Real Estate Finance

# UK Real Estate Digest

**January 2023**

## Liquidity set for recovery in 2023 as investors sniff a bargain

A glance at the record books will show that 2022 was a solid, if unspectacular, year for the commercial property investment market. £55bn was traded across the year, almost exactly in line with the average from the previous 10 years. However, the reality was far less mundane. The first half of the year was the second strongest ever recorded, with £35bn worth of deals completing, as confidence rose following the easing of the pandemic. In stark contrast, the final quarter was the weakest since the height of the global Financial Crisis in 2008. This lack of liquidity is what many market participants fear most. Developers worry they won't be able to sell their end-product, borrowers and lenders worry about loan maturities and investment agents worry about losing their jobs. Whilst activity across the whole market was 45% down on the long-term average, this understates the situation in some sectors. In what is traditionally the busiest quarter of the year, office investment was just one-third of the 20-year average, whilst shopping centres and leisure assets were running at just a quarter of that long-run benchmark.

The pattern of the investment market in 2022 mirrored that of 2007, when a healthy first three quarters gave way to an anaemic final quarter. That poor final quarter in 2007 was followed by two painfully slow years, with volumes at less than half the level of preceding years. However, there are reasons to believe that liquidity will recover far more quickly in this cycle. The first, whilst clearly very painful for many, is the sheer speed at which pricing has adjusted. In the second half of 2007, values fell by around 10%, which at the time felt like a dramatic movement, yet it pales in comparison with the 20% decline seen in the second half of last year. This has served to return risk premia to sensible levels and to alleviate pressure on interest cover tests for potential buyers looking to finance their acquisitions. The background of the debt market is also very different, with most investors retaining some equity to protect and most lenders still having the appetite and ability to lend.

## COMMERCIAL PROPERTY RETURNS

The MSCI Monthly Index fell by a further 3.7% in December, rounding off a record quarterly decline of 15.6% in Q4 and a cumulative decline only a fraction short of 20% since mid-year. However, the fact that the December decline was smaller than those in October and November perhaps offers some evidence that the largest falls are behind us.

The largest drop was again recorded in the Industrial sector; down by 5% in December, a remarkable 20.3% in Q4 and almost 27% since the market peaked at mid-year. Perhaps even more remarkably this precipitous fall has only taken values back to a level they first reached 18 months ago.

Retail declines also moderated in December, yet values are nonetheless down by 12% in Q4, and by 15% since mid-year. Over the year as a whole, Retail Warehouses have been the most resilient sub-sector, ending the year down just 5.9%. In contrast, the low-yielding supermarket sector ended the year down by almost 20%.

Although all office regions have seen double-digit declines since mid-year, there were wide regional variations over the year as whole. The outer South-East region, heavily influenced by Oxford and Cambridge, saw values off by just 8%, a similar outcome to the West End of London. In contrast, the Inner South-East (largely the M25 markets) saw values come off by around 20%, a similar picture to that in Scotland.

### Capital Growth to end-December 2022 (%)

| % | 1 Month | 3 Months | 12 Months | YTD |
|---|---|---|---|---|
| All Property | -3.7 | -15.6 | -14.2 | **-14.2** |
| Retail | -2.6 | -12.3 | -9.4 | **-9.4** |
| C London Offices | -2.2 | -10.6 | -10.4 | **-10.4** |
| Regional Offices | -4.1 | -14.2 | -16.5 | **-16.5** |
| Industrial | -5.0 | -20.3 | -18.0 | **-18.0** |

Source: MSCI Monthly Index

## INVESTMENT MARKET ACTIVITY

£2.5bn of deals closed in December, representing a welcome improvement in liquidity relative an incredibly slow November. Nonetheless, the £6.3bn transacted across Q4 represents the weakest end to any year since 2008. The sharp change in market pricing is illustrated by the average yield in Q4 coming in at 6% compared to 4.75% over the preceding 3 quarters.

