

WATLING 

PROPERTY MARKET REVIEW

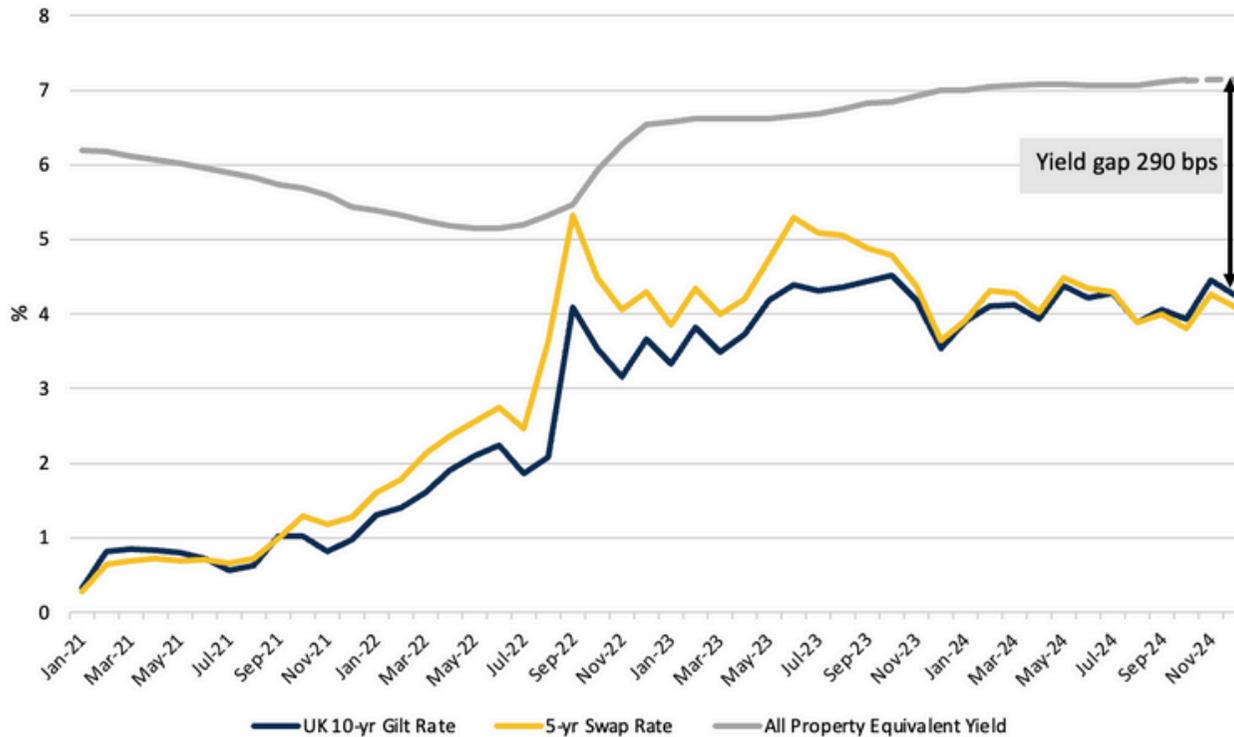
Focused for Insolvency Practitioners and Business Support professionals dealing with Real Estate assets across the UK

December 2024

MARKET OVERVIEW

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Gilt and Swap Rates edging down following post-budget spike



Source: FT, Investing.com, Various

- ▶ 10-year gilt rates spiked at 4.59 on November 6th following the October 30th Autumn budget. 5-year swap rates peaked at 4.364 on November 5th.
- ▶ Subsequently, both 10-year gilt and 5-year swap rates have fallen by c.30bps to 4.39 and 4.184 respectively (November 22nd) as the financial markets adapt to the latest economic environment.
- ▶ The yield gap between All Property yields and 10-year gilt rates is currently 290bps. With the base rate expected to fall over 2025 and into 2026 the 10-year gilt rate should continue to trend down. Assuming a property valuation lag, the yield gap will likely widen for a period before property yields also assume a modest downward trend.

With the Bank of England warning that the base rate will remain higher for longer, financing and refinancing costs will remain challenging, causing issues for highly leveraged investors. Consequently, across the macro real estate market we are not expecting yield compression (thus an uptick in values) anytime soon. However, with 10-year gilts likely to trend down next year, there is reason to believe capital values may start to show modest increases from H2 2025.

