UK property update: H1 2022

September 2022

Synopsis

At the start of 2022, the outlook was positive for UK real estate. Tenant and investor demand were showing good signs of recovery following the pandemic and all sectors had improved over the previous 12 month period.

The momentum in the market changed at the end of Q1 2022 following the outbreak of war in Ukraine which exacerbated a number of economic headwinds that were already starting to affect the market, in particular inflation with the additional impact of the war on global energy costs.

The real estate sector was also starting to struggle with post pandemic supply chain issues and raw material availability. This has prompted significant construction cost inflation which is impacting the supply of new stock due to viability issues.

Most sectors have been impacted by this shift in construction cost inflation and it is only the industrial/distribution and residential markets where this feature has yet to significantly slow the supply of new accommodation.

A recent RICS survey has confirmed that the issues of Ukraine, inflation and rising build costs have replaced Covid as the leading concerns for the market.

Higher interest rates are also impacting the market and, in combination with the above factors, are likely to result in a reduction in volumes of investment trading during the remaining months of 2022 and 2023.

Some sellers are withholding planned disposals in the hope that there will be a return to the conditions of early 2022. This seems unlikely, and ultimately sellers may be forced to dispose of real estate over the next 18 months as an increase in loan to value ratios starts to bite and greater liquidity is required.

FIGURE 1: IPD UK MONTHLY INDEX
April 2022 (%)

	INCOME RETURN	CAPITAL VALUE GROWTH	RENTAL GROWTH	TOTAL RETURNS
All property	0.4	1.3	0.3	1.7
Office	0.4	0.3	0.1	0.6
Retail	0.5	1.5	-0.1	2.0
Industrial	0.3	2.0	0.9	2.2
Residential	0.4	0.9	0.0	1.3
Hotel	0.4	1.2	-0.2	1.7

Source: MSCI

Purchasers will anticipate higher yields over the next 18 months and it is possible that a yield shift will see some assets fall into the 'redevelopment zone' – this is particularly relevant to office and retail assets where repurposing to residential use remains a possibility.

The two sectors which are likely to prove more resilient are the residential and industrial/distribution sectors. In the residential sector, the long-term imbalance between supply and demand and high employment rates should see continuing activity. The concern is the impact of increasing interest rates and the availability of mortgages which may have a short to medium term impact on the buyer market. Most commentators are anticipating moderate price growth through the remaining months of 2022, but it is likely that this will fall off in 2023.

The industrial and distribution sector has become the main institutional focus for UK investment. Continuing tenant demand, significant rental growth (particularly in the regions) and a structural shift in occupancy away from retail into distribution will continue to attract investor interest. However, economic headwinds and the resultant interest rate shift mean that in all likelihood the yield profile is now past the peak, at least for the time being. There is evidence that yields moved out by c.50bps in July this year, with prime yields moving to c.4.25%. Most commentators anticipate a further shift later this year and prime industrial yields could start to move towards 5%.

Most market data for H1 is skewed by the initial confidence in the market earlier in the year and across the investment and office sectors where a limited number of very large transactions have bolstered the numbers, thereby hiding an overall reduction in market activity as the year progressed. This is particularly relevant to the investment market where transactions such as the sale of 5 Broadgate and Central St Giles Street in London accounted for £2bn of value.

The major area of uncertainty still relates to the retail market. This sector has faced challenges for several years which were compounded by the pandemic and a growing shift towards online shopping. Currently, online sales represent 27% of total retail sales, which is down from its peak during the pandemic of 37.7% but is still well ahead of the pre-Covid figure of 19.7%. However, the location of some retail at the heart of towns and city centres means that there is a 'repurposing' opportunity which developers and investors are now actioning. Public Sector Bodies (Local Councils) are taking an increasingly active role in an attempt to salvage their towns and city centres, and this includes planning and fiscal support. The looming issue for retail is that with reduced consumer spend forecast over the next 18 months, tenant failure is likely to accelerate, placing struggling assets under further stress.

