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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

January 2024

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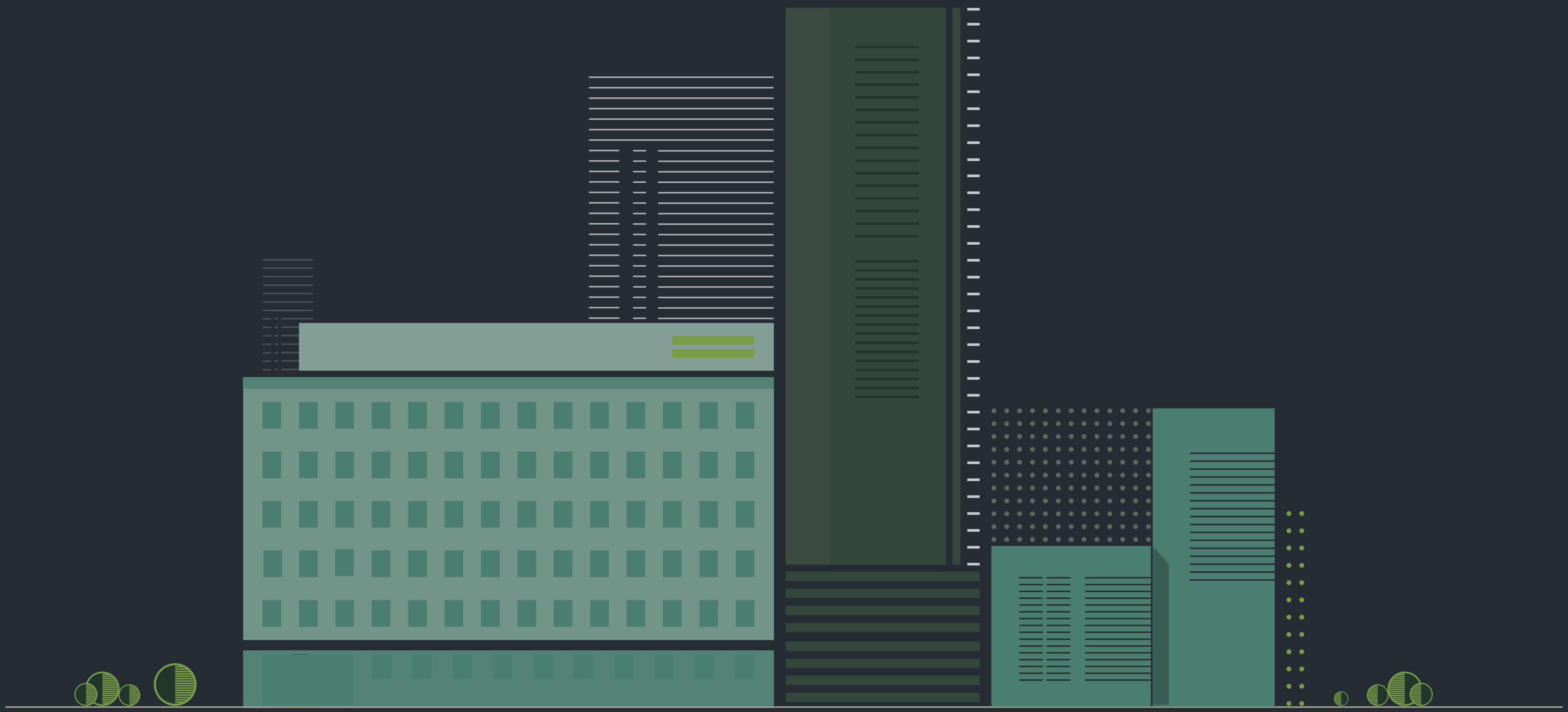

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JANUARY UPDATE

All Property annual total return increased sharply again in December to finish the year effectively at zero. Offices, particularly London City offices, significantly underperformed in 2023 while Industrial total return has surged ahead again, dominating the other sectors over all time horizons. The final quarter of 2023 was likely the bottom of the market and there was the lowest number of investment transactions since Q2 2011. Investor confidence and property returns are set to pick up, but there is limited scope for yield compression.

