UK Real Estate Overview

Q3 2021

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UK Economy

- Strong positive growth continues in the UK with 2021 GDP forecasts of 7.2% growth. However, the recovery is facing mounting headwinds as gains from the reopening of the economy are now largely behind us, government support schemes are being withdrawn, a Health and Social Care levy will be introduced from April 2022 and the temporary uplift to universal credit has ended, all of which combined will see GDP growth in 2022 moderate to 5.7% from 6.7%.
- Growing labour and component shortages and escalating supply-chain disruption are weighing in whilst inflationary pressures are building. The combination of the reversal of the VAT cut for the hospitality sector, rising petrol prices, a 12% rise in the energy price cap and rising global goods prices could see inflation reach 4.5% by the end of 2021, adding to the pressures faced by consumers.
- But, consumers having had limited opportunities to spend over the past 18 months have seen households repay unsecured credit and accumulate savings. This strengthening of household balance sheets has left, a proportion of, consumers in a relatively strong position to support the recovery by taking on new credit and spending some of their excess savings.

Key Risks

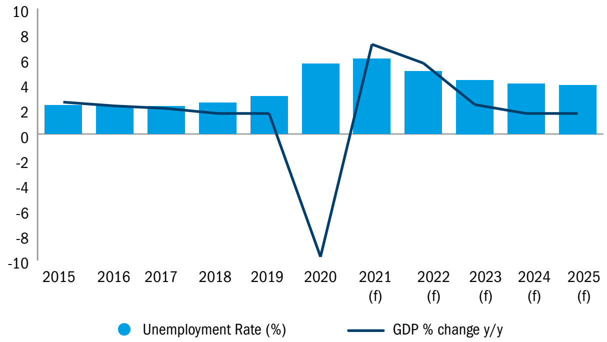
Our review and outlook is a marketing communication providing an overview of the recent economic and property market environment. It should not be considered as advice or a recommendation to buy, sell or hold investments. Nor is it investment research and has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. As with all investments, capital is at risk.

The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

The value of directly held property reflects the opinion of valuers and is reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

- The winding down of the furlough scheme at the end of September does not appear to have had a detrimental effect on the labour market with unemployment having already peaked at just over 1% above it pre-pandemic level.
- The recovery has been supported by exceptional fiscal and monetary policies which are being withdrawn, but the recovery is sufficiently entrenched that it can withstand the loss of the support. Furthermore, it is likely that inflation will slow in 2022 as labour shortages ease and supply chains normalise and the Bank will gradually raise the base rate to 0.5% by the end of 2022.

GDP growth & unemployment rate (%)