FIGURE 2: UK REAL ESTATE INVESTMENT MOVEMENTS

SECTOR	YIELD (%)	MOVEMENT SINCE LAST MONTH	MOVEMENT OVER LAST 12 MONTHS	TRENDING
SHOPS – HIGH STREET				
Prime	6.25	←→	↓	Stable
Functional towns	8.00	←→	←→	Stable
Secondary	10.00	←→	↓	Stable
SHOPPING CENTRES				
Dominant regional	6.75	←→	←→	Stable
Town centre	8.00	←→	←→	Stable
Secondary schemes	12.00	←→	↑	Stable
RETAIL WAREHOUSES				
Prime parks	4.50	←→	↓	Stable
Secondary parks	7.50	←→	↓	Stable
Solus units	4.75	←→	↓	Stable
Foodstores – supermarkets	3.50	←→	↓	Stable
LEISURE				
Leisure	7.25	←→	↓	Stable
OFFICE				
City <£40m	3.75	←→	↓	Stable
City £40m–£125m	3.75	←→	↓	Stable
City >£125m	3.75	←→	↓	Weaker
West End <£40m	3.50	←→	←→	Stable
West End £40m–£125m	3.50	←→	↓	Stable
West End >£125m	3.50	←→	↓	Stable
OFFICES				
Greater London area preferred	5.00	←→	←→	Stable
South East prime	5.25	←→	←→	Stable
Regional city prime	4.50	←→	↓	Stable
Sub regional city prime	5.75	←→	←→	Stable
LIFE SCIENCES				
Life sciences prime	3.75	←→	↓	Stable
INDUSTRIAL / LOGISTICS				
Regional single let	3.50	←→	↓	Stable
South East single let	3.25	←→	↓	Stable
London single let	3.00	←→	↓	Stable
Regional multi-let	3.75	←→	↓	Stable
South East multi-let	3.50	←→	↓	Stable
London multi-let	3.00	←→	↓	Stable
ALTERNATIVES				
Car showrooms	5.00	←→	↓	Stable
Self storage (prime)	4.75	←→	↓	Stable
Hotels – London prime (20yrs)	3.75	←→	↓	Stable
Hotels – Regional prime (20yrs)	4.25	←→	↓	Stable
JLL PRIME YIELD*	4.40			
MONEY MARKETS – AS AT 21 JUNE 2022				
UK SONIA Rate	1.19	↑	↑	
SONIA 5 Year SWAP Rate	2.88	↑	↑	
Gilt 10 years	2.26	↑	↑	
Base rate	1.25	↑	↑	

Source: 2022 Jones Lang LaSalle IP, Inc. *JLL, 1 June 2022. For indicative purposes only.

Sector analysis

OFFICES

London
In the first 3 months of 2022, 2.4m sq ft was let across Central London. This was the strongest quarter since 2018 and was slightly above the 10 year Q1 average of 2.3m sq ft.

The professional services sector was the most active during the quarter, followed by banking and finance, which between them accounted for over 50% of take-up.

Landlords are expanding existing 'flexible space' businesses in response to an increased demand from corporate tenants for shorter leases and greater agility.

South East
Outside London, in the rest of the South East, the market has been far more challenging. Life Sciences continues to be a popular sub-sector with London, Oxford and Cambridge (the 'Golden Triangle') performing well and attracting interest from international capital.

Secondary locations have been impacted by the price of raw materials and construction cost inflation. The viability of potential refurbishment has come under pressure, particularly as rents are only increasing for the very best stock.

Regional
The combined occupier take-up across major UK regional cities in H1 was 2.5m sq ft. This is up 18% over the previous 12 months but is still 7% below the 10 year average.[1]

Vacancy rates across the major UK regional cities have increased from 7.2% to 8.3% over the 12 month period and the amount of Grade A space has remained stable at about 3m sq ft.[2]

Construction cost inflation and interest rate changes are likely to stifle new starts during 2023. This is likely to be matched by a softening in occupier demand with the expectation that the availability of Grade A space remains reasonably static.

