Real Estate Finance

UK Real Estate Digest

April 2023

NatWest

The UK is not always doomed to follow in US footsteps

Trends that originate in the US will usually find their way over to the UK sooner or later. Fast food, cable TV, SUVs, athleisure and school leavers going to the "prom" were all oddities from across the pond before gaining a foothold on these shores. In the real estate market, we can probably thank the Americans for shopping centres, retail warehouses, business parks, build-to-rent and co-working. Of course, not all trends translate; cheerleaders have somehow never come off in Manchester in the same way as they might in Miami, and we're very happy with our own version of football thank you very much. However, it is foolish to look at events in the States and think that they would never happen here. We learned this lesson in 2008 when what started as a sub-prime mortgage crisis in places like Detroit eventually became known as the Global Financial Crisis. More recently, US commercial property values declined by 5% in Q2 last year whilst values in the UK continued to rise, seemingly oblivious of the dramatically changed monetary environment.

Commercial property values in the UK have now responded, and indeed moved further and faster than those in the US. However, there are other trends in the US which have had investors on this side of the Atlantic casting nervous glances and wondering if we are likely to see something similar here. Fears that the failure of a number of mid-tier US banks would spread contagion to the UK banking sector appear to have been assuaged, yet there are still concerns that we may suffer some of the same symptoms. The Fed reports that 70% of US banks tightened lending standards in the final quarter of last year, which is unfortunate timing when a record quantum of commercial mortgages is due to mature this year. A small number of high-profile defaults from some giant US investors have also contributed to the sense of jeopardy and raised questions as to whether this is another US trend that is about to hit our shores.

COMMERCIAL PROPERTY RETURNS

The MSCI Monthly Index returned positive capital growth in March following eight successive months of decline. Average values rose by a marginal 0.2% in March, having fallen at record speed since the middle of last year, delivering a peak to (possible) trough decline of 21%.

This nascent recovery did not extend to the office sector however, where values declined by an average of 1% in March. The City of London saw the largest drop month-on-month drop (2.4%) and is down by 18% from peak. The largest cumulative decline has been in the Inner South-East (M25) market where values have come off by circa 25% to date.

Industrial values recorded a small bounce in March, rising by 0.7%, having fallen by 28% over the preceding eight months. The distribution and standard industrial sub-sectors have moved in tandem through this cycle, perhaps explained by the blurring of boundaries in metropolitan locations. Rental values rose by c2% in Q1, continuing an annual rate of c8%.

At a sector level, Retail delivered the strongest rebound in March, with values rising by an average of 0.8%. This was largely driven by Retail Warehouses, with capital values climbing by 1.3% in the month, having declined by 16% over the preceding eight months. Rental values in the sub-sector have been quietly edging up over the last year.

Capital Growth to end-March 2023 (%)

%	1 Month	3 Months	12 Months	YTD
All Property	0.2	-1.2	-18.8	**-1.2**
Retail	0.8	-0.2	-13.5	**-0.2**
C London Offices	-0.9	-1.9	-13.1	**-1.9**
Regional Offices	-1.0	-4.0	-20.0	**-4.0**
Industrial	0.7	-0.9	-24.3	**-0.9**

Source: MSCI Monthly Index

INVESTMENT MARKET ACTIVITY

£3.7bn of transactions completed in March, less than half the volume completed last March but easily the strongest month so far this year. All sectors recorded an improvement relative to January and February suggesting that some liquidity may be returning to the market.

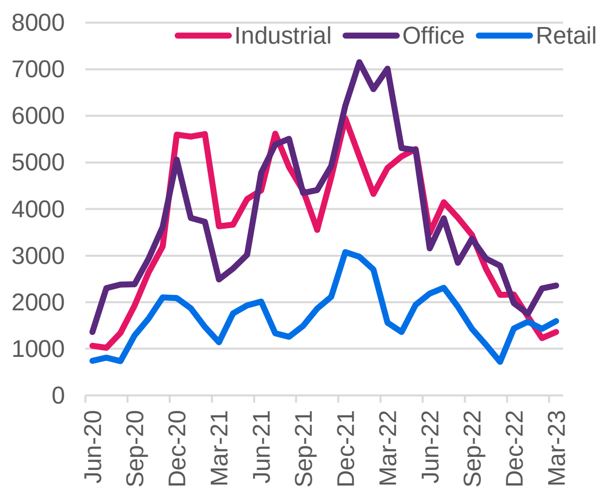
The largest trade in March was the sale by Supermarket Income REIT of a 51% share in the Sainsburys Reversion Portfolio to Sainsburys themselves for £430m. This appears to crystallise a healthy profit for the REIT on the 25.5% share which they acquired for £196m in January.