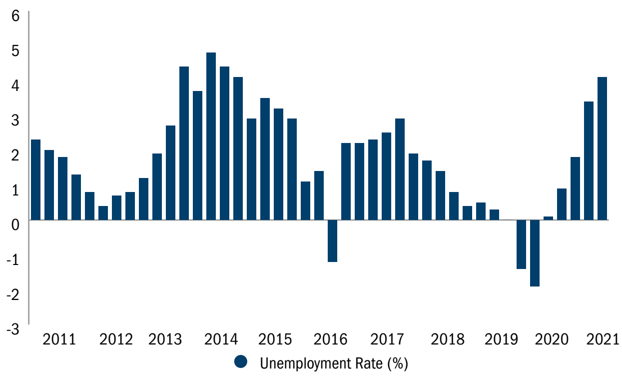


Source: Oxford Economics as at 01-Nov-21

Total returns performance strongest in six years

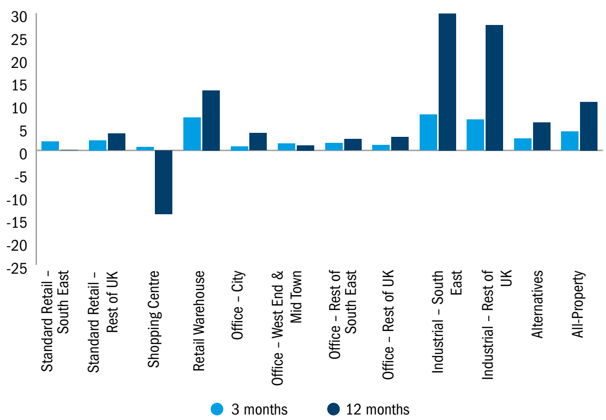
- On a twelve month rolling basis total returns are back in double digit territory, with an all-property total return of 10.6% over the year to September 2021, driven largely by yield compression. This is the highest it has been since March 2016 – just before the Brexit Referendum. The total return in the three months to September was very strong, posting a 4.1% return, and is the strongest quarterly performance since the end of 2014.
- Industrial has been the stand out sector over the past twelve months with a total return of 29.0%, setting a new record high and eclipsing the all-property total return over the same period. There is no material divergence between logistics and standard industrial with activity continuing to be fuelled in part by the onward march of e-commerce and restructuring of supply chains.
- On a quarterly basis industrial is again the best performing sector (7.4%) with both yield compression and positive rental growth. Retail follows, having made a comeback over the last two quarters, with a Q3 total return of 3.8%, driven by yield compression while rental growth is slow.
- Divergence in the retail sector is becoming more evident with retail warehouses posting a strong quarterly total return of 7.2%, on par with industrial, driven by yield compression, while rental growth was stable. Shopping centres and high streets both saw yield expansion and negative rental growth over the quarter as structural changes continue to play out.
- Offices are positive overall, but progress is slow, with a quarterly total return of 1.4%. Momentum in the City gathers pace with a positive annual return of 3.8%, with the West End, albeit improving, still negative on an annual basis (-0.6%).
- Looking forward, the strongest all-property performance is in 2021 at 14%, moderating to 5.8% in 2024. Over the five-year forecast horizon, industrial and retail warehouses are predicted to be the best performing sectors.

Three month all-property total returns to September 2021 (%)



Source: MSCI UK Quarterly Property Digest as at Sep-21

Total returns 3 & 12 months to September 2021 (%)

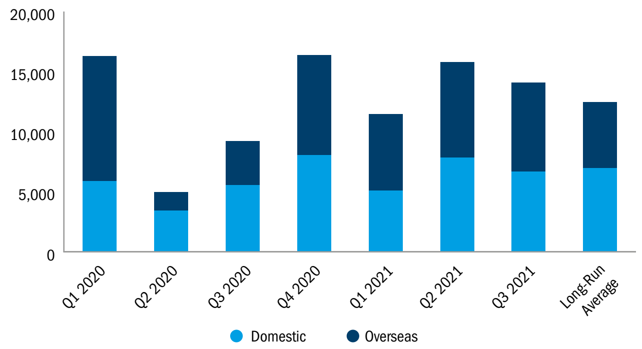


Source: MSCI UK Quarterly Property Digest as at Sep-21

Investment Market

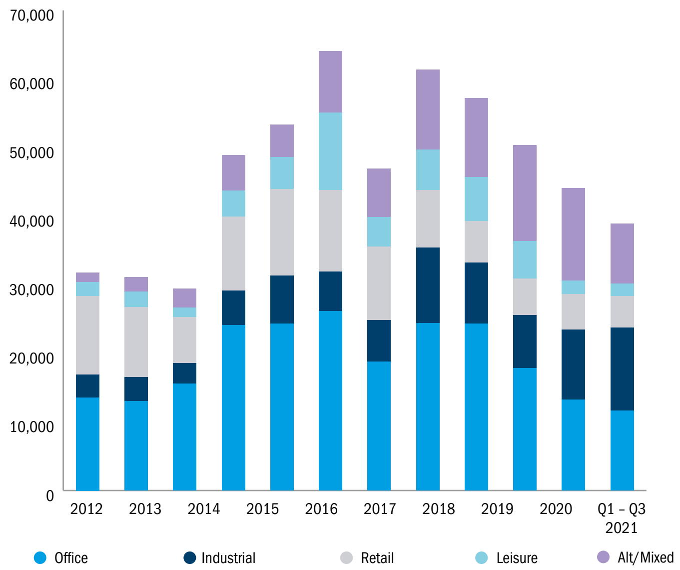
- The recovery continues with £14.1 billion invested into the UK real estate market, well ahead of the £12.4 billion long-run average, solidifying that the final year's total will exceed that of 2020 and likely to be in excess of £55 billion.
- Overall volumes have been boosted by the resurgence of the living and industrial and logistics sectors over the recent past as investors show a clear preference for sectors that are underpinned by their ability to offer long-term, defensive income.
- Cross-border investors continue to increase their allocation to UK real estate, with a 60% share of third quarter deals, up from the 55% seen in Q2. Capital from outside Continental Europe is of note with investors from North America, Singapore and Hong Kong particularly acquisitive in Q3.
- The hype around the future of offices is subsiding as the need for a hub for employees becomes clear, but there is a notable focus on the best quality assets, in the best locations with strong income streams. Overall activity in 2021 is subdued against historic levels, but the Q2 bounce back has flowed into the third quarter, with a 31% share.
- With fundamentals supportive of further rental growth in the industrial sector, £4.4 billion worth of deals closed in Q3. So far this year volumes reached £12.2 billion and is likely 2021 will set a new record. Demand is set to push yields lower and with this some investors are looking to assets with a level of risk, be that location or leasing, or a need for improvement/ refurbishment/ future proofing of stock in order to drive higher returns.
- Retail is seeing more divergence with food stores and retail warehousing more immune to online competition and have been pretty resilient over the past 18 months. Shopping centres and high streets, with lower levels of demand are however beginning to see rising levels of, albeit, select interest and not just with the aim of repurposing.
- Pricing for quality assets is generally holding firm, with a few notable exceptions in the retail (shopping centre and high streets) and leisure segments.

