Following our previous reports on the HMO market (2016), the Private Rented Sector (PRS) (2017), and the overall BTL market (2018), I am delighted to introduce our latest research on the commercial investment market. This report explores the various sub-sectors within the market, historic and future trends, and the impact of the changing political landscape.

Once again, we partner with the hugely experienced Centre for Economics & Business Research (Cebr) and thank them for their work compiling and analysing data specific to a market where this task is often hugely challenging.

Changing priorities for investors
Commercial investment is becoming increasingly attractive to experienced property professionals. As set out in the 2018 Shawbrook BTL Report, residential landlords have faced a variety of challenges as a result of the shifting tax landscape and changes in regulation for lenders. Whilst this has led to some modest market contraction, as amateur landlord activity has diminished, the more interesting dynamic is that it has prompted savvy investors to explore other opportunities such as commercial investment, where yields can often be more attractive.

The commercial arena is very much the area of specialist lenders such as Shawbrook, with their expertise in the sector being combined with a personal approach to lending that delivers more flexible arrangements for borrowers that reflect a genuine understanding of the specifics of every transaction.

Amidst an uncertain political outlook
The shadow over all of this is, of course, Brexit, however we see reasons to be positive, provided that investors focus on the long term. Research demonstrates that investors operating in the prime commercial space are simply postponing activity until we have a definitive Brexit outcome. The implication is of a potential ‘post Brexit binge’ from professional investors when the dust eventually settles. In the meantime, with capital growth less certain in the short term, we expect to continue to see investors seek opportunities to add yield, for example in secondary commercial assets. This won’t always tick the boxes of a traditional commercial investment proposition and lenders must understand investor strategies to support them. We have invested in a deep understanding of our specialist markets and with this understanding comes the knowledge that the product is only the first step, and the long-term solution for professional investors is often the icing on the cake.

Thus whilst the short term outlook for the commercial market is arguably volatile, the long term perspective remains healthy. The market remains fundamentally resilient in terms of both yield and capital growth, stands strongly as an integral part of the UK economy, and is still an attractive asset for professional investors looking for growth.

John Eastgate
Managing Director, Property Finance
Shawbrook Bank
Executive Summary

- The UK commercial property sector is a highly developed market with an estimated size of nearly £900 billion.

- Given that commercial property is not highly correlated with several other asset classes, it is an interesting area for investors looking to diversify their portfolio.

- Nevertheless, commercial property is not immune to larger macroeconomic shocks: data shows that capital value growth turned negative in Q3 2016 following the EU referendum and, most recently, in Q4 2018 as the anticipation of Brexit weighed on companies’ confidence.

- Overall, however, the returns on commercial property are high compared to other asset classes. Between 2000 and 2018, commercial property returned 308% compared to 209% for the FTSE 100.

- Average yields across all sectors have been stable in recent years remaining nearly unchanged at 5.0% since 2015. As of early 2019, the retail sector showed the highest yields at 5.7%.

- High levels of political uncertainty caused by the ongoing Brexit negotiations have contributed to a rise in consumers who are increasingly pessimistic about the near-term economic outlook of the UK. As a result, commercial properties in the retail sector have come under pressure with total returns turning negative towards the end of last year. Additional difficulties in the sector stem from increasing costs and the advancement of e-commerce and online sales, which rival stores on the high street.

- A growing services economy is an overall positive backdrop for commercial office space. In particular, the ‘business and professional services’ sub-industry represents an important part of the services sector. For the better part of the past two decades, growth in business and professional services has outpaced the wider service economy.

- Staff relocations from the City to other European financial capitals will weigh on demand for office space in the next year. In the case of a no-deal Brexit, the economic consequences would unquestionably be felt in the sector. Under this scenario, our forecasts show capital values dropping by as much as 1.8% in Q3 2019 before recovering again.

- Although there are various potential sectors of the economy that require industrial properties, the closest relationship is likely to be found with the manufacturing and wider production sector. Between 2014 and 2018, growth has averaged 1.3% both for the manufacturing sector and production as a whole.

- Industrial properties have shown resilience over the past years. Stockpiling activity and strong demand for warehouses from online retailers have helped the sector to withstand other economic headwinds. The unwinding of the stockpiling effect, however, poses a risk, as does a no-deal Brexit, which would severely harm many of the manufacturers that are the current tenants of industrial properties.
1 Introduction

In 2017 and 2018, Shawbrook Bank and the Centre for Economics and Business Research (Cebr) produced two detailed reports looking at the state of the Buy-to-let sector in the UK and how it was affected by tax and regulatory changes. Building on this successful collaboration, this report will present an analysis of the commercial property sector.