Headline rents across the major regional cities continue to grow. The UK Cities Rent Index shows an increase of 3.3% over the 12 month period with eight of the ten major UK cities recording a rise in prime rents.

Bristol and Edinburgh have recorded the highest increases with headline rents of over £40 psf. Manchester, arguably the biggest market, is still at around £35 psf headline rent although this location may see more rental growth than other major cities over the next five years.[3]

INDUSTRIAL

Take-up increased by 30% from Q1 2021. This was a consequence of companies taking space to accommodate greater stock levels due to supply chain issues.

Logistic service providers account for the largest portion of take-up at 39%, overtaking retailers at 35% which had previously dominated the market during the pandemic. The largest amount of available supply is in the South East, which has 30% of the vacant stock. Rental levels have continued to grow, with 19% year on year growth in the 'Big Box' market. Investors have focused on rental growth opportunities in this sector and regional markets, where rentals are still sub £10 psf, may offer better long term rental growth prospects.

As in other sectors, construction cost inflation is a concern which is affecting the development pipeline. This is particularly relevant in the 'Big Box' market where bespoke specifications are required, which further inflate construction costs.

Land availability for new development also affects the pipeline of new schemes. Distribution schemes are land hungry, and the supply of land is finite. This is pushing developers and occupiers to seek new solutions for their distribution needs which now includes developing real estate over more than one floor.

Whilst investor demand for distribution assets has outstripped other sectors, there was a noticeable shift in sentiment towards the end of H1. This was fuelled by a number of factors, including a withdrawal from the market by a number of US private equity funds and profit warnings from Amazon. The market view is that yields softened by c.50bps in July and are likely to soften again in the face of rising interest rates.

The yield differential between prime and secondary distribution real estate has tightened over the last two years. This has been caused by a lack of investment supply. If there is a repricing exercise in the market, it is likely that the weakening of yields in the secondary sector will be greater than in the prime asset sector.

RETAIL

The difficulties facing the retail market, caused largely by a shift in consumer habits continue to depress the market.

H2 2022 will see inflation hit disposable incomes to a level not seen in a generation and it is likely that this will continue through much of 2023. This will inevitably have an effect on tenant failure in the retail sector, occupational take-up and investor sentiment.

Investment volumes reached £1.242 bn in Q1 2022, slightly up on the previous 12 month period. There was a marked increase in shopping centre investment which suggests that investors are taking the view that the market for these assets had 'bottomed out'.

ESG considerations are becoming increasingly important to investors and lenders. Retail schemes with weaker ESG credentials are becoming less saleable and more difficult to finance.

The peak in investor activity at the start of 2021 was likely driven by the potential for town centre retail locations to be repurposed for residential use in the medium term. A further downturn in the market for retail assets is likely to accelerate redevelopment/ repurposing initiatives.

ALTERNATIVES MARKET

Hotels
Interest in hotels with investment grade covenants increased throughout 2021 with Pension Funds being particularly active in this sector.

Interest has continued in H1 2022 and there is a lack of stock in the market. However, hotels with investment grade leases generally have rent review mechanisms subject to CPI of 0-4%. This means that inflation is out-pacing rental growth and it is likely that there will be a softening in pricing over the next 12 months.

The secondary market is challenging, particularly those properties with weak covenant strength occupiers or which are over-rented. As an example, there seems little interest in Travelodge assets and this market dynamic is likely to continue for the foreseeable future.

Car showrooms

Whilst 2021 saw some improvement in this market, showing improvement from its difficulties during the pandemic, 2022 and 2023 are likely to be difficult for this sector as consumer spending tightens.

