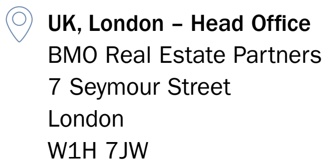
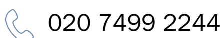
COLUMBIA THREADNEEDLE
INVESTMENTS | REAL ESTATE PARTNERS

UK Real Estate Overview

Q4 2021

Contact us


UK, London – Head Office
BMO Real Estate Partners
7 Seymour Street
London
W1H 7JW


020 7499 2244

Research

Joanna Tano

jtano
@columbiathreadneedle.com

Business Development

Angus Henderson

ahenderson
@columbiathreadneedle.com

Telephone calls may be recorded.

UK Economy

- In 2021 GDP rose by 7.5% – the strongest growth since the second World War – as the economy rebounded from the 2020 hit brought on by the health crisis. The 0.2% contraction in December caused by the omicron variant was less than expected, offsetting some of the impact dealt to many service industries, and the government's 'Plan B' guidance was lifted by the end of January 2022.
- The hope is that the worst of the health crisis is behind us, but as COVID related headwinds begin to fade they are being replaced and there are two key markers to watch. Firstly the speed of further interest rate rises as the Bank of England look to curb the inflationary pressures, having raised the rate by a quarter point to 0.5%, the first back-to-back rise since 2004 and a signal that more rises are to come.
- The second is inflation staying above the 2% target for longer having reached a 30-year high of 5.5% in January 2022. It is expected to peak in April at around 7.5% when the household energy bill cap is set to rise by 54%. In mitigation, the Chancellor offered an underwhelming package of support and while a £9.1 billion package might sound impressive, the detail was perhaps less so.
- As household finances are squeezed from high inflation this is delaying the rotation in spending back from goods to services. Retail sales in January probably saw some revival following December's sharp drop whereby volumes fell 3.7%, reflecting an

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.

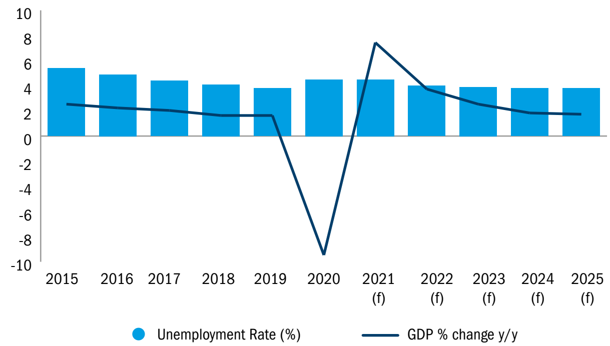
The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

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.

unwinding of previous strength as some consumers made Christmas purchases ahead of the holiday season. As infection numbers decline and the timing of spending returning to more normal patterns, retail sales are forecast to have rebounded by 2.2% in January.

- The strength of the labour market is perhaps underestimated
as employment has recouped the falls after the furlough scheme, the unemployment rate has fallen to pre-COVID levels and job vacancies are at a record high putting pressure on wage growth.

GDP growth & unemployment rate (%)