Investment activity £m



Source: Property Data as at Sep-21

Investment activity by sector (£m)

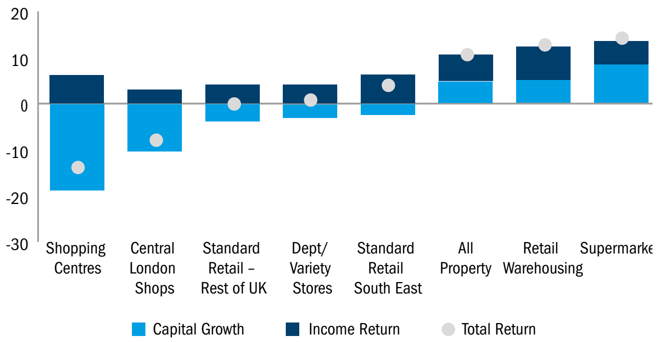


Source: Property Data as at Sep-21

Retail

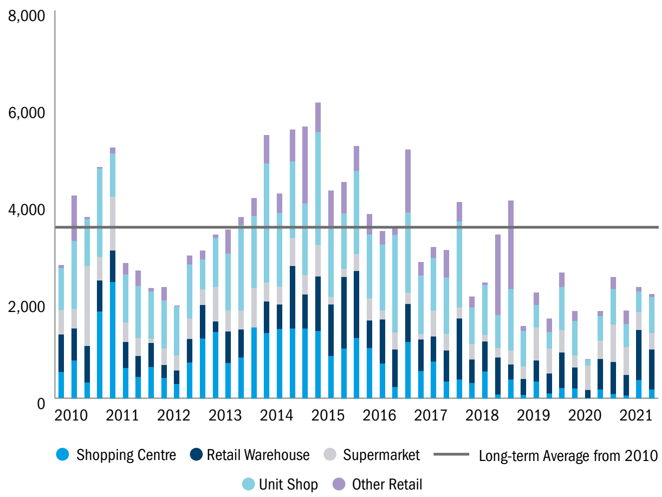
- The positive momentum seen in the second quarter has flowed into the third quarter posting a 3.8% total return – the second positive result since mid-2018. The annual total return is positive at 3.1%, a significantly better performance than the -12.9% in the year to September 2020.
- On a quarterly basis retail is the second best performing sector (after industrial), with a Q3 total return of 3.8%. Divergence in the retail sector is becoming more evident with retail warehouses posting a strong quarterly total return of 7.2%, on par with industrial, driven by yield compression. Supermarkets are showing a similar story. Shopping centres and high streets both saw yield expansion and negative rental growth over the quarter as structural changes continue to play out.
- Across the UK retail appears to be improving, albeit from a low base. Wales posted the strongest quarterly total return of 2.0%. London is beginning to see a more positive performance as shops reopen with rising numbers of workers returning to offices and rising number of tourists.
- Investment volumes in Q3 reached £2.2 billion – supermarkets and retail warehouses continued to perform well, underpinned by their ability to offer longer leases and together accounted for 54% of Q3 activity (£1.2 billion).
- Repurposing remains a key theme, particularly for shopping centres, while high streets have seen a number of redevelopment driven deals and both have seen a noted rise in interest as a counter-cyclical play. Retail warehouses have seen a 25 bps drop in Q3 yields, solidifying their attraction to investors and ability to offer returns with strongest demand for rebased, discount-led parks.
- The outlook for yields will be determined by stock availability, debt and confidence around retail covenants. The end of the rent moratorium in Q1 2022 will be keenly watched and while could have a negative impact, it is not expected to be a seismic shock to the sector.