The report will analyse recent trends in commercial property values and examine the sector’s attractiveness as an asset class. Furthermore, the analysis will offer capital value forecasts across three types of commercial property under two scenarios: a ‘benign scenario’ which assumes a relatively seamless Brexit transition process that sees the UK leaving the European Union with a deal after 31 October. The ‘hard Brexit’ scenario assumes a more disruptive exit leading to an economic downturn in the short term including impacts on the commercial property sector.

Why should we be interested in commercial property as an investment class in the first place? The commercial real estate sector in the UK is highly developed, and in 2016 the Investment Property Forum estimated its size at £883 billion. As this report will show, commercial property is an attractive asset class for investors looking to diversify their portfolios and achieve strong returns. Commercial property is generally not highly correlated with other asset classes such as equities or bonds, which means that investors could be able to offset the natural ups and downs associated with the stock market on their portfolios. Having said that, the commercial property sector is still exposed to the general macroeconomic environment and significant events such as the 2008 financial crisis also affect the performance of this particular class. It is also worth mentioning that commercial property has the added advantage that stamp duty is capped at 5% over £250,000, but SDLT can reach 12% on properties over £1.5m. The profit and loss statement of a commercial investment now works differently than buy to let, where mortgage interest relief is still available on commercial rental income if the property is owned in the landlord’s personal name.

The most important categories within this space consist of retail, office and industrial properties. These are also the categories that will be the subject of further analysis in this report. To better understand the performance of these asset categories, it is useful to look at those sectors of the UK economy that are most closely linked to these categories.

- **Retail** – properties in this category are used in one way or another to serve the retail sector of the economy. This means properties such as smaller shops are included as well as supermarkets or shopping centres.

- **Industrial** – commercial properties in this category are used in the industrial and manufacturing processes (involving property of varying sizes). These can range from smaller buildings zoned for industrial use up to large-scale warehouses such as the ones used by large internet retailers.

- **Office** – comprising buildings that contain office space used in a broad range of sectors.

As will be explained in more detail in the following sections, these three main categories of commercial real estate are linked to the performance of certain sectors of the economy.
2 Recent trends in the commercial property market

In this section, we will take a more detailed look at recent trends in the commercial property market and its main sub-categories.¹

As mentioned earlier, commercial property is not highly correlated with various other asset classes, which makes it a suitable investment for individuals trying to diversify their portfolio. Nevertheless, the commercial property market is also exposed to larger economic trends and shocks. This becomes apparent when looking at the capital value growth rates for commercial property (across categories) over the past 18 years.

As can be seen in Figure 1, quarterly changes in the capital values of commercial property show a higher volatility than quarterly GDP growth for the UK. Having said that, the impact of exceptionally severe economy-wide shocks such as the 2008–2009 financial crisis on the commercial property market is also visible. Economic crises of such calibre are rare – we have to go back to the Great Depression of the 1930s to find any comparable contraction in economic activity on a global scale. The financial crisis followed a period of sharp asset price appreciation and was acutely felt in both the residential and commercial property sectors. Interestingly, the price drops in commercial property actually preceded the downturn in the economy with capital values falling from Q3 2007, almost a year before GDP growth turned negative. Further periods of weak capital growth are visible during 2012 up until Q1 2013 when the UK only narrowly avoided a double-dip recession. Capital growth has also turned negative in Q3 2016 following the EU referendum and, most recently, in Q4 2018 as the anticipation of Brexit weighed on companies’ confidence. Accordingly, GDP growth also fell back to just 0.2% in that quarter.