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

354 ▼
Q4 2023 investment transactions – the lowest since Q2 2011

9.6bn ▲
Q4 2023 commercial property investment

1.6% ▲
2025 GDP growth forecast

1.5% ▼
2025 average CPI inflation forecast

3.25% ▼
End-2025 Bank Rate forecast

3.4% ▼
End-2025 10-year government bond yield forecast

Lowest number of quarterly investment transactions in Q4 since 2011 indicates the bottom of the market

All Property annual total return increased sharply again from -7.9% in October to -3.0% in November to around zero in the latest December data. This we anticipated as the base effects of the sharp upturn of property yields in late 2022 have now fallen completely out of the figures. Valuation yields for Industrial and Retail were remarkably stable over 2023 with a small tick up in the final couple of months. Agents in the direct market estimate that yields should have softened more in Q4 but valuers are under pressure to maintain LTV covenants and this movement may lag into early 2024 or be smoothed off altogether. In contrast, office yields unambiguously repriced over 2023, particularly over the second half, by a massive 117 basis points.

This is reflected in drastically different total return profiles for the alternate sectors. **Offices** significantly underperformed in 2023 with a total return of -11.8%; negative yield impact eroded an average 17.2% from capital values across the UK. London City offices were the most significantly affected and were the worst performing segment in 2023 with -16.8% total return. The **Retail** total return was positive for 2023, but at only 1.0% it characterised a balance between a high income return after years of capital value decline but little rental growth and some small negative yield impact.

Meanwhile **Industrial** surged ahead again with a return of +5.1%, helped on by ongoing rental growth momentum and only moderate negative yield impact. The strongest performing segment in 2023 was multi-let industrial in the regions outside of the South East – these assets benefitted from rental growth and a relatively high income return component. Astonishingly, Industrial once again has a stronger return profile than the other sectors over 1 month, 3 months, 12 months, 3 years, 5 years, 10 years, and in fact over the entire period since the MSCI monthly universe inception in 1986.

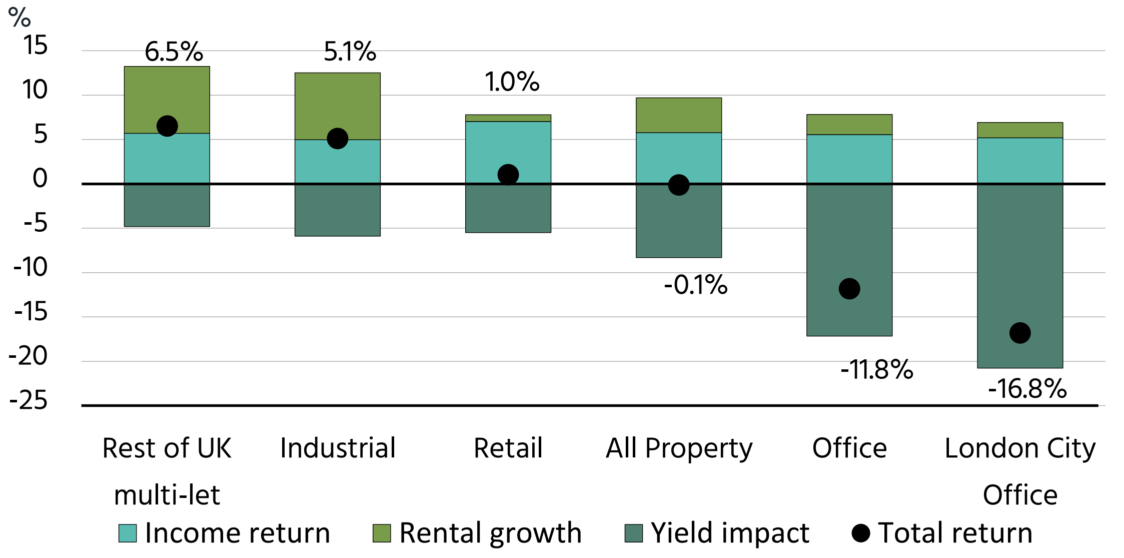
The final quarter of 2023 was characterised by intensified geopolitical risk aversion, economic uncertainty and an occupier and investor hiatus. Consequently, the Q4 investment volume came in low at £9.6bn in Q4. The headline figure was 6.4% up on the £9.0bn that transacted in Q3, but this was augmented by a small number of exceptional large deals. Underlying activity was weak. To give a context, the number of individual investment transactions in Q4 came in at only 354. This was the lowest since Q2 2011 and was the fifth lowest quarter on record this century. Furthermore, in value terms H2 2023 was the sixth lowest half year real terms transactional total over that same time period.

Despite weakness in the real economy, investor confidence is set to pick up over 2024, with greater depth and competition to the buyer pool. Market pricing now reflects that the monetary environment may become more accommodating sooner in 2024 than the Bank of England had previously been signalling and the cost of debt has fallen. Nevertheless, there is still uncertainty for inflation and the economic recovery relating to global conflicts and the upcoming UK general election later this year. On balance, the outlook for returns is more positive but the mitigating factor is that property yields are still below where the monetary fundamentals suggest they should be, and this will limit yield compression and upside returns over the medium term.