The largest regional BTR funding deal so far was agreed for Moda's Great Charles Street scheme in Birmingham, which will eventually deliver 722 homes. The JV between Harrison Street, NFU Mutual and Apache Capital, which has now done six deals together, committed £302m. The deal took investment in the sector past £1bn in Q1.

Three sizeable office deals closed in March. Pension Insurance Corp forward funded a scheme let to the Home Office in Croydon for £268m. CIC sold 1 Great Winchester Street, which will be vacated by Deutsche Bank this year, for £257m. The Obayashi Corporation paid £160m for 60 Gracechurch Street, sold by KGAL who acquired it in 2010 for £116m.

Levels of activity have been picking up gradually in the Retail Warehouse sector, with £272m changing hands across 14 deals in March. British Land purchased parks in Preston and Farnborough for £87m and are reported to be under offer on a third. DTZ acquired Aldi-anchored Purley Cross in Croydon for £59m. Columbia Threadneedle also completed two deals, taking their investment in the sector to almost £500m in 3 years.

Investment Market Trends (Rolling 3m, £m)



Source: propertydata.com

MARKET YIELDS

JLL reported the first sign of a potential rebound in the industrial sector, moving all six of their yield benchmarks for the sector in by 25bp. Their prime industrial benchmarks now range from 4.75% in London to 5.25% in the regions. JLL perceive that yields are now stable at this level, between 150bp and 175bp higher than their level this time last year.

In fact, JLL take the view that yields are now stable across most commercial sub-sectors, albeit that transactional evidence is still relatively scarce. The only mainstream sector that JLL perceive as being on a weakening trend is larger lot-size City offices. In contrast, they believe that the next movement for prime retail park yields is likely to be inwards.

The “Living” sectors have yet to see the same level of outward yield shift, with benchmarks typically only 25bp to 75bp higher than they were at the peak of the market. BTR yields have only softened by around 25bp so far, although JLL suggest a further outward trend. In the Student sector, JLL perceive that yields for direct let assets have stabilised after just 25bp of outward shift whilst leased assets have moved by 50-75bp and likely have further to go.

Market expectations for peak base rate have increased again over the last month and this has translated into a rising trend in longer-term interest rates. The benchmark 10-year Gilt yield and the five-year swap rate have both moved out by around 40bp since early March, which may put further outward yield pressure on those sectors with little prospect for rental inflation.

Benchmark prime yields (%)

%	Apr 23	Mar 23	Apr 22
Regional City Office	**5.75**	5.75	4.75
Solus Retail Warehouse	**6.25**	6.25	4.75
Supermarket	**5.25**	5.25	3.50
Regional Multi-let Ind	**5.25**	5.50	3.75
Regional BTR (stabilised)	**4.25**	4.25	4.00
Regional Student (Direct)	**5.25**	5.25	5.00

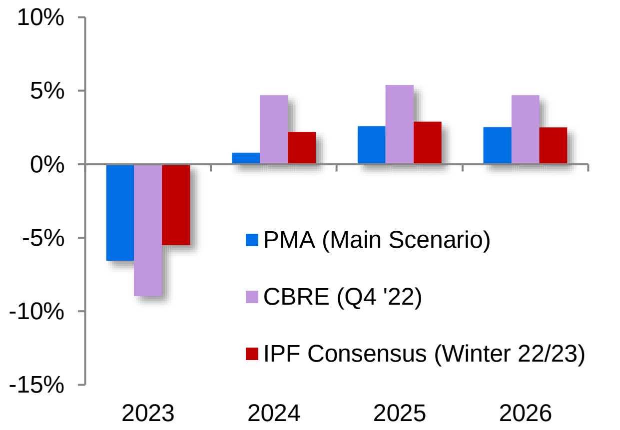
Source: JLL Monthly Yield Sheet

AUCTIONS

The Allsop auction in April was unusual in that it consisted purely of betting shops let to William Hill. All 57 lots had new leases, typically with a CPI linked uplift in year 5 but also often allowing for tenant breaks every three years. All 57 lots sold, with an average sale price of £157k.

