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IN BRIEF

UK COMMERCIAL PROPERTY UPDATE AND OUTLOOK

November 2023

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NOVEMBER UPDATE

All Property annual total return jumped from -13.6% in September to -7.9% in October as the base effects of the sharp upturn of property yields in late 2022 begin to fall out of the figures. Industrial returns are improving more noticeably while offices continue to struggle. Investment activity in the final quarter of 2023 is likely to be weak, given the recent increased geopolitical volatility that has impacted sentiment. But when the switch to monetary loosening to support the economy comes next year there is reason to believe it can and will be more significant than market pricing currently suggests.

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

-7.9% ▲	-0.4% ▲	1.4% ▲	1.4% ▼	3.75% ▼	3.8% ▼
All Property annual total return, October 2023	All Property annual total return forecast, end-2023	2025 GDP growth forecast	2025 average CPI inflation forecast	End-2025 Bank Rate forecast	End-2025 10-year government bond yield forecast

Investor hesitancy but upside potential for more supportive monetary policy over the medium term

All Property annual total return jumped from -13.6% in September to -7.9% in October as the base effects of the sharp upturn of property yields in late 2022 begin to fall out of the figures. Gerald Eve modelling indicates that this will trend will continue, with the 2023 end-year annual return at -0.4% (effectively around zero). For the calendar year as a whole, the impact of some further yield softening (notably for offices) is likely to neutralise the positive impacts of income return and rental growth (notably for industrials). The dynamics are somewhat different across the different property sectors.

Valuation yields for industrial and retail have been remarkably stable over 2023, with only some slight softening in secondary markets. Secondary yields have been more impacted by the significant increase in debt financing costs while occupier markets are more vulnerable to the economic slowdown. The stability of prime **industrial** is reflective of ongoing investor confidence in the occupier market; rental growth may have eased but the segment retains a relative breadth and depth of demand. **Retail** subsector rents have largely recovered from their precipitous decline over the pandemic, with retail warehouses looking stronger and shopping centres still characteristically weak. Yields are relatively high for this segment and have broadly stabilised having already repriced so significantly over the Covid pandemic.

In contrast, **office** yields have repriced more actively over the second half of 2023, softening 69 basis points between May and October. This has been particularly acute for London City offices, which are the worst performing segment over 12 months on the chart overleaf. Meanwhile industrial segments continue to work their way from the lower-performing area on the right to a relatively stronger position on the left. Indeed, the top right chart on this page shows negative annual industrial returns improving relatively rapidly as the particularly impactful outward yield shift from 2022 falls out of the figures.

Investment activity in the final quarter of 2023 is likely to be weak, given the recent increased geopolitical volatility that has impacted sentiment and narrowed buy-side requirements further. Commodities and money markets from recent events have been relatively unaffected, but there is investor hesitation borne out of aversion to when, where and what magnitude the ultimate negative economic fallout might be.

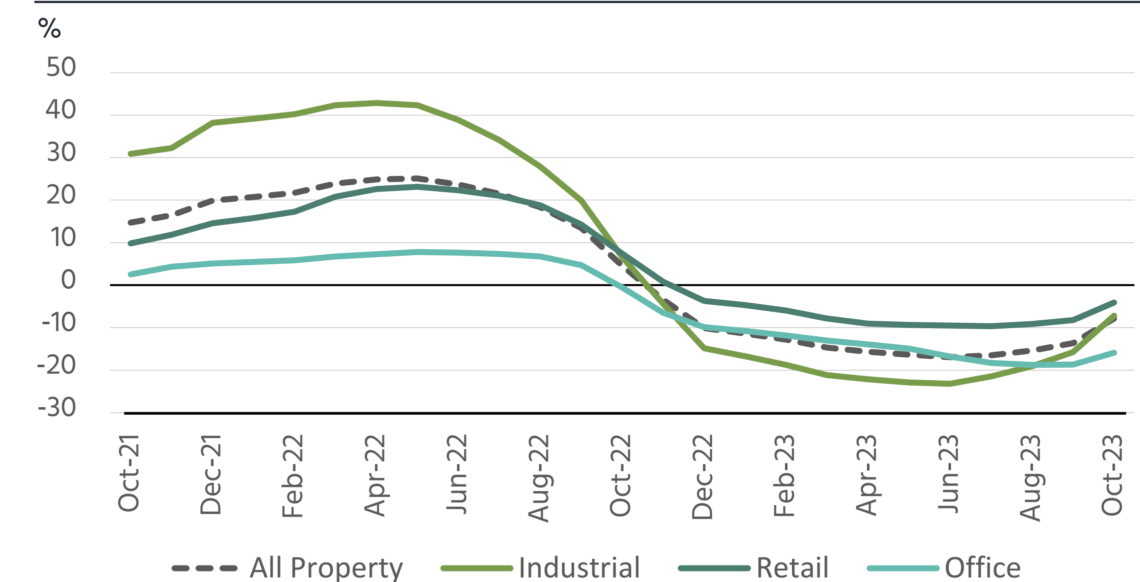
Interest rates may have peaked but the Bank of England's "high-for-longer" narrative continues to dampen sentiment and impact pricing. However, there is reason to believe this wording reflects a policy tool rather than an explicit forecast, and interest rates could be cut more aggressively from mid-2024 than is currently priced in. Various economics commentators and forecasters unanimously predict that when the switch to monetary loosening to support the economy comes next year it can and will be more significant than the market currently implies.