The sub-sectors most under pressure continue to be offices and in-town retail, with little positive data available across these asset classes. For example, London City office investment in Q3 2024, was 60% below the 10-year average as investors increasingly favour markets such as Life Sciences, Data Centres and the Living Sectors. In respect of retail, the recent budget will do little to increase consumer confidence and sales volumes and, with few retailers having occupational requirements on the High Street, we expect challenges to remain.

Well publicised issues, such as insolvencies, finance costs and supply chain shortages throughout the construction industry continue to impact the development market. Speculative development remains limited in most sub-sectors, which is resulting in rental growth in supply constrained locations.

4.75%

Current base rate

4.0%

Forecast base rate end 2025

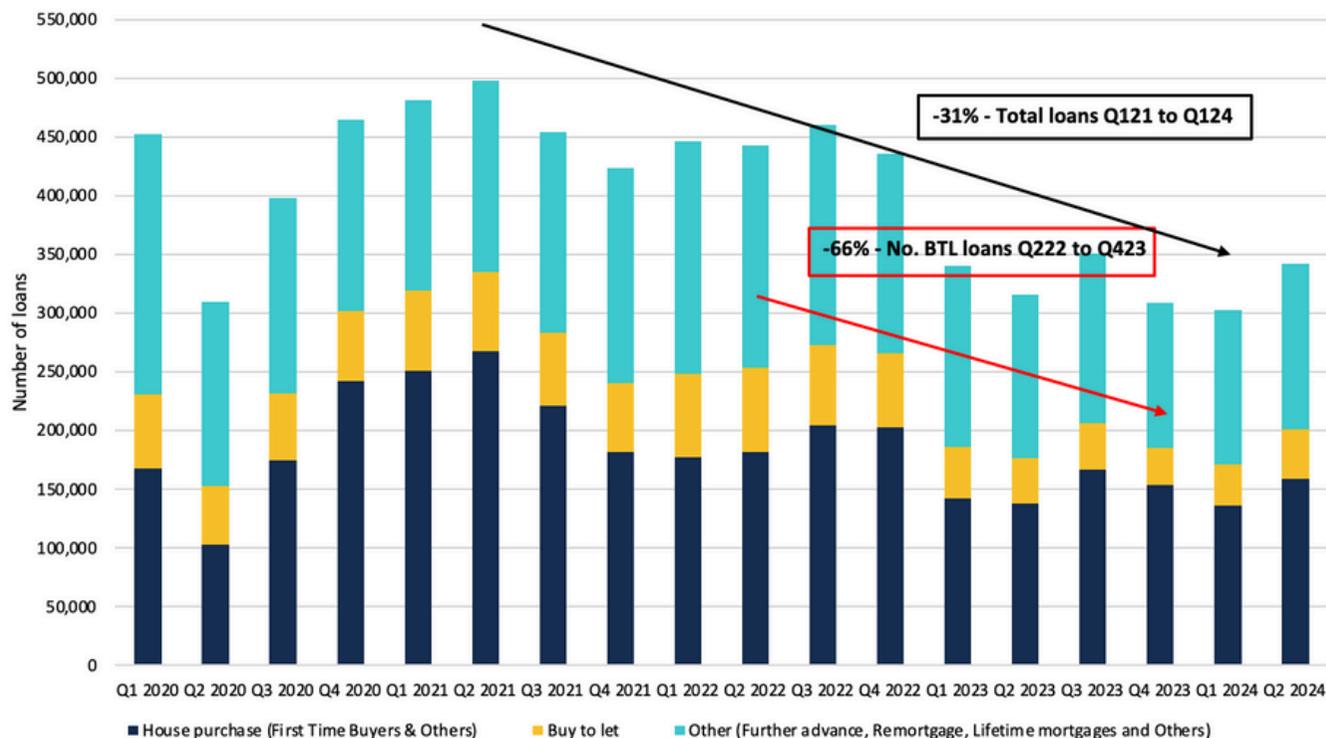
30bps

Fall in 10-year gilt and 5-year swap rates since Autumn budget spike

RESIDENTIAL SECTOR

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Mortgage loans by purpose



Source: Bank of England

- The total number of loans fell by 156,700 between Q1 2021 and Q1 2024 (-31.5%). Q2 2024 saw a slight recovery, but issued loans remain low by historic levels.
- The number of buy to let (BTL) loans fell by a staggering 66% in the 18-month period Q2 2022 to Q4 2023 to just 31,700. 2024 has seen an uptick to 42,400 BTL loans, but it remains 41% below mid-2022 levels.
- BTL loans represented 41.3% of loans issued during Q2 2022 compared with 30.1% in Q2 2024.
