Vail Williams

Property Investment Report 2023

*Sources: Vail Williams' transactional information, PropertyData, CoStar

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Summary

As we head through Q2 of 2023, it is hard to comprehend where we are in the property market cycle.

Before the commencement of the war in Ukraine, the investment market looked to be stabilising and we saw the beginnings of a more solid economic footing after two years of global distress. Indeed, there was almost a cautious sense of optimism in the air.

Twelve months on, and we have seen the coming together of Brexit, the ongoing effects of the pandemic, high inflation, the cost-of-living crisis, interest rate rises and the war in Ukraine, to create the perfect investment market storm.

As a result, we have seen yields push out and caution return to the property investment market, but there are signs that positive shoots are starting to emerge.

Inflation reduced in March, investor confidence is starting to strengthen and there was an increase in office uptake nationally by over 65% last month.

Whilst some commercial property investors feel we have reached the "bottom" of the market, others continue to wait for even greater distress, providing more buying opportunities with the potential to deliver greater return on investment in the future, especially on the Federal Reserve rate rise to 5 - 5.25%.

> *"Inflation reduced in March, investor confidence in starting to strengthen and there was an increase in office uptake nationally by over 65% last month."*

So, what can we expect for the remainder of 2023? We explore this, and more, in our latest investment market report.

If you would like to discuss any of the information in it, or a prospective acquisition or disposal, do get in touch.

Our team of regional agents based across the country, together with our investment, lease advisory, valuation and building consultancy experts, will provide the market insight necessary to inform your investment decisions.

Richard Dawtrey
Partner, Head of Investment
Vail Williams.

Market snapshot

2023 has already proved to be a challenging year for commercial property investors.

The new Government catchphrase is “we’re back”, but how much of this is bravado, given the current economic reality?

In 2022, nearly 70% of all deals were transacted in the first six months of the year, slumping heavily in the second half.

As a result, property agents struggled to price commercial investments, due to market evidence scarcity.

The war in Ukraine has continued to drive economic woe – both in the UK and wider global markets, directly influencing inflation with the knock-on effect of base rate rises. Until this ends, we will continue to see a volatile investment market.

Of course, there will undoubtedly be buying opportunities as asset values are pushed lower on the back of rising debt costs.

The big question is, has inflation peaked and will base rate rises begin to reverse?

A recent announcement by the Office of National Statistics shows a slight drop in inflation to 10.1% (March 2023) from 10.4% - less than was forecast. This is due, in part, to high food inflation (15.7%).

In May 2023, the Bank of England increased the base rate yet again, to 4.5%.

However, once stabilisation hits, probably towards the end of the year, we expect investment activity to increase in all sectors, as economies grow - assuming there are no further extreme economic or geopolitical events, of course!

Proceed with caution

The phrase of the hour for property investors is to “proceed with caution”.

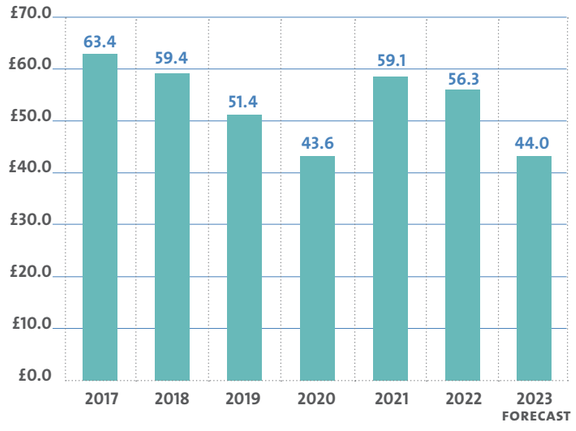
In a rising economy, it is easier to make investment mistakes in a forgiving market. When the market is on a downward trajectory, mistakes and their impact are exacerbated.

Of course, there is nothing wrong with buying in a distressed market, as long as you have programmed in potential losses.

