propertymark

Commercial Outlook

Q1 2023

HIGHLIGHTS:

- Take-aways see biggest improvement in expectations regarding investment yields for next year.
- 46 per cent of agents see increase in fee-paying professional work as landlords seek to lock in current rent levels.
- 83 per cent of agents report increase in number or value of tenant incentives offered in last quarter as deals become harder to agree.

SUMMARY

In February, NAEA Propertymark Commercial agents reported a more positive outlook for many sectors compared to last quarter. Better than anticipated performance of the UK economy and resettling after the Truss/Kwarteng budget have resulted in improved expectations. The land and yards sector is still seen as best placed to weather the pressures of inflation and interest rate rises with capital values, rental levels and investment yields all expected to rise over the next year by most agents due to a continued lack of stock.

The worst overall outlook for the next year remains in the pubs and restaurants sector. With cost-of-living concerns, energy prices and interest rate rises affecting tenants' bottom lines, combined with liquidations leading to rising supply, rental levels are expected to decline along with capital values and investment yields. Though, there has been some improvement in sentiment with regard to this sector, again resulting from better than anticipated broader economic outcomes.

The economy remains the biggest concern for agents, with many finding higher interest rates are having an adverse impact on the sector. Members also reported having to increase the number of tenant incentives in this quarter to complete on deals.

In our continuing look into agents struggles with planning, our latest survey revealed the crux of the problem appears to be a chronic lack of staff in local authorities.

“The commercial property market has clearly seen the impact of the recent economic downturn. Higher interest rates have hit deals agreed and broader investment in the sector. Our members reported having to increase tenant incentives to complete on deals and fill vacant property.

Two sectors stand out for me in this quarter’s Outlook – take-aways and business transfers. Our members agree that the outlook has improved for take-aways, as consumers switch from dining in to taking out. And business transfers are likely to struggle over the next twelve months as supply increases and demand falls away through the anticipated recession.

Agents are seeing an increase in repurposing from commercial to residential property as the housing sector struggles with capacity issues. In this regard, I am pleased that Propertymark has recently responded to the All-Party Parliamentary Groups for Ending Homelessness and APPG for Housing Market and Housing Delivery joint inquiry into housing solutions for homeless households – rethinking residential to commercial conversions to advise on the phenomenon and how it could help to provide more affordable homes especially where commercial property is left derelict with no purpose at all.

“Finally, it is good to see our investigation into planning issues experienced by members has reached the heart of the issue. 58 per cent of respondents reported a lack of staff in local planning offices and the delays caused by this as the crux of the problem. Delays limit the prosperity of our local communities and leave our high streets empty. The UK Government must do more to push local authorities to expand recruitment in planning offices. The UK Government also needs to spearhead the introduction of a class use register for all commercial premises in the UK so that delays in use queries and change of use applications are greatly reduced.

Anthony Meadowcroft,
President
NAEA Commercial

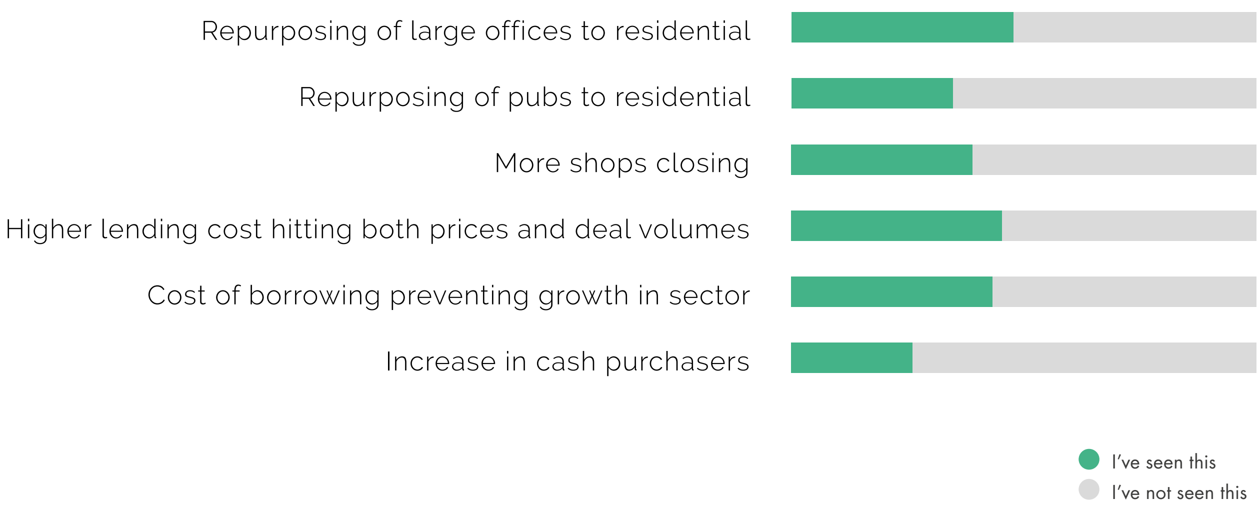
Keeping an eye on **trends**

Last quarter our agents highlighted several potential trends to keep an eye on over the next year. These were repurposing of pubs and offices to residential, higher lending costs limiting growth – hitting both price and deal volumes, an increase in cash purchases, and more shops closing down.

48 per cent of responding agents reported noticing a continuing trend of large office spaces being repurposed to residential. With reduced demand for large and/or low-grade office space since the pandemic, repurposing has been seen as both a channel through which to increase returns and a potential solution to the UK's housing crisis.[1]

With the cost-of-living crisis hitting hard in Q4 2022, some agents expected to see a similar pattern emerge in the pubs sector as well as an increase in retail closures. In our latest survey agents were less likely to report noticing a new trend of pubs being repurposed to residential (35 per cent). They were also unlikely to have noticed an increase in shops closing (39 per cent). However, the economy performed better than expected in the final months of 2022, which perhaps explains why these new trends have not been so widely experienced as yet.