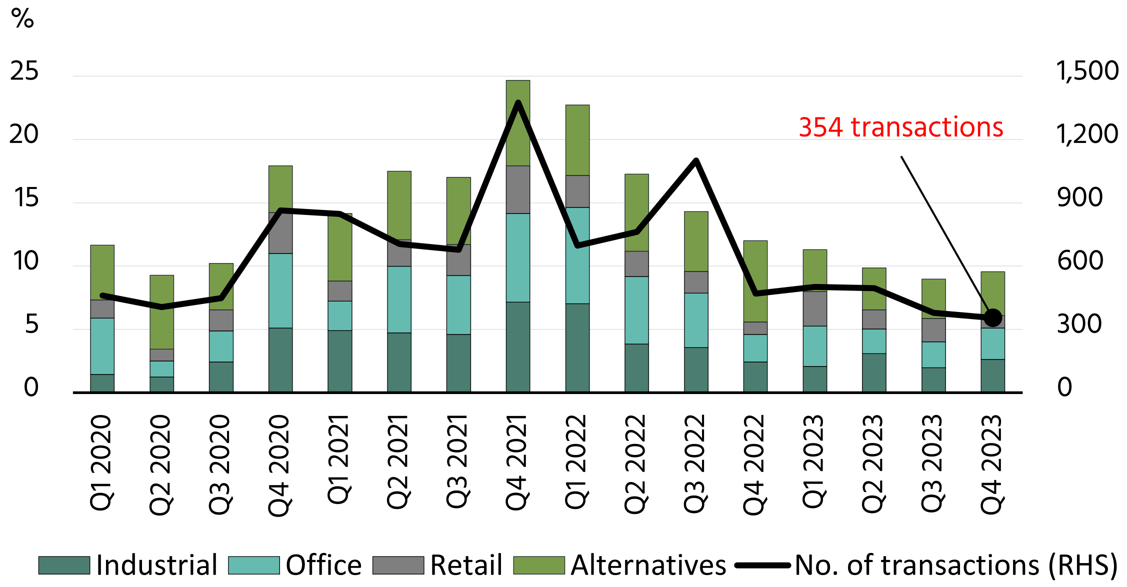
354▼
Q4 2023 investment transactions – the lowest since Q2 2011

