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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

March 2024

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MARCH UPDATE

UK commercial property return was relatively stable in February after the periods of volatility during the pandemic and the more recent sharp rise in interest rates. Investor sentiment has undoubtedly picked up as anticipated in Q1, but the market continues to be characterised by a lack of investment supply. The outlook for annual returns is more positive but they will likely still be subdued in 2024. There is more scope for stronger performance in 2025 if interest rates are cut as anticipated and if occupier markets at that point are expected to meaningfully benefit from the wider economic recovery in 2026/27.

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

-0.1% ▲
Quarterly All Property total return, Feb 24

0.7% ▲
Annual All Property total return, Feb 24

2.0% ▲
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

Relative stability in performance but the market still characterised by a lack of investment transactions

All Property annual total return improved very gradually to 0.7% in February after drifting into positive territory in January for the first time since October 2022. Similarly, the quarterly return was running at just under zero in February. These headline data ostensibly suggest a broad stabilisation after the periods of relative volatility during the pandemic and the more recent sharp rise in interest rates, but there is varied activity within and across the sectors that underlie them.

The occupier market and rate of rental growth is considerably stronger for Industrials than the other property sectors. Retail rents have effectively stabilised after a long period of decline. The office market, meanwhile, is polarised and offset between prime and more troubled secondary markets. Valuation data suggest that quarterly rental growth slowed for Industrial and Offices in the first two months of 2024. Industrial fell to 1.3% in February, which is the lowest since March 2021 and down from 4% at its peak in December 2021.

In the direct market industrial lettings agents have in fact reported a much better start to the year compared with the end of 2023, though the number of enquiries remain tight. And while prime pricing in some markets has occasionally been undercut by new good quality second hand marketed space that is more prevalent now than it was, say, a year ago, developers are in the main continuing to push to move prime rents on to be able to justify the build costs.

Office rental growth slowed to only 0.4%, which is less than half the rate of April 2023. However, this is more likely a return to more regular rates of growth after an artificially elevated recent period, boosted by 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 has now eased.

In the investment market sentiment has undoubtedly picked up in Q1 as anticipated, and various potential buyers have adopted a more active (though cautious) stance for the right product. This includes the return of the sovereign wealth funds, plus a small uptick in the number of active pension funds. However, this is still largely notional given the lack of investment stock available and consequently the volume of transactions this quarter is not dissimilar to Q4 last year. There are very few sellers at this point in the cycle, though direct benefit pension funds continue to divest and there is considerable M&A activity.

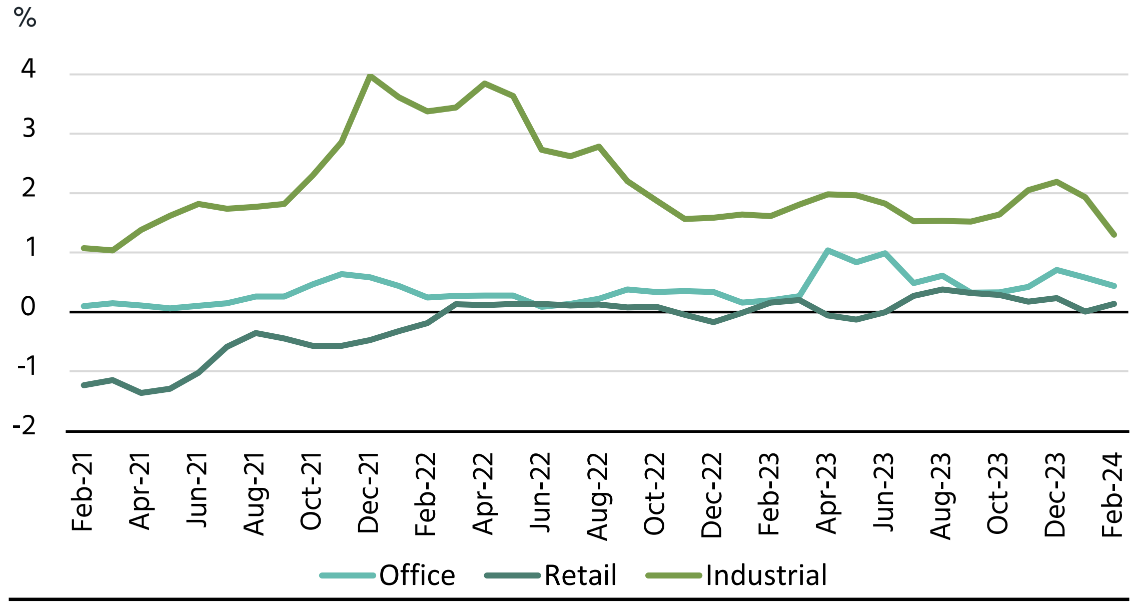
Valuation yields continue to drift out across all sectors. This has been most pronounced for Offices since the midpoint of last year, but the rate of increase has slowed in 2024. Industrial yields in the direct market have been stable for some time and the valuation data are simply catching up. Negative yield impact will continue to lessen as property yields near their peak.