This could provide a boost for property returns, not only on the financing side, but also by giving occupiers more confidence and ability to invest in their business operations. 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.

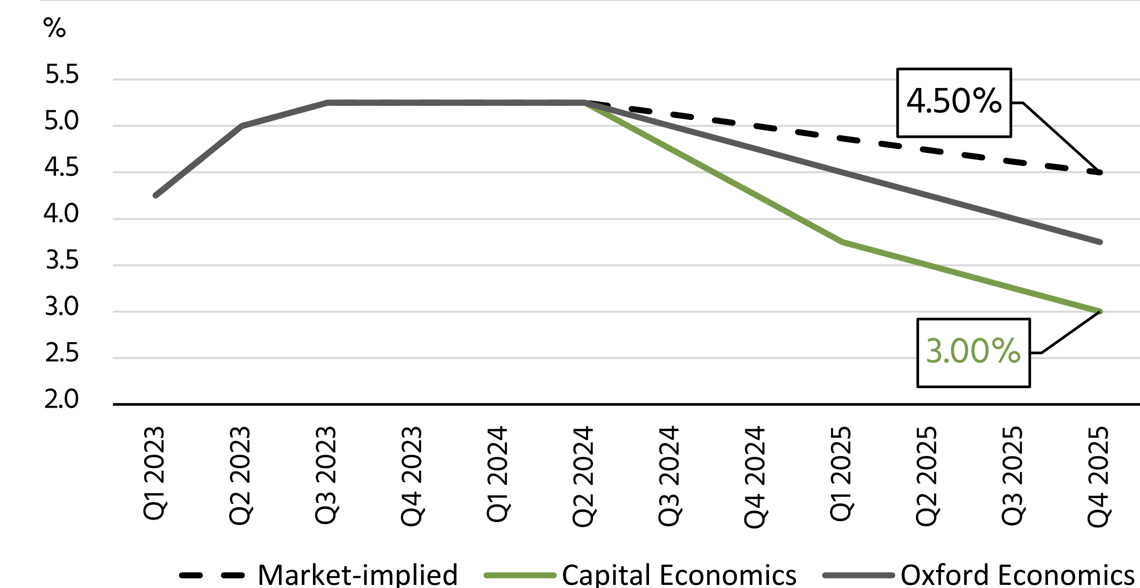
-7.9%▲
All Property annual total return, October 2023

-0.4%▲
All Property annual total return forecast, end-2023

Annual total return by sector
Source: MSCI



UK Bank Rate forecasts
Source: Bank of England, Oxford Economics, Capital Economics



UK property segments

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

UK economy

UK GDP grew 0.2% month-on-month in September and was essentially unchanged between Q2 and Q3 despite the extra working day. Activity has faltered in recent months, most notably in July when GDP contracted 0.6% month-on-month. Oxford Economics forecasts a slowdown to 0.4% annual growth in 2024 while other commentators have pencilled in a mild recession. Thereafter GDP growth is forecast to pick up to only 1.4% in 2025 with momentum held back by the lagged impact of tighter monetary policy and increasingly restrictive fiscal policy, despite the giveaways in the recent Autumn Statement and those likely in the run up to the general election next year.

GDP growth in September was largely accounted for by fewer working days lost to strike action in the health sector. Meanwhile, more timely business and consumer indicators suggest that activity has continued to contract so far in Q4. In the manufacturing sector sentiment gained some ground but aggregate demand is muted and monetary policy restrictive both at home and abroad. Services sector forward-looking survey responses remain downbeat but more finely balanced with some easing in cost pressures.