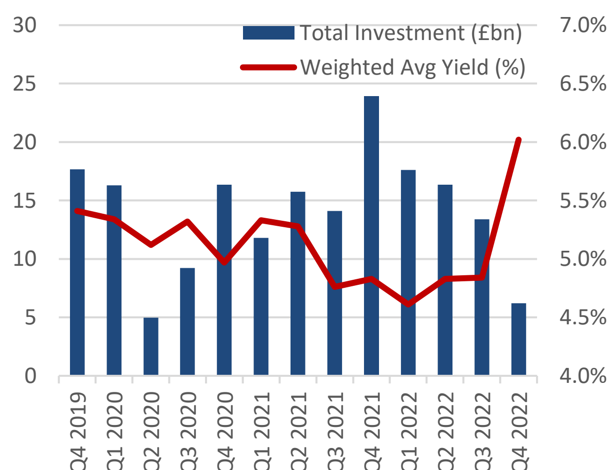
The two largest deals in December involved sales by occupiers. Fenwick sold their Bond Street store for £430m to Lazari, who are expected to redevelop the site after the retailer vacates next year. Elsewhere the new private equity owners of Morrisons completed a sale and leaseback of seven distribution centres to ICG Real Estate for £220m.

A handful of sizeable regional office deals closed in December, notably in Gloucester, Crawley and Manchester. Gloucester Business Park, acquired by Brookfield in 2021 as part of the Arlington portfolio, was sold to Dunedin for £122m. The asset was first marketed a year ago for £135m.

In the context of a very slow investment market, liquidity remains reasonably healthy for retail warehouses, with £215m changing hands in December across 11 deals. US investor Realty Corporation completed three more acquisitions in December for c£70m, taking their calendar year activity in the sector to £504m across 15 deals.

A notable transaction completed in the shopping centre sector as Golden Square in Warrington was acquired by the Adhan Group for £22.5m. The vendors, the Alaska Permanent Fund initially acquired the asset from the developers for £141.5m in 2014.

### Investment Market Trends




Source: propertydata.com

# MARKET YIELDS

The correction in market pricing continued over the turn of the year, but there were perhaps early signs that the rate of outward yield shift may be slowing. This is most notably the case for the Industrial sector where JLL consider that prime benchmarks have now stabilised following the dramatic 175-200bp of outward movement during the second half of 2022.

JLL see more of a mixed picture in the office sector, with Outer London, South- East and regional benchmarks all moving out by a further 25bp over the month and continuing to trend weaker. These benchmarks have now been moved out by between 75 and 125bp. Prime West End benchmarks were also moved out by 25bp but are now considered stable at 4.0-4.25%.

JLL also consider the Retail sector to be trending weaker, with prime benchmarks for retail parks and solus units moved out by a further 25bp to 6% and 6.25% respectively. These benchmarks are now 100-125bp higher than they were last summer. Secondary shopping centre benchmarks are thought to have moved out by a further 100bp to 14%, though in truth the initial yield is no longer a commonly used measure of value in the sector.

Yields in the “living” sectors have proved far more resilient than their commercial counterparts but have not been entirely immune. Benchmark yields for stabilised prime BTR assets are thought to have moved out by c25bp since the summer and are still thought to be trending weaker. Student benchmarks have softened by up to 75bp since the market peak.

### Benchmark prime yields (%)

| % | **Jan 23** | Dec 22 | Jan 22 |
|---|---|---|---|
| Regional City Office | **5.50** | 5.25 | 4.75 |
| Solus Retail Warehouse | **6.25** | 6.00 | 5.50 |
| Supermarket | **5.25** | 5.25 | 3.50 |
| Regional Multi-let Ind | **5.50** | 5.50 | 3.75 |
| Regional BTR (stabilised) | **4.00** | 4.00 | 4.00 |
| Regional Student (Direct) | **5.25** | 5.25 | 5.00 |

Source: JLL Monthly Yield Sheet

# AUCTIONS

Reflecting the broader investment market, the commercial auction market slowed markedly towards the end of the year. Sales proceeds were down by around a third in December relative to the previous year, driving a 16.5% year-on-year decline across the final quarter as a whole. Nonetheless, this compares favourably to the 75% year-on-year decline in the broader market.

Allsop have published their catalogue for their first commercial auction of the year in February. It has more lots listed than any February auction since 2019 and will be a good barometer of whether pricing and liquidity continues to hold up better at the smaller end of the market than elsewhere.