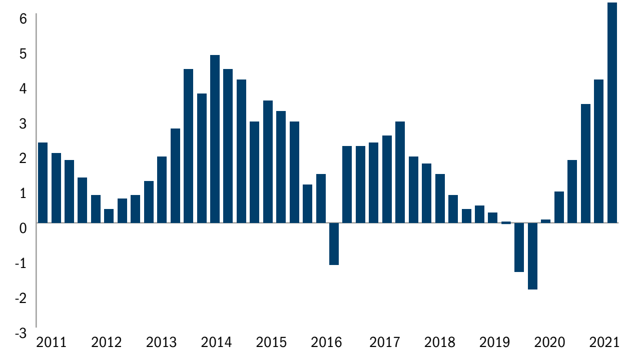


Source: Oxford Economics as at 14-Jan-22

Best quarterly performance since 2009

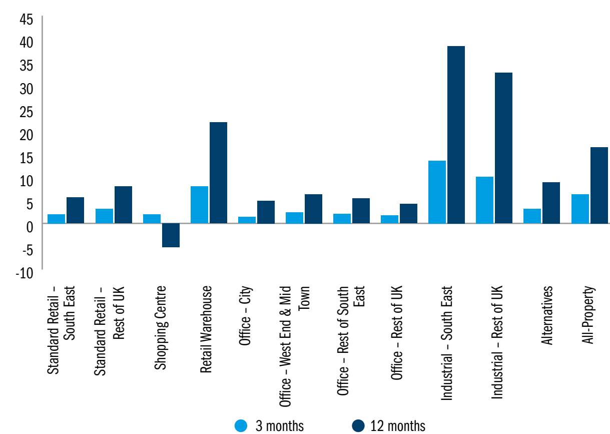
- Momentum in Q4 2021 rolled over from Q3 with an annual all-property total return of 16.5%. In the three months to December the all-property total return was 6.3%, a quarterly performance not bettered since 2009. The bulk of performance was driven by yield compression, but rental growth has been showing signs of improvement at 1.2% for the quarter.
- Nuances play out behind the scenes with industrials grabbing the majority of the headlines, posting a staggering annual total return of 36.4%, a level not seen since 1988. The sector also posted the largest ever quarterly total return of 12.4% with 2021 leasing activity hitting its highest level ever reported pushing the national vacancy rate to the lowest ever.
- Retail, despite the ongoing shift to online leaving its indelible mark and driving structural changes was, perhaps surprisingly, the second best performing sector over three and twelve months to December 2021, posting respective total returns of 4.6% and 10.4%. While there is more stability on high streets and shopping centres, retail warehouse is the stand out segment as the shift to hybrid working favours local and retail warehouses have proven resilient over the course of the pandemic in terms of value and footfall.
- Offices are seeing more signs of stabilisation with an annual total return of 5.3%. The all-office total return is expected to accelerate over 2022 as yields continue to compress and rental growth picks up. Positive rental growth is being seen in Central London and whilst it is marginal, it is positive nonetheless. Sentiment in the regional office market is upbeat with well-located, good quality assets with a strong tenant base continue to receive good levels of interest.
- The 16.5% annual total return is driven by yield compression but with positive rental growth becoming more evident and widespread. Over five and ten years direct real estate outperformed equities and bonds showing that real estate is a strong asset class over the medium to long term.

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



Source: MSCI UK Quarterly Property Digest Dec-21

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

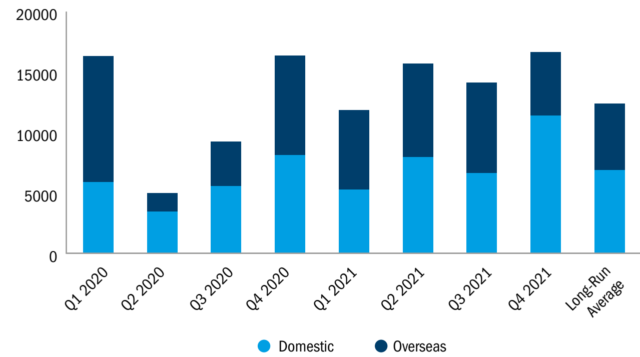


Source: MSCI UK Quarterly Property Digest Dec-21

Investment Market

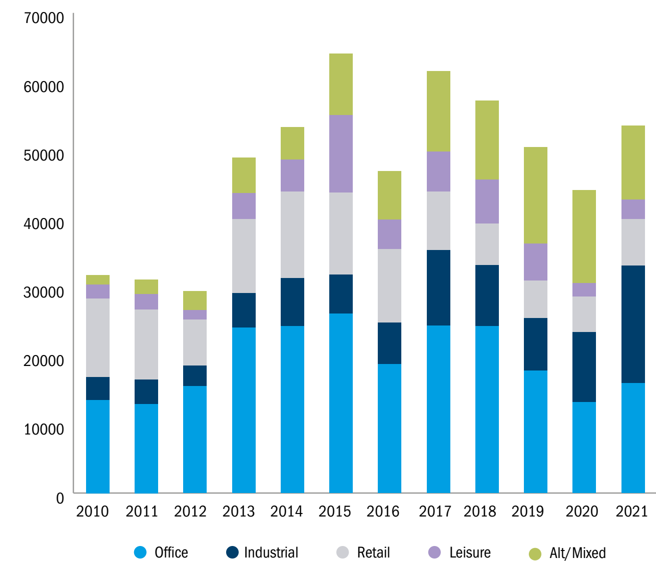
- The UK investment market demonstrated extraordinary resilience across 2021. Quarter 4 saw activity shift into a higher gear and was the best performing of 2021 with £16.6 billion invested pushing the annual trading volume to £58.3 billion, exceeding the £55 billion anticipated earlier in the year and reaffirming investor appetite for the UK.
- Industrial was the standout sector with the share of deals rising dramatically year-on-year as investors continue to capitalise on the acceleration of the shift to online and realignment of supply chains. For the first time the industrial sector was the most active, accounting for the largest share of transactions at 32%.
- Offices are seeing a renewed level of appetite supported by more clarity on how hybrid working will evolve and the future role of the office but the focus remains firmly on core product and the level of demand here as caused yields to fall and so those investors looking for higher returns will need to look to non-core office markets or strong regionals cities outside the capital, or by assuming development or leasing risk.
- Retail has seen a notable rise in interest since the depth of the pandemic with momentum building over the year ending on a high of £3.8 billion in Q4. Volumes were boosted by retail warehousing which had the strongest year since 2015. Challenges remain for shopping centres but the dramatic falls in capital values could see fortunes begin to change, attracting some opportunistic capital back to the sector.
- Sustainability and the wider ESG agenda will remain a top priority this year and occupiers and investors across all real estate sectors are focusing on green buildings which will play an increasingly important role in investor strategy and asset allocation alongside how those assets integrate into the communities that surround them.
- The combined weight of capital and strength of appetite for real estate positions 2022 as an active year with the annual volume expected to be 10% – 15% higher than 2021. Yields are trending downwards following the outward shift at the onset of the health crisis, supported by relatively healthy occupational drivers.