1 The data source used for the analysis in this section is the CBRE Monthly Index. CBRE Group, Inc. is the world’s largest commercial real estate services and investment firm, with 2017 revenues of $14.2 billion and more than 80,000 employees (excluding affiliate offices). The monthly index data is based on valuations of properties that CBRE values on a monthly basis, i.e. in order to be included in the index for any given month properties need to be valued by CBRE in that month.
Comparing developments across commercial property values with the UK residential house price index shows a largely similar picture. Given the importance of the UK housing market to consumer confidence and the wider economy, this is hardly surprising. Investment into both commercial and residential property is to some degree driven by expectations about future asset price developments which often are pro-cyclical i.e. in good times, investors expect prices to rise further and in bad times expectations often nosedive. Some smaller commercial properties will also benefit from similar price drivers as those applicable to residential properties. Imagine, for example, a multi-purpose building with a shop on the ground floor and residential units in the top floors. Factors that could affect the prices of the residential units, e.g. a new transport network improvement in the vicinity, the opening of a new school or other types or redevelopment, would also increase the price of the commercial property. This is due to the fact that the underlying land price has increased.

For investors, commercial property can deliver returns in two ways. First, the owners of the property receive a rental income from the tenant (we take a closer look at yields in the next chapter); secondly, the price of the asset might also appreciate, which is shown by the evolution of capital values shown in the figures above. In order to fully reflect the benefits of investing in commercial property, it is therefore useful to examine a metric that combines the returns from rental income and capital value appreciation.

**Figure 2**

Commercial property capital values and UK house price index, quarterly change

![Figure 2](source: CBRE data, Cebr analysis)
Recent trends in the commercial property market continued

Figure 3 above shows a comparison of total return measures\(^2\) for a commercial property as well as for the FTSE 100, Cash ISAs and UK gilts. For equities and bonds, total return measures assume that all dividends are reinvested. The graph shows that commercial property has outperformed UK gilts, Cash ISAs and the FTSE 100 in most years. While gilt and Cash ISA performances lag considerably behind, the comparison between commercial property and the FTSE 100 index reveals a closer relationship, especially in the five-year period following the financial crisis. Since 2015 however, the total returns for commercial property are comfortably ahead of the FTSE 100. Between 2000 and 2018, commercial property returned 308% compared to 209% for the FTSE 100.

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\(^2\) According to CBRE, the total return is defined as the “aggregate income received from all the sample properties over the month plus the aggregate change in the capital value of the sample, divided by the aggregate capital value of the sample at the start of the period.”
2.1 Yields in the commercial property sector

Given the importance of yields for commercial property investors, it is worthwhile taking a closer look at the historic yield performance of the different sub-sectors. Similar to the residential property sector, the yield for commercial property is calculated by dividing the annual rental income (less expenses) by the purchasing price of the property. A higher rental income increases the yield, as does a lower purchasing price, holding all else equal. Vacancies reduce the annual rental income and therefore push yields down. The commercial property sector is generally characterised by longer term leases than the residential sector, which increases security for landlords. However, vacancies can be harder to fill, especially in an economic downturn, so the greater yield potential also comes with higher risk.

Figure 4 below shows yields by sector based on the CBRE monthly index data. Average yields across all sectors have been stable in recent years remaining nearly unchanged at 5.0% since 2015. The graph shows that, by and large, yields for the three main commercial property sub-sectors are driven by similar trends. At the beginning of 2019, retail properties show the highest yields at 5.7%, followed by industrial with 4.6% and office at 4.5%. Industrial was the category with the highest yields until around mid-2016 when it begins to fall, while retail and office yields remained largely stable.

The below graph is a useful addition to the analysis and gives a good indication of expected average yields in the commercial property sector. However, due to the nature of the data source, interpretation should be done with care. Given that the data is based on a changing sample of properties valued by CBRE, it is not possible to separate market movements that impact yields from a change in the yield profile of the properties that are contained in that month’s sample. The two marked spikes in industrial yields in September 2014 and November 2015 are also likely in part caused by an inclusion of high-yield industrial properties in the sample during these two months. Nevertheless, it is reasonable to assume that wider macro trends are reflected in the data, including the drop in real estate prices during the financial crisis, which led to an increase in yields, as well as the rise in the value of industrial properties over recent years with the opposite effect on average yields in the sector.

Figure 4
Commercial Property, Initial yields by sector

\[\text{Source: CBRE monthly index}\]

3 The graph shows initial yields, calculated as a weighted average of the initial yield of all the properties in the sample.
Recent trends in the commercial property market continued

2.2 Commercial property trends by sector

We’ve already discussed how the location of a commercial property can have an influence on its value. Capital values and rental returns of commercial properties can also change due to the more direct effects of supply and demand. Similar to the demand for housing, the demand for commercial property units is highly dependent on location. Whether a commercial property, such as a store or an office block, is located in city centre close to transport links or in a distant, badly connected part of a city will make a huge difference in terms of demand for that property and the rents that can be achieved. Data from the Valuation Office Agency analysed by the Centre for Cities show that central London commands the highest prices with a median rateable value of £424 per square metre compared to the English and Welsh median of £81 per square metre.4

The location of a commercial property unit will also likely affect capital value appreciation, though any potential changes to the areas in question such as redevelopment programmes or transport upgrades need to be carefully considered. Given that the supply of attractive buildings in well-connected locations generally increases only slowly, informed investors can profit by seeking out undervalued properties.

