Real Estate Finance

UK Real Estate Digest

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NatWest

Stubborn inflation changes calculus for real estate investors

The ONS release on inflation is not typically a source of fascination to anyone with a full life, yet this month it was enough to send many in the real estate market scurrying back to the drawing board. The fact that the headline inflation figure had not dropped back at all from the previous month was shocking enough, yet lurking in the text was an even more unpleasant surprise; core inflation had risen to a 30-year high of 7.1%. In normal times core inflation is little more than a footnote, reflecting the leftovers when all the interesting/volatile stuff is excluded. However, today it implies growing second around inflationary effects and undermines the hope that headline inflation would fall back quickly towards the 2% target. This was bound to stir the MPC into action, and sure enough they responded by doubling down with a 50bp rate hike. Markets now expect rates to peak around 6% and take longer to start coming down again.

For real estate investors, changes in market expectations of rates have direct and material impacts. The risk-free rate, represented by the 10-year Gilt yield, is now comfortably north of 4%, which in turn increases the required return of property investment. An investor requires a premium over the risk-free rate to compensate them for illiquidity, obsolescence, tenant credit risk, etc. This premium might be say 2% for a prime asset, implying a required return for prime property today would be around 6.3%. Or to put it another way, a property needs to yield at least (a net) 6.3% unless the purchaser is confident that the asset will deliver income growth through their hold period. For leveraged investors the mathematics are even more challenging, with assets needing a net yield that will provide sufficient interest cover to satisfy lenders on day one. In practice this will mean that acquisition finance for prime assets will typically be capped in the mid 50's and that investors who over-leveraged in the last cycle are going to find refinance very challenging.

COMMERCIAL PROPERTY RETURNS

The MSCI Monthly Index was flat in May, as capital growth in the Industrial and Retail sectors was balanced out by declining values in the Office sector. On average values are 1.1% lower than they were at the start of the year, and 20.8% down from their June '22 peak.

A slow recovery is getting started in the Industrial sector, with positive capital growth in each of the last 3 months. Capital values are now broadly flat this year, albeit still 27% off their peak. Rental growth has remained consistently robust, with rental values up by 8.2% year-on-year.

The Retail sector has also shown modest signs of recovery, with average values rising by 1.1% over the last three months. However, this has been driven entirely by the Retail Warehouse sub-sector (3m growth of 2.2%). In contrast, the value of shops, shopping centres and supermarkets have all continued to drift down.

The Office sector is now established as the weakest part of the market, with average capital values down by almost 5% so far this year. This has been entirely yield-driven, with rental values having actually edged up by 1.0%. The capital value picture varies widely by region, with office parks in the South-East off by 11.3% year-to-date, whilst West End offices have seen values fall by just 1.3% over the same period.

Capital Growth to end-May 2023 (%)

%	1 Month	3 Months	12 Months	YTD
All Property	0.0	0.3	-20.5	**-1.1**
Retail	0.2	1.1	-15.0	**0.1**
C London Offices	-0.7	-2.2	-14.8	**-3.1**
Regional Offices	-1.2	-3.3	-22.1	**-6.2**
Industrial	0.4	1.6	-26.1	**0.1**

Source: MSCI Monthly Index

INVESTMENT MARKET ACTIVITY

£2.1bn of commercial property transactions closed in May, an improvement from a very weak April, yet still reflective of a very slow market. The year-to-date total of £14.4bn represents a 58% drop against the £34.4bn traded over the equivalent period last year.

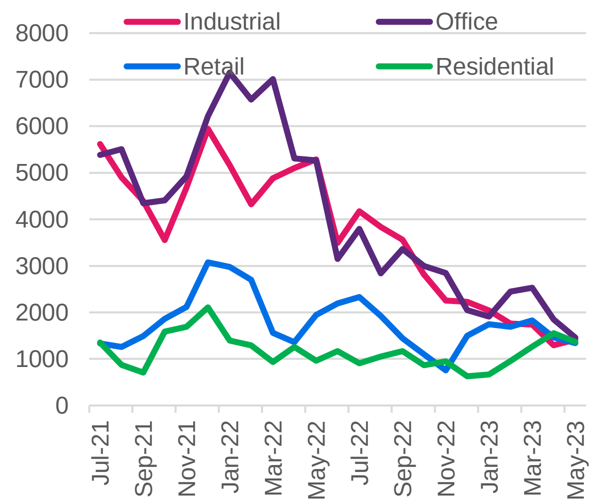
The largest deal of the month was the £315m purchase of a City office building by a JV between Greycoat and Mitsui. Goldman Sachs had been due to buy Sancroft at St Pauls for £370m in January, but were able to pull out after the developers fell behind on the project. The BREEAM Excellent and LEED Platinum scheme is currently 50% let.