The outlook for annual returns across all sectors is more positive but the current yield drift and low rental growth means they will remain relatively subdued in 2024. There is potentially more scope for stronger returns in 2025 if interest rates are cut as anticipated and if occupier markets at that point are expected to meaningfully benefit from the wider economic recovery in 2026/27.

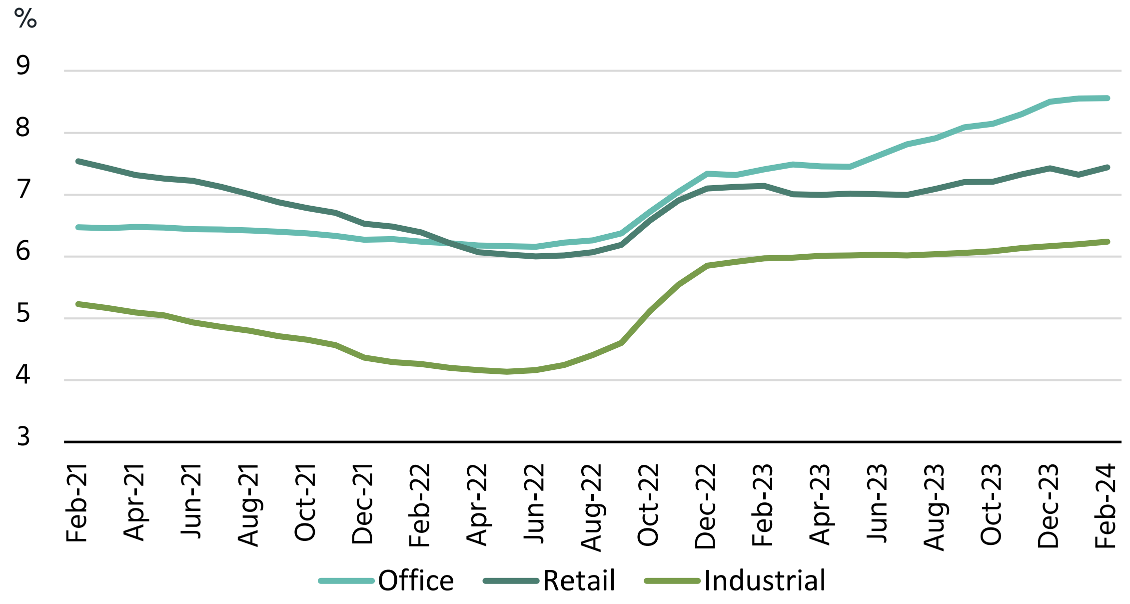
-0.1% ▲
Quarterly All Property total return, Feb 24

