UK Commercial – July 2023

MARKET IN MINUTES

Savills Research

Market in Minutes

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Pricing uncertainty

Several sectors saw a 25bps upward trajectory of prime yields in June, with eleven sectors expecting further upward movement in the coming months and no sectors expected to see yield compression in the short term. This moves the average prime yield to 5.80%; almost 100bps higher than 12 months ago. Despite pricing concerns this is equivalent to the long term average.

In June interest rates reached 5% for the first time since 2008, with the BoE making a 50bps increase in order to try to curb inflation. Many investors expect rates to reach 6% by the end of the year and although several sectors now look good value, with sentiment for further outward yield movement, there is less incentive to buy now and many potential vendors are deciding to hold at current pricing levels.

This uncertainty continues to constrain investment volumes across all asset classes, but transactions remain above GFC lows. UK commercial investment is expected to be down -40% compared to the average point at H1 over the last 4 years, with volumes broadly in line with 2020.

To put context on why market uncertainty is reflecting in a slowdown in activity, last month Savills ran a survey to lenders and investors to gauge a sector-by-sector view on where pricing would go to over the next 6 months. The results articulate clearly the challenges faced when trying to agree a position on pricing. There is typically a 30-40% spread for most sectors, reflecting wildly different perspectives on whether prices are expected to rise or fall.

With fewer assets coming to market and transactions taking longer than usual, in a relatively volatile market environment this adds to the pricing uncertainty. The question many owners will be asking themselves is why sell now if they don't need to? Pricing to a new floor, or at the very least stabilising for a few months would remove some of this uncertainty, with the spread needing to narrow significantly in all sectors, even where there are adequate transactions to provide a realistic view on valuations.

Savills prime yields

	June 2022	May 2023	June 2023
West End Offices	3.25%	4.00%	4.00%
City Offices	4.00%	5.00%	5.00%
South East Offices	5.25%↓	6.50%	6.50%↑
Provincial Offices	4.75%↓	5.75%	6.00%↑
High Street Retail	6.00%↓	6.50%	6.50%↑
Shopping centres	7.50%↑	8.00%↑	8.00%↑
Retail Warehouse (open A1)	4.75%	5.25%	5.50%↑
Retail Warehouse (restricted)	4.75%	5.75%	6.00%↑
Foodstores (OMR)	4.25%	5.00%	5.00%
Ind/ Distribution (OMR)	3.50%↑	4.75%	5.00%↑
Industrial Multi-lets	3.50%↑	4.75%↓	4.75%↑
Leisure Parks	6.75%↓	7.00%	7.25%↑
London Leased (core) Hotels	3.50%	4.25%↑	4.25%↑
Regional Pubs (RPI)	5.25%	5.75%	5.75%↑

Source Savills

Key Stats

5.8%

5.8% - UK average prime yield edged slightly higher in June

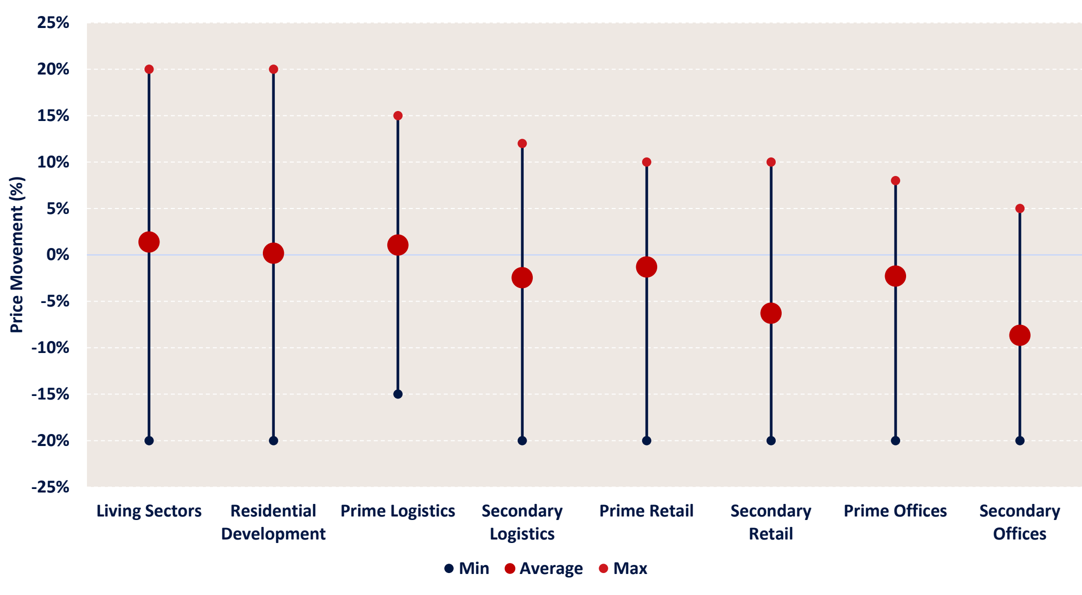
5

5 - number of sectors seeing 25bps upward prime yield expectation

-40%

-40% less commercial investment than H1 last 5 years

Landlords and investors are divided in their expectations of where prices will move to in the next 6 months, with a 30-40% spread in most sectors



Source Savills,

We are yet to see the cost of living crisis dampen retail occupational demand in core locations