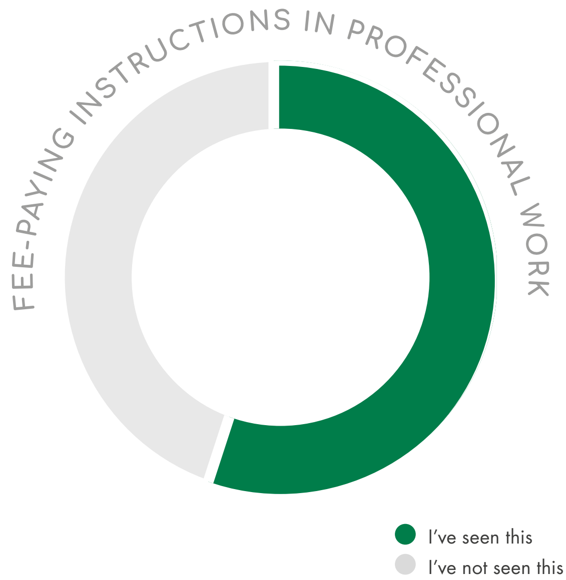
The spectre of interest rates rises in Q4 caused some agents to expect a negative consequence on property deals, growth in the sector and an increasing proportion of cash purchases. To some extent this quarter, agents reported these expectations bearing out. 46 per cent have seen higher lending costs impacting both prices and deal volumes, 44 per cent have seen the cost of borrowing preventing growth in the sector, while only 26 per cent have seen an increase in cash purchasers. It appears buyers have been waiting to see what happens in the economy before committing cash to new expansion.



1 propertymark.co.uk/resource/caution-issued-on-converting-commercial-properties-for-residential-use.html

In addition to market trends, we asked members about changes in their work practices over the past quarter.

46 per cent of our agents told us that they have recently seen an increase in fee-paying professional work (rent reviews, lease renewals, schedules of dilapidations, non-red-book valuations, etc). Members have been telling us that this has been driven by market expectations of future rental level growth. In the anticipation of a decline, landlords have been fastidious in implementing outstanding reviews. By locking in rents at today's prices, landlords are insuring themselves against a future demand slump.

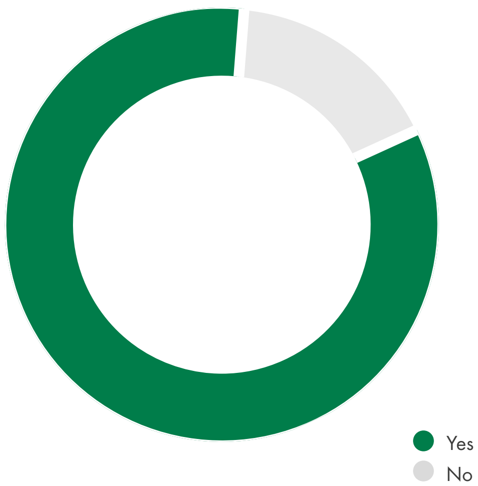


HAVE YOU HAD TO INCREASE THE NUMBER OR VALUE OF TENANT INCENTIVES?

Finally, 83 per cent of agents reported an increase in the number or value of tenant incentives in the last quarter.

Since the Truss/Kwarteng budget and ensuing economic turmoil, tenants have been slower to sign lease agreements.

Our agents report that it has become increasingly necessary to include or improve tenant incentives in order to reach completion (e.g rent free periods, stepped rent, side letters, etc). As we move into a more stable economic environment and the new year naturally brings more applications, the number and value of incentives required to reach completion is likely to fall back.



The BIG issues

Agents reported the biggest issue remains the countrywide economic situation – 65 per cent of agents responding to this question noted concerns related to this factor. Nevertheless, sentiment has improved since Q4 2022.

Three months ago, 44 per cent of agents responding to this question noted interest rate rises as a key area of concern. This fell to only 12 per cent this quarter. Indeed, concerns were much more varied this quarter and included planning delays, pricing, negative press coverage, solicitor delays, and changing EPC requirements on let property.

PLANNING

Over the past two surveys we have been gathering insight from our member agents regarding issues in planning. In the last Commercial Outlook, we reported that average waiting times for change of use planning permission to be granted was now over three months, with some members experiencing delays of up to half a year.

These delays inevitably put pressure on deals agreed and force landlords into a difficult position with vacant property while waiting to see whether permission is granted.

In our latest survey, we asked our members about the specific issues they have faced. The majority of respondents (58 per cent) reported a lack of planning staff in their local authority and the backlogs this has caused as the crux of the issues they face. Delays in change of use planning permission can cause deals to fall through and keep units vacant for longer.

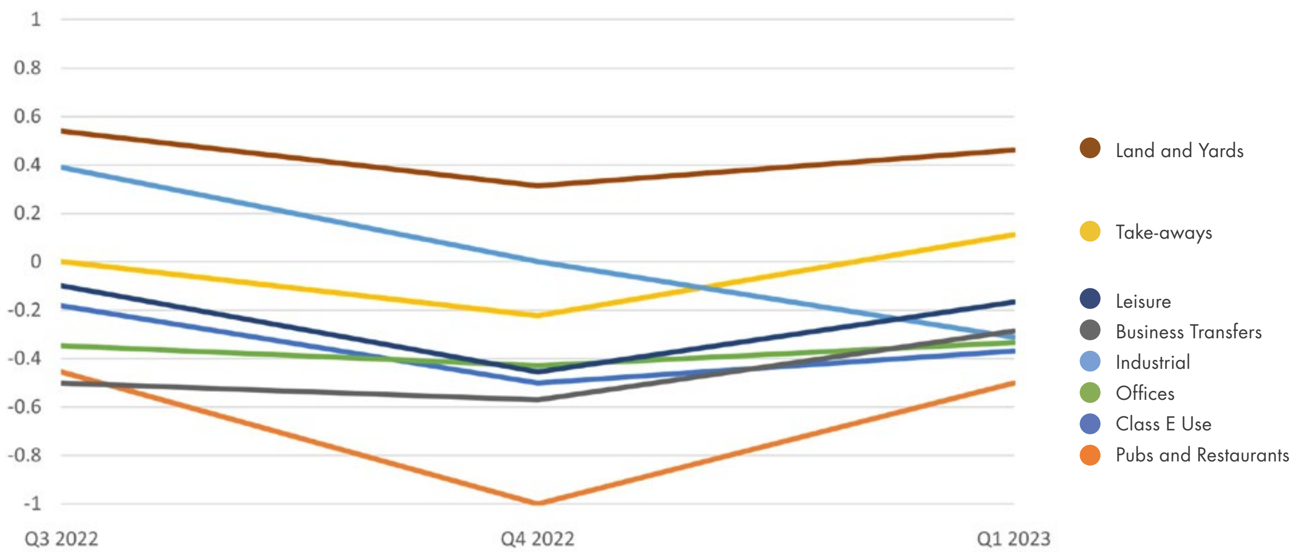
This all feeds into reduced economic output, fewer jobs in the local community and empty high streets.