The best assets (in terms of location and covenant) continue to attract investor interest. Manufacturers and dealers are rationalising their property portfolios and divesting of the less attractive secondary locations. New entrants into the market have absorbed this stock, but it is likely that vacancy rates will increase over the next 12 months.

The best car showroom assets are still attractive to investors, largely as a consequence of long-dated income, index linked reviews, and strong covenant. This has resulted in a sharpening of prime yields since 2020. Conversely, secondary yields continue to move out due to concerns regarding re-letting prospects in the event of tenant failure.

RESIDENTIAL

The supply and demand imbalance in the UK residential market continues and it is reasonable to expect this sector to out-perform other property sectors over the next two years.

Annual house price growth remained in double digits at the end of H1 2022, but there were signs that the economic headwinds affecting the UK market were starting to impact on the residential sector. The RICS Sales Expectation Index fell to a 17 month low in June, meaning that activity may slow significantly in the coming months.

Rising interest rates and therefore mortgage rates, combined with concerns over inflation (particularly energy cost inflation), is likely to erase some capital growth in the residential sector over the next year. Across all London and regional residential markets, capital growth in 2023 is forecast to flatten off. 2024 is forecast to have a significant bounce back with positive capital growth at 1.5% in London and up to 4% in some regions.[4]

The 'super prime' London market has had its strongest half year since 2006. There were 294 transactions for £5m+ properties in London. There was a significant up-tick in the number of £10m+ transactions with a 41% increase on H1 2021.[5]

Traditional prime central London areas continue to dominate and account for over 50% of all £5m+ transactions.[6]

Whilst the super prime sector will inevitably be impacted by the economic difficulties that the UK is facing, it is a sector which is likely to continue to perform. Domestic buyers continue to dominate sales and this market is less reliant upon debt and therefore is unlikely to be affected to the same extent by interest rate shifts. However, unless there is a return to the market of high net worth foreign investors, capital growth will be moderate.

Build to rent market

Whilst inflation and interest rate changes will adversely affect the buyer market, it is anticipated that occupiers will turn to the rental market as a short to medium term solution for their housing needs. There has been significant growth in this asset class over the last five years with increasing institutional investor interest.

Whilst the capital value of residential property is likely to flatten in 2023, rental levels are forecast to continue rising. UK rental growth for 2022 is forecast at 5.5% overall, falling to 3.7% in 2023.[7]

Whilst there has been a shift towards professionally managed, purpose-built living assets in city centres, institutional scale Build to Rent assets remain a minor part of the private rented sector. Institutional scale investment in this sector can be defined as 200+ units, offering on-site facilities (gymnasium, co-working area etc). These assets generally have a capital value exceeding £30m.

As an investment asset class in its UK infancy, the Build to Rent market remains interesting. It is the fastest growing sector in UK real estate and has the potential to increase materially if USA levels of market penetration are achieved.

Circa £2.5bn was invested in the UK Build to Rent market in the first six months of 2022. A lack of stock is driving investors to forward fund in an attempt to secure stock.

So far, investor appetite has not been adversely impacted by economic and geo-political uncertainty. The UK offers attractive yields compared to other European markets and UK residential is more sheltered from the consumer spending squeeze (on the assumption that tenants will pay their rent before spending more on non-essential items).

Investment into housing can support ESG strategies, particularly where repurposing of assets is the route to creating stock.

Yields compressed during H1 2022 with prime London Build to Rent yields at 3.25% and prime regional Build to Rent at 3.75%. The yield differential between London and key regional markets such as Manchester and Birmingham is starting to narrow as investors seek stock around the UK.[8]

Over the next five years it is likely that rental growth will outpace house price inflation.

Like other sectors, the development of new Build to Rent schemes is being adversely affected by construction cost inflation and until prices stabilise there will continue to be an imbalance between investor demand and the development of new stock.

Endnotes

[1] Knight Frank
[2] Knight Frank
[3] Knight Frank
[4] Savills
[5] Savills
[6] Savills
[7] Savills
[8] Savills

Notes

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