- At the end of Q2 2024 there were 13,570 BTL mortgages in arrears greater than 2.5% of the outstanding balance. This was up 51% on the same quarter a year previously. There were 710 buy-to-let mortgage possessions taken in Q2 2024, up 33.8% on the same quarter a year previously.

It is of little surprise that the BTL sector is falling out of favour with some investors. With relatively high interest rates, stamp duty increases and government intervention all having a detrimental impact on landlord returns.

Most landlords will seek to pass these increased costs onto tenants by way of increased rents. However, with the cost of living remaining high (thus impacting tenant affordability) and the possibility of the government rent controls, there is an uncertainty as to whether the additional costs can be passed on in full. For some landlords and lenders, this will present a real challenge. We are seeing highly leveraged investors restructuring their investments and or exiting the market, with values often underpinned by vacant possession value rather than an income / yield approach.

In respect of sub-sectors, there is an increasing polarisation. Investment in the city centre build to rent (BTR) sector remains strong as investors perceive an undersupply in most regions and rental growth is likely to be more easily digested by the tenants.

However, stress is more apparent in the single family home rental (SFR) market where, typically, lower income families reside. In this sector tenant default is more prevalent and, with evictions for arrears taking up to a year, landlord stress is plentiful. At this point in the cycle, we are generally witnessing landlords and their lenders finding consensual solutions and seeking to mitigate risk by requiring tenant guarantors (of substance) and including RPI annual rent increases. Wide scale distress in the sector may follow.

