UK Commercial – Summer 2022

MARKET IN MINUTES

Savills Research

Savills ProgrammE and Cost Sentiment Survey

“With inflation rising we would ordinarily expect to see reduced levels of activity, which in turn would put downward pressure on build costs. However, the combined impact of the tragic situation in Ukraine, global post-Covid supply chain readjustment, strong occupier markets, and an even greater emphasis on energy efficient buildings is conspiring to place even greater demands on the construction sector meaning that notable falls in costs remain out of sight.”

SIMON COLLETT, HEAD OF PROFESSIONAL SERVICES

Wider macro trends keep pressure on costs

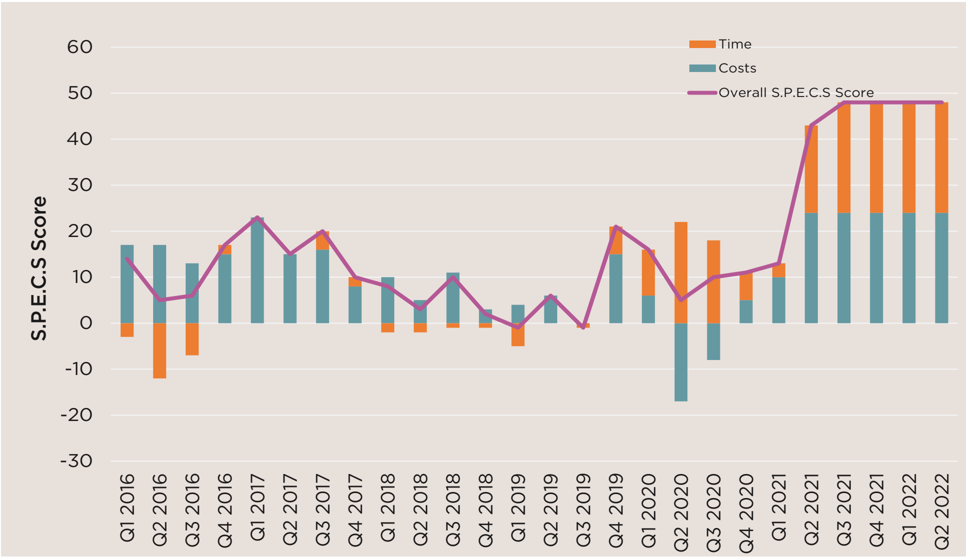
As the months have passed in 2022, it is clear to see that sentiment in economies the world over has changed dramatically. Whilst inflation was already starting to rear its head at the start of the year, the situation in Ukraine has amplified the situation further, largely through higher energy and food costs. In the UK, consumer confidence has fallen to the lowest level since records began, and whilst retail sales are still showing increases in value, the volume of sales has been declining steadily since October 2021, according to data from the ONS.

Whilst construction supply chains have become far more resilient over the last two years uncertainty and unpredictability still reigns as companies seek to remove dependencies on Ukrainian and Russian raw materials, which adds further cost and time to projects.

With central banks acting quickly to ramp up base rates in an effort to reduce demand, and therefore inflation, we would expect our index to show downward pressure as inflation falls. However, with most occupational markets showing robust metrics and occupiers looking to secure grade A, energy efficient buildings, we are not yet seeing a fall in construction activity.

This is reflected in our latest S.P.E.C.S index with a score of 48 for the 5th successive quarter, this means that in all markets we cover our sector specialists are seeing upward pressure on build costs and project timescales. Whilst activity in some sectors may dissipate in the next 12 months, it is likely that we will continue to see elevated S.P.E.C.S scores until inflation starts to fall.

S.P.E.C.S Q2 2022



Source Savills Research

Q2 2022 S.P.E.C.S Indicators

	New build and refurbishment costs	New build and refurbishment timescales*	Occupier fit-out costs	Occupier fit-out timescales*
Offices - Central London	↑	↑	↑	↑
Offices - Regional	↑	↑	↑	↑
Warehousing <100,000 sq ft	↑	↑	↑	↑
Warehousing 100,000 - 500,000 sq ft	↑	↑	↑	↑
Warehousing 500,000+ sq ft	↑	↑	↑	↑
Central London prime residential	↑	↑	↑	↑
Central London mid-market residential	↑	↑	↑	↑
Regional mid-market residential	↑	↑	↑	↑
Foodstores	↑	↑	↑	↑
High street retail	↑	↑	↑	↑
Out of town retail	↑	↑	↑	↑
Shopping centre	↑	↑	↑	↑

