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Real Estate Finance

UK Real Estate Digest

Consensus is not the best ingredient for an active market

Market commentators are increasingly in agreement that we have reached the bottom of the real estate valuation cycle. Yet transactional activity has remained persistently lacklustre. Indeed, the volume of investment this summer has been lower than at any time since the depths of the pandemic. The market was certainly waiting for the first cut to base rate, which has now happened and is expected to be the first of many.

So, when are we going to see the first signs of a revival in the investment market? The paradox currently is that given broad market consensus on the cycle and relative sector attractiveness, most investors are generally interested in buying and selling the same types of assets. As a result, mutually attractive deals are hard to come by. Using Industrial as one example, valuations adjusted very rapidly as yields moved out to reflect the changed interest rate environment.

Yet, with rental values still growing at c6% per annum, and medium-term interest rates now trending downwards, very few owners are prepared to sell at those reduced values. If the investment market expects capital values to recover, and the occupier market is paying you to wait, why sell now? At the other end of the spectrum, would-be office investors are expecting more distressed sales to materialise as refinancing pressures come to bear and therefore feel in no hurry to transact now. Whilst there are plenty of office owners who would be only too happy to sell, they have not reconciled themselves to accepting offers at barely half what they thought their asset was worth a couple of years ago.

From the mainstream commercial sectors this leaves Retail, a sector that has been benighted by weak liquidity for years. The sector continues to divide opinions, and it is for that very reason that it may see the earliest recovery in transaction volumes from currently very depressed levels. Taking retail warehouses as an example, two of the countries largest REITS have taken opposing positions, with British Land buying whilst LandSec sells. Even Shopping Centres, until recently the Gobi desert of liquidity, have attracted a growing minority of opportunists who perceive value in the sector, whilst there are plenty of owners fed up enough to take the other side of the trade.

Commercial Property Returns

According to MSCI, average commercial property capital values edged up by 0.1% in August, and are now only very marginally down compared to the start of the year. Nonetheless, capital values are on average still almost 25% down from the market peak in June '22.

The Office sector has been the weakest performer this year, with values down by 4.9% YTD. Even this figure, masks the extent of decline for some regions. Offices in Scotland are down by an average of 13.2% this year, and those in the Inner South East by 8.5%. In contrast, Offices in the West End and East Anglia (driven by Cambridge) have been far more resilient.

Industrial values have been edging up gradually since March and are on average up 1% YTD. Nonetheless, they remain 26% below their Jun '22 peak. Rental growth remains very healthy at 6.1% year-on-year, and has been fairly steady over the last 12 months. As a result, the average equivalent yield has risen from 4.2% in June '22 to 6.3% today.

The strongest performing segment this year, from a capital value perspective, has been Retail Warehouses, up 2.3% YTD, backed by 0.9% rental growth. In contrast, average shop values are off by 2.8% YTD, despite rental values edging upwards by 0.7%.

Capital Growth to end-August 2024 (%)
Source: MSCI Monthly Index

%	1 Month	1 Month	12 Months	From Jun '22 Peak
All Property	0.1	0.2	-3.8	-24.8
Retail	0.2	0.7	-4.1	-19.3
C London Offices	-0.1	-0.4	-9.2	-26.0
Regional Offices	0.0	-1.6	-13.5	-37.0
Industrial	0.2	0.7	0.5	-26.0

Investment Market Activity

Data from RCA show that £2.1bn worth of transactions completed in August. Even this relatively modest number was flattered by three large "beds" portfolios which accounted for more than half of the total. The cumulative total for the first 8 months of the year is £27.8bn, on a par with 2023, but barely half the total from the same period in 2022.

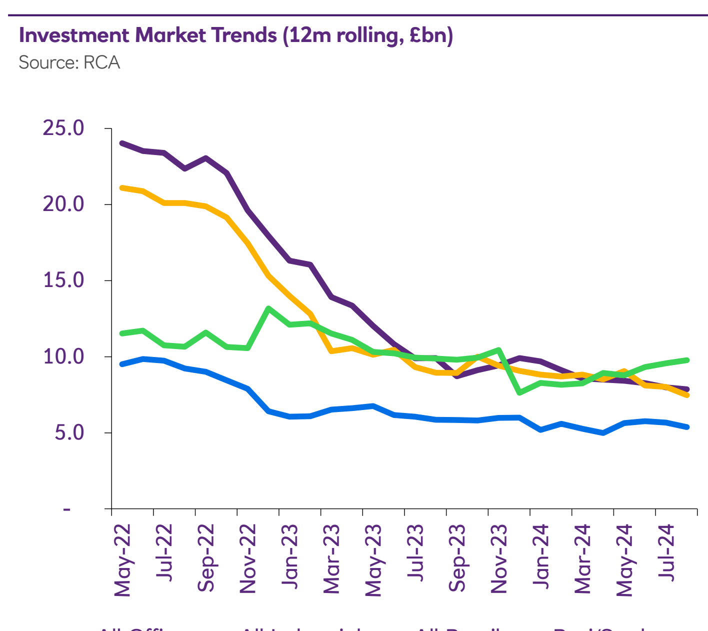
The largest deal to complete in August was the sale by Canadian REIT NorthWest of 14 private hospitals and clinics for around £500m. FTSE 250 listed Assura acquired the assets to diversify their existing portfolio which consists predominantly of GP surgeries.