0.7% ▲
Annual All Property total return, Feb 24

Quarterly rental growth by sector
Source: MSCI

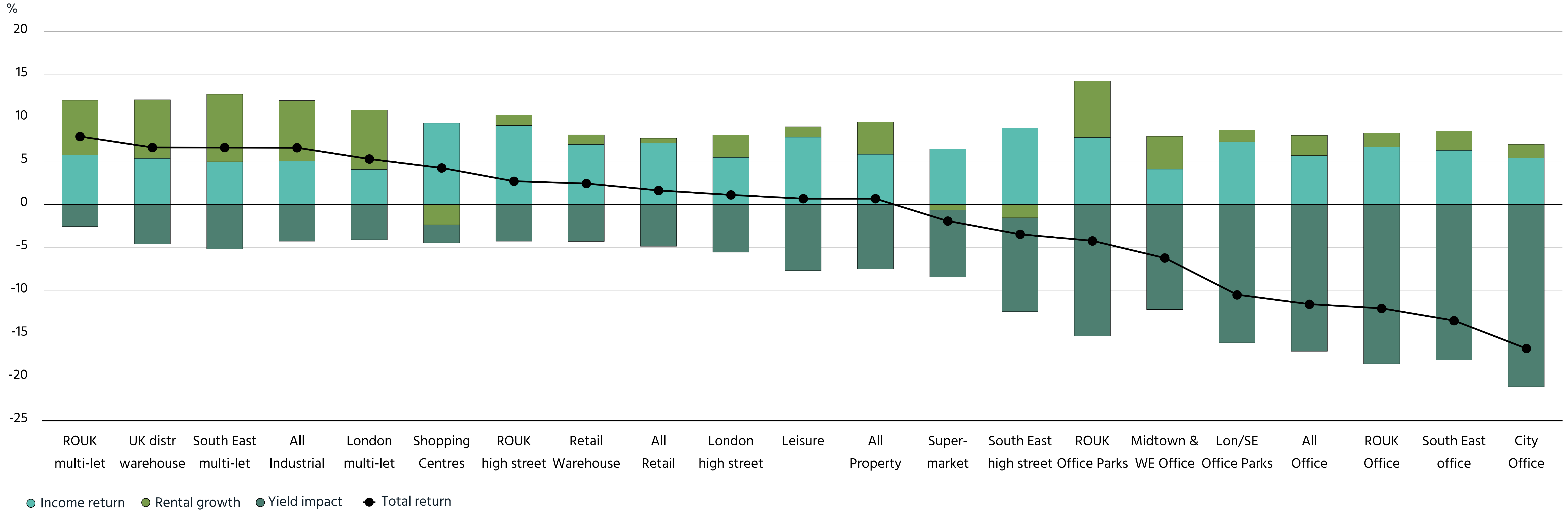


Equivalent yield by sector
Source: MSCI



UK property segments

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



UK economy

UK GDP increased by 0.2% month-on-month in January. More recent data have also been broadly positive for growth and the technical recession in the second half of last year is almost certainly already over. Business survey sentiment data hit a nine-month high in February and slipped only modestly in March. The overall figure has been in growth territory for the last five months but, importantly, the manufacturing component moved alongside services firms into growth mode for the first time in 13 months. This improved business sentiment, activity and outlook can be attributed to the more positive prognosis for real incomes and the continued fall in inflation.

CPI inflation continued to come in under expectations and fell from 4.0% in January to 3.4% in February. The lagged effects of the interest rate increases that peaked at 5.25% in July 2023 continue to impact domestic demand across the economy. Meanwhile, global energy prices are substantially lower than a year ago and while shipping costs have increased sharply in line with intensified geopolitical tensions, these too have fallen in recent weeks. Private sector wage inflation is a key statistic for interest rate setters and while it remains relatively elevated it is trending downwards as the labour market has continued to loosen. Tighter monetary policy and the slowdown in activity has weakened hiring intentions and the number job vacancies while lower inflation expectations has taken the heat out of wage growth.

The real UK interest rate - calculated as the nominal 5.25% minus inflation - has risen as inflation has come down. Effective monetary tightening has thus become more restrictive without having to change policy, and this will give greater scope for the MPC to begin cutting nominal interest rates. This is forecast to begin in June - Oxford Economics expects 75bps of cuts in H2 2024 and a further 100bps in 2025 to take the Bank Rate to 3.5% by the end of 2025.

The further 2%pt cut in National Insurance contributions in the March Budget and the wider improvement in real incomes point to a gradual improvement in consumer spending over 2024. This has led Oxford Economics to increase its 2024 and 2025 GDP growth forecasts to 0.5% and 2.0%, respectively. Nevertheless, the wider fiscal policy trend will still necessarily continue to be a drag and limit the recovery to relatively low rates of GDP growth over the medium term, irrespective of the results of the general election later this year.

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2025 GDP growth forecast

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End-2025 10-year government bond yield forecast