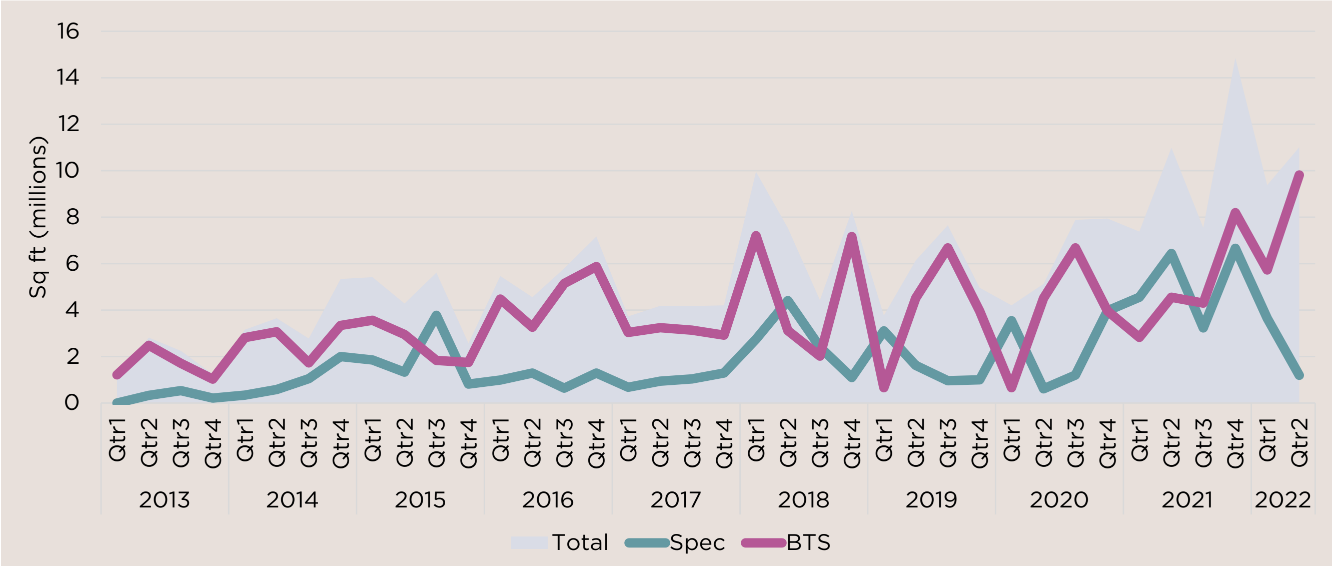
METHODOLOGY & APPROACH

Savills Building and Project Consultancy sector experts track build cost and programme timescales sentiment across 48 separate markets and sectors. A high S.P.E.C.S score would mean that most sectors are experiencing upward cost and timescale pressure whereas a highly negative score would suggest that most markets and sectors are experiencing downward pressure. A score around zero suggests that build costs and programme timescales are largely static.

BUILD COSTS RISEN BY 25-30% PSF IN LAST 2 YEARS

Source Savills Research **Note** *Time taken from project sign off to commencement including procurement and delivery of building components

Upward pressure on build costs for logistics



UK Logistics pipeline remains high despite falling speculative development

Source Savills Research

Dynamics change in logistics but high demand keeps upward pressure on costs

Over the last two years the logistics market has boomed. The demand for warehouse space has increased from a pre-Covid average of 25.9m sq ft worth of new deals per year to a post-Covid average of 53.1m sq ft per year. Developers have reacted to these market conditions by delivering speculative units to the market at levels not seen since before the Global Financial Crisis of 2008, and despite 2021 seeing a record level of speculative announcements at 20.9m sq ft, the vacancy rate in the market has remained structurally low at 3.01%.

Over the last two years, the price of raw materials have been rising with many developers suggesting that build costs have risen by up to 25-30% on a per sq foot basis. Given the supply and demand imbalance in the market these costs have been passed onto the occupier in the form of higher rents, with MSCI reporting that industrial rents have risen by 18.3% since the end of 2019.

These factors are reflected in our SPECS index, with all size ranges of the industrial and logistics market reporting upward arrows for both build costs and programme length for the last five quarters.

As we move into 2022 the market dynamics have changed quickly and dramatically, particularly in the capital markets. As inflation has surged central banks across the world have been raising base rates and in the UK they now stand at 1.25%, with further rises practically guaranteed. This has presented a mathematical dilemma to many investors in the market as the rising cost of debt, coupled with rising build costs, has given way to a period of naval gazing as investors wait for signs that strong levels of rental growth will still be achieved.

This is reflected in our data covering speculative announcements which shows that 4.8m sq ft of new schemes have been announced so far in 2022, a fall of 56% compared with the first half 2021. A fall of this level would ordinarily be expected to put downward pressure on build costs as contractors start to bid more competitively for less work, and whilst some developers are reporting that build cost tenders are stabilising, we are yet to see any meaningful falls in construction cost.

One explanation for this is that whilst the level of speculative development has fallen, the level of new leases for build-to-suit schemes has surged, accounting for 54% of the new leases signed in 2022, the highest level on record. This means that the total development pipeline is currently 90% above the long-term average.

With occupier requirements remaining at elevated levels and volatility in the capital markets suppressing speculative development it remains likely that vacancy rates will remain low, which in turn will continue to push rents. And whilst a deteriorating economic environment will force down some commodity prices we do not foresee dramatic downward shifts in build costs. Furthermore, with rising energy costs, we are now seeing even greater emphasis on developing new warehouse units to even higher ESG standards. We expect that occupiers will place an even higher weighting on warehouse features that save on cost and reduce the carbon output of the warehouse operation.

CITIES SET THEIR SIGHTS ON NET ZERO

By 2030, approximately 60% of the world's population will live in cities, according to the UN's World Cities Report 2020. It is therefore vital that these urban centres play a leading role in the quest for a net-zero future.

Cities currently consume 78% of the world's energy and produce more than 60% of greenhouse gas emissions. Recognising the need for immediate change, cities initially led countries in setting net-zero carbon targets. The built environment is at the heart of achieving this.

Data compiled by Savills World Research shows that, prior to 2019, a greater proportion of cities were setting net-zero targets in comparison with countries. Since the COP26 climate conference in November 2021, countries have overtaken cities as more nations were encouraged to set their own targets. However, many cities continue to develop more ambitious targets than the countries in which they are located.

For greater insight on this topic, detailed analysis is provided in our latest IMPACTS report, where more information can be found here.

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