The student accommodation sector came back to life in May after a very quiet start to the year. Blackstone's IQ Student Accommodation agreed a £140m forward funding of a 1,200-bed scheme in Coventry, which will be one of the UK's largest when completed. Watkin Jones forward sold an 819-unit scheme in Bristol to KKR for £103m.

A handful of sizeable industrial deals progressed in May. Workspace sold 5 assets from the McKay portfolio for £82m (4.5% yield). Abrdn sold an Amazon warehouse in Brent for £74m (3.5%). Tritax Big Box REIT acquired Junction Six park in Birmingham from M&G for £59m (5%).

The steady flow of Build-to-Rent deals continued in May. Brent council acquired 294 units across two blocks at Regal & London's Fulton and Fifth scheme for £85m. In Glasgow, Casa by Moda (Moda Living's new single-family platform), committed £41m to the Vista Park scheme which will comprise 156 homes including one and two-bed flats and houses.

Investment Market Trends (Rolling 3m, £m)



Source: propertydata.com

MARKET YIELDS

Market expectations that interest rates will be higher for longer have fed through into property market pricing. In their monthly yield sheet, JLL report that the compression of yield benchmarks appears to have run out of steam. Of 32 commercial benchmarks, 28 are considered to be stable at current levels, whilst the remaining four are thought to be trending weaker.

Industrial benchmarks have hardened by 25bp over the last quarter but are now considered to have plateaued 150-175bp out from the market peak. Retail Warehouse and supermarket benchmarks had also firmed up in recent months but have now settled between 75 and 175bp out from last year.

Sentiment in the office sector remains weak. Yields for the largest City offices have softened by 25bp to 5.0% in the last month, 125bp out from the market peak. Smaller lot sizes in the City are at 4.75% but are also predicted to soften further. Outer London and South-East prime benchmarks are at 6.25/6.50% (125bp out from the market peak) are also now expected to move out further.

The change in rate expectations has made it increasingly likely that benchmarks in the “Living” sectors will have to shift further than they have to date. So far, benchmarks for Build-to-Rent and Student accommodation have only edged out by 25bp. However, JLL consider that most benchmarks are now on a weakening trend and expected to soften further.

AUCTIONS

Data from EIG on the commercial property auction market, show that there were almost 20% fewer sales in May than a year earlier, and sales proceeds were down by almost half. However, the monthly figures can be volatile and it’s perhaps more instructive to look at the rolling 3-month figures. Even on that basis, sales are down c4% and proceeds down by c25%.

Allsop has sold 352 lots at auction so far this year, with an average sale price of c£500k. Larger lots have become increasingly common in recent years, and almost a quarter of the 124 lots listed for July guided at £1m or more.

MARKET FORECASTS

Colliers recently released updated forecasts which paint a notably more optimistic picture than many other commentators. They predict only a very marginal decline in values for 2023, implying that average values will end the year slightly above where they are today. They then expect that values will bounce back by more than 10% through 2024/25.

These capital growth forecasts are based in the premise that yields will stabilise this year and start to gradually compress again from next year. Colliers predict that rental growth will remain fairly healthy throughout the forecast period, averaging 2.3% per annum.

Colliers are most bullish on the Industrial sector, forecasting capital growth of almost 20% by the end of 2025, underwritten by solid rental growth of more than 4% per annum. On a total return basis, Colliers expect both the distribution and multi-let sub-sectors to deliver around 10% p.a. through 2027.

Colliers predict that most Retail and Office sub-sectors will experience rental growth through the forecast period, with only shopping centre rents expected to be lower in five years than they are today. On a total return basis, City Offices are expected to underperform (5.4% p.a. ‘23-‘27) whilst Retail Warehouses are predicted to outperform (9.0% p.a.)