We asked our qualified agents whether they expect capital values, rental levels, investment yields, supply, and demand to increase, decrease or stay the same over the next year for all sectors in which they operate.

Their responses are converted to a numeric scale bounded by 1 and -1 and reported below. Positive values indicate that the majority of respondents expected a rise in that factor over the next year. Negative values indicate that the majority of respondents expected a fall. All graphs refer to the UK.

In comparison to last quarter's Outlook, sentiment among agents is broadly up across the sectors covered reflecting a recovery from the impact of the Truss/Kwarteng budget fallout recorded in Q4. Notable outliers are in expectations of capital value growth in the industrial sector as the market levels out and rising supply and falling demand for business transfers.

CAPITAL VALUE

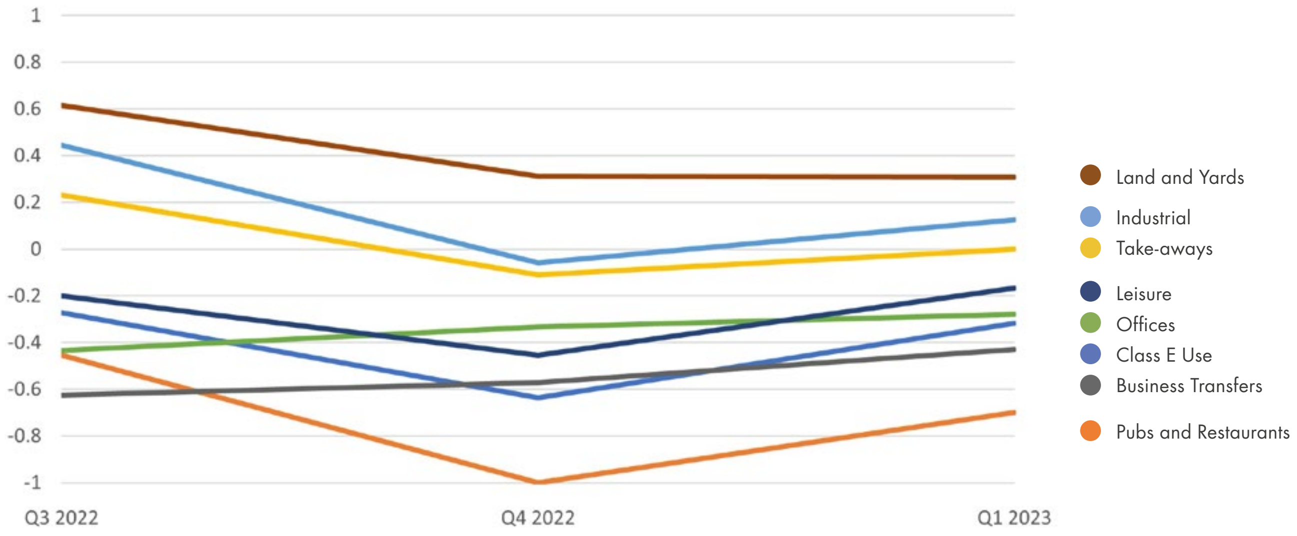


Land and yards remains the sector with the broadest agreement on capital value growth expectations over the next year according to our latest survey. Pubs and restaurants remain the sector most widely expected to see a fall; though, the majority of agents appear to agree that the outlook has improved since Q4 2022.

Now being in a more stable economic environment and experiencing the natural uptick in applications since the new year, this is perhaps not so surprising. In contrast, capital value expectations have fallen for Industrial property and are now broadly expected to fall over the next 12 months, which reflects a levelling out of the market after strong recent growth.[2]

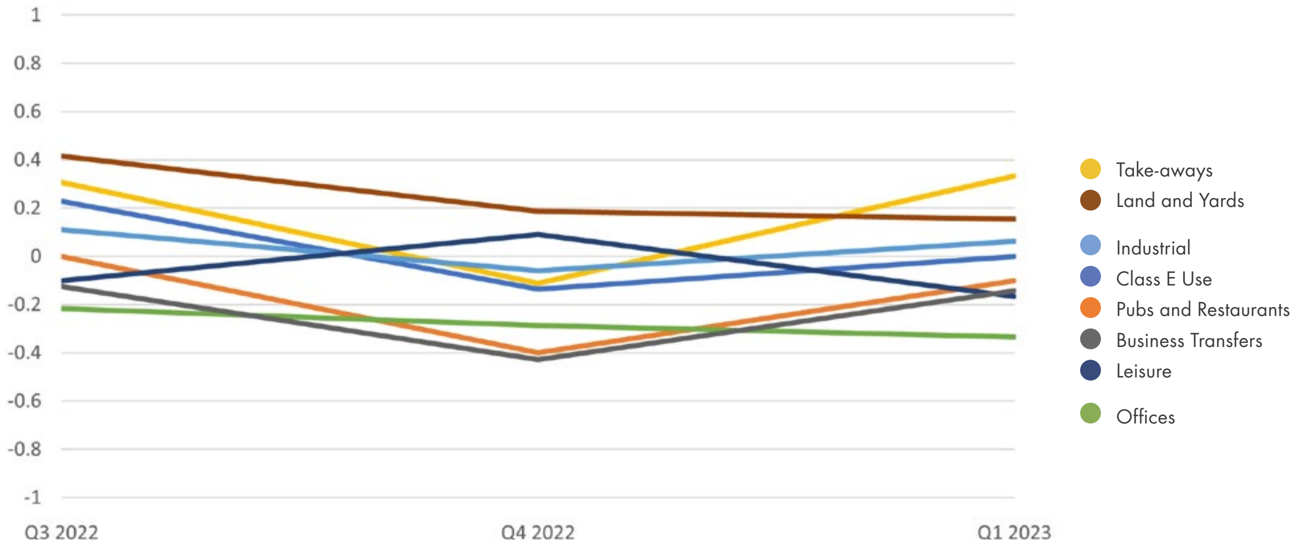
[2] *Hotels have been omitted from the Q1 2023 report because of low response rate.*

RENTAL LEVELS



Rental growth is most broadly anticipated to be greatest in the land and yards sector over the next twelve months. Similar to capital value expectations, NAEA Propertymark Commercial agents widely foresee rental level decline in the pubs and restaurants sector; though, again, agents' sentiments have improved since Q4 2022.