Retail total returns by selected segments annual to September 2021 (%)



Source: MSCI UK Quarterly Property Digest as at Sep-21

Retail investment activity (£m)

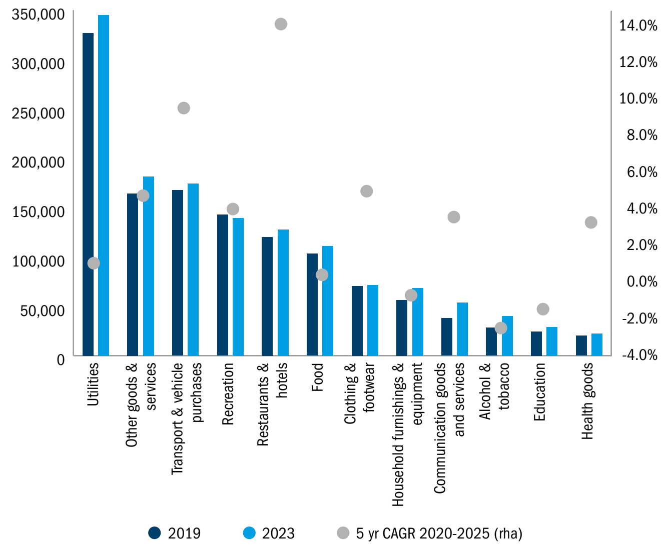


Source: Property Data as at Sep-21

Retail occupier market

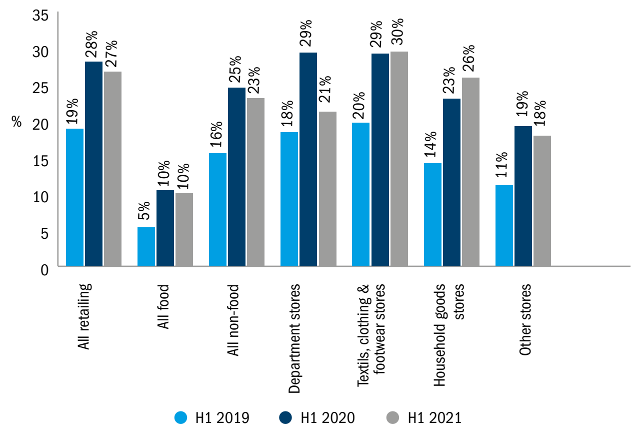
- Occupational demand is improving, although most activity is in the leisure and discount/essential retailer sectors with well capitalised tenants beginning to take space, but it is on a very selective basis as they cherry pick the best units.
- The marked improvement in consumer sentiment following the lockdowns has begun to slow as the cost of living rises and energy prices surge amidst continued supply chain disruption.
- Non-essential retail spend grew by 12.9% compared to equivalent 2019 levels, and while still inherently positive, it softened compared to August, highlighting the early beginnings of consumer concerns and perhaps, looking ahead, indicates a further reduction in discretionary spending.
- The share of online shopping has been declining from its peak earlier in February 2021 when it reached 36%, dropping to around 27% as non essential retail reopened and consumers adapted to the 'new normal' way of shopping.
- March 2022 will see the moratorium over tenant evictions end with many occupiers holding back rent payments from periods of enforced closure, while at the same time looking to renegotiate leases. Rents have come under further downward pressure as a result but the pace of decline is beginning to ease and there are now signs of stabilisation in some stronger locations albeit at much reduced rental levels.
- 2021 has seen retail failures slow, aided by Government support, but levels could rise again as occupier costs increase and the much hoped for cut in business rates in 2023 does not materialise in the October budget.
- Rent collection is still a challenge with around 60% of rent collected in the third quarter, and whilst an improvement on Q2, the rise is from a low base. Improvements could materialise with new deals that return tenants to rent paying position (often by writing off historic arrears).