£9.6bn▲
Q4 2023 commercial property investment

Annual total return to December 2023
Source: MSCI

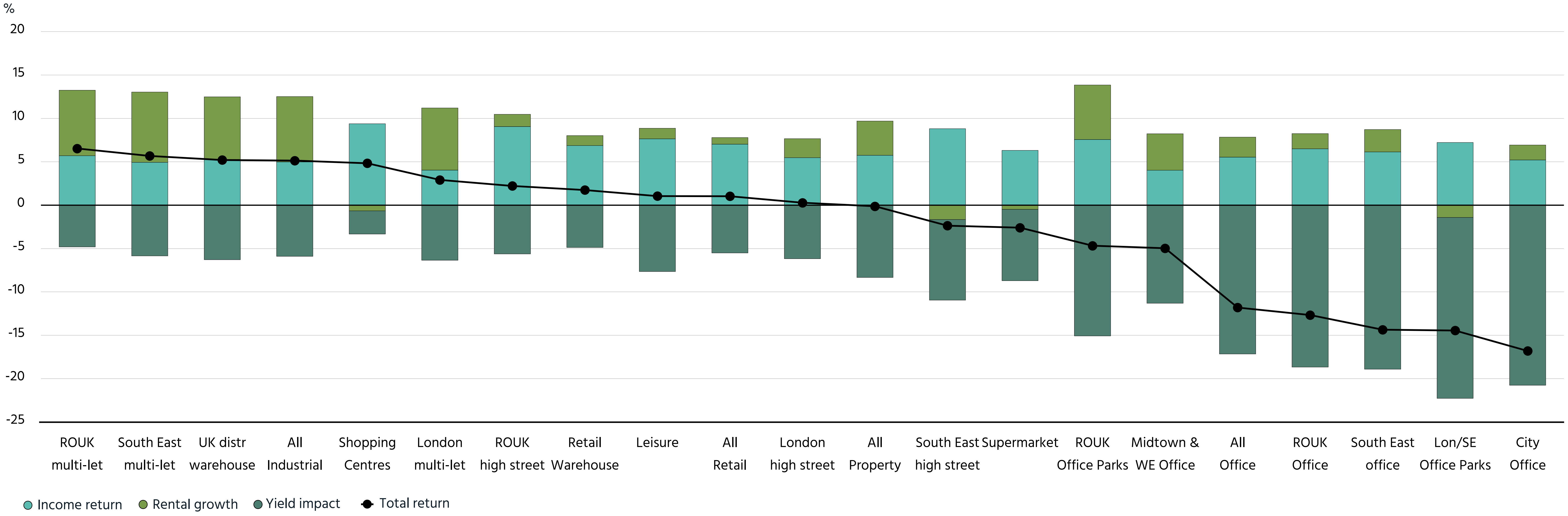


Quarterly investment volume and transaction number
Source: RCA



UK property segments

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



UK economy

UK GDP data in Q4 have been volatile, with the 0.3% month-on-month fall in October reversed in November. The ONS has revised down its estimates for GDP in Q2 and Q3 2023 and thus the Bank of England has given an even chance that the UK economy is technically in recession. Business sentiment indicators point to a stronger pace of private sector activity in December, with a rise for the service sector into expansionary territory, though this will be mitigated to some degree by the early 2024 strike action in the health sector. In contrast though, manufacturing sentiment fell still further into contraction territory. On balance economic momentum should build over 2024, but nevertheless very gradually from an estimated 0.3% GDP growth in 2023 and a forecast 0.6% and 1.6% growth in 2024 and 2025.

Headline CPI inflation ticked up from 3.9% in November to 4.0% in December but the overall trend over recent months has been steeply downwards from the double-digit rates that characterised late 2022 and early 2023. There have been sharp falls in oil and wholesale gas prices, and a series of services, food, and core goods price inflation figures that have come in under expectations. Oxford Economics projects that the target 2% rate of inflation will be reached by April.

The Chancellor has revealed that there will be some tax cuts in the March budget but that they will be limited in scope and inflationary impact. The reduction in Red Sea shipping capacity along with higher fuel and insurance costs has led to a 200% rise in the cost of shipping containers. This is likely to last at least six months but is estimated to raise core CPI inflation only by around 0.4% in Europe. The Bank of England is likely to have room to reduce rates sooner than previously expected and Oxford Economics expects 100bps of cuts to occur in both 2024 and 2025, starting in May this year with the Bank Rate down to 3.25% by end-2025.

As with the national accounting data, retail sales have also been volatile. More broadly, lower inflation should increase households' real spending power and wage earners will have benefitted from the cut in National Insurance contributions from 12% to 10% in January. However, this will be kept in check by higher debt interest costs, with roughly 1.5m mortgagors set to roll onto more expensive fixed-rate deals before the end of 2024, plus the impact of the ongoing freeze in tax thresholds and the loss of energy support payments. Consequently, the outlook for retailers is only steady at best.

1.6% ▲
2025 GDP growth forecast

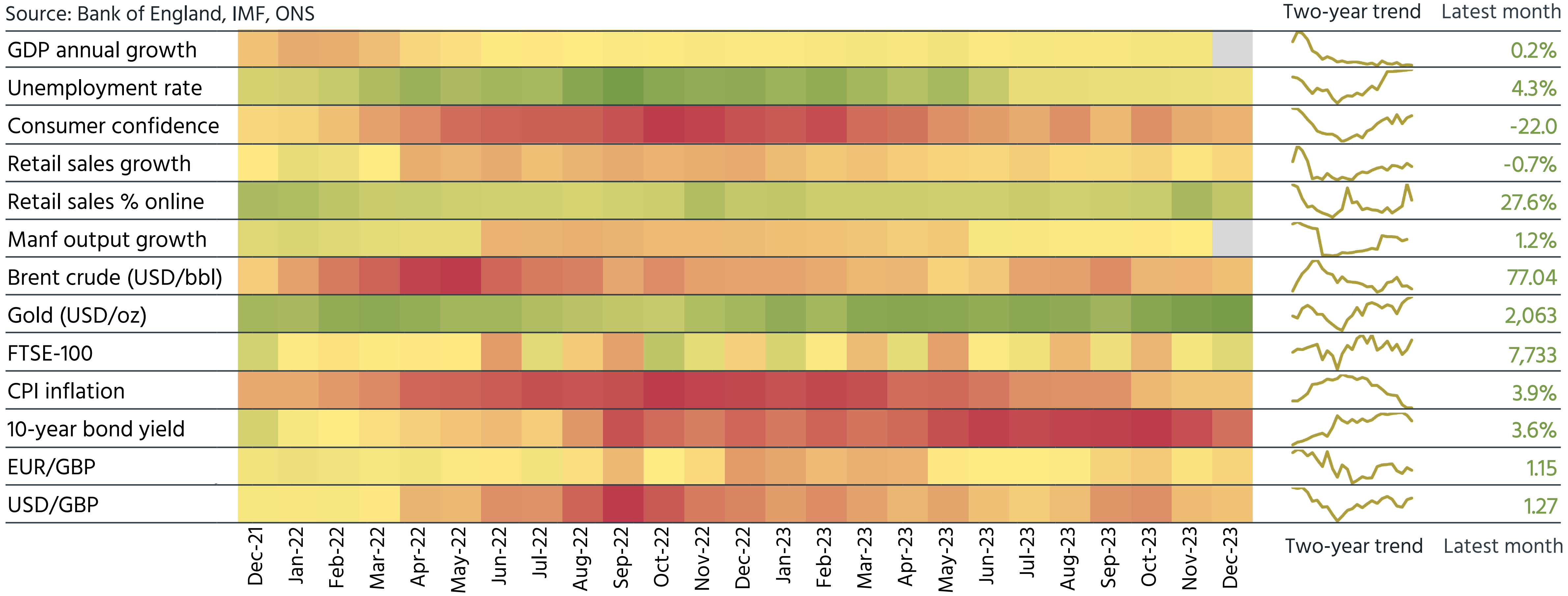
3.4% ▼
End-2025 10-year government bond yield forecast