2.1% ▼
2025 average CPI inflation forecast

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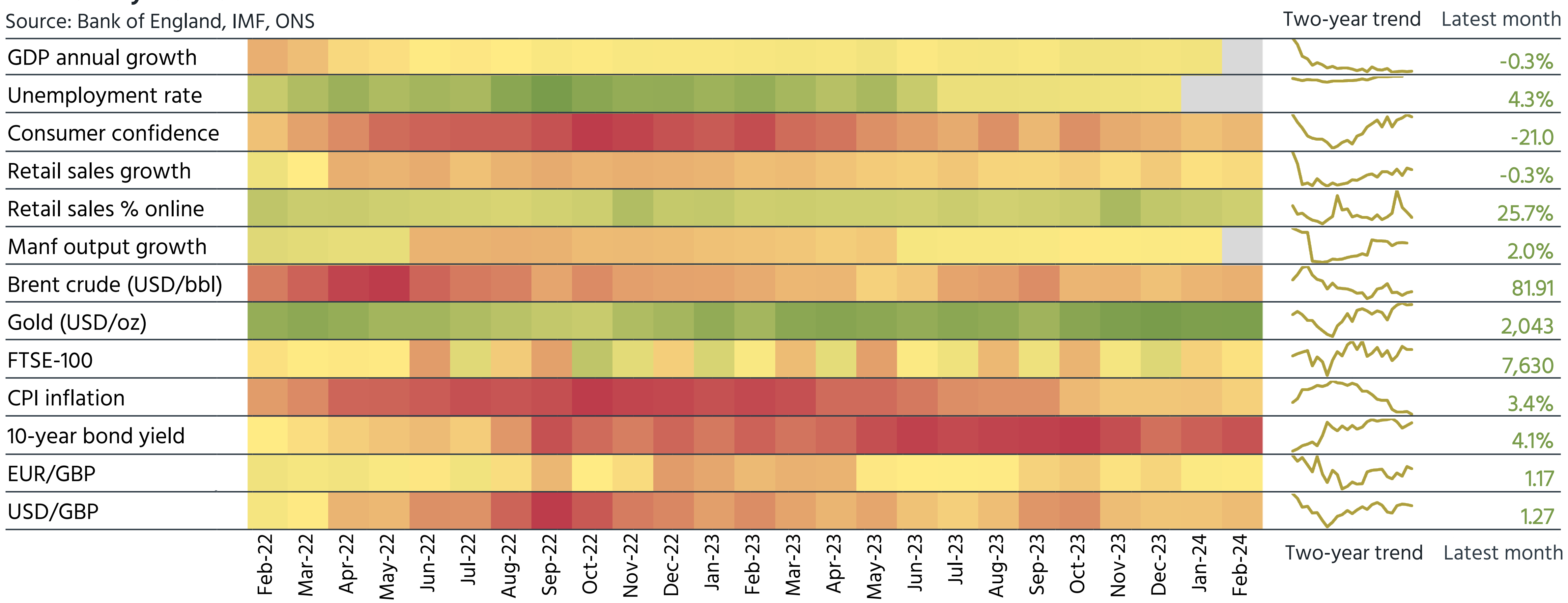
End-2025 Bank Rate forecast

The monthly monitor
Source: Bank of England, IMF, ONS



Outlook

With interest rates having peaked at 5.25% and expectations of cuts starting in June, 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 and annual property returns should trend upwards over the medium term – notably in 2025 when there may be some small scope for inward yield shift.

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 sustain positive rental growth.

Office prime/secondary polarisation is set to continue as alternative working practices allied with EPC obstacles continue to negatively impact occupancy and investment demand for secondary space. For **retail**, eroded real incomes and the elevated cost of debt should begin to turn a corner but households and retailers are nevertheless in for ongoing challenges. The significant rise in retail yields and reset of rents over the last several years that has so negatively impacted capital values should provide a small offsetting cushion in the form of relatively greater income return.

Total return and components by sector, March 2024 forecasts
Source: Gerald Eve, MSCI

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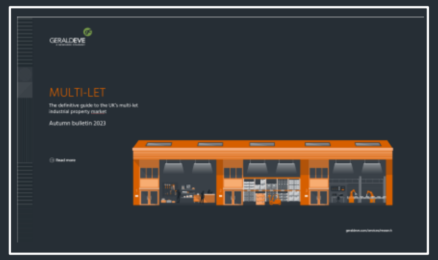

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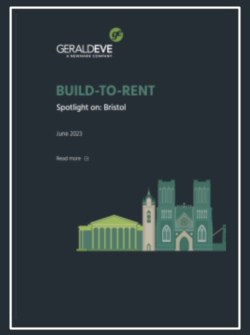

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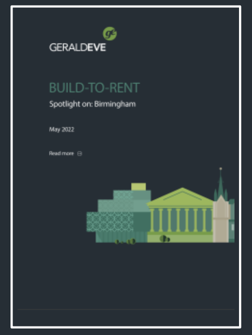

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