UK Commercial – June 2023

MARKET IN MINUTES
Savills Research

Savills ProgrammE and Cost Sentiment Survey

savills

Continued volatility in global economic indicators has placed pressure on UK occupational and capital markets, meaning that we expect to see less development occur. Whilst pressure remains to deliver new or refurbished space that meets or exceeds ESG requirements it is likely that we will start to see construction prices stabilise and, in some cases, start to fall

SIMON COLLETT, HEAD OF PROFESSIONAL SERVICES

Early signs of price stabilisation

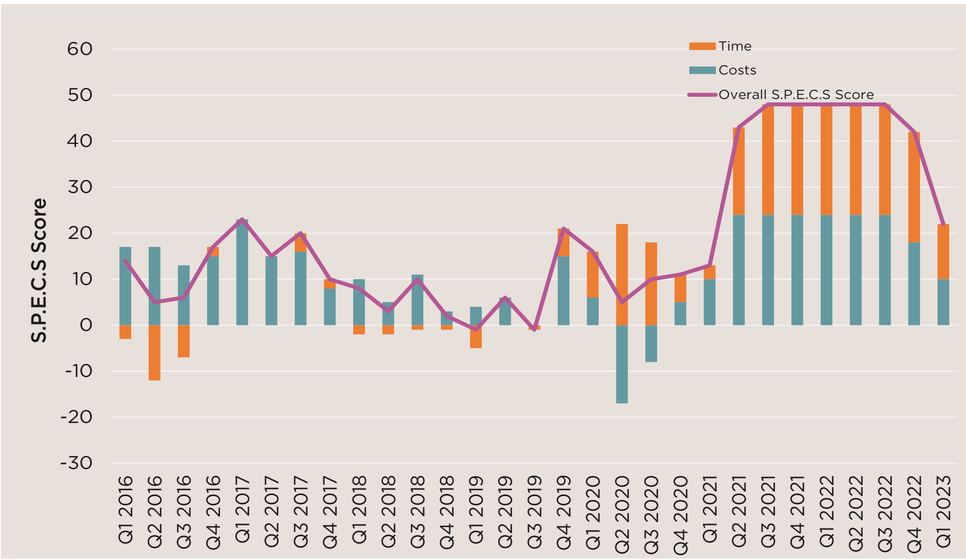
Economic data in the UK remains volatile and unpredictable as recently demonstrated by two recent announcements. Firstly, revised forecasts from the IMF suggest that it is likely that the UK will avoid recession in 2023 and instead post growth of 0.4%, a significant upgrade from earlier forecasts which suggested a fall of 0.5%, they did however note that inflation remained "stubbornly high". This was demonstrated by the recent announcement from the ONS stating that CPI fell less than expected to 8.7% meaning the UK now has the joint highest inflation in the G7.

These indicators would suggest that a further rise in base rates is inevitable meaning developers and investors will be questioning the viability of proposed schemes. Indeed, in many sectors we have already witnessed a fall in development activity. For example, the logistics sector has seen speculative development announcements fall by 66% when comparing 2023 with the same period in 2022.

Contractors are therefore starting to cut their cloth accordingly as we are witnessing increasing price competition at the tender stage and some projects completing under budget, albeit these are projects at the higher value end where greater margin is available.

This is reflected in our latest S.P.E.C.S index with a score of 22 which is the lowest score since Q1 2021. This suggests that we are now seeing stabilisation in some sectors, although this is not uniform, both in terms of project costs and timescales. With development activity expected to remain constrained, on the whole, it is likely that we will see further stabilisation as the year progresses.

