



Signs of hope from across the pond even as UK values tumble

Commercial property values in the UK have been falling at what might be described as an alarming rate. The drop recorded in October was unprecedented in the more than 30 years of the MSCI/IPD Monthly Index. The pace hardly slowed in November and the last three months combined were a hair's breadth from being the worst ever recorded. Amidst such drama it would be easy to believe that the bottom has fallen out of the market entirely. Yet there are reasons to believe that the first phase of the correction, the direct impact from higher interest rates has already peaked. Some support for this case is offered by the US market, where sharp falls recorded by the Green Street Commercial Property Price Index (CPPI) between June and October gave way to a far smaller decline in November. We must be careful to read too much into one month's data, but long-term interest rates on both sides of the Atlantic have fallen markedly since October and as Green Street's Peter Rothmund comments about the US market "While pricing may continue to go down, the large moves should be behind us."

The UK market may have been a month behind the US in reacting to dramatic changes in the monetary environment, but there's little reason to expect the overall impact on values to be too different. The Green Street CPPI shows a 13% decline in the US market since the end of May, whilst the UK market has fallen by almost 17% since the end of June. Of course, the UK had our own idiosyncratic factors with the September mini-budget and the market's reaction to it. This in part explains the very dramatic drop in the MSCI Monthly Index in October, yet most of the announcements from the mini-budget have been reversed as has the sharp spike in Gilt yields that followed in its wake. It is reasonable to assume that there will be another material drop in values in December as many valuations are given a more rigorous assessment at the end of the quarter, yet it seems equally reasonable to believe that the worst will then be behind us.

COMMERCIAL PROPERTY RETURNS

The MSCI Monthly Index declined by a further 6% in November, taking the cumulative decline since mid-year to 16.9%. November was a slight improvement on the record 6.8% drop in October, but the 14.7% decline between September and November was only a fraction short of the record 14.9% 3-month drop recorded in the last quarter of 2008.

Industrial values down were by 7.6% in November, and by a cumulative 22.9% since mid-year. It is a reflection of the remarkable growth in recent years that this only takes values back to August last year. The decline has been driven entirely by 140bp of outward yield shift, whilst in contrast rental values have continued to rise, and are up by 3.2% since mid-year.

Retail values are slightly more resilient to yield shift given the higher yields prevalent in that sector, yet capital values still fell by an average of 5.3% in November. Yields are out by an average of 90bp since mid-year, whilst rental values have been flat. Supermarkets have been hardest hit to date, with 110bp of outward yield shift knocking 16.2% off values.

The Office sector has been a mixed bag, with the Eastern region, dominated by Cambridge, seeing values fall by just 6.8% so far. In contrast, the M25 markets have seen values drop by almost 16%. Across the sector as a whole values are down by an average of 12% since mid-year, with 90bp of outward yield shift outweighing 0.6% of rental growth.

INVESTMENT MARKET ACTIVITY

Just £900m worth of transactions completed in November, less than at any time during the pandemic and the lowest level of activity in any month since early 2009. Total investment since mid-year is just £16bn, compared to more than £34bn completed in the first half of the year.

Build to Rent is likely to be one of the more resilient sectors over the coming months and the sector accounted for the largest deal to close in November. The Pension Insurance Corporation committed £200m to forward fund 667 units in Birmingham city centre. The deal is highly likely to have been able to proceed without the need for debt financing.

Another of the largest deals to complete in November also had a residential connection. Slough Borough Council sold a former Akzo Nobel site for £100m which has planning consent including 1,000 residential units. However, it is reported that the new buyer may not proceed with the residential element and instead focus on a data centre.

Northdale AM and Magnetar Capital closed one of the largest Retail deals since mid-year with the £76m acquisition of the One Stop centre - a retail park and shopping centre in Perry Bar - and 150 retail units across Corby town centre. The buyers previously acquired the Yate Shopping centre and Riverside Retail Park near Bristol for £58m.