LOOKING FORWARD

One of the major questions for the commercial market is to what extent inflation can benefit investors. Clearly in this respect real estate holds a significant advantage over Gilts, the real value of which is eroded by inflation even if the nominal value is guaranteed. To illustrate the point, the nominal yield on index-linked Gilts yield is currently less than 1%, reflecting the fact both the coupon and redemption value will rise in line with inflation. If you therefore believe that your asset can deliver growth in line with inflation then this would arguably be a more relevant benchmark than the normal Gilt yield. In reality of course, very few property assets will fully hedge inflation in the same way, and none have their exit value guaranteed by the government. Nonetheless, most forecasters, even those bearish on prospects for capital growth, are predicting that rental values will, on average, continue to rise. This provides some comfort that the investment case for commercial real estate at today’s values has not been completely undermined by the rise in medium-term interest rates.

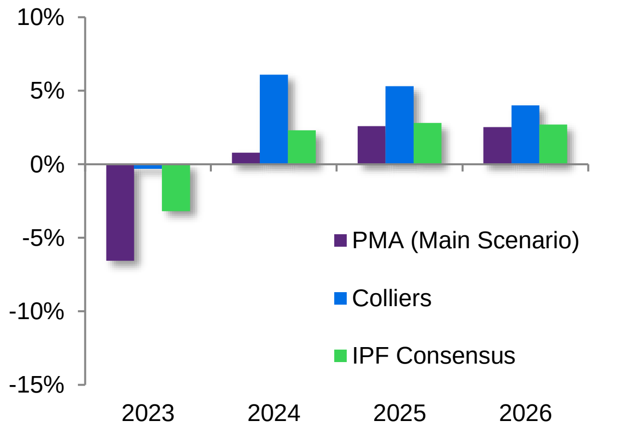
The closest thing the industry has to an index-linked Gilt are properties which benefit from a long-term index-linked lease backed by a blue-chip covenant. However, such assets are few and far between, are typically capped at 4 or 5% and hold the spectre of very significant leasing risk and/or cap ex requirements as the lease runs down. Elsewhere, investors need to rely on the underlying fundamentals of supply and demand to drive inflationary income growth. The closest the property market gets to that today is Build-to-Rent. Whilst residential rents aren’t a true inflation hedge, they are highly correlated with nominal earnings and hence nominal income growth is almost guaranteed over the medium-term. Other sectors with constrained supply like urban logistics, well-located student halls and highly sustainable offices should also be able to capture some inflationary growth. It’s even possible that parts of the Retail sector will once again benefit from inflation, as retailers are able to push through prices rises following many years of stagnation.

Benchmark prime yields (%)

%	**Jun 23**	May 23	Jun 22
Regional City Office	**5.75**	5.75	4.50
Solus Retail Warehouse	**6.25**	6.25	4.75
Supermarket	**5.25**	5.25	3.50
Regional Multi-let Ind	**5.25**	5.25	3.75
Regional BTR (stabilised)	**4.25**	4.25	4.00
Regional Student (Direct)	**5.25**	5.25	5.00

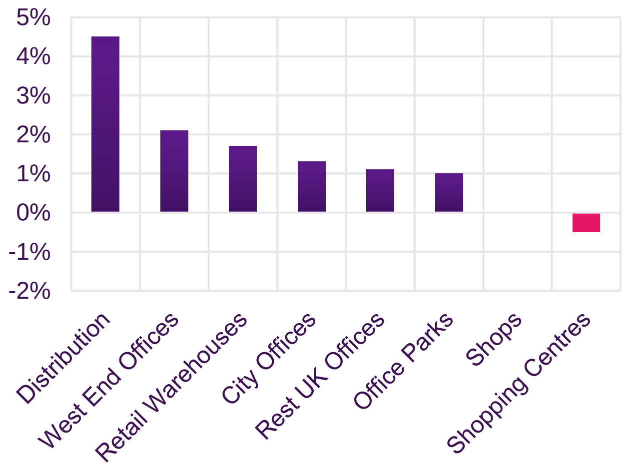
Source: JLL Monthly Yield Sheet

Capital growth forecasts (%)



Source: PMA Spring ‘23, Colliers Q2 ’23 (2026 based on 23-27p.a.), IPF Consensus Forecasts (Spring’23)

5-year Rental Growth Forecasts (2023-27)



Source: Colliers Q2 ‘23 forecasts

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