UK Commercial – June 2023

UK Regional Office Investment Market Watch

savills

Investment activity muted amidst lack of prime opportunities

The demand for prime assets across the regional office market has been resilient, with these types of opportunities attracting good levels of investor interest. This was highlighted by the recent sales process of Halo, Bristol and Building 2 Ruskin Square, Croydon, demonstrating the investor demand for assets that have experienced high levels of tenant demand with strong ESG credentials. This trend has been reflected in the pricing of best-in-class assets with the prime regional office yield moving by 25 basis points from the start of the year. The prime yield currently stands at 5.75% and there had been signs of stabilisation in the market with the prime yield remaining at that level for the last three months. The Bank of England's decision to raise the base rate by 50 basis points to 5.00% has however created uncertainty on pricing in the short term.

Whilst there is demand for prime assets, there has been a lack of these types of opportunities brought to the market which is evident from the low levels of investment activity. Turnover was 55% below the long-term average in Q1 2023 and provisional figures show that investment volumes were 66% below the long-term average for the first half of the year across the regional office market, highlighting the current investor inertia present in the market.

Regional Office Yields May 2023

	Year	Prime	Secondary	Spread
Birmingham	May-23	5.75%	7.50%	175 bps
	May-22	5.00%	6.75%	175 bps
Bristol	May-23	5.50%	7.50%	200 bps
	May-22	4.75%	6.50%	175 bps
Cardiff	May-23	6.25%	9.00%	275 bps
	May-22	5.50%	8.50%	250 bps
Edinburgh	May-23	5.75%	8.00%	175 bps
	May-22	4.50%	6.25%	175 bps
Glasgow	May-23	6.00%	8.50%	250 bps
	May-22	5.00%	7.00%	200 bps
Leeds	May-23	6.00%	8.75%	275 bps
	May-22	5.00%	7.50%	250 bps
Manchester	May-23	5.50%	7.75%	225 bps
	May-22	4.50%	6.50%	200 bps
M25	May-23	6.50%	10.00%	350 bps
	May-22	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

Key Stats

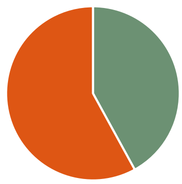
5.75%

Average prime regional office yield

£

£799m

Office investment volumes outside of central London at the end of Q1 23



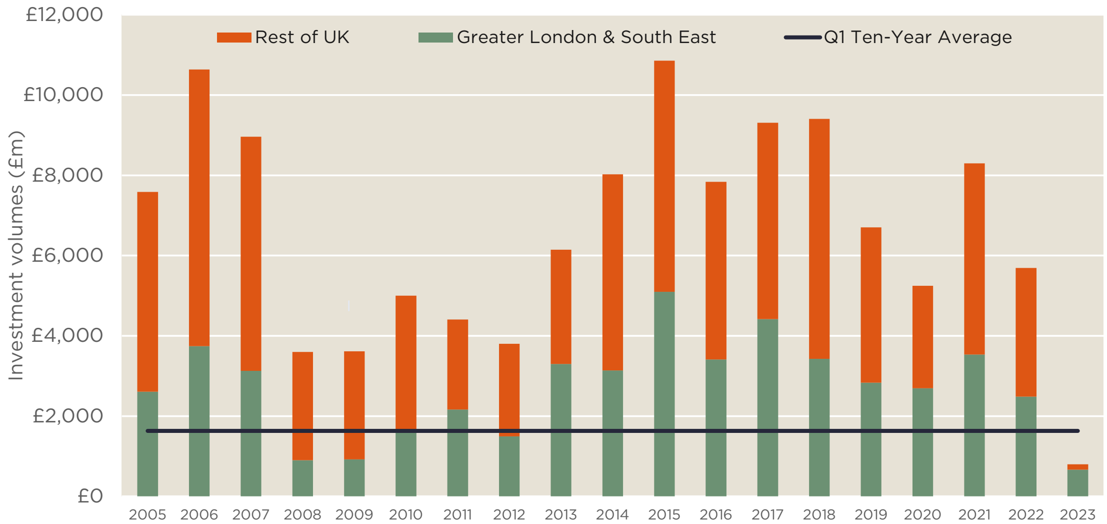
55%

Investment volumes in Q1 23 were 55% below the long-term average for the first quarter

72%

The number of deals below £10 million in Q1 23

Office investment volumes Total turnover recorded in Q1 2023 was 55% below the long-term average



Source Property Data/Savills

The pricing correction has been more stark when compared to previous downturns

There has been a significant repricing of assets across the regional office market with values correcting faster than previous downturns amidst rising interest rates and the wider economic uncertainty.