# MARKET FORECASTS

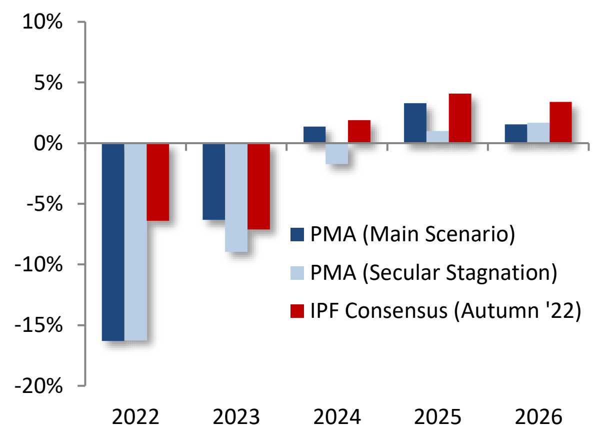
The Winter 2022 update by independent forecasters PMA reflects that values corrected even faster than they had anticipated. In the Autumn round they had predicted a 12% decline for 2022 as a whole, which itself had been far more bearish than the consensus expectations, yet they downgraded this to -16% in the December release.

However, the outlook for 2023 has in turn been slightly moderated, from a predicted decline of 7.1% to one of 6.3%. Moderate growth is then expected to return in 2024 with a further pick up in 2025. In effect, the PMA base case scenario implies that average values at the end of 2026 will be roughly the same as where they were at the end of last year.

However, the picture diverges widely across sectors. London industrial values are expected to be 15% higher at the end of 2026 than they are today whilst business park values are forecast to be 16.5% lower.

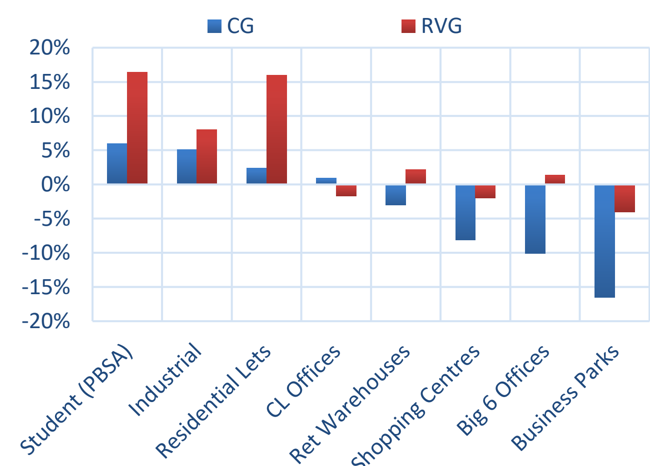
The picture is more broadly positive for rents which are expected to be almost 4% higher on average by the end of 2026 with most sectors seeing net growth over that horizon. Residential rents are forecast to be 15% higher by 2026.

### Capital growth forecasts (%)




Source: PMA Autumn 2022, CBRE, IPF Consensus Forecasts

### Net Capital and Rental Growth Dec 22-Dec 26




Source: PMA Winter ‘22 Main Scenario

# LOOKING FORWARD

Any rebound in investment activity in 2023 is unlikely to reach all corners of the market, despite the material repricing that has been seen almost everywhere. The shopping centre sector is still very much in the doldrums despite values having fallen by more than 60% since 2015. A few more opportunists took the plunge last year but most surveys of investor intentions place the sector firmly towards the bottom of the list for new acquisitions. Older office assets in secondary locations also look likely to suffer from constrained liquidity, with the investment required to bring them up to modern sustainability standards sometimes exceeding any realistic end-value.

Elsewhere, the pricing correction already seen should be sufficient to awaken animal spirits amongst potential buyers. Yields for prime industrial, office and retail warehouse assets have moved out by up to 200bp and no longer need heroic rental growth assumptions to deliver a decent risk-adjusted return. Prime logistics yields for example are estimated to have moved out from 3% to 5%, so income growth of just 1% per annum would deliver a return 270bp above the 10-year Gilt yield. Prime retail parks and prime regional city offices offer a similar return without any income growth at all. From a vendors perspective, any impending refinance events will focus minds on whether to take the money today or inject more equity and/or pay higher debt costs in the hope of a higher price in the future.

The final part of the jigsaw is for those assets where the balance of supply and demand is so favourable that they are still expected to deliver robust income growth. Recently completed BTR assets, student halls close to the strongest HE institutions, last-mile logistics in the densest urban populations and offices with the very highest sustainability credentials are all likely to be chased with renewed vigour in 2023. In the hunt for such assets, patience is unlikely to be rewarded.

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