-31.5%

Reduction of total number of loans between Q1 2021 and Q1 2024

42,400

Number of BTL loans in Q2 2024 – still low by historic levels

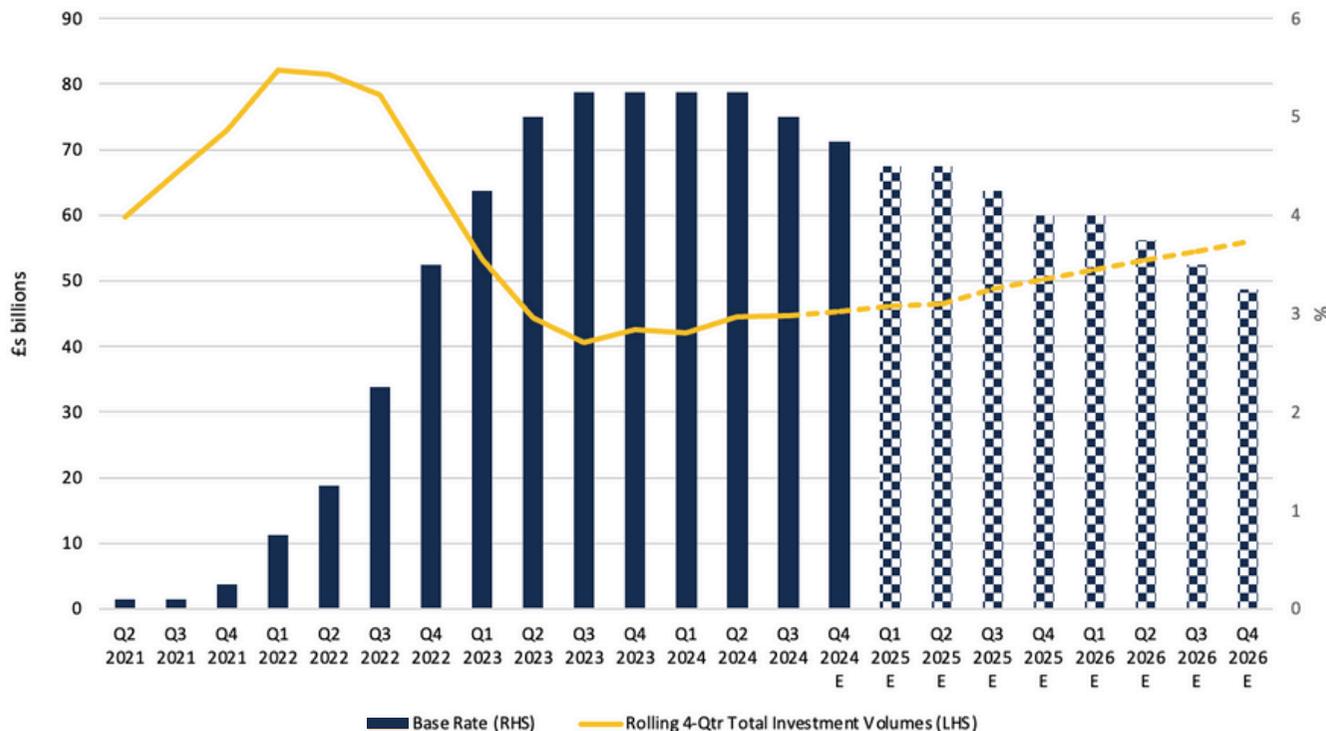
51%

Q2 2024 y/y increase in BTL mortgage arrears

INVESTMENT MARKET

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Steady recovery in investment volumes as base rates fall



Source: Bank of England, Various, Watling Real Estate

- ▶ With the ongoing inflationary threat, interest rates will stay higher for longer. Our view is that rates will edge down gradually to 4% at the end of 2025. Assuming no major external shocks, the base rate should continue to trend down to c. 3.25% in Q4 2026.
- ▶ Investment volumes will increase as base rates decline, investor confidence returns and the cyclical turning point is confirmed. Increasing volumes will increase liquidity and, with that, an increase in capital values should follow.
- ▶ With Trump threatening global trade tariffs, and instability in Ukraine and the Middle East, the course of economic growth and interest rate movements is far from certain – all of which could impact on investor confidence.

Whilst All Property values have fallen 24.4% from their peak in June 2022 (MSCI), there is little doubt the market has now generally stabilised with only Offices continuing to see value erosion in the last quarter.

As we move into 2025, the falls in office values are likely to continue and be more pronounced in regional markets. A lack of debt availability for refinancing office assets is likely to become more pronounced, resulting in further distress and, potentially, crystallising lower valuation points.

Industrial values have increased since March, albeit at a modest rate, and we expect that this sector will continue to thrive, particularly for prime / logistics units. Secondary industrial markets will continue to be threatened by environmental obsolescence with lenders continually assessing EPC risk weighting across their portfolio.

Growth sectors will include Living, notably PBSA (for the short term, see Watling i Q3 2024), senior housing, co-living, and infrastructure, including data centres, renewables and energy storage. Repurposing obsolete underperforming assets to these emerging sectors may present exits for some stressed cases.