To better understand market forces within the context of commercial properties, it is further useful to look at the specific subcategories. This is because the price-determining forces for say a London office block and car manufacturer’s factory can be quite different. While both residential and commercial property markets are characterised by considerable regional variation, the buildings used for commercial purposes are also closely tied to the performance of the particular sector of the economy they are being used for. Keeping with the example from above, this means that the price of the property containing office units is tied to the demand for offices. In other words, if the service sector of the economy, including industries such as banking, law, professional services, finance and accounting, is doing well, we’d expect the price for office space to increase as more firms are entering the sector. Likewise, if the manufacturing sector of the economy is doing well, prices for industrial commercial space are expected to increase in line with demand for such properties. Retail, the third major sub-category for commercial real estate, is closely linked to domestic consumption, i.e. how much consumers spend in the stores and shops around the country.

Figure 5
Total return for commercial property sub-categories, annual change

<table>
<thead>
<tr>
<th>All Retails</th>
<th>All Offices</th>
<th>All Industrials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: CBRE, Cebr analysis</td>
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</table>

Figure 5 shows the different rates of annual total returns for the main sub-categories of commercial property. The chart illustrates that returns for retail, industrial and office properties can diverge significantly at times. We see this for example in the early 2000s when returns on retail properties were higher than for industrials or offices, as consumers enjoyed a period of rising wealth and consumption expenditure. Looking at the end of the time series, we see that industrials has been the category with the highest returns for the last two years with the retail sector struggling and returns actually entering negative territory at the end of 2018. However, we also see that larger macroeconomic trends shape the returns on commercial property across all categories, such as the financial crisis and subsequent economic recovery.

“Retail is a challenging market, however not one to be written off.

Location is key, and where it creates consumer convenience such as out of town parks for ‘click and collect’ services and experience shopping for example, landlords have been able to secure rent increases at a time when one could expect rents to remain flat.”

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Retail

Commercial properties in the retail sector cover all buildings in which consumers spend their money, from the small mixed-goods shops around the corner to large furniture stores at the edges of cities. Many smaller units are also home to businesses in the service industry such as hairdressers or dry cleaners. Overall, demand in the sector is closely linked to the financial situation of the UK consumer.

Figure 6 shows the annual growth rates in consumption expenditure between 2000 and 2018. In the early 2000s, UK households increased their consumption rapidly, with growth rates comfortably above 3%. This was in no small part driven by an increase in household debt and the fast rising residential property prices at that time which added to the wealth of homeowners. The subsequent financial crisis led to several years of decreases in consumer expenditure until the economy started to recover from 2012. Consumer expenditure growth increased steadily in the following years, reaching a temporary high of 3.2% in 2016 before falling back again in 2017 and 2018.

Figure 7 shows two important drivers of consumer expenditure: regular pay growth and credit growth. The shape of the annual change in unsecured lending to individuals graph is quite similar to the growth rates of total consumption expenditure presented in Figure 6. This similarity suggests that consumption expenditure is indeed largely driven by the borrowing cycle. While real wage growth is certainly also a factor influencing households’ financial situations, the extent to which households go into debt to finance their consumption is a telling signal about consumer confidence and the population’s optimism that they will be able to repay their debts without any problems. As for the latest movements, we see that real wage growth has accelerated after the spike in inflation following the EU referendum caused a period of negative real wage growth. However, the increase in inflation-adjusted pay has been met by a decline in the growth rate of unsecured lending as consumers are increasingly pessimistic about the near-term economic outlook of the UK. High levels of political uncertainty caused by the ongoing Brexit negotiations will further weigh on consumers’ minds. As a result, commercial properties in the retail sector have come under pressure with total returns turning negative towards the end of last year, as shown in Figure 5. Additional difficulties in the sector stem from the advancement of e-commerce and online sales, which rival stores on the high street.
The retail sector has been hit by a combination of factors which, when seen alongside the growth of on-line sales, has forced an ‘adapt to survive’ mentality.