Consumer spend (£m) and 5 year annualised growth (%)



Source: Oxford Economics as at 15-Oct-21

Online sales as a proportion of all retailing by category

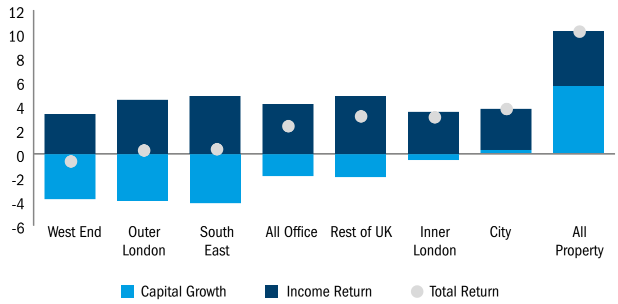


Source: Source: Local Data Company, Office of National Statistics as at Sep-21

Offices

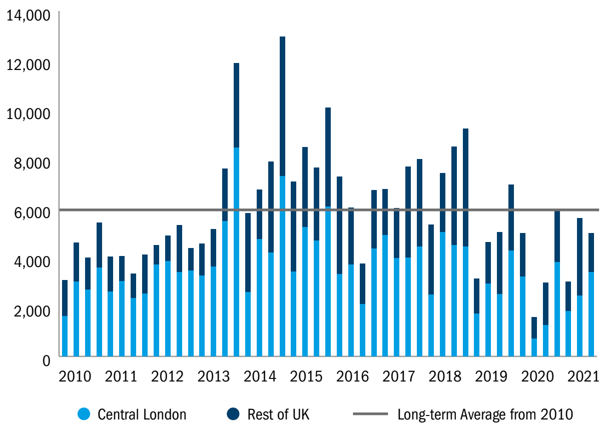
- There was much better news coming out of the office sector which delivered a 1.4% return in the three months to September, building on the 1.4% total return from the second quarter.
- More positive signs for offices are emerging as occupational demand picks-up and availability stabilises. The total return for this year is expected to be in the region of 3.7%, averaging 5.5% between 2021 and 2026. Central London and South Eastern offices are expected to be the best performing regions over five years.
- Offices are positive overall, but progress is slow, with a quarterly total return of 1.4%. Momentum in the City gathers pace with a positive annual return of 3.8%, with the West End, albeit improving, still negative on an annual basis (-0.6%).
- £5.0 billion was invested into the office sector in Q3, brining the year's total so far to £13.6 billion. Over half of which transacted in London making the third quarter the strongest for inflows into the capital in 2021, reaching £3.4 billion.
- London prime office yields are now at 3.25% in the West End and 3.75% in the City, both 25 bps below their levels pre-COVID-19 as the pricing discount with major European capital cities is further eroded.
- Despite a slowdown in overall numbers due to the health crisis, London maintains the top spot for cross-border investment attracting a truly global investor base. The share of foreign capital dipped at the peak of the crisis as international borders were closed, but has steadily climbed since to reach 70% in 2021 so far, with Germany, North America, Hong Kong and Chinese investors the most acquisitive.
- The regional office markets, albeit largely targeted towards the 'Big Six,' are attracting a considerable weight of capital with Q4 expected to be the strongest quarter of the year. With a growing mismatch between buyer and seller expectations and with a clear investor focus on prime and value-add, a widening yield gap between prime and secondary is more evident.

Offices total returns by selected segments annual to September 2021 (%)



Source: MSCI UK Quarterly Property Digest as at Sep-21

Office investment activity (£m)