Blackstone-owned Sage has sold a portfolio of 3,000 shared ownership homes for £405m. The homes were acquired by USS and will be managed by their recently launched Sparrow Shared Ownership. Elsewhere, Starwood sold a portfolio of 3 Marriott Residence Inn aparthotels in Central London, which they first acquired from NAMA in 2015, for £230m.

The largest deal to complete in mainstream commercial sectors was the acquisition of Western Avenue Business Park in Park Royal, West London for £125m, reflecting a net initial yield of c4.25%. The asset, which comprises urban logistics and retail warehouse elements, was reportedly first marketed by vendor DTZ Investors for offers over £100m.

Three interesting Retail deals closed in August. JPMorgan Asset Management bought 291 Oxford Street for £71m (5.8%), the largest single-asset deal on the street in three years. British Land acquired three of the remaining 7 retail parks from the M7 Box+ II Fund for £45m. AEW Europe reportedly sold The Bridges Shopping Centre in Sunderland for £24m (£39/sq ft), 10 years after acquiring it for £145m (£250/sq ft).

Investment Market Trends (12m rolling, £bn)
Source: RCA



Market Yields

The Bank of England's Monetary Policy Committee were almost unanimous in holding base rate at 5.0% in September. Nonetheless, markets continue to expect a steady progression of cuts over the next 18 months. Swap rates imply a base rate of 3.25% by the end of next year, reflected in the five-year Sonia swap which is has moved in from 4% to 3.5% over the last 3 months.

Despite, the decline in financing costs, CBRE report that property yield benchmarks have remained almost entirely unmoved over the last 3 months. Of nearly 60 benchmarks monitored by the firm, just one, prime high street retail, edged down by 25bp. This apparent stability in fact reflects a lack of market evidence, and a persistent gap in the bid-offer spread.

Prime Industrial benchmarks have been entirely unmoved for the whole of 2024, yet investment volumes have been running at less than half the levels of last year. This perhaps reflects a reluctance of would-be vendors to sell when many have called the bottom of the market, and rents continue to rise.

In contrast to the positive consensus on Industrial, there remains a range of views on Retail Warehouses. As a result, there have been both willing buyers and sellers, resulting in more activity and more clarity on pricing. Benchmark yields softened at the back end of 2023, but then firmed up in Spring and are expected to harden further over the coming months.

Benchmark prime yields (%)
Source: CBRE

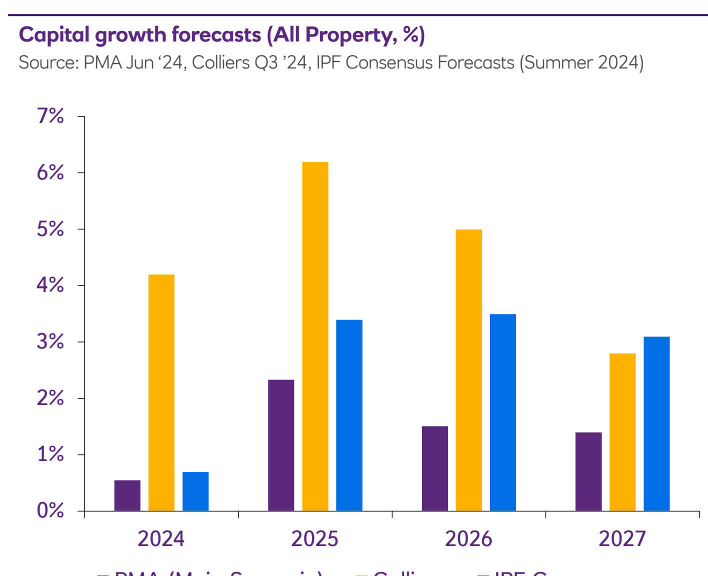
%	Sep 24	Jun 24	Sep 23
Regional City Office	6.50	6.50	6.00
Retail Park (Open)	5.75	5.75	6.00
High Street Shop	6.75	7.00	6.75
Regional Multi-let Ind	5.25	5.25	5.25
Regional Cities BTR	4.35	4.35	4.25
Regional Student (Direct)	5.00	5.00	5.00

Auctions

The Allsop auction in September had the largest book for over a year, with 148 lots listed. However, the total raised of £45m was the lowest for any auction over that period, a quarter lower than the previous auction in July. An unusually high number of lots (35) were withdrawn prior to the auction.