UK retail sales fell a further 0.3% month-on-month in October after a significant 1.0% fall in September. The next year will be challenging for households and for retailers. The inflation shock may have eased in terms of real wage growth, but the legacy real terms cut to spending power has been significant and there will be no energy support payments this winter. Meanwhile, around 1.5m homeowners will remortgage onto new higher fixed rate deals before the end of 2024.

Inflation fell significantly to a two-year low of 4.6% in September, down from 6.7% the month before. While mostly attributable to base effects from global energy prices, domestic core and services inflation showed encouraging signs of easing.

The Bank Rate is set to be kept on hold now at 5.25%. The Bank of England's "high-for-longer" wording appears to have been accepted by the markets and is reflected in the pricing of financial instruments (and forms the implied forecast shown on p3). However, this is perhaps better considered as part of its inflation-dampening policy toolkit rather than an explicit forecast. Economics commentators unanimously anticipate there to be scope for more aggressive cuts to the Bank Rate to support the economy once the ongoing inflation risk is deemed to have been sufficiently and sustainably quashed.

1.4% ▲
2025 GDP growth forecast

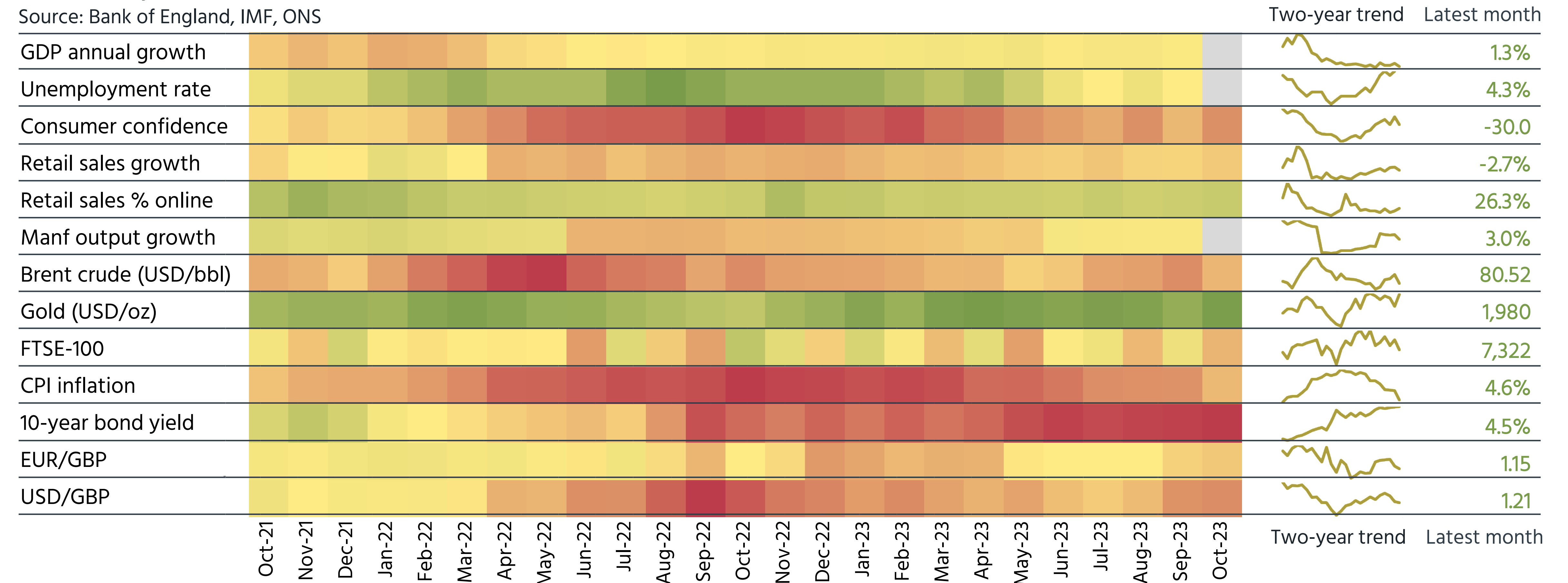
3.8% ▼
End-2025 10-year government bond yield forecast

1.4% ▼
2025 average CPI inflation forecast

3.75% ▼
End-2025 Bank Rate forecast

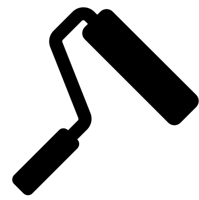
The monthly monitor

Source: Bank of England, IMF, ONS

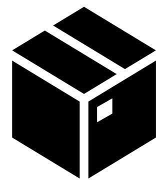


Spotlight on...multi-let industrial occupiers

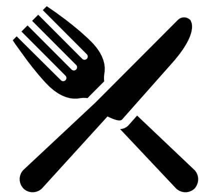
Download the Multi-let autumn bulletin when it is available, click here