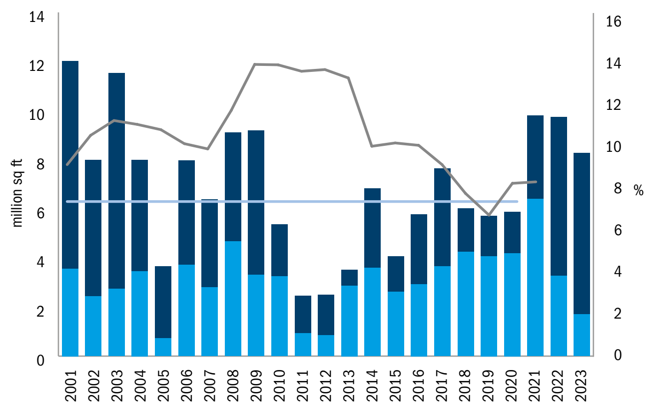


Source: Property Data as at Sep-21

Office occupier market

- London's occupier market continues to see positive signs that the recovery has not lost momentum as the third quarter saw another quarterly rise in both the amount of space let and the number of deals that concluded, equating to 2.4 million sq.ft of take-up as searches put on hold due to the health crisis have been reactivated and the level of new, active requirements rises as well.
- A broad range of occupiers are looking to take space, including from the tech sector, professional services and finance, but some occupiers are looking to build in lease flexibility or take shorter leases. As occupiers continue to review their office accommodation strategies, some are opting to renew or extend their leases while the full impact of the new hybrid working environment evolves further, and it may not be until spring 2023 that the full impact of the future of offices is fully understood.
- Vacancy in London is 7.3% and is showing signs of stabilisation as some availability is taken off the market, some older, excess space is repurposed and a large proportion of the development pipeline is pre-let. This is being reflected in a stabilisation in headline rents as occupiers gravitate to well-located, quality space, while sublease space is typically being offered at 10% – 20% discounts.
- While overall take-up figures are lower, there has been a notable flight-to-quality emerge with occupier demand focused on buildings which promote wellness and better support modern, collaborative layouts. This comes at the detriment of older stock, causing rental growth on prime offices to outpace the rest of the market.
- The trends in the regional office markets are not notably different to the capital. 2.4 million sq.ft was leased in Q3 across the top nine regional cities which is 11% up on the ten-year average.
- Centrally located, Grade A space is the most sought after and an increase in refurbishments has been noted as landlords look to improve their stock and make it more attractive to tenants.

Key UK office markets – development pipeline

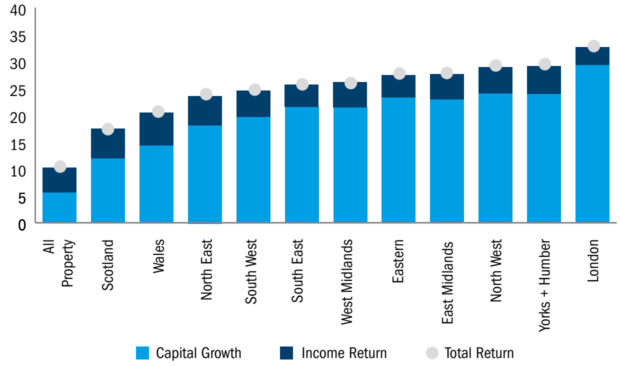


Source: Colliers, Q3 2021 update

Industrial

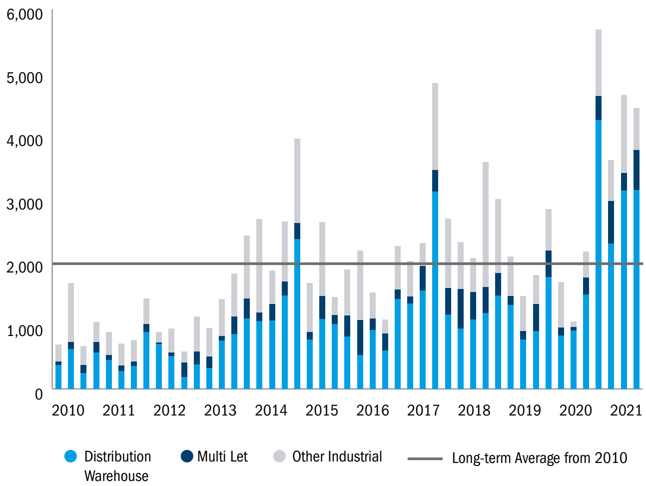
- Industrial has been the stand out sector over the past twelve months with a total return of 29.0%, setting a new record high and eclipsing the all-property total return over the same period of 10.6%. There is no material divergence between logistics and standard industrial with activity continuing to be fuelled in part by the onward march of e-commerce and restructuring of supply chains.
- London goes from strength to strength and over the year to September 2021 was the strongest performer, posting a return of 33.8%. While all regions posted robust returns, outside the capital, the North West and Yorks & Humber, both with annual total returns of 30% were the next best performing regions.
- Investor sentiment is buoyant, with volumes over the first nine months of 2021 reaching £12.7 billion, accounting for 29% of the total market – the highest ever share for the sector and well above the 2020 annual total of £10.6 billion.
- Overseas investors have been the most acquisitive so far in 2021 with involvement in 60% of transactions. US investors have spent in the region of £5.4 billion in 2021, although the sector is attracting capital from across the globe with money from Singapore, Canada, Switzerland, Germany and Australia also prevalent.
- 2021 will be a record breaking year for investor activity with the current pipeline of deals and equity raises indicating a busy last quarter. With the pool of occupiers continuing to grow in the sector, rents are rising as demand outstrips supply, creating opportunities for investors looking to capitalise on those markets with strong rental growth potential, and activity is flowing into further yield compression.
- As yields continue to sharpen, value is becoming increasing difficult to find and returns are being squeezed. While logistics still looks attractive, underpinned by the strong rental growth assumptions, investors, looking for higher returns, see capital drawn back to the office, retail and leisure sectors, and the reallocation of capital to those sectors hit hardest by the pandemic is likely to slow logistics yield compression.