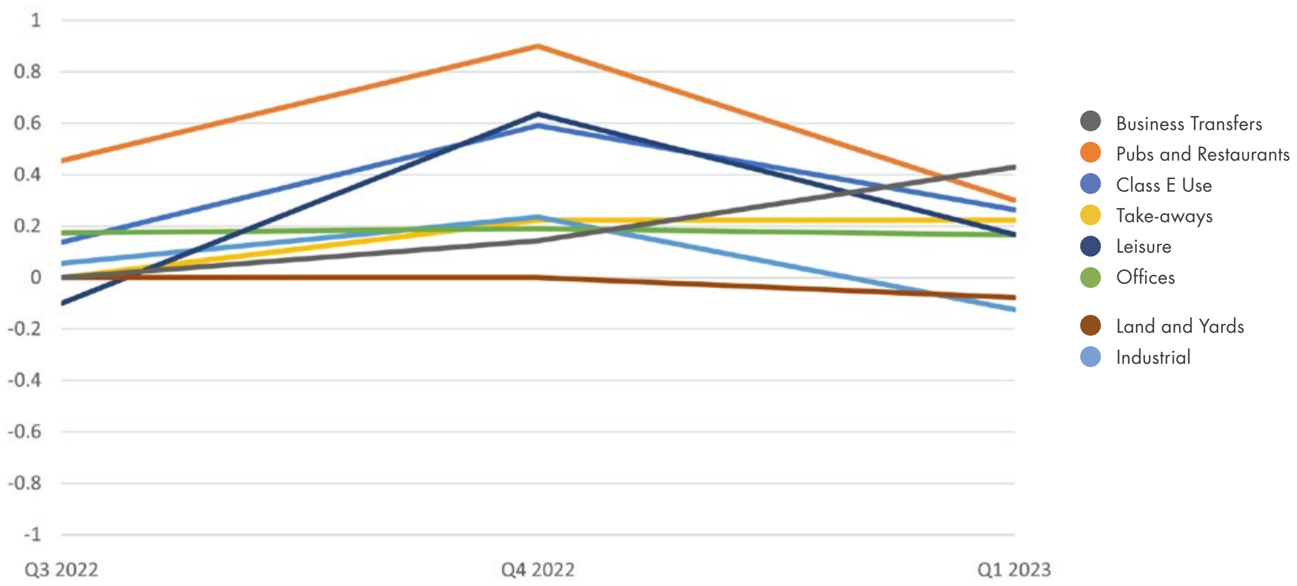
INVESTMENT YIELDS



In comparison to capital value and rental levels the land and yards sector is not that with the broadest investment yield growth expectation (though, it is second). Investment yields are most widely expected to grow in the take-away sector, reflecting a continued anticipation of a shift from dining out to take-away through the economic downturn.

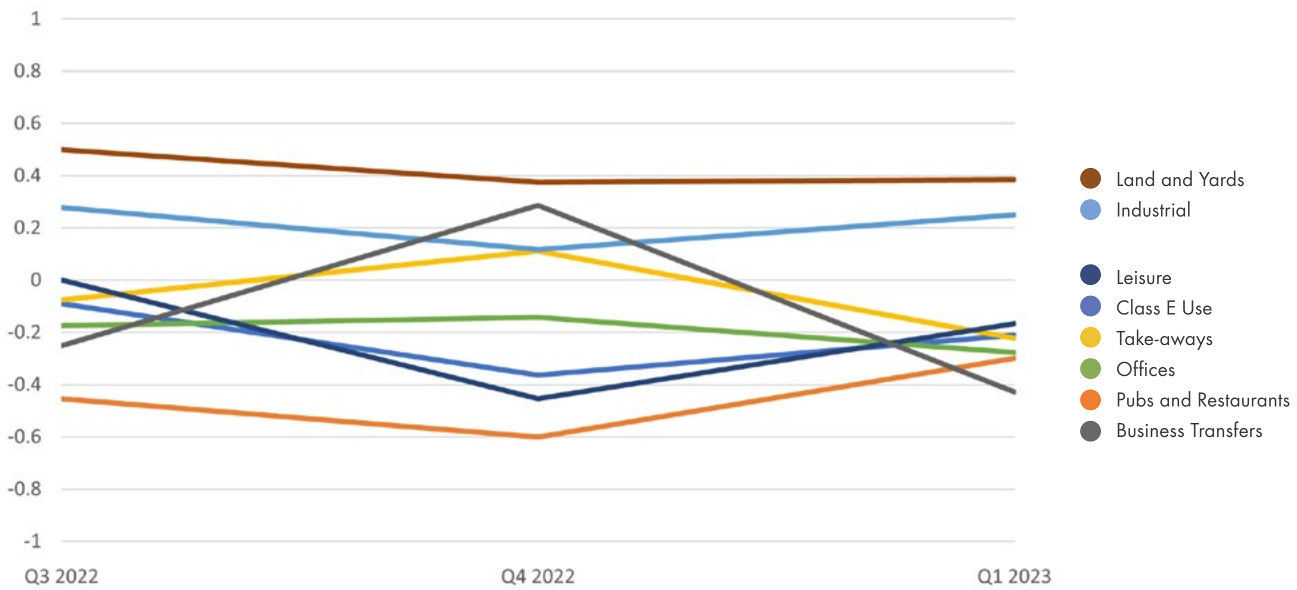
Sentiment among agents operating in this sector has broadly improved with regard to investment yields since last quarter, reflecting the recovery from the impact of the Truss/Kwarteng budget fallout recorded in Q4. Investment yields are still widely expected to fall in the offices sector; though, leisure has seen the greatest downturn in agent confidence among the divisions.

SUPPLY



The business transfer sector is most broadly projected to see an increase in supply after expectations in pubs and restaurants, class E use, and leisure all fall following lower than anticipated GDP decline and adjustments in household spending over the last quarter. A weaker outlook for supply over the next 12 months is in the industrial sector – now falling below land and yards for the first time.

DEMAND



Demand is most broadly anticipated to continue rising in the land and yards sector over the next year. In a dramatic reversal of fortunes, the business transfers sector is now most widely expected to see a reduction in demand over the next twelve months as economic woes hit the sector.

Aside from capital value, rental levels, investor yields, supply and demand, our agents reported several other expected market trends to emerge over the next year.

Small efficient traders with low overheads succeeding over the larger firms, thus increasing the demands for light industrial units.

Niche sector Telecoms—Increasing acknowledgement and acceptance of legislative changes.

