UK Commercial – November 2022

MARKET IN MINUTES

Savills Research

UK Regional Office Investment Market Watch

savills

Upward yield movement across the market

The negative reaction to the UK government mini-budget announced in October by the financial markets combined with the rising cost of debt and a recession forecast in 2023, has significantly impacted on investor sentiment. This has been reflected in pricing with an upward movement in prime yields across all submarkets in the regional office market with the prime regional office yield moving out to 5.75% which reflects a 100 basis point increase from June 2022. The polarisation in investor demand is reflected by the growing gap between prime and secondary yields on a submarket level which has been most evident in the M25/South East region where the current gap between prime and secondary yields is 400 basis points. The outward movement in yields has seen significant price discounts in assets that were placed under offer in the summer of around 10%-20% in value.

There is a lack of core capital seeking regional offices with increasing nervousness amongst investors on capital expenditure requirements to adhere to the proposed Minimum Energy Efficiency Standards. The limited accessibility to debt to improve returns has also combined to result in a slowdown in investment activity. This was evident in Q3 with investment volumes totalling £912 million which was the lowest quarterly total since Q2 2013. It is expected that investment activity will continue to be muted for the remainder of the year with the buyer pool for assets currently being limited.

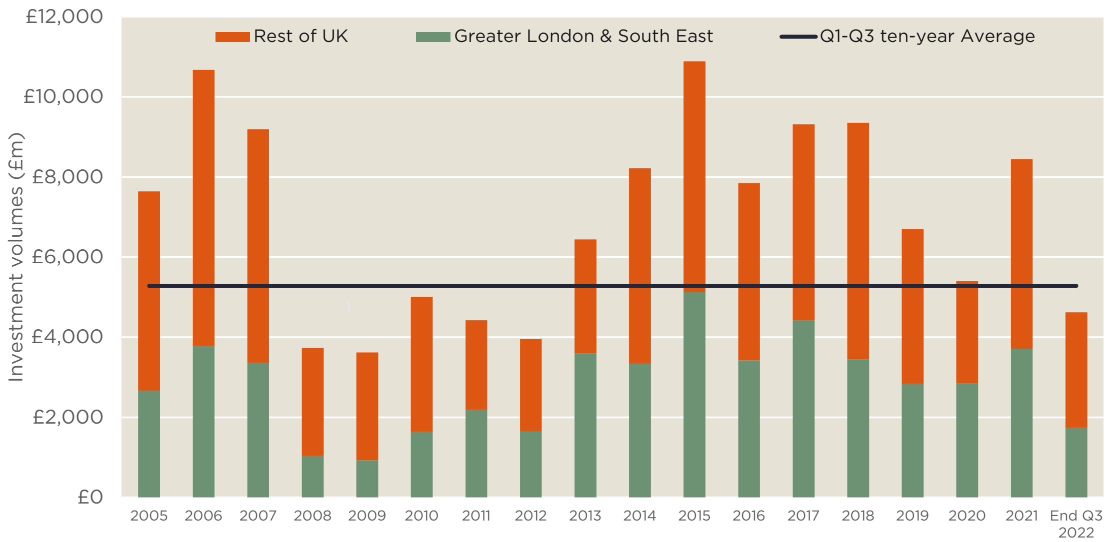
Regional Office Yields November

	Year	Prime	Secondary*	Spread
Birmingham	Nov-22	5.50%	7.25%	175 bps
	Nov-21	5.00%	6.75%	175 bps
Bristol	Nov-22	5.25%	7.25%	200 bps
	Nov-21	5.00%	6.75%	175 bps
Cardiff	Nov-22	5.75%	8.50%	275 bps
	Nov-21	5.50%	8.00%	250 bps
Edinburgh	Nov-22	5.50%	7.00%	150 bps
	Nov-21	4.50%	6.25%	175 bps
Glasgow	Nov-22	6.00%	7.75%	175 bps
	Nov-21	5.00%	7.00%	200 bps
Leeds	Nov-22	5.25%	8.50%	325 bps
	Nov-21	5.00%	7.25%	225 bps
Manchester	Nov-22	5.00%	7.00%	200 bps
	Nov-21	4.75%	6.50%	175 bps
M25	Nov-22	6.00%	10.00%	400 bps
	Nov-21	5.50%	8.50%	300 bps

Source Savills Research

*Secondary yields refer to buildings in core locations of both a lower quality and rental price point

Office investment volumes Total turnover recorded in Q1-Q3 2022 was 12% below the long- term average for the first three quarters of the year



Source Property Data/Savills

Key Stats

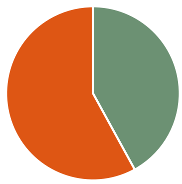
5.75%↑

Prime regional office yield

£

£4.6bn

Office investment volumes outside of central London at the end of Q3 2022



46%

Overseas investors accounted for 46% of total investment in 2022, which was the highest proportion amongst all investor types

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The number of deals over £100m at the end of Q3 2022. This was the second highest total in the last ten years

