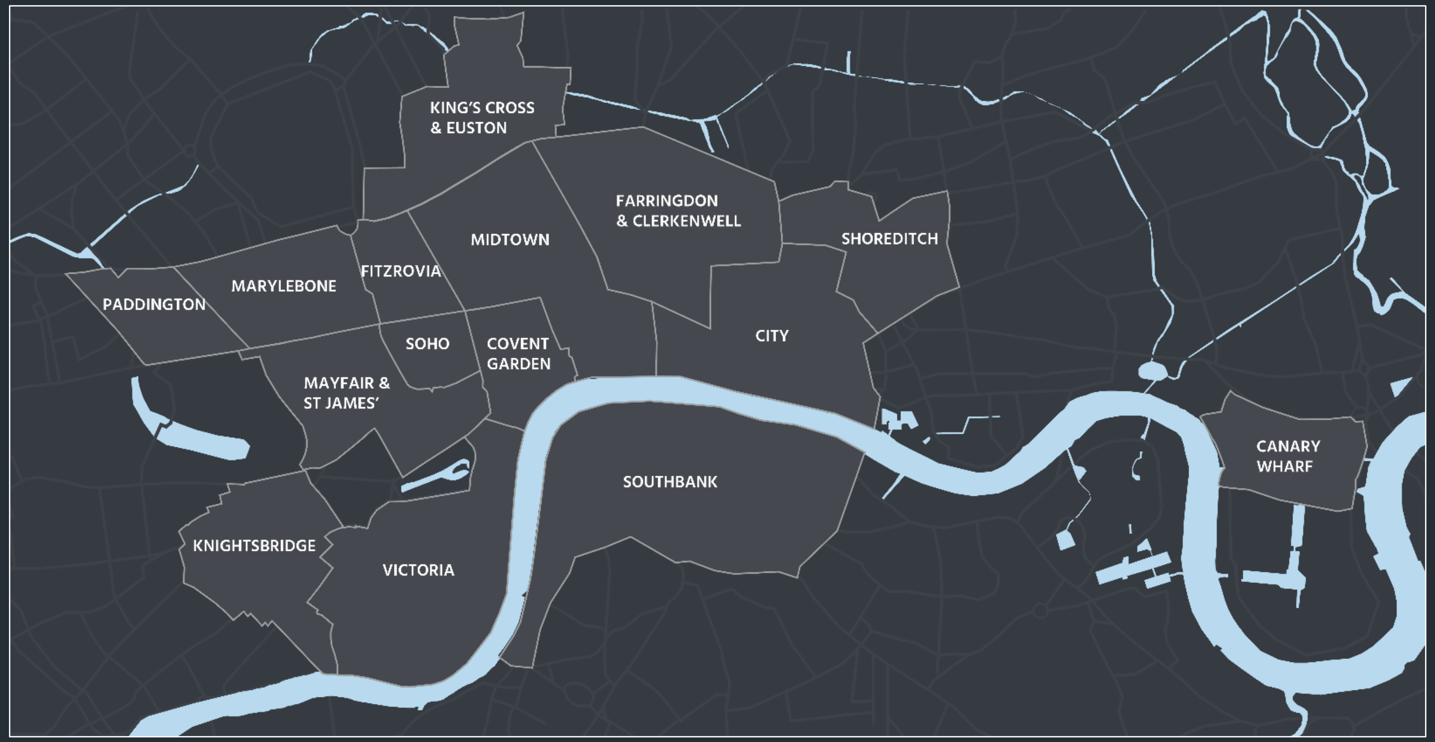

Outlook

With interest rates having peaked at 5.25% and expectations of substantive cuts beginning in the summer, the cost and availability of debt should continue to become more accommodating. But the upside potential for property returns will be limited, given that current commercial property yields continue in the main to be below where the monetary fundamentals suggest they should be. The outlook is cautiously optimistic - annual property returns should trend upwards over the medium term as yields discontinue softening (notably for offices) and rental growth comes back in line with the (albeit gradual) economic recovery.

The resilience of the **Industrial** occupier market will continue to appeal to investors and continues to support prices that having corrected in late-2022 now remain relatively robust. Rental growth may have cooled, but this is from very strong rates in 2021/22. Void rates and default rates are likely to stop rising in 2024 and remain below previous downturns, which will maintain positive rental growth. Investors will continue to have confidence in the sector.

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. Real incomes and the cost of debt are set to begin improving but households and retailers are nevertheless in for another challenging year. The significant fall in capital value 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, February 2024 estimates and forecasts
Source: Gerald Eve, MSCI

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

JOSH PATER
Partner
jpater@geraldeve.com
Tel. +44 (0)20 3486 3473

Valuation

RICHARD MOIR
Partner
rmoir@geraldeve.com
Tel. +44 (0)20 7333 6281

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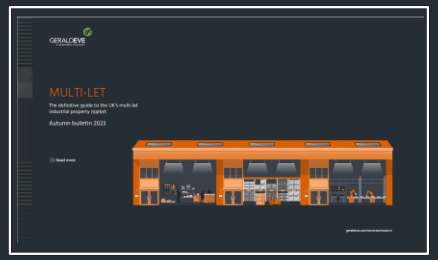

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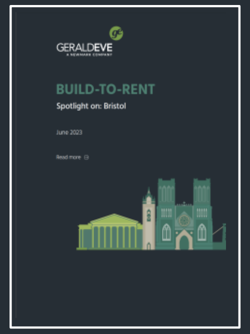

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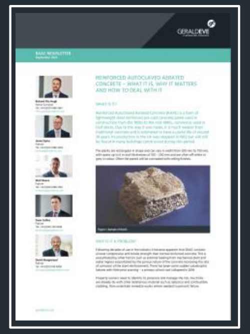

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