Many existing businesses may look for new premises. This may include expanding their existing operation or looking to acquire property that provides a reduction in the cost of operation (Heating, Lighting, Repair, etc.).

Continued disparity between uptake of small E-class units in market towns continuing to be positive against the backdrop of the large units seeing multiple retailers falling vacant with far lower take-up.

A definite increase in residential developers looking at all sorts of property with change of planning use in mind.

Slow decision making from market participants.

More larger clothes and restaurant mid- to high-end retailers struggling.

Some slowdown but also more opportunities.

THE UK ECONOMIC OUTLOOK

The following section is based on data provided by external sources. Latest expectations are that high inflation will continue to fall away over the year before returning to target levels at the beginning of 2024. GDP growth is expected to enter negative territory and not re-emerge until mid-2024. Bank of England interest rates are expected to rise further in the first half of 2023, peaking around 4.5 per cent by the summer.

While the depth of the anticipated recession has been reduced in the latest forecasts, it is now expected to last longer, with the UK perhaps not seeing a return to growth until 2025.

Falling staff vacancy rates in key industries and steady material prices suggest construction and refurbishment costs will level out. These factors have fed into current expectations of construction growth in industrial property of 5.1 per cent in 2023 along with broader commercial property construction growth of 2.0 per cent. These figures show robust investment in the sector, especially when compared to residential property.

INFLATION (CPI)

The Bank of England (BoE) expects that inflation has now peaked and should fall sharply over 2023. While wholesale energy prices have come down from their peak, inflation in the services sector has remained stubbornly high.

As a result, the BoE increased interest rates on 2 February to 4 per cent. As previously discussed, the hospitality and leisure industries are likely to be the hardest hit by constrained consumer spending.

FIGURE 1: INFLATION PROJECTION TO Q4 2025

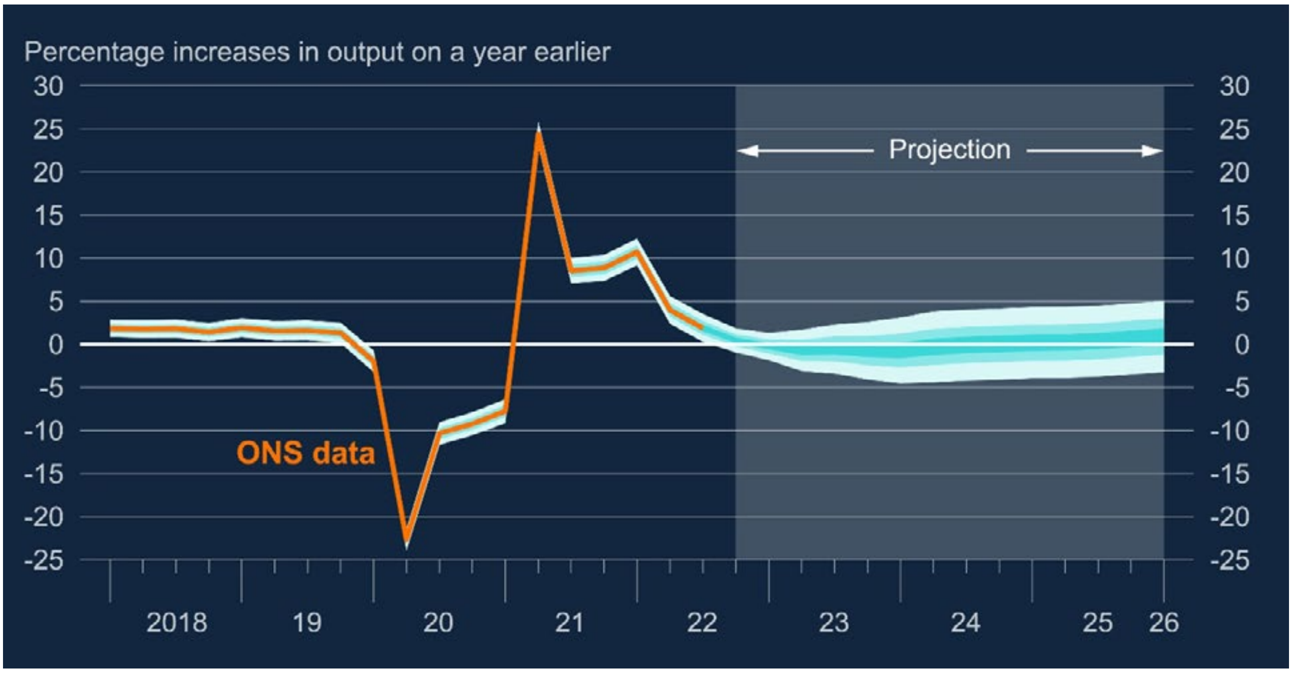
Source: Bank of England, *Monetary Policy Report—February 2023* (released 2 February 2023)

GDP GROWTH

Another reason why interest rates have been increased to 4 per cent perhaps more quickly than the BoE anticipated, is because the economy has not contracted as much as expected over the last quarter—putting further pressure on inflation.

The Bank now expects the downturn to be rather shallow but linger for longer. Economic growth is now not forecast until the end of 2024.

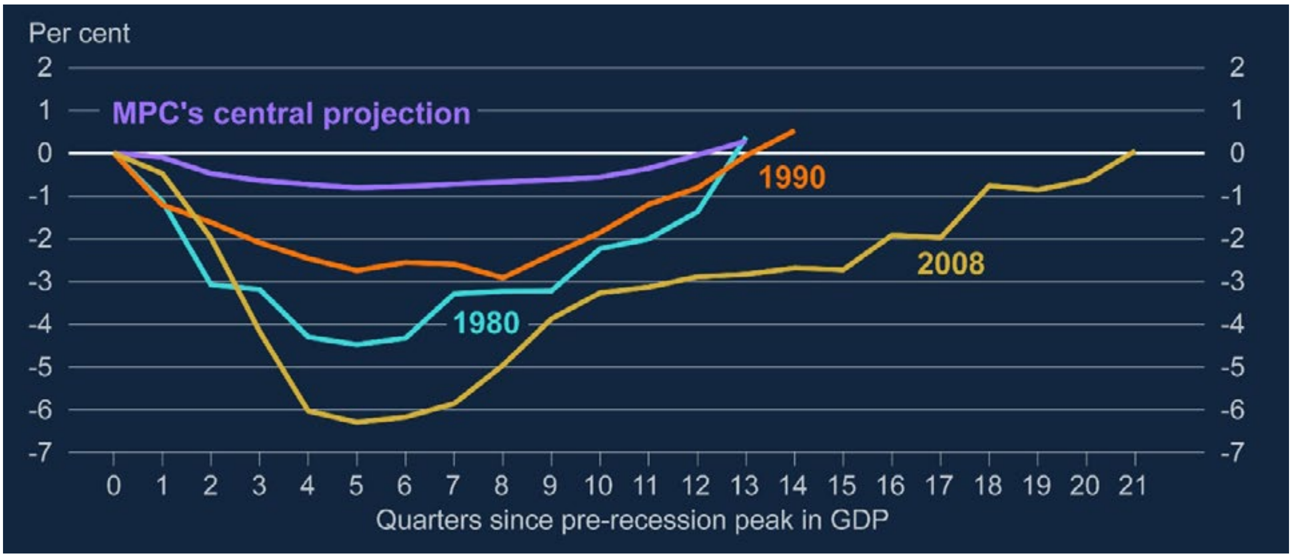
FIGURE 2: GDP GROWTH PROJECTION TO Q4 2025