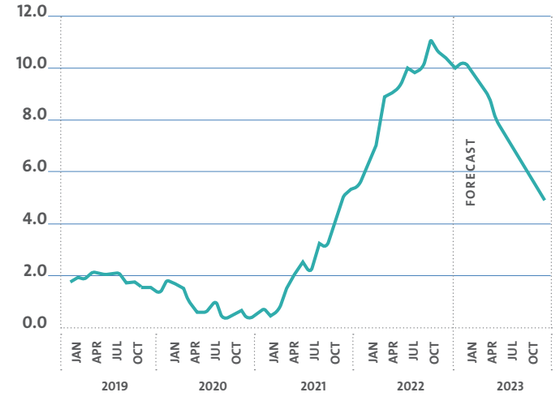
Indeed, many of our clients, especially cash buyers, are taking advantage of these lows to acquire and achieve a greater return, with the potential for capital gains once the market direction shifts back to positive.

Before making an investment decision, however, take time to consider the occupier and their level of stability or stress. Think about the rent and whether it is going up, down or is stable; and consider the sector in the context of long term trends and post-pandemic occupation.

All Commercial Property Transacted by Volume (£m)



Inflation (%)



Many are assuming a predicted intense drop in inflation by the end of the year from March’s rate of 10.1%, resulting in a stabilisation of the base rate which will lead towards its eventual decline.

The difficultly is understanding the extreme set of circumstances required to to get to this level. Looking at UK inflation forecasts, a steep decline is needed, yet there remain few signs that this will occur.

It is, of course, possible - especially when we review how quickly it got to its 41-year high of 11.1%, but one can’t help but wonder whether the world economies have changed enough to meet this.

> *“Many are assuming a predicted intense drop in inflation by the end of the year.”*

Is confidence is returning?

Following the pandemic, some markets, particularly China, opened up their export channels again.

Recent growth in China is hitting 4.5%, with goods now coming into the UK albeit at lower rates than before, as this will take time to filter through.

Energy and fuel wholesale costs are also heading the right way which is positive for the economy.

However, food consumer price inflation (CPI) sat over 15.7% in March 2023, and other goods / materials remain very high, so whether we can get to circa 5% inflation by the end of 2023 is debateable.

This is particularly true following the surprise rise in inflation in February.

There is a question over when the Bank of England will reduce their interest rates when inflation does, eventually, decline. And how long will it be before retail banks pass this on to the customer?

Questions are already being asked about why the banks are not already passing on the significant increase in base rate savings to their customers, so we can only assume that there will be a delay on the mortgage side.

Despite the surprise rise in inflation rate in February, in general terms, and on the back of the Spring Budget, the economy is showing signs of moving towards a more positive position, as nearly every sector of the UK economy powers away from recession.

The Office for Budget Responsibility (OBR) canned its recession forecast, although the economy is still on track to contract by 0.2% this year. Despite this, we expect to see base interest rates start to reduce in 2024 (potentially the end of 2023), to a consistent new level of 3% by mid-2025.

This could even push to 2.75% by the end of that year, where we expect it to stabilise. However, inflation is notoriously hard to predict.

Office market

At the beginning of 2022, we expected a bumper number of office deals with the market appearing to gear up for an active year, with workforces making a gradual return to the office.

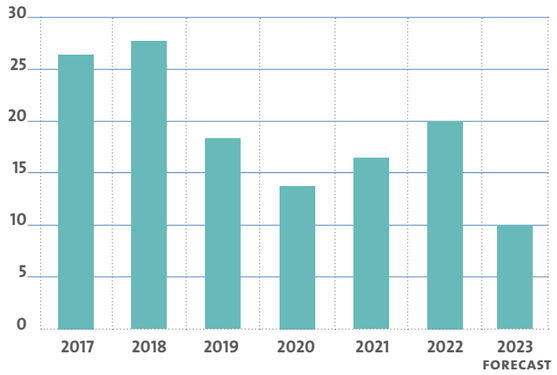
Admittedly, we did see a significant pandemic hangover of caution which stemmed from fluctuating occupancy rates.

However, the signs were looking positive. By the end of 2022, however, the office investment market had fallen to a 10-year low.

Investor appetite had cooled to such an extent, that it was nigh on impossible to find an active buyer.

Those office investments that did sell, were at significantly reduced levels reflecting the new dynamic of the market.

Office Capital Sales Volume (£bn)



We don't believe that the office investment market will fare better than it did in 2022 - even if supported by a buoyant H2 2023. But it will be strongly led by occupier confidence.

Whilst occupational transactional activity has been high in the first quarter of 2023, volumes have been low.