Whilst consumer confidence has been somewhat negative for some time, we can see that from Q4’18 to Q1’19 it stayed the same, when you would have expected it to fall because of the January Brexit defeat and ongoing Brexit uncertainty. This shows that UK consumers are ‘keeping calm and carrying on’.

In this challenging environment, retailers who can adapt to changing consumer preferences are most likely to succeed. And amidst the gloomy stories about the wider retailer landscape, there are notable exceptions of firms that thrive as they offer shoppers a new experience. ‘Experiential retail’ has become an important trend over the past years with retailers adding immersive activities to the shopping experience in order to attract customers and strengthen their relationship with their brand. A prime example of this trend is fast-fashion retailer Primark, which opened its largest shop worldwide in Birmingham earlier this year featuring a Disney-themed cafe, a barber’s shop and beauty studio.5

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5 https://www.bbc.co.uk/news/uk-england-birmingham-47867785
Recent trends in the commercial property market continued

Office
Returns of commercial property in the office category are driven by the health of the services sector of the economy. Given the importance of the services sector to the wider UK economy, larger economic trends are likely to be reflected in the returns on office property. Figure 8 shows the changing nature of the UK economy. While services have long been the dominant sector, as is the case for most developed countries without substantial natural oil reserves, the importance of services has further increased over the past 20 years compared to a shrinking role of the production sector. As the graph shows percentages of the overall GDP, it is implied that the services sector has shown on average higher growth rates than other sectors in the economy.

A growing services economy is an overall positive backdrop for commercial office space. Having said that, it is also important to keep in mind that the services sector is comprised of a variety of small and large sub-industries, from the hairdresser around the corner to investment funds in the City.

“The importance of innovation in this space cannot be underestimated, and ‘space as a service’ is an important growth area. What we have come to term as “commercial building fracking” is on the rise. This is where small businesses pay for spare facilities that larger businesses have (hot desking, conference rooms, parking spaces etc.) Emphasising this point is research from Savills who reported that the take-up of serviced office outside of London was up 409% in 2017 compared to 2016 (Savills Research 2018).”

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Figure 8
Composition of UK GDP, expenditure approach

Source: ONS, Cebr analysis
Only a number of these industries will be of importance for the commercial office space sector. Figure 9 shows the growth rates for the business and professional sub-industry and its importance as a share of the entirety of the services sector. For the better part of the past two decades, growth in business and professional services has outpaced the wider service economy. Finance and real estate, both part of business and professional services, are two of the most important growth drivers in the sub-industry and have helped it to become an increasingly important part of the services economy. Between 2000 and 2018, business and professional services have increased their share of the entire services sector from 36% to 41%. Growth, however, has slowed in past years and a return to the bullish pre-crisis years currently seems unlikely.
Recent trends in the commercial property market continued

**Industrial**
Industrial commercial property is used by businesses for various types of industrial activities. These properties can include smaller buildings zoned for industrial use, which often use the interior space flexibly, e.g. as a mix between warehouses, laboratories or small office units. Examples of larger industrial properties are logistics and distribution centres. Similarly to the retail and office sector, the performance of industrial commercial property as an asset class is linked to the economic fundamentals for the sectors which make use of this type of properties.
Although there are various potential sectors of the economy that require industrial properties, the closest relationship is likely to be found with the manufacturing and wider production sector.

Manufacturing is by far the largest sub-sector of the industrial sector, currently accounting for around 70% of all economic output in the production sector. Figure 10 shows annual growth rates for the manufacturing sector and all production industries. It is noteworthy that the production sector actually experienced the double-dip recession that the wider UK economy was able to avoid. The sector contracted in 2012 and 2013 following a temporary recovery after the financial crisis. Between 2014 and 2018, growth has averaged 1.3% both for the manufacturing sector and production as a whole.

The industrial category covers a large variety of different types of commercial properties. A distinctive feature of industrial properties is that they can often be re-purposed. For example, a building that used to be a warehouse might be re-fitted and turned into a car dealership. This allows landlords of industrial units to cater to different markets and customers. One of the fastest growing segments in recent years is the logistics sector. The popularity of online business models means that consumers can order virtually anything off the internet and have it delivered to their doorsteps. This means that all those goods waiting to be delivered need to be stored somewhere. Warehouses and distribution centres have, therefore, seen a noticeable uptick in demand in recent years.