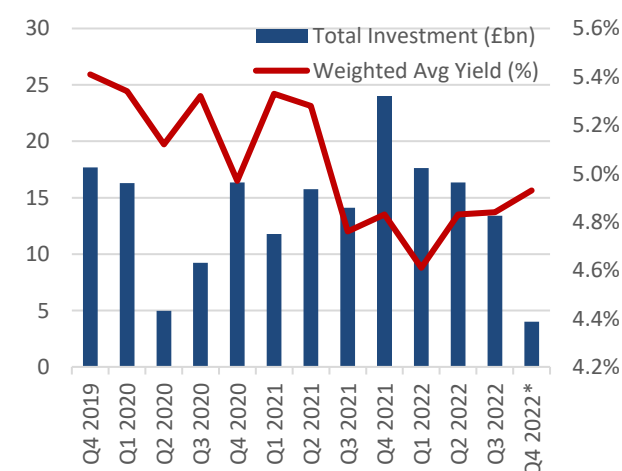
The Life Sciences sector continues to attract capital, with US specialist investor Kadans Science Partner completing a sale-and-leaseback deal of the Oxford Biomedica facility in Oxford for £60m. This was ahead of the £55m target and reflects a 15-year lease with a 34% uplift after year 5.

Capital Growth to end-November 2022 (%)

%	1 Month	3 Months	12 Months	YTD
All Property	-6.0	-14.7	-7.7	-10.9
Retail	-5.3	-12.0	-5.2	-7.0
C London Offices	-3.9	-9.9	-7.8	-8.5
Regional Offices	-5.5	-12.3	-12.7	-12.9
Industrial	-7.6	-19.2	-7.8	-13.7

Source: MSCI Monthly Index

Investment Market Trends



*At time of writing
Source: propertydata.com

MARKET YIELDS

The correction in market pricing continued in November as investors react to higher interest rates and a weaker economic outlook. Knight Frank report that benchmark yields moved out across most sub-sectors, although the shift was perhaps slightly less marked than in the previous month. Most benchmarks are reported with ranges of up to 50bp highlighting the level of uncertainty.

Industrial yields continue to drift, with logistics benchmarks out by another 25bp and some multi-let benchmarks out by 50bp. Prime yields have moved out from 3.0-3.5% in June to 5.0-5.5% today. The 200bp shift in prime logistics yields from 3% in June to 5% represents a notional 40% drop in values, although such a decline is unlikely to be reflected in valuations.

The office sector also saw further widespread yield shift with yields moving out by a further 25bp in most sub-markets, including those which had previously shown more resistance. West End and Life Sciences benchmarks are now out by 50bp since June, whilst single-let business parks have seen prime yields move out by 175bp since June to around 7.0%.

Yields in much of the Retail sector were under less immediate pressure because of their higher starting point, yet benchmarks softened further across most sub-sectors in November. Since mid-year High Street yields are out by up to 100bp, Retail Parks by 125bp and supermarkets by 175bp.

AUCTIONS

The commercial auction market has not been immune to the change in sentiment; sales between September and November were 5% down on the same period last year with a success rate of 74%, compared to 78% in 2021. Nonetheless, total proceeds were marginally up year-on-year.

The Allsop auction in December raised £34m, barely half the sum raised a year earlier. Higher value lots have not gone as well in recent months, perhaps reflecting a more challenging debt environment. The highest price achieved of £1.5m was for archetypal private investor stock - a retail unit in Pangbourne let to Co-op for 15 years with two residential flats above.

MARKET FORECASTS

The IPF Consensus Forecasts have now started to reflect the dramatic changes seen since mid-year. The Autumn round, collated between September and November reflect a material downgrade from the summer round collated over the preceding 3 months. The capital growth forecast for this year has dropped from 2.3% to -6.4%, yet even this remains behind the curve, with values already down by almost 11% before December.

The outlook for 2023 has also been materially downgraded, from a minor 1.5% decline to a far steeper 7.1% drop. It's notable however that rental values are still expected to grow throughout the 5-year forecast horizon, albeit at barely 1% per annum over the next four years.

Capital values are expected to fall furthest in the Shopping Centre sector, by 2.9% per annum between this year and 2026. In contrast, Retail Warehouse values are expected to be broadly flat over that five-year period. Sharp falls in 2022/23 are expected to be followed by a fairly strong recovery from 2024, led by the Industrial and Retail Warehouse sectors.