1.5% ▼
2025 average CPI inflation forecast

3.25% ▼
End-2025 Bank Rate forecast

The monthly monitor

Source: Bank of England, IMF, ONS



Spotlight on... prime logistics

Read more detail from the report, click here

COST-CONSCIOUS OCCUPIERS SCALE BACK DEMAND TO MATCH POST-PANDEMIC TRADING CONDITIONS

Occupier take-up was 11.9m sq ft in Q4 2023, up 4% on Q3, but 20% lower than a year earlier. Total demand in 2023 was the lowest since 2017 and 16% below the 10-year average, reflecting the general pause in expansionary activity and the more challenging and uncertain economic backdrop. Occupiers took a more cautious and cost-conscious approach, befitting the weaker post-pandemic trading conditions and elevated cost of doing business.

Q1 2024 has started off more positively. Occupier deals rolled over from last year have completed and investors are increasingly confident that debt financing will become easier and more affordable. Macroeconomic headwinds will continue to weigh on occupier activity in 2024 though, and long-term business planning will be hampered by short term uncertainty. But lettings will continue to tick over and the outlook for prime rents remains positive, albeit not as stellar as during the pandemic years.

The speculative development pipeline is set to be much lower over the medium term than it has been over the past few years. Set against this there are growth pockets of demand – including automotive, renewable energy, nearshoring and occupiers linked to e-commerce that will support demand.

Q4 2023 UK LOGISTICS MARKET DASHBOARD

Sources: Gerald Eve, ONS, RCA

		Q4 2023	Two-year trend
OCCUPIER DEMAND	Take-up	11.9m sq ft	
	% new/modern	66%	
AVAILABILITY	Availability rate	6.0%	
	New/modern availability rate	4.6%	
DEVELOPMENT	Development starts	7.2m sq ft	
	Spec development starts	2.5m sq ft	
OCCUPIER COSTS	Average prime rent, sq ft	£11.55	
	Average weekly earnings	£666	
INVESTMENT	Average prime yield	5.5%	
	Transaction volume	£1.7bn	
ECONOMY	Annual GDP growth	0.2%	
	Retail sales % online	28.3%	

Outlook

With interest rates having peaked at 5.25% and expectations of substantive cuts beginning in May, 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 may have corrected in late-2022 but 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. We remain relatively upbeat on the sector 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. 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, January 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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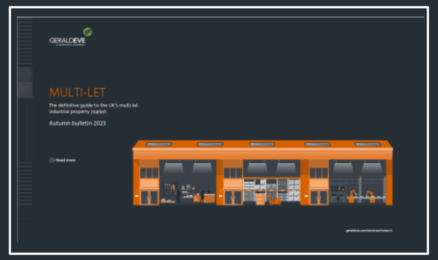

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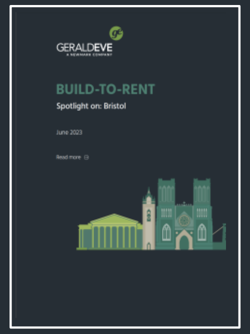

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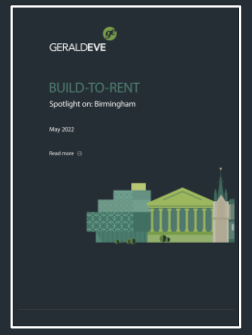

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