Industrial total returns by selected segments annual to September 2021 (%)



Source: MSCI UK Quarterly Property Digest as at Sep-21

Industrial investment activity (£m)

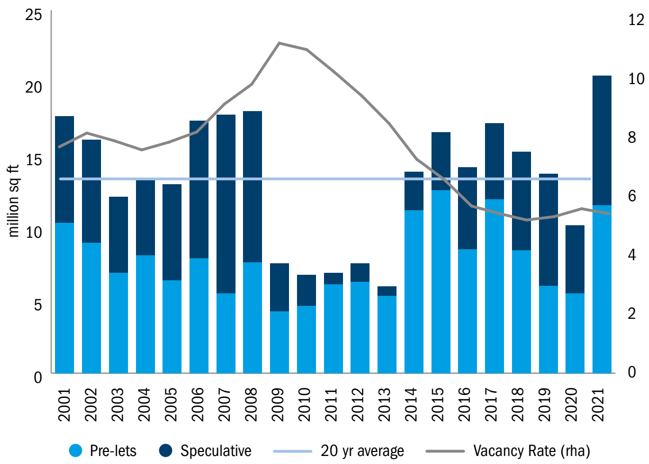


Source: Property Data as at Sep-21

Industrial occupier market

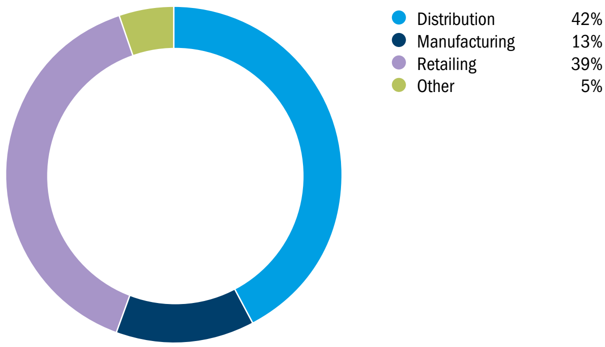
- 2021 has broken records more than once – third quarter leasing activity broke the record set in the previous quarter by 3%, with take-up just under 24.0 million sq.ft, bringing total occupier activity for the year so far to 62.9 million sq.ft, surpassing the total recorded in 2020.
- Logistics operators are active, in particular 3PLs and retailers as they assess their footprint and implement necessary changes as they look to establish, support and/or expand their online offering. But there is a depth and breadth to occupier demand, with the manufacturing sector stepping up, notably from battery and food production and green energy, to film and TV production occupiers taking space.
- Vacancy, at around 4.6%, is at an all time low as availability is driven down by unrelenting demand levels. The situation is especially acute in London, the South East and the Midlands markets.
- This leaves occupiers looking for space for immediate occupation with limited options. With approximately 13 million sq.ft of speculative space in the pipeline, this will go some way to alleviate the shortage, but much will pre-let before completion.
- Given demand levels outstripping availability, developers are more confident and rising numbers of schemes are breaking ground. Of the 15.3 million sq.ft of development starts in Q3, 42% are speculative. Some developers are looking to create value in repurposing older stock.
- As material shortages and supply chain disruption influence rising construction costs, these are likely to be pushed down to the occupier through higher asking rents. In addition, lead times have been extended as there is competing demand from some major infrastructure projects such as HS2 and Crossrail.
- The supply:demand imbalance has seen new rental benchmarks set in some markets with prime west London rents just shy of £20/sq.ft/year in Park Royal and Heathrow.