Source: Bank of England, *Monetary Policy Report—February 2023* (released 2 February 2023)

The Bank expects the current recession to be much shallower than previous recessions, suggesting the impact on employment, incomes, savings and investment will not be as pronounced.

FIGURE 3: RECESSION PROJECTION COMPARED TO PREVIOUS DOWNTURN



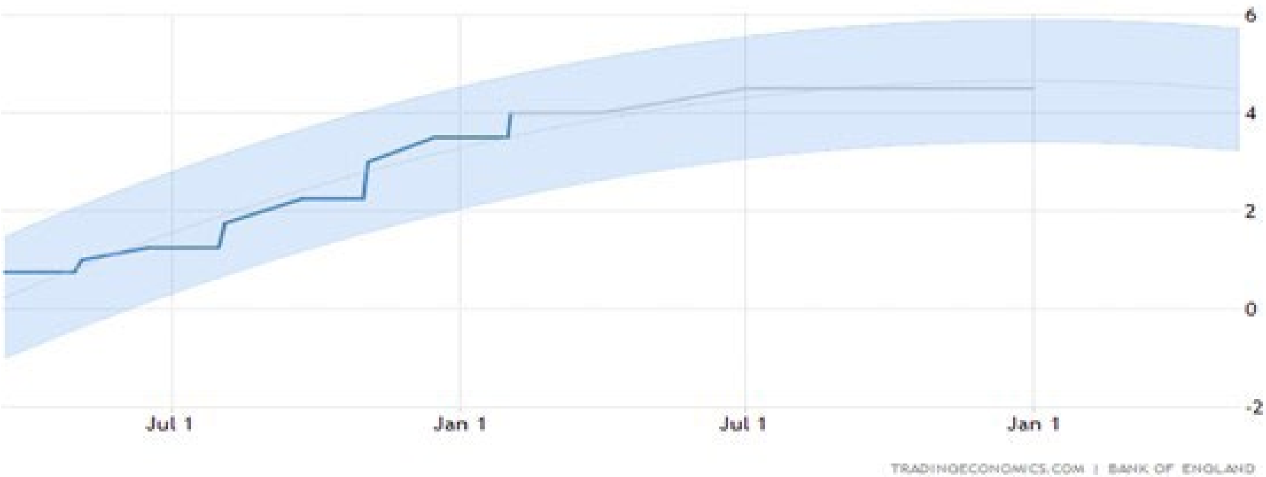
[Source: Bank of England, *Monetary Policy Report—February 2023* (released 2 February 2023)]

INTEREST RATES

As previously discussed, the Bank raised its base rate to 4 per cent on 2 February. Having analysed market conditions and wider expectations, Trading Economics forecast UK interest rates to rise to 4.5 per cent by the summer. This is in line with wider expectations and referenced in the BoE's latest communications.

The Bank did nothing to dispel this expectation in its 2 February report, suggesting the expectation is realistic. Furthermore, as the graph below implies, interest rates are expected to start falling by the end of the year. With inflation anticipated to be under control by this time, base rates should come down. Nonetheless, the days of a 0.1 per cent base rates are well and truly behind us at this point.

FIGURE 4: INTEREST RATE EXPECTATIONS

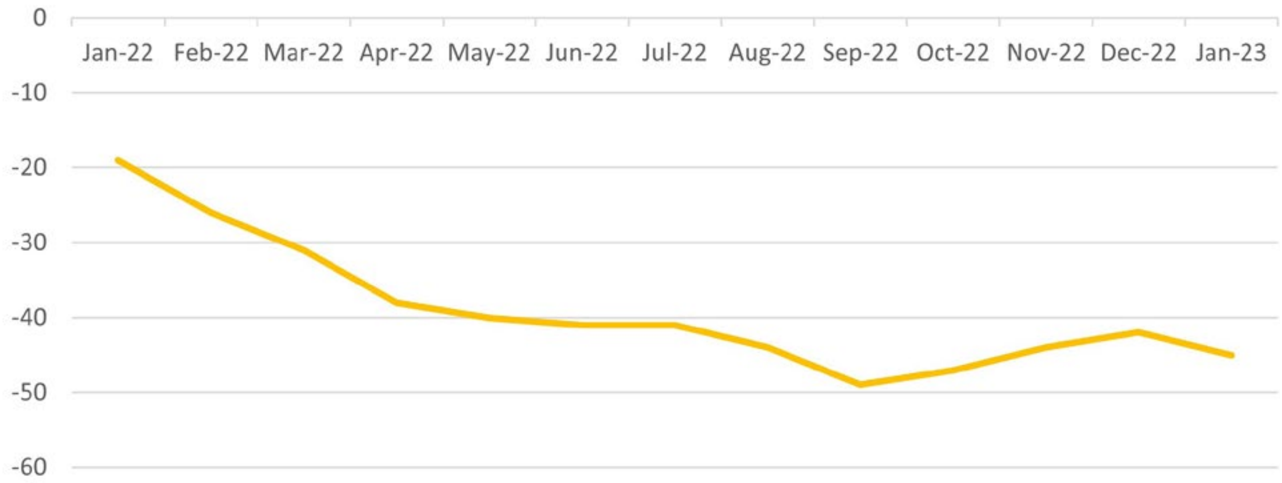


[Source: Trading Economics | Bank of England (retrieved 7 February 2023)]