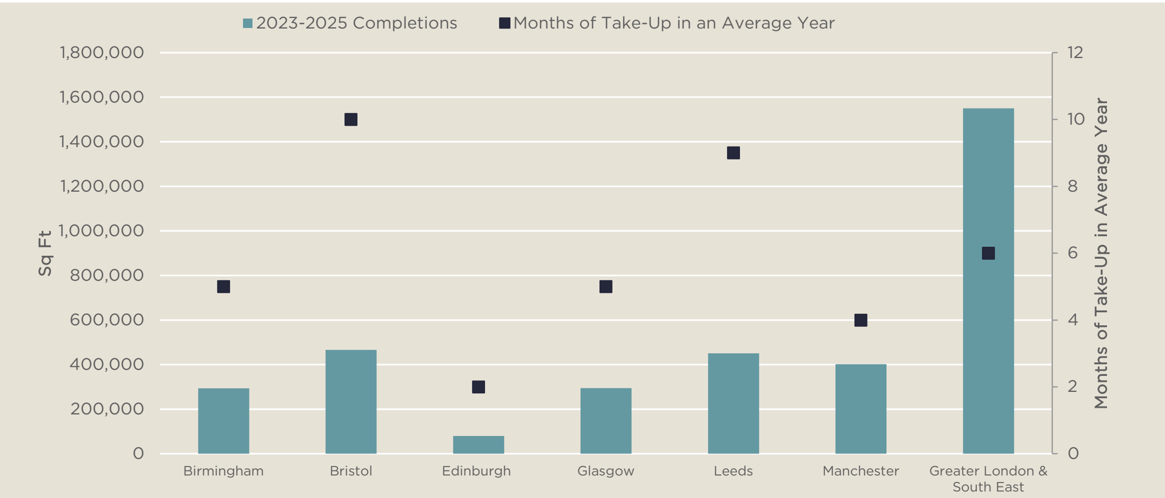
The occupational market remains robust with strong rental growth prospects

The underlying occupational market fundamentals of the regional office market remain robust despite the outward movement in yields that the market has been experienced. This is notably evident in the Big Six regional cites with each market having less than two years of grade A supply, based upon the five year average grade A take-up. The picture is more acute when analysing the availability of prime grade A space which is amenity rich and has strong ESG credentials with both Edinburgh and Glasgow having less than three months of supply of the best in class space.

The economic headwinds present in the market combined with rising finance and build costs have resulted in fewer development and refurbishment starts this year and we expect this to continue in 2023. This will result in lower than expected development completions in 2024 and 2025, across the Big Six regional cities and Greater London & South East markets. When reviewing the current space scheduled for completion across these market areas for 2023-2025, this equates to less than six months of take-up in an average year in four of the regional markets detailed in the chart below.

The supply constraints of the best in class space are set to persist which will result in stronger than expected rental growth across the market. Prime rental levels in Manchester, Birmingham and Bristol are expected to surpass £43 per sq ft by 2025. The Greater London & South East market has also been experienced rental growth with seven submarkets achieving record rents in 2022 following on from 13 submarkets achieving record rents in 2021. When reviewing MSCI data, offices located in the Outer South East & Eastern and Rest of UK regions have recorded the highest annual levels of rental growth as at Oct 22 at 1.8% and 1.5% respectively, when compared to other geographies.

Limited Development Pipeline In four of the regional markets there is less than six months of take-up in the development pipeline

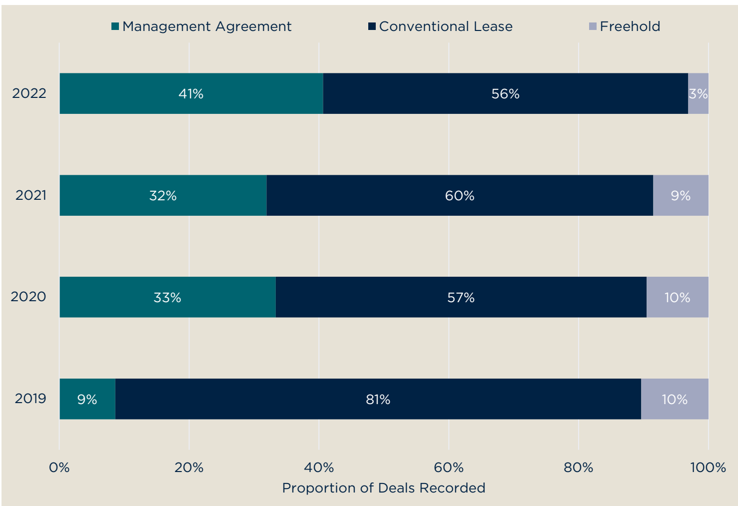


Source: Savills Research

Workthere have analysed the deal structure of UK flexible office space transactions since 2019 which uncovers that there has been a rise in the number of management agreements between landlords and flexible office operators. At the end of Q3 2022, 41% of transactions were agreed on this basis which was an increase from 9% in 2019.

It is expected that this trend will continue which was highlighted in Savills Landlord Flexible Office Survey 2022. The proportion of respondents who were open to entering a management agreement with a flexible office operator was 46% which was an increase on the proportion of 41% recorded in 2021.

Management Agreements There has been a rise in the number of management agreements between landlords and flexible office operators



Source Workthere

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