UK key industrial regions – development pipeline



Source: Property Market Analysis, Q3 2021 release

Q1 – Q3 2021 take-up by occupier type (%) (units over 50,000 sq.ft)

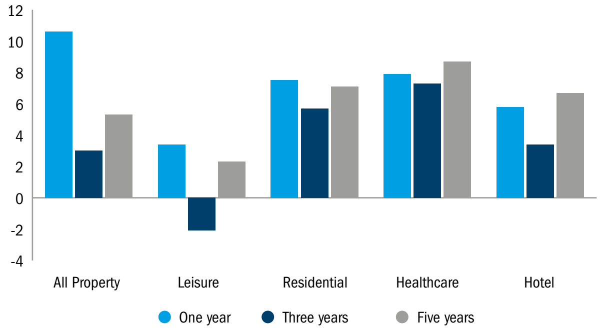


Source: Knight Frank as at Oct 2021

Alternatives

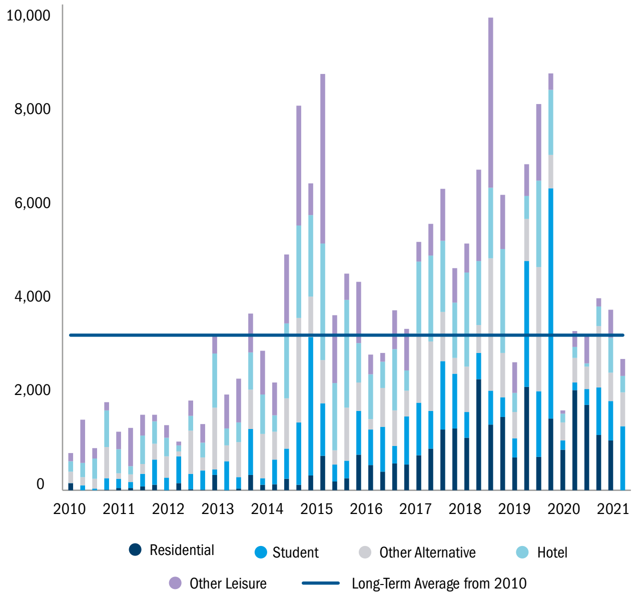
- The alternative sector delivered a quarterly total return of 2.6% to September 2021 and while underperforming the market. where the all-property total return was 4.1%, the gap is closing as lockdowns are lifted and previously closed sectors, in particular leisure and hospitality reopened – the total return in the year to September was 5.7%.
- There is less polarisation in the alternative universe than twelve months ago. Residential and healthcare continue to benefit from the health crisis, posting strong returns in the year to September of 7.5% and 7.9% respectively. Leisure meanwhile, has moved out of negative territory over the year, posting a 3.4% total return as the positive impact lifting of restrictions is filtering through to performance. On a quarterly basis the total return was 2.5%, the strongest since the end of 2017.
- The alternative sector has seen £8.2 bn worth of capital invested over 2021 to Q3, boosted by the £2.7 bn invested in Q3, just ahead of Q2 levels. Student accommodation was the stand out sector with £1.3 bn exchanging hands in Q3, boosted by the £969 mn portfolio sale of 11 sites by GCP Student Living to Scape Student Living and iQ Student Accommodation Group .
- Activity in the hotel sector in Q3 has been boosted mainly by domestic tourist demand driving occupancy and pushing up average daily rates. Mid scale and economy hotels recorded the largest rise in occupancy whilst the luxury upper scale hotels, and those in major city centres, more reliant on the international tourist and business traveller, continued to lag behind.
- Labour shortages and the cost of finding and employing staff will likely impact income margins. Investor demand is subdued with just £330 mn transacting in Q3, bringing the total in 2021 so far to £1.4 bn – the lowest Q1 – Q3 total since 2012. But, with a couple of deals close to £100 mn concluding as travel restrictions ease and occupancy levels rise, this is a sign of encouragement.

Alternatives total returns by selected segments annual to September 2021 (%)



Source: MSCI UK Quarterly Property Digest As at Sep-21

Alternatives investment activity (£m)



Source: Property Data as at Sep-21

Along with BMO Real Estate Partners in-house Research, a variety of sources have been used in the production of this document including CBRE, Knight Frank, Savills, Avison Young, PMA, MSCI and Oxford Economics.

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