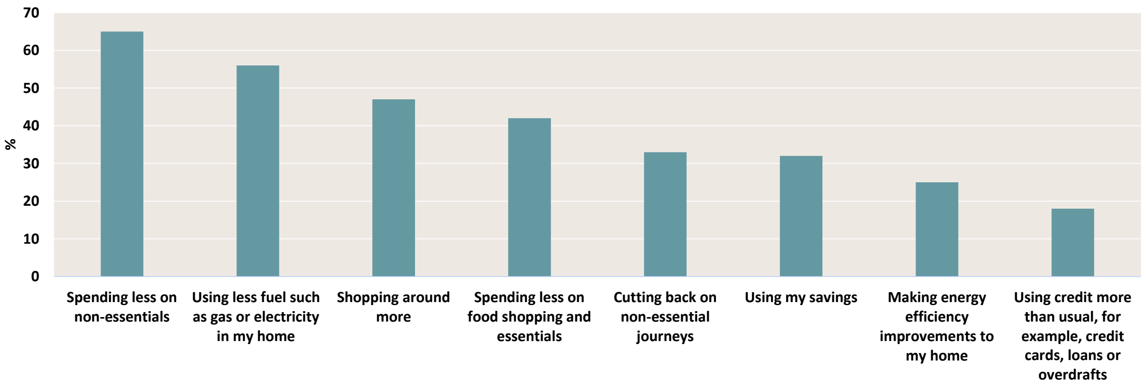
Occupational costs have come down thanks to April's business rate revaluation, a reduction in energy prices and a rebasing of rents, but the hangover from the cost-of-living may still bite as consumer's budgets continue to tighten.

Food inflation in the UK has slowed, but is up nearly 15% yoy; 2/3 consumers are spending less on non-essentials goods and 1/2 of consumers using less energy in their homes and buying less food; average pay has fallen in real terms. The impact of rising mortgage rates may impact fewer homes proportionately than other consumer costs, but with renewal rates now at 6% their effects are likely to have a prolonged impact on budgets; 40% of adults already have difficulties paying their mortgage or rent and 25% consumers report borrowing more or using more credit.

None of which encourages consumers to make more shopping trips or head to the office than is necessary and if people are reducing journeys this should dampen occupational demand in those markets. And yet in June, retail sales grew by 0.3% - ahead of market expectations. A cost-of-living impact in the retail sector has been anticipated for over 12 months, but has yet to result in a tipping point in the occupational markets.

In fact so far in 2023, the number of stores affected by CVA or administration has only been half the equivalent period within the 10-year average. National retail vacancy has held at 14% for the last 3 quarters, though long term vacancy has increased. For the best retail pitches and within the retail warehouse sector, rates are below 4%. So we're seeing strong occupational demand in core locations, reflecting the continued trend of 'flight-to-prime', localism and convenience. Despite ongoing challenges elsewhere the market is 'holding up'; closure of independent retailers are so far just 10% of the full year average of the last 5 years, while a more affordable environment is opening up pitches to new occupiers.

Consumer response to the cost of living crisis - June 2023



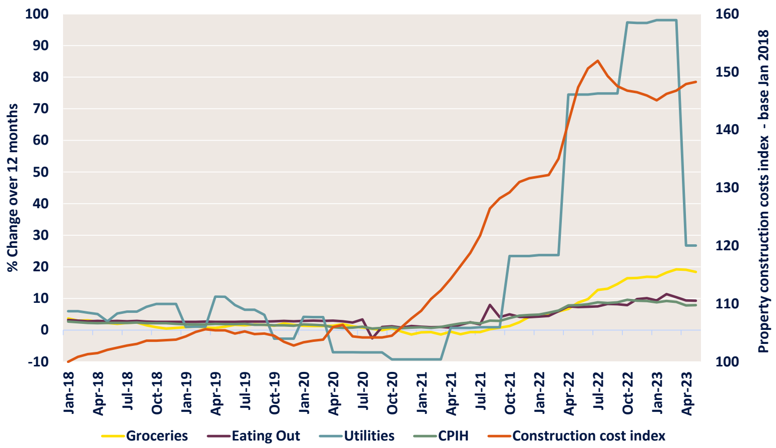
Source ONS

Redevelopment viability is affecting shopping centre investment activity, but buyer appetite remains if there is good income return

Inflation is also impacting the construction sector, where costs rose by 4.7% yoy in April, due to material and labour cost and availability. Costs have stabilised in recent months, but remain 50% more than pre-pandemic levels. Much has been discussed about the need to repurpose shopping centres, but construction inflation is hampering viability. Over the last few years, SC transactions sold on the basis of development potential have accounted for 44% of transactions. In 2023, this has reduced to below 20%. This doesn't indicate a reduction in the amount of redevelopment needed, but it is delaying schemes being brought to market. Conversely and despite headwinds, resilient retail occupational markets in core asset classes and locations means that landlords are starting to look to income returns rather than capital gains in their breakup and redevelopment strategies.

Despite the narrative of a sluggish investment market, we're seeing money looking at the UK that is more sector agnostic and not afraid to look at a long term view on secondary stock. This plays well with the repurposing story and the creation of more diversified use classes as the market returns, with conversion to alternative uses having a positive impact on broader occupational demand. Just as we have seen department store conversions transform tired pitches in the retail sector, we're now seeing interest from education sectors leasing office space as student numbers increase, which in turn benefits the demand for student housing and rental properties in those locations.

UK household costs inflation & construction cost index



Source ONS

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