CONSUMER CONFIDENCE

The GfK Consumer Confidence Barometer picked up slightly in the last few months of 2022. This fell again in January over concerns with the economic outlook and reduced plans to make major purchases in the immediate future.[3]

FIGURE 5: CONSUMER CONFIDENCE



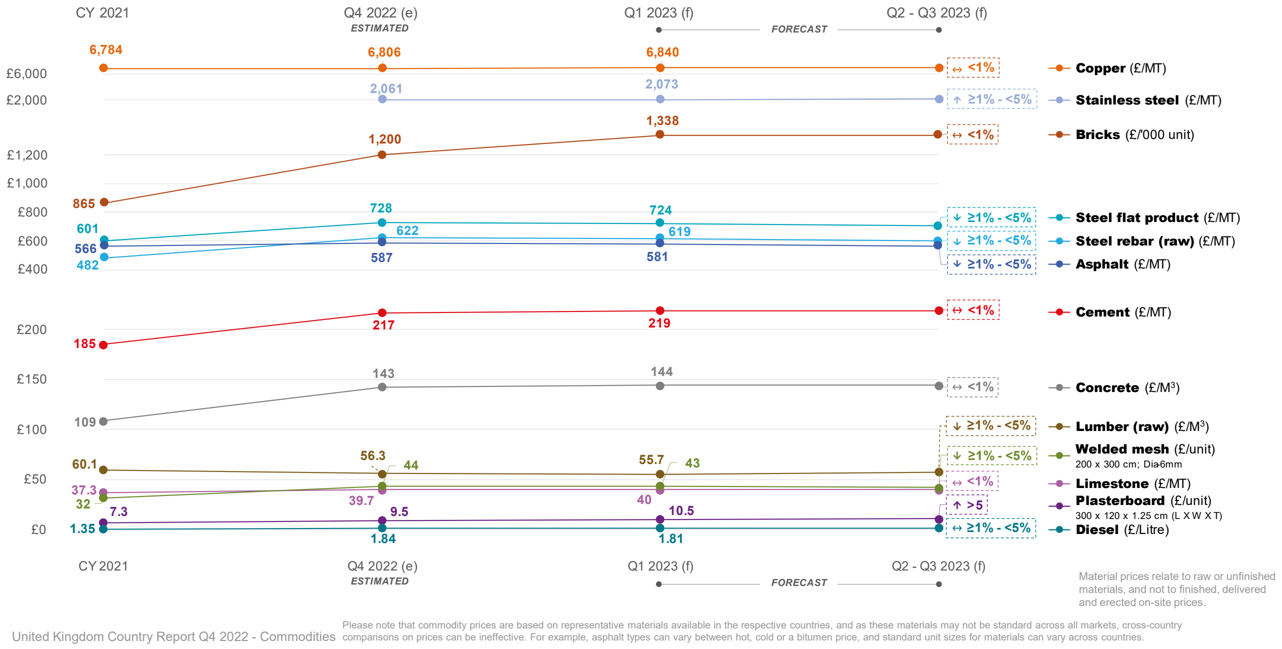
Source: *GfK Consumer Confidence Barometer* (released 21 October 2022)

[3] *GfK derive their monthly consumer confidence figures from questions about the present and future. Thus, it can also be seen as confidence in the UK economy over the next year by consumers.*

Data provided by the global consultancy firm, Linesight, shows construction material prices holding steady into the third quarter of 2023. A more static price level in construction will allow developers to be more confident when calculating the cost of build from residual valuations on developments.

FIGURE 6: PROJECTED CONSTRUCTION MATERIAL PRICES

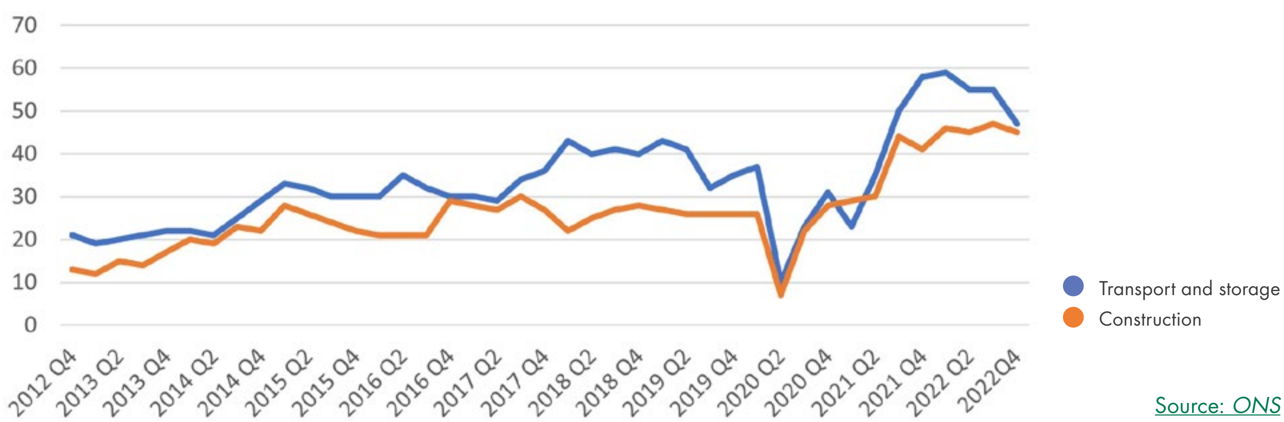
UK construction materials pricing (2021–23)



Source: *Linesight Global Country Commodity Reports* (released 1 February 2023)

Vacancies in the construction and transport and storage sectors rose sharply in 2021 and have remained high. Nevertheless, they started to come down in Q4 2022 and have continued to come down in the first part of Q1 2023. This reduction reflects a reduced demand for labour in these industries following the recent economic downturn. As vacancy rates fall, wage levels should also follow. This will be good news for the industry and developers looking to buck the trend and invest during the dip.

FIGURE 7: VACANCIES



Source: ONS

A recent report published by the Industrial Training Board (CITB) for the construction industry in Great Britain (Scotland, England and Wales), revealed an anticipated contraction in construction output in the housing sector, while industrial and commercial sectors are expected to retain strong growth. Industrial construction is forecast to be particularly robust with strong growth in the next two years before falling back to a steady state of between 1.5-2 per cent per year thereafter. Commercial construction growth is expected to remain steady at 2.4 per cent on average per year.