### Figure 10
Manufacturing and all production industries, GVA, annual change
3 Scenario outlook

The following section presents the results of a forecasting exercise which explores the relationships between the various commercial property sub-categories and industries outlined previously. It is worthwhile to stress that the forecasting models used do not take into account more complex interactions between the supply and demand factors in the commercial property sector. Given the myriad possible interactions between the different actors in the market, the complexity of such a model would require much deeper analysis. Nevertheless, the following forecasts give a useful indication of future trends in the different market segments and can be used as basis for further discussion and research.
Brexit assumptions in this report

It is important to mention that any forecasting in the current times of heightened political and economic uncertainty is conditional on certain assumptions about the future developments of the Brexit process. As of the time of writing this report, the UK and the European Union have agreed on an extension of Article 50 until 31 October. This was made necessary to avoid the UK exiting the EU without a deal, after the Withdrawal Agreement negotiated by Prime Minister May had been repeatedly defeated by Parliament. The coming months will reveal whether the UK Government and Parliament can find common ground on the terms under which the UK should leave the EU. If a solution to the negotiation deadlock can be found by the end of the summer, this could have a positive effect on buyer sentiment, lifting property prices. Until then, however, the risk of a no-deal Brexit is still present and the possibility remains that the UK exits the EU without any transition period after 31 October. Given that these two scenarios would likely have very different effects on the wider economy and the commercial property sector in particular, it is sensible to present two sets of forecasts. Accordingly, the following section will have forecasts for future capital value trends under a deal and under a no-deal scenario.

“A potential “Brexit Binge” is also on the horizon as investors start to sell off the lower performing elements of their portfolio, generating a cash stockpile in order to quickly take advantage of the lower value post Brexit landscape until the picture invariably improves in 2020. An additional and perhaps unwelcome side effect of this flurry of activity would be the return of the ‘amateur’ investor looking for value which would increase competition on property purchases. It is logical to assume that the net effect of this would be to subsequently drive prices back up.”

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3.1 Assumptions of the no-deal scenario

While we think it is more probable than not that some sort of a deal will be passed, it is still useful to lay out some of our assumptions regarding the economic effects of a no-deal Brexit. Exiting the EU would almost certainly lead to several very painful adjustments in the UK economy. Among those reactions would be a strong depreciation of the pound, likely by 10% – 20%, which would lead to a rise in inflation as imports become more expensive. Supply-chains across the continent would be disrupted as the EU would insist on having border checks and levying the common external tariff on imports from the UK. This could be highly problematic for some industries that rely on just-in-time delivery, such as car manufacturers. But also the agriculture sector would suffer as its exports to the EU would face a significant tariff barrier, which would likely render UK products too expensive to sell in European markets. Business confidence would likely fall even further and investors could withdraw funds from the UK.

All in all, the effects would lead to

- An increase in inflation
- Lower consumer spending growth
- Lower growth in the services sector of the economy
- Lower growth in the production sector of the economy
- Lower overall growth in the economy
3.2 Retail sector forecasts

Forecasts of capital value growth for retail property are shown in Figure 11. The near-term outlook for retail property is challenging, even without taking Brexit into consideration. For 2019, we expect consumer expenditure to grow only modestly, as households continue to prioritise debt consolidation rather than borrowing more. Given the economic uncertainty, many employees will take a cautious approach despite the positive developments in the labour market and decent gains in real incomes.
Moreover, large parts of the retail sector are still grappling with changing consumer preferences. Namely, the move towards online retail has had a significant effect on many traditional tenants of high street retail property. Over the past year, multiple big names on the UK high street have had to file for administration as their business models were no longer sustainable. Consumers increasingly shop from the comfort of their homes or even on the go, leading to a decrease in footfall. Studies further show that younger generations increasingly prioritise spending on experiences rather than goods. According to Google trends data, mentions of “peak stuff” spiked in early 2016 and have been relatively frequent since. This overlaps with the period when total returns for retail properties began to underperform other commercial property sectors and a broader slowdown in consumer expenditure growth. As a reaction to this challenging environment, the Government announced a business rate discount scheme for retail properties in the latest Budget. Occupied retail properties with a rateable value of less than £51,000 can apply for a discount of up to one third of their business rate bill in the next two years. This discount could provide some much needed support for the sector.