The highest price achieved was £633k (4.5% net initial) for a betting shop in Manchester with a new 15-year lease, CPI at year 5 with an unusually generous cap/collar of 10%/5%, and no break until year 7. Other assets to sell well typically also had residential income or potential.

Capital growth forecasts (%)



Source: PMA Autumn 2022, CBRE, IPF Consensus Forecasts

MARKET FORECASTS

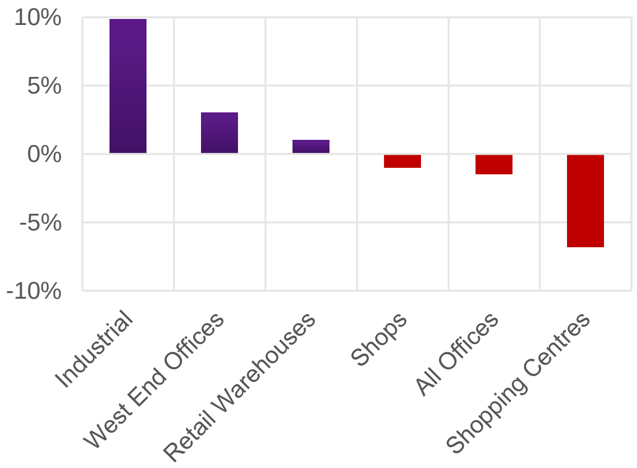
The latest IPF Consensus Forecasts, which were compiled between mid-December and mid-February and published in March, show a moderate improvement in sentiment compared to three months earlier. Capital values are still expected to fall this year (-5.5%) but are now expected to grow slightly over a five-year horizon (0.7% p.a. from -1.0% p.a. last quarter).

The outlook varies quite widely by sector, with Industrial expected to once again be the strongest performer following the rapid repricing seen last year. The mean forecast was for capital growth of 1.9% p.a. over a five-year horizon, supported by rental growth of 2.6% p.a. over the same period.

The picture is less positive for offices, with values expected to decline by 0.3% p.a. over the period, driven by a 7.7% fall this year. This somewhat mundane consensus hides a wide range of views, with the most pessimistic forecaster predicting -3.8% p.a. whilst the most optimistic expects growth of 1.5% p.a.

Forecasters predicted a wide spectrum of returns across the Retail sub-sectors. Retail Warehouses were expected to outperform, with marginal growth of 0.2% p.a., underwritten by 1% p.a. rental growth. In contrast, Shopping Centre values were forecast to decline by 1.4% p.a.

5-year Capital Growth Forecast (2023-27)



Source: IPF Consensus Forecasts, Winter 22/23

LOOKING FORWARD

In the UK, as in the US, there is likely to be something of a refinance gap over the next few years as lenders seek to get loans back within appetite. LTVs on existing loans may have moved out by up to 10 percentage points given market value movements whilst ICRs might have halved given the rough doubling of all-in debt costs. This will undoubtedly cause some challenges for both borrowers and lenders, but the size of the gap is not yet large enough to cause systemic problems such as those seen in the GFC and investors will typically still have large equity stakes that mean they will be heavily incentivised to come to a consensual arrangement with their lender. JP Morgan analysts predict that debt liquidity will remain stronger in Europe than in the US and this is so far backed up survey and anecdotal evidence.

High-profile defaults in the US have almost exclusively involved office assets, and the travails of that sector are one trend that investors on this side of the pond will be most anxious that we do not follow. According to JLL, vacancy in the New York office market has doubled since 2019 to a record high of 16.1%, and in the first quarter of this year net absorption was negative, to the tune of 1.4 million square feet. This contributed to a total of over 75 million square feet of vacant office space in the city (another record high), a third of which has been vacant for more than two years. In contrast, whilst London office vacancy has also doubled since 2019, it only reached 8.6% and has even come down slightly since, to 8.1%. Of course, this data is somewhat backward looking, and similar comments could have been made 10 years ago about the UK shopping centre market. However, the UK embraced online retail like no other country in the world whereas the signs are that remote working has not proved quite as popular here as in the US. Hybrid working is here to stay, and it will certainly have an impact on the office market, but there are reasons of both supply and demand to believe that swathes of empty office towers are a US trend that won’t catch on in the UK.

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