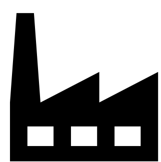
TRADE COUNTERS: The largest individual segment in multi-let continues to be the mainstay of occupier demand. However, construction and household sector weaknesses means many tenants are in wait-and-see mode when it comes to expansion plans. Most are currently focussing on lease renewals to maintain their space and seek cost-effective improvements where possible.



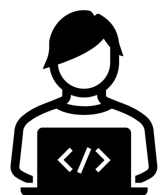
LOGISTICS: An integral part of the industrial market clustered around the UK's densely-populated urban centres. Structural e-commerce tailwinds continue to support parcel & post occupiers. However, the proportion of online spend has returned to its pre-pandemic trend and strong take-up over recent years means that most requirements have largely been satisfied for the short term.



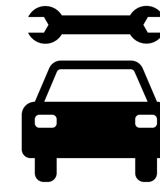
FOOD-RELATED: Q-commerce has been the disruptive new entrant in recent years, rivalling logistics occupiers to establish networks with last touch depots in premier locations. The sector has now matured, which has eased requirements for new space. Meanwhile some specialist food suppliers to restaurants have been impacted by the slowdown in discretionary spend.



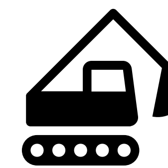
GENERAL MANUFACTURING: This longstanding traditional activity in multi-let has been crowded out to some extent but continues to have the second largest footprint after trade counters in many UK regions. Despite current economic headwinds at home and abroad, occupier demand is supported by numerous manufacturing hubs, government action plans and the rise in nearshoring.



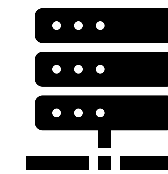
HIGH-TECH ENGINEERING: The more specialist end of the production industries in multi-let occupies a smaller and typically more expensive footprint. Occupier demand has been buoyed in recent years by pharmaceutical R&D, and through technological advances in the automotive industry and aeronautics. An acceleration in the use of AI is likely to provide a boost in the coming years.



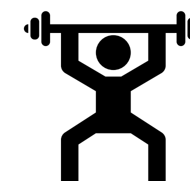
ON-SITE SERVICING: A diminishing component of the multi-let occupier footprint, certainly in the institutional portfolios. MOT centre operators now account for only low single digit percentages of floorspace. The business model for these types of tenants is under threat as automotive technology moves on and multi-let rent affordability becomes more of an issue.



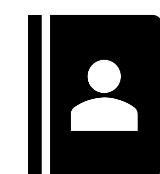
OFF-SITE SERVICES: This segment includes vehicle & equipment hire along with activities related to the construction sector. It is a challenging period for construction, reflected in its 40% average share of UK company insolvencies. However, there has been limited passthrough to multi-let and units have not come back to the market with any regularity.



QUASI-OFFICE: This segment can include any type of office use, for example public sector, legal, finance and more broadly the creative industries. The diversity of demand and the flexibility and relative affordability compared with traditional offices gives this segment real defensive resilience. Datacentre use provides another significant opportunistic strand of future demand.



LEISURE: The occupier footprint is relatively small and tends towards health and fitness when nearer urban centres and child-friendly play and/or sports such as karting in more peripheral locations. Occupiers that rely on discretionary spend are under pressure currently and the default risk is higher than several of the other multi-let use types.



INDIVIDUALS: These micro business tend to represent the smallest component of multi-let occupier demand. However, some pockets remain quite prevalent in more peripheral locations outside of the South East in sub-5,000 sq ft units. The current unpredictability of economic activity coupled with high input cost inflation and strained borrowing affordability puts these tenants at high risk.