S.P.E.C.S Q2 2023



Source Savills Research

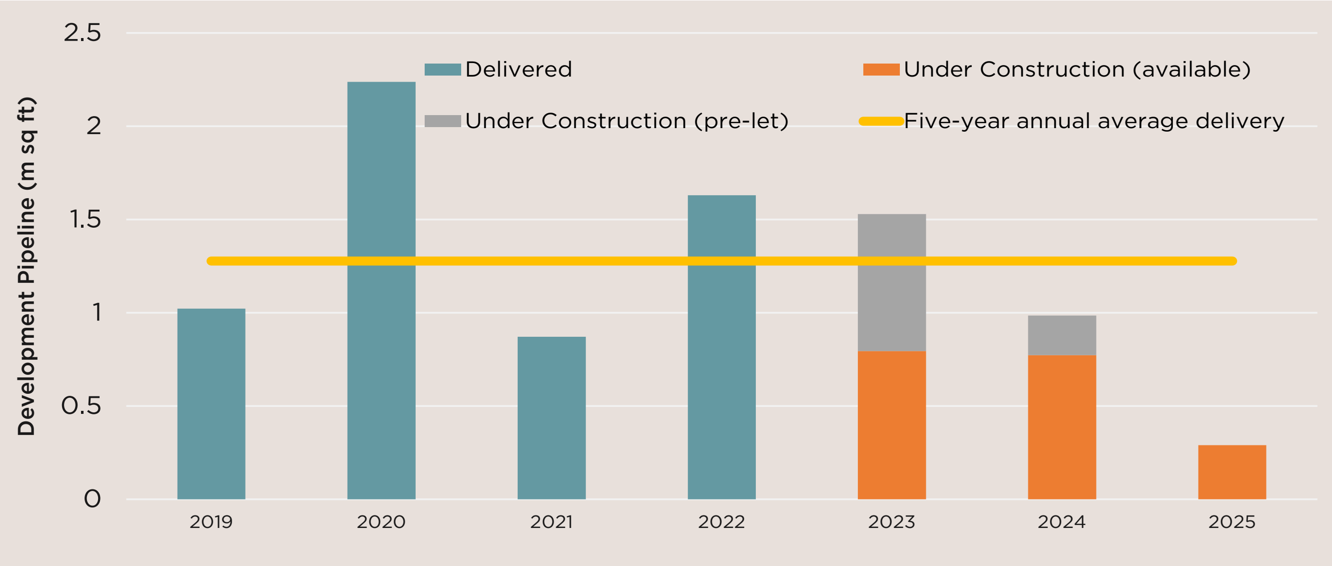
Q2 2023 S.P.E.C.S Indicators

	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.

LATEST IMF FORECAST SHOWS 0.4% GDP GROWTH IN 2023

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



Regional Offices lower than average development pipeline expected

Source Savills Research

Volatile occupier market, rising build costs and a lack of quality supply mean tough decisions ahead

As the impact of Covid-19 as a public health emergency fades into the distance, the impact on property markets is still to be determined as corporate office occupiers still wrestle with agile working policies that will, in time, have an impact on the make-up of the UK's office stock.

Whilst structural drivers, such as agile working policies, remain key in terms of right-sizing future office developments, there remain further drivers in the here and now that are having a key impact.

Firstly, 80% of the office stock in the UK currently has an EPC of Grade C or below. Bearing in mind that all EPCs, by law, will need to be Grade B by 2030, this creates a pressing issue when considering new development and refurbishments of existing stock.

Secondly, it is also important, particularly in times of economic stress, to examine the market more fundamentally and examine the core variables around supply and demand.

For the 'Big Six' office markets (Birmingham, Bristol, Edinburgh, Glasgow, Leeds and Manchester), take-up in the first quarter of 2023 reached 880,000 sq ft, which is 15% below the five-year Q1 average. However, 2022 as a whole reached just over 4m sq ft, which is on par with 2021 - but scratching the surface of this data shows some interesting trends. For example, whilst the total level of space transacted has fallen, we have observed that the total number of deals signed in 2022 was actually higher than the five-year average. This means that the average size deal has decreased from 6,000 sq ft in 2018 to 4,200 sq ft in 2022. This correlates with research from Savills that shows that 48% of office movers have decreased their footprint since 2021.

On the supply side, the availability of prime office stock remains acute. Indeed, five of the Big Six markets currently have less than one year of supply of prime offices and the development pipeline remains constrained. Based on our research, we are expecting deliveries to fall below the long-term average of 1.3m sq ft in both 2024 and 2025, suggesting that take-up is set to be constrained by a lack of supply in the near term.

The latest data from our S.P.E.C.S index shows that build costs and project timescales for regional offices are still rising as contractors remain at tendering capacity. We are also observing that increases in the price of materials and labour are testing the viability of new projects and requiring the reassessment of older ones.

As economic conditions continue to have an impact, particularly on investment yields and land values, we are starting to observe a conflict in decision-making which pitches cost, sustainability, time and quality against each other. The longer market uncertainty prevails, it is likely that corporate ESG pledges will start to be tested, which in some cases can already be seen with choices being made around the quality and cost of certain materials.

However, all things being equal, it remains unlikely that development starts will cause an upward pressure on vacancy rates, which, in turn, will continue to mean prime rents continue to rise, which should assist with project viability in many cases.

THE IMPACT OF THE ENERGY CRISIS ON COMMERCIAL REAL ESTATE

New Savills research has identified which sectors are most at risk from rising energy prices. The built environment in the EU accounts for approximately 40% of total energy consumption and roughly 36% of the total greenhouse gas emissions. Furthermore, since the start of the energy crisis in late 2021, around €768bn has been spent on energy support schemes by European governments. The research has found that office and industrial buildings appear to be most shielded from the impact of the energy crisis since energy bills represent a small share of total occupier cost and most increases in energy bills can be passed on to customers. However, data centres and life sciences are most exposed to higher energy bills since they require large amounts of energy to operate and have fewer options for alternative energy sources. Retailers may have options to pass cost increases to consumers, but they may prove to be difficult when inflation is straining household budgets.

For more insight on this topic and to download our research please visit here.

Savills team

Please contact us for further information

Simon Collett
Head of Professional Services
0207 409 5951
scollett@savills.com

Kevin Mofid
Director
Commercial Research
0203 618 3612
kmofid@savills.com