Having said that, a no-deal Brexit would certainly lead to a more pronounced and prolonged slump in the sector, as shown in Figure 11. Given the weaker economic fundamentals under a no-deal scenario, we would expect a weaker bounce back from the 2019 slump and a more sluggish recovery. Prolonged declines in capital values cannot be ruled out under this scenario. Even under the baseline scenario, we see capital value growth hovering around 0% with faster growth expected for 2023.

Figure 11
Retail, capital value growth, QoQ change

3.3 Office sector forecasts

The outlook for the office sector, shown in Figure 12 below, is overall a more positive one than for the retail sector. Nevertheless, the sector faces some challenges in the years ahead and, as is the case with retail, a no-deal Brexit poses a significant downside risk for capital value growth.

By leaving the European Union, the UK will cease to be a member of the EU’s single market for services. Single market membership has brought with it some considerable opportunities for the UK services sector, as businesses with a presence in the UK were able to sell their services easily to clients in other single market member states. This has been especially attractive for the financial services sector. Over the past 20 years, London has further cemented its reputation as one of the world’s foremost financial capitals, attracting large numbers of international firms who chose London as the centre of their European operations.

During the Brexit negotiations, it quickly became clear that the EU would not be willing to grant UK firms passporting rights, i.e. the right to offer financial services across the European Economic Area (EEA), after Brexit. Rather than offering a comprehensive trade deal built around financial services, the EU has stated that future relations would be based on the principle of ‘equivalence’.7 In order for businesses to offer their full service spectrum to clients on the continent, they have to set up a subsidiary in an EEA member state. EU regulators have further made it clear that these subsidiaries would need to be appropriately capitalised and staffed in order to be recognised, meaning that a mere ‘letter box’ company registration is not sufficient. This means that a considerable number of financial and professional services firms in the UK are currently considering moving part of their operations and staff to other European countries or have already done so. The extent of these movements is hard to quantify at the moment, as not all firms have disclosed their relocation plans. Professional services firm EY keeps track of publicly announced staff and capital movements by financial services firms. According to their latest Brexit Tracker report, around 7,000 jobs are confirmed to be moved from the UK to other cities in Europe.

7 Under equivalence, third-country institutions can gain access to parts of the EEA’s single market in services if the EU regulator deems regulation and oversight in the third-party country to be sufficiently close to EU standards. Importantly, equivalence is much more of a piecemeal approach covering only specific business activities and it can be unilaterally revoked by the EU at short notice.

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**Figure 12**

Office, capital value growth, QoQ change
A no-deal Brexit would likely have the effect of firms ramping up their relocation plans, moving more people and at a quicker pace to the continent. Moreover, a no-deal scenario would likely cause a substantial economic shock that could hurt demand for office space. As firms curtail their investment during economic downturns any expansion plans are likely to be shelved for some time, leading to a drop in asking prices for commercial office real estate. Under this scenario, our forecasts show capital values dropping by as much as 1.8% in Q3 2019 before recovering again.

Under a deal scenario, capital value growth is also expected to be more volatile until around 2020 when most of the fall-out from Brexit-related relocations is expected to have played out with a more positive outlook in the following years.

Despite these headwinds in the financial services sector, we estimate that the underlying demand for professional services firms in the UK will work in favour of the office sector going forward. As shown above, the UK economy is largely driven by the services sector and we expect that businesses will aim to increase their competitive edge over firms in Europe and elsewhere. This is likely to be the case for some established industries such as legal services and consulting, but also increasingly so for players in the creative and tech sectors, which have become a major driver of the UK economy in recent years.
3.4 Industrial sector forecasts

The forecasts for capital value growth in the industrial sector are shown below in Figure 13. Capital values in the industrial sector have shown the strongest growth over the previous three years pushing up total returns. In fact, the gap between industrial and retail, the best and the worst performing commercial property categories over the last few years, has widened substantially in recent times.

This outperformance of the industrial sector is illustrated in Figure 14, which shows the spread between the best and worst performing category in percentage points. Industrials has been the commercial property class with the highest total returns since May 2016. Since October 2016, the spread between industrials and retail has risen dramatically and currently stands at nearly 20 percentage points, more than three times the 2000 to 2015 average. The comparison of total return forecasts shown in Figure 15 further underlines the positive outlook for commercial property in the industrial category.