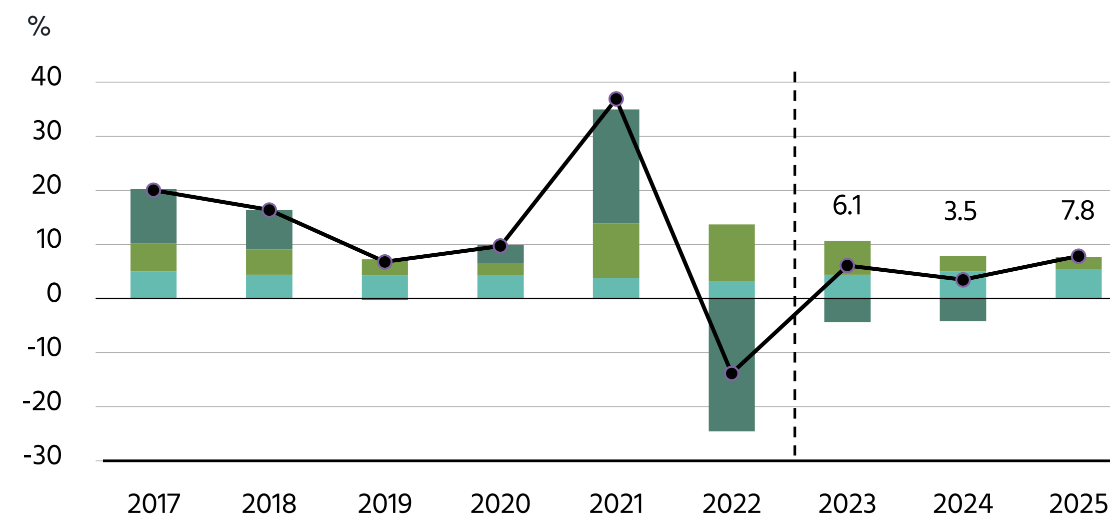
Outlook

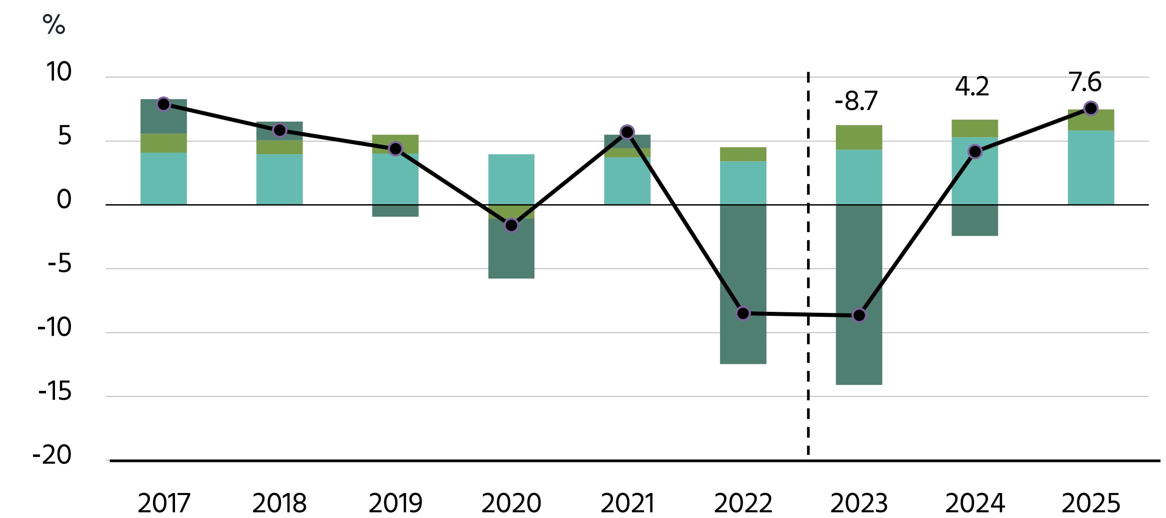
With interest rates having peaked at 5.25% market pricing suggests that we are in for a sustained period of elevated commercial debt costs. Monetary policy may turn out be able to be more accommodating from late-2024 than is currently priced in but the upside potential for property returns will be limited, given that current commercial property yields continue in the main to be below where the monetary fundamentals suggest they should be. All Property annual total return is set to be effectively zero in 2023, with positive returns from industrial and retail driven by income return (and rental growth in the case of industrial) while office returns suffer some significant losses through outward yield shift. Annual property returns should continue to trend upwards thereafter as yields discontinue any softening (notably for offices) and rental growth comes back in line with the economic recovery.