The highest value sale was for an industrial estate in Nottingham, which achieved £4.63m (6.9% initial yield). A freehold shop with offices above on Kensington Church Street sold for £3m (5.3%). In contrast, a freehold car park in Norwich city centre (£5m), a shopping centre in Great Malvern (£3m) and a parade of shops in Greenwich (£2.75m) all failed to sell..

Capital growth forecasts (All Property, %)
Source: PMA Jun '24, Colliers Q3 '24, IPF Consensus Forecasts (Summer 2024)



Market Forecasts

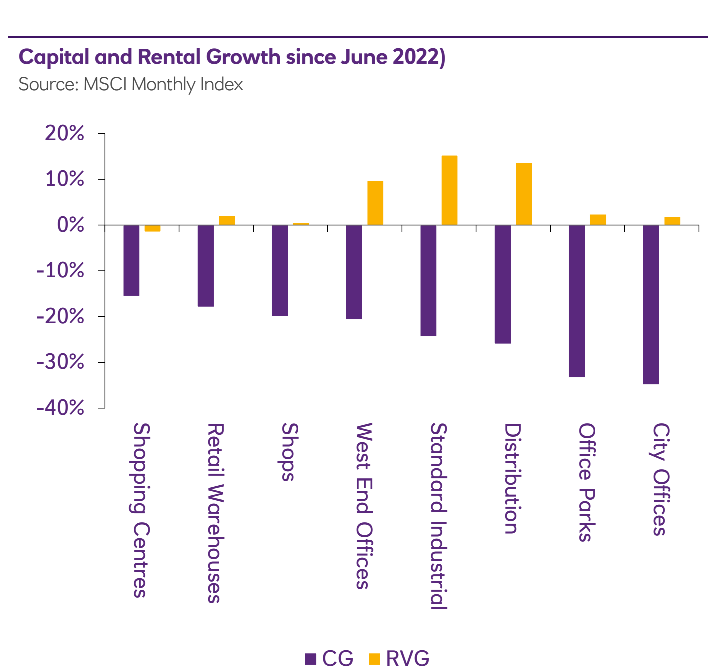
The latest IPF Consensus Forecast, comprising contributions from 16 organisations from July and August, point to increasing confidence that overage property valuations have bottomed out. The consensus capital growth figure for this year (0.7%) implies that the very marginal growth recorded in recent months will continue for the rest of the year.

The recovery is expected to start in earnest from next year, with cumulative capital growth of 13% expected on an All-Sector average basis between 2025 and 2028. The main driver of this growth is anticipated to be rental growth of 2.6% per annum, supporting total returns north of 8% per annum.

All sectors are expected to deliver positive capital growth from next year. Industrials are expected to continue to outperform, with capital growth of 5.1% predicted for 2025, but will be closely followed by Retail Warehouses (4.0%) and West End Offices (3.6%). Shopping Centres (1.5%) and regional offices are expected to be the laggards.

On a 5-year total return basis, Retail has seen biggest improvement in sentiment since the previous quarter. The forecasts for shops and shopping centres have improved by 50bp per annum to 7% and 7.7% respectively, whilst the forecast for retail warehouses has improved by 100bp to 9.5% per annum, overtaking Industrial (8.5% per annum)

Capital and Rental Growth since June 2022)
Source: MSCI Monthly Index



Looking Forward

To escape from the current stagnant investment market, either buyers or sellers need to adjust their expectations to end the stand-off. The good news is that with the broad effects of higher rates having fed through to property values, and those rates now going into reverse, the next phase of the cycle is likely to be characterised by material changes in buyers' perceptions of value.

Appraisals of potential acquisitions will be impacted by three key factors. First, the broad market consensus that market values have bottomed out, will reduce the safety margin investors have (consciously or not) been building in to protect against further falls. Second, the downwards trend in medium-term interest rates has reduced the risk-free benchmark and made leverage increasingly affordable and accretive. Third, rental growth, which has been surprisingly resilient throughout the downcycle, should be supported by gradually improving economic conditions. The first of these factors may persuade hesitant investors the time has come to make a move, whilst the latter two can have a very material impact on the price that those investors are prepared to pay. 50bp off funding costs and a moderate upgrade on rental growth assumptions can be sufficient to convince an investor to sharpen their pencil and satisfy the vendor's aspirations.

This effect will be seen in those parts of the market with established rental growth trends and pent up investor demand, setting keener pricing benchmarks as buyers compete aggressively for the best assets. This is arguably already happening for Industrial assets, and will likely spread to the very best offices, as well as retail assets where rents have rebased and income growth potential has been proven. In contrast, for parts of the Office and Retail sectors where long-term occupier demand trends are highly uncertain, it is likely to remain very much a buyers' market.

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