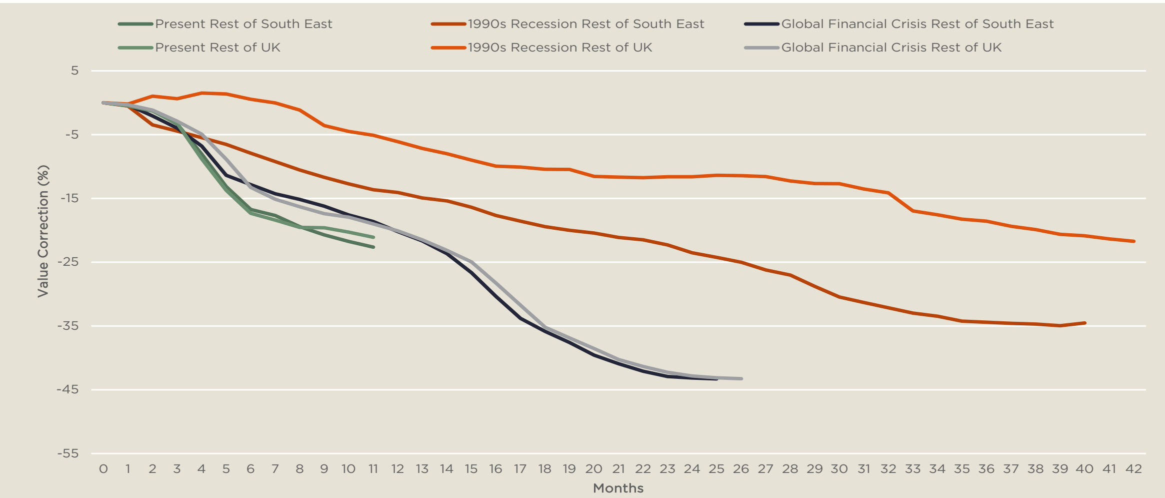
This trend is illustrated in the chart below which reviews the MSCI capital growth index for "Rest of UK" offices and "Rest of South East" offices. Values have fallen by 21.1% and 22.6% across both indexes in the last 11 months. The same levels of pricing correction took 13 months during the Global Financial Crisis and over two years in early 1990s recession, highlighting the rapid change in sentiment amongst investors.

The lack of investment activity in the market can be primarily attributed to a mismatch in pricing expectations between purchasers and vendors. Whilst prime yields have softened by 25 basis points since the start of the year, given the flight to quality occurring in the regional office market, the valuations of non-prime offices are lagging market sentiment.

The Bank of England's decision to raise the base rate to 5.00%, the highest level since 2008, will place further pressure on values for this type of product with secondary assets more reliant on lender finance.

Purchasers of non-prime offices have been seeking significant discounts to counteract higher refurbishment costs to satisfy tenant requirements and environmental standards. There have been assets that have traded at discounts in excess of 30% which will have to become more frequent to simulate further investment activity across the market.

Price correction Values across the regional office market have corrected faster than previous downturns

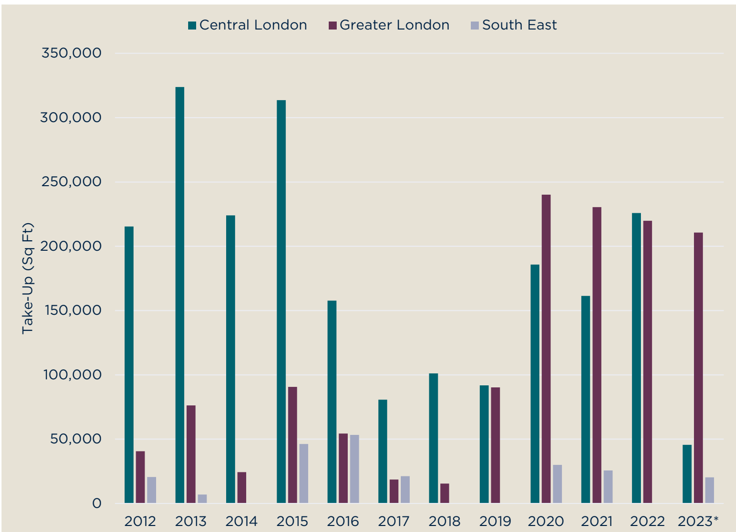


Source: MSCI

There has been an acceleration in office leasing activity from education occupiers notably in the Greater London & South East region in 2023, which was revealed in our recent Spotlight report. Take-up recorded by the sector reached 277,000 sq ft at the end of May which is the highest total in the last three years at this stage of the year. This follows annual take-up surpassing 400,000 sq ft each year since the start of 2020 which previously had only occurred twice from 2012-2019.

The growth of the sector has been underpinned by an increase in student numbers with UCAS reporting that applications to study in the UK reached record highs in three consecutive years from 2020-2022. This trend is set to continue with UCAS forecasting a 30% increase in higher education applications to reach one million people by 2030.

Education Sector Expansion The sector has been expanding its footprint as student numbers increase



Source Savills Research *As at end May

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