While this is partially driven by the underperformance of the retail sector, it is also interesting to look at the reasons for the high returns and relatively strong capital growth rates of properties in the industrial category.

The industrial sector is one of the beneficiaries of firms’ efforts to prepare for Brexit-related disruption. Demand for warehouses and logistics centres has solidified over the past two years as firms are securing space to increase their stocks. This trend has likely intensified in the past year with take-up of distribution warehouses in the first nine months of 2018 up 13% from the year before. Brexit stockpiling has become a widespread phenomenon among firms that fear that supply chains will be disrupted after Brexit, fuelling demand for large warehouses.

However, it is important to note that this stockpiling activity will have repercussions once Brexit uncertainty clears and businesses have some clarity about future trading relations between the UK and the EU. As these become clearer, businesses will run down their stocks and it is likely more warehouse space will come onto the market suppressing valuations. In our forecasts, we therefore see a slowdown in capital value growth under both scenarios. In the case of a no-deal, we’d expect that the economy-wide repercussions will also be felt in the industrial commercial property sector, leading to a deeper slump, slower recovery and lower capital value growth in the outer forecast years.

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Figure 13
Industrial, capital value growth, QoQ change

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8 https://www.ig.com/uk/news-and-trade-ideas/shares-news/how-is-the-uk-commercial-property-sector-performing----181127
**Figure 14**
Spread between best and worst performing category of commercial property, total return

![Spread between best and worst performing category of commercial property, total return](source: CBRE, ONS, Cebr analysis)

**Figure 15**
Comparison of total return forecasts for commercial property by type

![Comparison of total return forecasts for commercial property by type](source: CBRE, ONS, Cebr analysis)
4 Conclusion

The commercial property sector is an integral part of the UK economy and an interesting asset class for investors. Individuals looking to diversify their portfolio and those seeking to include assets that are not highly correlated with equities or other bonds should consider examining the commercial property market. This report has shown that over the past 20 years, commercial property has consistently delivered higher total returns than the FTSE 100 and gilts. Looking at yields alone shows that commercial property has been a reliable source of income for investors over recent years. Average yields across the sectors have stood nearly unchanged at 5% since 2015. Overall, fundamentals in the market remain strong given the limited supply of attractive properties in prime locations. Investors are further attracted to the UK due to low borrowing costs and a reliable legal system, which offers stability that some other international markets often lack.

However, commercial real estate is not immune to economic shocks and the performance of the different subcategories can vary substantially. It is therefore necessary to be aware of the links between commercial property and the various sectors of the economy and how these shape the outlook for commercial real estate in the years to come.

Since the EU referendum, the performance of retail, office and industrial assets has shown some considerable divergence. For the retail properties, a number of factors have come together to create a ‘perfect storm’. On the back of a decade of very low real wage growth, consumers have turned away from the high street and increasingly do their shopping online. In anticipation of Brexit, they have also reined in their borrowing habits which will weigh on consumer expenditure going forward. This in turn will have a detrimental effect on capital value growth for assets in this category.

In the office sector, demand has been strong following the recovery from the last recession. The increasing importance of professional and business services for the UK’s economy provides a strong macroeconomic background for assets in this category. However, Brexit is having a tangible effect on those services firms which want to continue to serve their clients in continental Europe. Staff relocations from the City to other European financial capitals will weigh on demand for office space in the next year. In the case of a no-deal Brexit, the economic consequences would likely be felt acutely in the sector prolonging the slump in capital value growth for this category.

Finally, factories, warehouses and other industrial properties have shown resilience in the past and become the best performing asset class of the three analysed in this report. Stockpiling activity and strong demand for warehouses from online retailers have helped the sector to withstand other economic headwinds. The unwinding of the stockpiling effect, however, poses a risk to this asset class as does a no-deal Brexit, which would severely harm many of the manufacturers that are the current tenants of the industrial assets.

"The sector presents opportunity for experienced investors to grow and diversify their portfolios. Any headwinds that present will most likely precipitate a soft landing at worst due to some of the trends mentioned in this report - with cash stockpiling in advance of a European exit featuring as a key driver.

This does not mean every commercial property investment will automatically generate great returns, particularly in the short term. Investors should take a long term view, take care to research their properties carefully, and look for expert support in order to make the best investment decisions in the current market."

Shawbrook Bank