2.3%

October CPI (vs September 1.7%) – inflation still an issue

20-25%

Expected growth in investment volumes through to Q4 2026

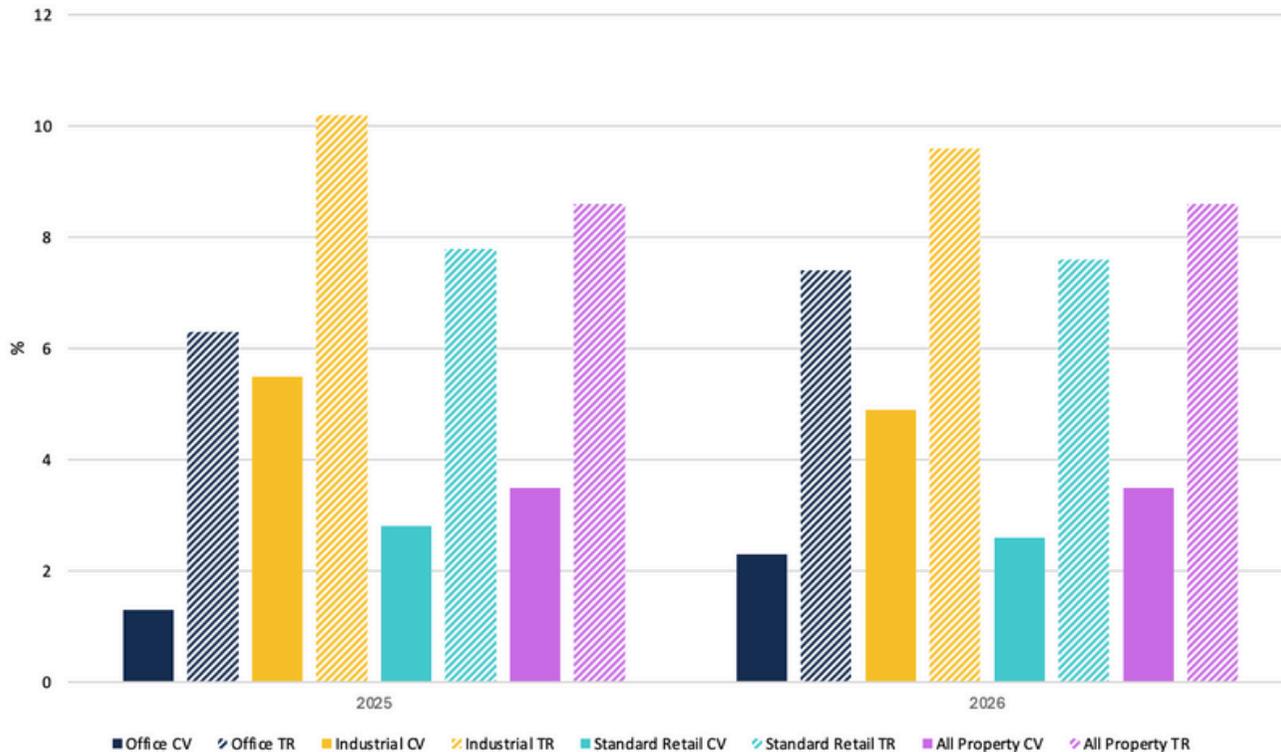
>£55M

2026 investment volumes

2025 REAL ESTATE FORECAST

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Capital Value and Total Return forecasts



Source: IPF

- ▶ All Property capital growth is forecast to recover from c.0.6% in 2024 to 3.5% in both 2025 and 2026. Combined with stable income returns of 5%, All Property total returns of 8.6% are anticipated in 2025 and 2026.
- ▶ The Industrial and Retail Warehousing sectors are expected to be the top performing sectors, with relatively strong rental growth driving returns of >10% in 2025 and >9% in 2026. Shopping Centres, long out of favour, stage a strong comeback. Retail warehousing is forecast to be the best performing sector over the five-year period 2024 to 2028 with a total return of 9.4%.
- ▶ Both the Office and Standard Retail sectors return to positive capital growth in 2025 (1.3% and 2.8% respectively). Offices will benefit from supply constraints of quality stock as office-based employment continues its post-covid recovery, although it remains the weakest performing sector over the five-year forecast period. Standard Retail benefits from modest rental growth in prime locations and the sharp sector re-pricing experienced in recent years.

The forecast data for real estate paints a mixed picture for 2025 and beyond. Moreover, commentators tend to focus on prime assets and, as a result, this masks stress and challenges with secondary buildings and locations.

This may be best illustrated for Offices where the sector is increasingly polarised as both occupational and investor demand focuses on the highest quality stock and prime locations. Tenant demand for “best in class” will drive rental growth in prime locations. However, increasingly stringent environmental legislation and weak tenant demand risks a raft of obsolete secondary stock and further falls in value.

While the retail sector is staging a modest recovery, led by retail warehousing, the full impact of higher employer costs and business rates have yet to be fully felt. The retail and hospitality and leisure sectors are highly vulnerable, and we expect further distress as we move through 2025.

Strong occupational demand and supply constraints will continue to drive strong performance in the Industrial sector, particularly large distribution units. Challenges may present in the SME-driven multi-let industrial segment as businesses adapt to higher post budget costs.

A comprehensive overview of our thoughts on themes and trends for 2025 will be released in early January 2025.

3.5%

All Property forecast capital value growth 2025 and 2026

8.6%

All Property forecast total return 2025 and 2026

10.3%

Top sector 2025 - Retail Warehousing total return



WATLING 

LONDON

60 Cannon Street, London, EC4N 6NP

BIRMINGHAM

75/77 Colmore Row, Birmingham, B3 2AP

LEEDS

One, The Embankment, Neville Street, Leeds, LS1 4DW

MANCHESTER

125 Deansgate, Manchester, M3 2BY

BRISTOL

17-19 Berkeley Square, Bristol, BS8 1HB

WATLING.COM

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