On a total return basis Retail Warehouses are predicted to be the clear winners, with a return of 6.4% per annum over five years once both capital and income are taken into account. In contrast, the office sector is only expected to deliver total returns of 2.7% per annum given the lower income return.

LOOKING FORWARD

The next phase of the correction should be less dramatic. The impact of higher interest rates will have largely been reflected in the 150-200bp outward shift in valuation yields that I would expect to culminate over the next couple of months. With a suitable risk premium having been re-established the focus will then move to prospects for income growth, a phase which will be both more protracted and more discerning than the first. Some of the sectors which have been hardest hit by the first phase, notably logistics, will start to reassert their credentials as sources of income growth. In contrast, other sectors such as shopping centres and secondary offices are likely to see a more prolonged outward drift of yields as investors try to work out where occupier demand and rental values will end up.

There is likely to be something of a dual market through the first half of 2023, where those investors with significant equity are likely to be able to take advantage of rebased pricing whilst those who are already highly levered may need to inject more equity into existing assets. Sectors with higher growth prospects and therefore lower initial yields, such as Residential Build to Rent, urban logistics and the very best offices, are likely to be dominated by investors who are able to cover at least half the ticket with their own equity. All-in financing costs may have come in materially since October, yet they remain very significantly higher than they were a year ago, and supporting anything more than moderate leverage will remain challenging. This dynamic is reflected in the depressed level of transactions in recent months.

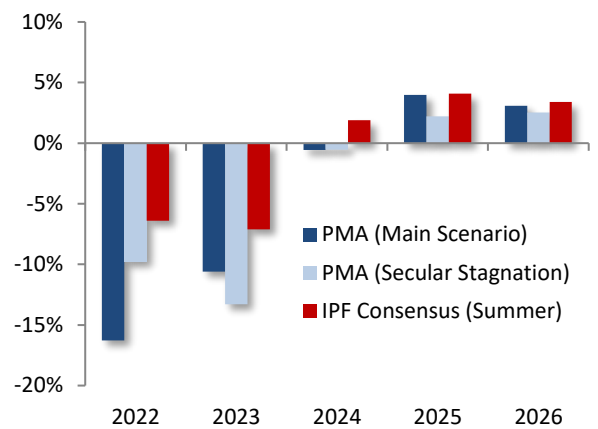
The pain is not over quite yet, with the impact of slower economic growth on occupier markets yet to be fully understood. We have not seen the end of the correction, or probably even the beginning of the end. But as somebody once said it may just be the end of the beginning.

Benchmark prime yields (%)

%	Dec 22	Nov 22	Dec 21
Prime Regional High Streets	6.75	6.50	6.50
Regional Shopping Centres	8.00	7.75	8.50
Open A1 Retail Parks	6.00	5.75	5.50
Supermarkets (RPI)	5.00	4.75	3.50
Regional City Offices	5.75	5.75	5.00
Regional Industrial Estates	5.50	5.25	3.50

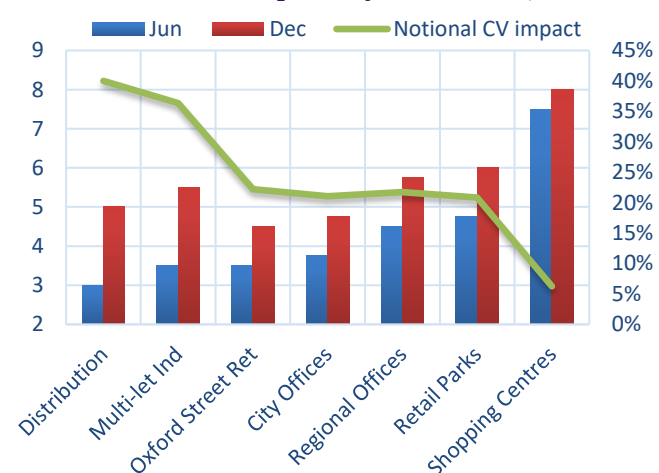
Source: Knight Frank

Capital growth forecasts (%)



Source: PMA Autumn 2022, CBRE, IPF Consensus Forecasts

Shift in benchmark prime yields since June



Source: Knight Frank, NatWest analysis

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