FIGURE 8: EXPECTED CONSTRUCTION OUTPUT

CONSTRUCTION OUTPUT – UNITED KINGDOM (£ MILLION, 2019 PRICES)

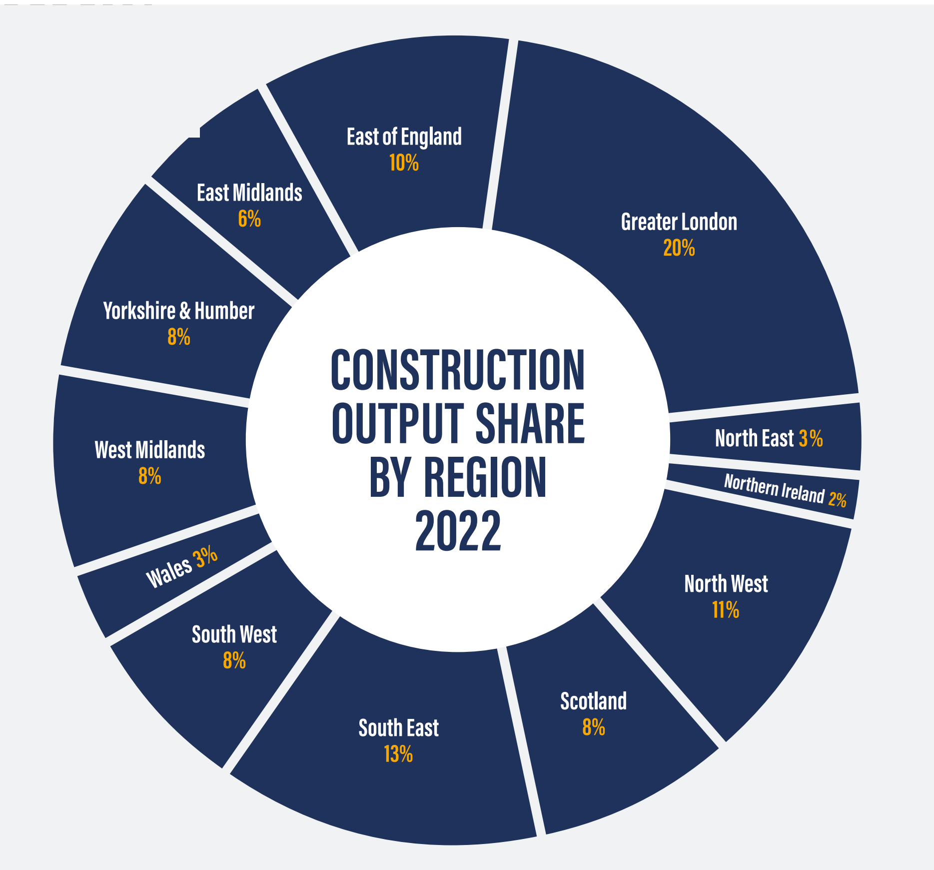
Source: Experian
Ref: CSN Explained, Section 4, Note 2

	Estimate	Forecast (Annual % change, real terms)					Annual average
	2022	2023	2024	2025	2026	2027	2023–2027
Public housing	5,248	-4.4%	1.5%	2.5%	2.9%	2.9%	1.1%
Private housing	40,608	-0.2%	2.3%	2.6%	2.8%	2.9%	2.1%
Infrastructure	27,877	0.5%	0.3%	2.7%	2.4%	2.4%	1.7%
Public non-housing	9,414	-3.7%	0.8%	1.0%	1.8%	1.9%	0.3%
Industrial	6,793	5.1%	3.8%	1.2%	1.9%	1.9%	2.8%
Commercial	22,864	2.0%	2.0%	2.6%	2.7%	2.6%	2.4%
New work	**112,804**	**0.3%**	**1.7%**	**2.4%**	**2.5%**	**2.6%**	**1.9%**
Housing R&M	31,951	-3.9%	0.1%	1.0%	1.7%	1.9%	0.1%
Non-housing R&M	35,234	0.2%	1.1%	2.6%	2.0%	2.2%	1.6%
Total R&M	**67,186**	**-1.7%**	**0.6%**	**1.8%**	**1.9%**	**2.1%**	**0.9%**
Total work	**179,990**	**-0.5%**	**1.3%**	**2.2%**	**2.3%**	**2.4%**	**1.5%**

The annual average growth rate is the rate of growth between the end of 2022 and the end of 2027, i.e., a five-year period.

Source: CITB "CSN Industry Outlook - 2023–2027"; Experian

FIGURE 9: EXPECTED CONSTRUCTION OUTPUT BY REGION



The majority of construction growth is forecast to be in the East of England, Greater London, East Midlands, the South East, and Yorkshire and the Humber.

[*Source: CITB "CSN Industry Outlook - 2023–2027"; ONS, NISRA and Experian*]

TAKE THE NEXT STEP

The views and figures in this Propertymark Commercial Outlook refer to the UK as a whole. Specific geographic locations and markets (city centre/suburban/etc.) will vary.

We strongly recommend that you contact a NAEA Propertymark Commercial agent in your area to discuss opportunities that suit you. You can find your local agent at propertymark.co.uk/find-an-expert

There are several reasons why you should use an NAEA Propertymark Commercial agent over any other:

INTEGRITY

As members of Propertymark, our agents have a proven dedication to professionalism within the commercial property sector.

CUSTOMER PROTECTION

Propertymark member agents are regulated by Propertymark, which is a nationally recognised regulatory brand, and provide high standards of service.

COMPLIANCE

Our members have access to the latest legal and best practice guidance.

ENDS

ABOUT THE PROPERTYMARK COMMERCIAL OUTLOOK

This report is based on a survey of Propertymark Commercial Agents conducted between 24 January and 14 February 2023. It is further addended with an analysis conducted by Propertymark of key statistics relevant to the commercial property market.

ABOUT PROPERTYMARK

naea | propertymark COMMERCIAL

Propertymark is a leading professional body of commercial and other agents. We are member-led with a Board which is made up of practicing agents and we work closely with our members to set professional standards through regulation, accredited and recognised qualifications, an industry leading training programme and mandatory Continuing Professional Development.

The Commercial division of Propertymark represents members who practice from over 650 offices and aim to reassure the public that by appointing a Propertymark Protected agent to represent them, they will be safeguarded and receive the highest level of integrity and service for all property matters.

EDITOR NOTES

For further information contact:
Phillip Nelson, Propertymark Research Officer
Email: insight@propertymark.co.uk

LEGAL DISCLAIMER