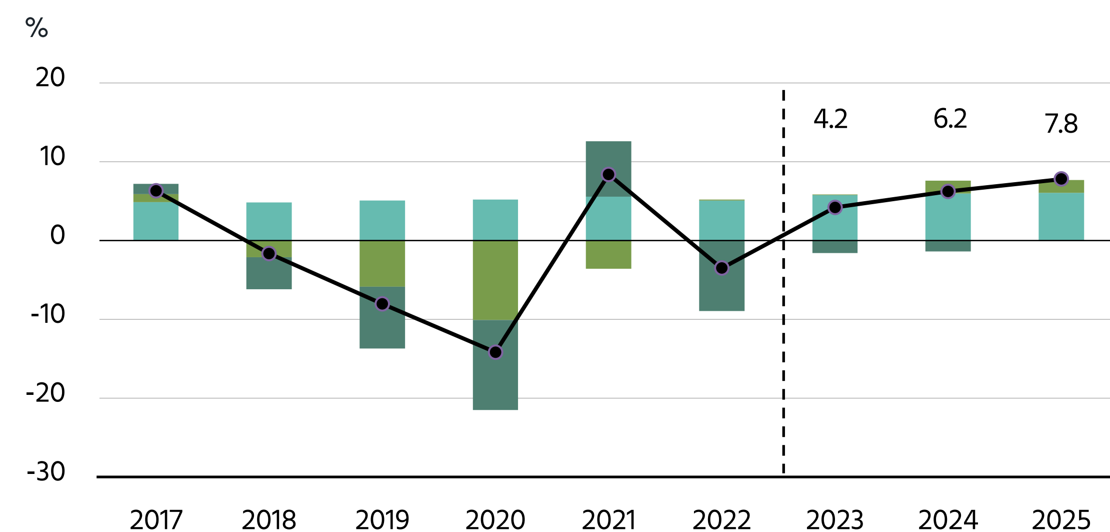
The resilience of the **Industrial** occupier market will continue to appeal to investors and has maintained yield pricing in the prime markets. Rental growth may have cooled, but this is from very strong rates in 2021/22. Void rates and default rates are likely to continue to rise and peak in 2024, but well below previous downturns. We remain relatively upbeat on the sector and expect nominal rental growth to remain positive.

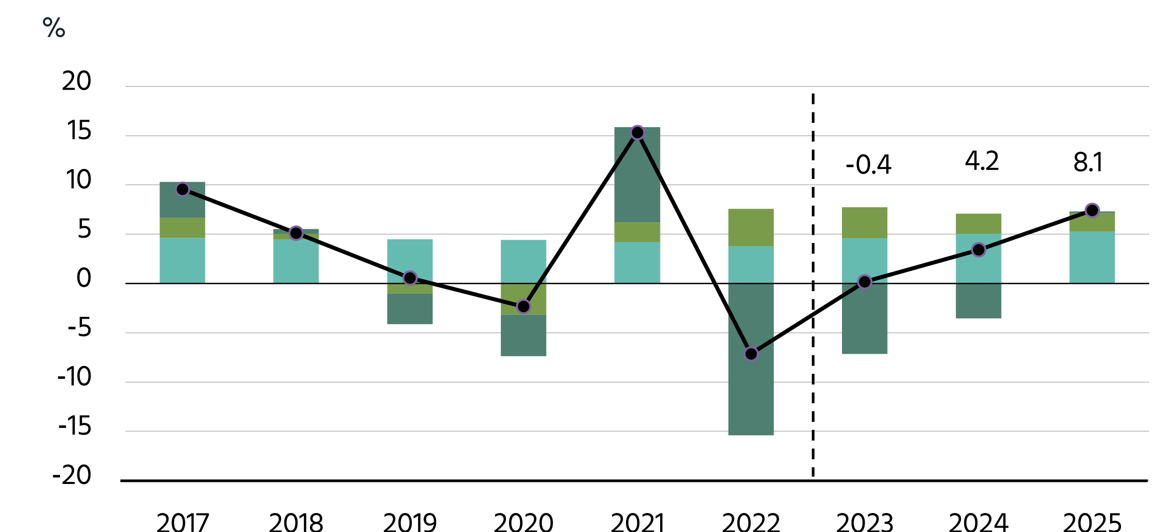
In contrast, **retail** and **offices** have more structural problems to contend with. **Office** prime/secondary polarisation is set to intensify as alternative working practices allied with EPC obstacles continue to negatively impact occupancy and investment demand for secondary space. Meanwhile households and retailers are 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, November 2023 forecast
Source: Gerald Eve, MSCI









Income return | Rental growth | Yield impact | Total return

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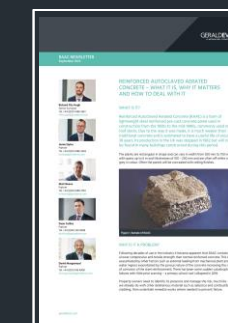
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