The only trend buckers are those estates enjoying the highly sought-after Life Science market, particularly in the Oxford – Cambridge ARC where occupancy has been growing and yields are stable to low.

Flight to quality continues

It is clear, from strategising with our clients, that employers are seeking affordable but high-quality Grade A accommodation to attract staff back into the workplace.

As a result, this is costing occupiers more money, the cost implications of which are that many are downsizing their office accommodation needs. However, for many, this meets better with their new hybrid workplace strategies.

> *"We don't believe that the office investment market will fare better than it did in 2022 - even if supported by a buoyant H2 2023."*

Investors continue to be attracted by those offices with strong ESG credentials and EPC ratings – particularly with the implementation of MEES Regulations, leading to much more scrutiny of EPC ratings than ever before.

Secondary office yields are continuing to push up with investor appetite remaining thin, flanked by the detrimentally high cost of capital expenditure.

In short, the office market is going to have a challenging time over the next 18 months, whilst corporates determine the extent to which their staff will occupy space going forward – particularly as the cost of refurbishment, with increasing ESG credentials in mind, remains high.

Industrial market

Occupationally, every agent we speak to across the UK says the same thing – whilst demand for industrial premises remains high, supply of appropriate stock is severely lacking.

You might think this means everyone wants to buy industrial land and build out industrial, logistics and warehousing units. Sadly, not.

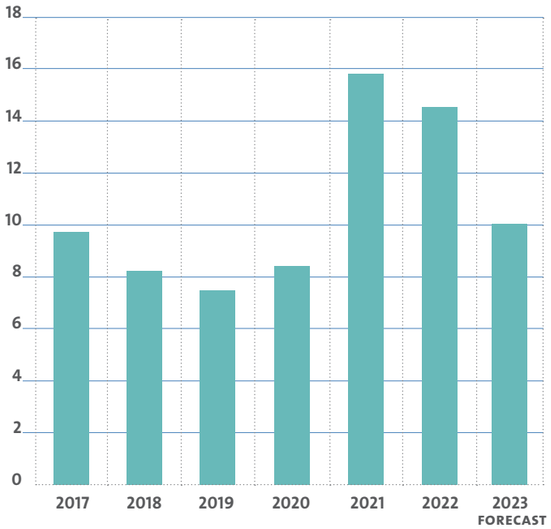
Build cost inflation, due to rising materials and labour costs, together with the pushing out of yields, has made many investors err on the side of caution, despite some materials costs starting to stabilise.

Meanwhile, depending on the region, we have seen some land values drop by over 50%. Many, developers, including big market names, are now playing the development site waiting game.

On the ground, we are seeing a great deal of land banking, with developers holding fire until rents, which continue to grow, catch up with increased yield, to make sites viable again.

Despite this, the capital volume of industrial deals transacted in 2022 was the second highest amount ever recorded, beaten just by 2021.

Industrial Capital Sales Volume (£bn)



As the graph shows, throughout the pandemic, investors continued to deploy more capital into industrial assets – a shift from offices and retail. We expect this to remain the case, albeit to a lesser extent (and despite this market actually declining in value), because occupier demand is such that it remains a relatively safe investment haven.

Of course, the shock of the base interest rate rise has pushed out all yields in the industrial market by just over 1.25% overall, causing investor sentiment to decline.

However, unlike other sectors, we are now beginning to see the yield decline stabilise, and we expect a levelling off to come in the next month or so.

Some agency firms are predicting yield compression to occur in some prime assets with suitable ESG credentials imminently, albeit transactions are thin so proving this will be difficult.

We are forecasting a decrease in capital sales volumes, reflecting the decreased market sentiment. This has been true of the logistics market, where falling occupational demand has affected investor attitude.

This year, we forecast that the main demand will come from supply chain providers looking to improve on lacking or poorly managed occupier systems whilst occupiers take more of a back seat.

Despite this, we believe the fundamentals in this market remain strong and we expect this sector to make a marked recovery by the end of 2023.

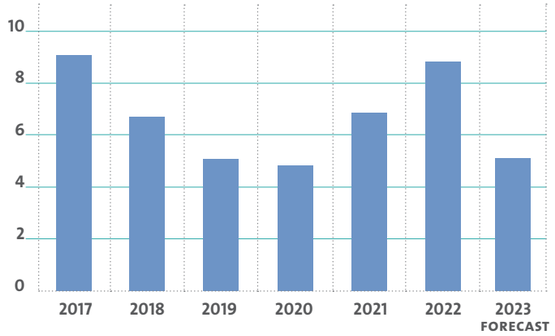
Latest reports also suggest that industrial yields have pushed in by 0.25%, albeit this is off a very limited number of transactions.

Retail market

At the beginning of 2022, it looked like the retail sector had finally turned a corner with some notable transactions sending the retail investment sector up to its five-year high.

However, rising interest rates and the cost-of-living crisis, together with changes in consumer buying to online, have cooled retail investment, putting a dampener on this sector once more.

Retail Capital Sales Volume (£bn)



It is not all bad news though, as some sectors have been more resilient, particularly those that remained open during the pandemic such as convenient stores and supermarkets where yields remain sub 5% regionally and sub-4% in greater London.

High street investments remain in a sensitive market and it is clear that some Councils are now using this opportunity to pursue town centre regeneration or repurposing schemes with delivery partners.

However, investors who remember the closures on the high street during the pandemic and the number of retailers going under once the Government furlough scheme stopped, remain anxious about its future.

We have said that the key to rebuilding the high street is in rebalancing occupation and revisiting the purpose of our town centres, to ensure that any redevelopment or repurposing is done with a researched need in mind.

High street retail needs to provide a less homogenous experience, giving consumers a broader mix of retailers, including independents, with a unique offer tailored to the demographic, to drive footfall numbers.

There is nothing wrong with reducing retailer occupation on the basis of pushing leisure or cafés / restaurants further. What is clear is that retail rents must be affordable, to strengthen profit viability for the investor.

This is particularly true amid business rates revaluation and the impact this could have on business rates viability for retail occupiers, which despite the ailing high street has, in some areas, increased.

Weighted average yields per sector

OFFICES	JAN-22	JAN-23
Prime south-east/ m25 border	5.75% ↓	6.25 – 6.5% ↑
Prime regional	5% - ↻	6.5% ↑
Secondary (good)	6.5% ↑	8% ↑

INDUSTRIAL		
Distribution (prime)	3.5% ↓	4.75% ↑
Estate (greater london)	2.75 – 3% ↓	4.25 -4.5% ↑
Estate (south-east)	3.5 – 3.75% ↻	5.25% - 5.5% ↻
Secondary (good)	4.5% ↓	5.25 – 5.75% ↑
Secondary	5.5% ↓	6.5 – 7% ↑

RETAIL HIGH STREET		
Prime (excluding central london)	6.5% ↑	6.5 – 7% ↑
Secondary (good)	8.5% ↑	9.25% ↑
Tertiary	11.5% ↑	11.5 – 12% ↑

SHOPPING CENTRES		
Prime	8% ↻	8% ↑
Secondary (good)	11% ↑	11% ↑

RETAIL WAREHOUSING		
Park (open a1)	5.5% ↓	6.75% - 7.25% ↑
Park (bulky)	5.5% ↓	6%+ ↑
Solus (bulky)	5.25% ↓	5.75 ↑
Park (secondary)	6% ↓	6.0%+ ↓

↑ Up ↻ Stable ↓ Down

Stick to the investment basics

In any crisis, people will continue to pursue long term stable income.

As businesses return to the workplace, we will see greater demand from office occupiers which will start to return improved yields. Meanwhile industrial assets will remain robust investments amid the ongoing lack of meaningful supply in the market.

With the unexpected rise in inflation in March, and the knock-on effect of this on Bank of England interest rates, it is wise to stick by your investment basics.

Focus on strong locations and do your research into the underlying occupational trends in the market you want to invest in.

As always, don't get drawn into what looks like a 'too-good-to-be-true' deal with high yielding investments, because there is likely to be a reason for that or a potential issue lurking in the background.

Risk and return go hand in hand, so consider your personal risk appetite before considering making an offer.

Finally, explore opportunities to add value and manipulate the investment asset to generate a better return.

Sticking to some of these investment basics whilst getting expert insight into the markets in which you wish to invest in, will help you to make the most of what 2023 might bring.

For support in sourcing the right property investment to meet your needs, contact our property investment experts.

> *"With the unexpected rise in inflation in March, and the knock-on effect of this on Bank of England interest rates, it is wise to stick by your investment basics."*

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