Investment activity £m



Source: Property Data as at Jan-22

Investment activity by sector (£m)

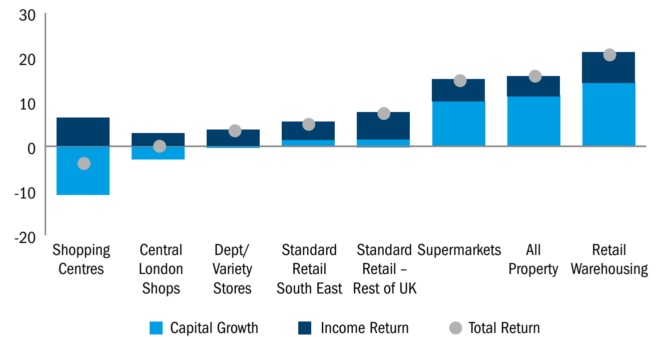


Source: Property Data as at Jan-22

Retail

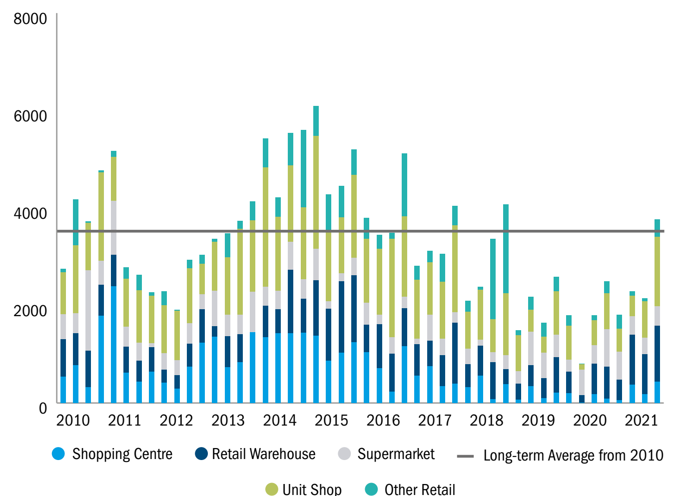
- In the three months to December 2021 the retail sector posted a total return of 4.6%, the best quarterly performance since the beginning of 2010. Retail warehouses played a significant role and is the stand out segment with an 8.0% quarterly return. Shopping centres are seeing a modest level of improvement posting a 1.9% total return over the last three months.
- All regions of the UK have seen an uptick in performance and all posted positive total returns over the quarter to December, with the exception of the London City & Midtown that continue to be impacted by the lack of sustained worker numbers but this is expected to change with the lifting of all restrictions.
- The investment market ended on a high with quarter four the most active and £3.7 billion exchanging hands. All segments saw an increase on quarter three activity but retail warehouses and shops are of particular note, together accounting for around two-thirds off all retail transactions.
- With a resilient tenant mix, and redevelopment opportunities, retail warehouses are expected to continue to be popular. With a turnover of £3.4 billion this makes 2021 the most active for the subsector since 2015. Opportunistic and private equity buyers were the most active at the start of 2021, but the second half of the year saw some more traditional retail park owners emerge, partly as obtaining debt has become easier although terms do remain pretty cautious.
- The prime end of the market will see a strengthening of rental growth prospects which will put further downward pressure on yields but it is important for investor to do their due diligence – not all retail parks are equal. Shopping centres and high street yields are not expected to see the same level of compression, but some opportunistic investors will seek out repurposing opportunities.
- The outlook for 2022 is of a tangibly better year than 2021 as retail investment markets continue to recover although performance will be polarised and the lifting of the moratorium
  in March is not expected to be a seismic shock to the sector.

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



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

Retail investment activity (£m)

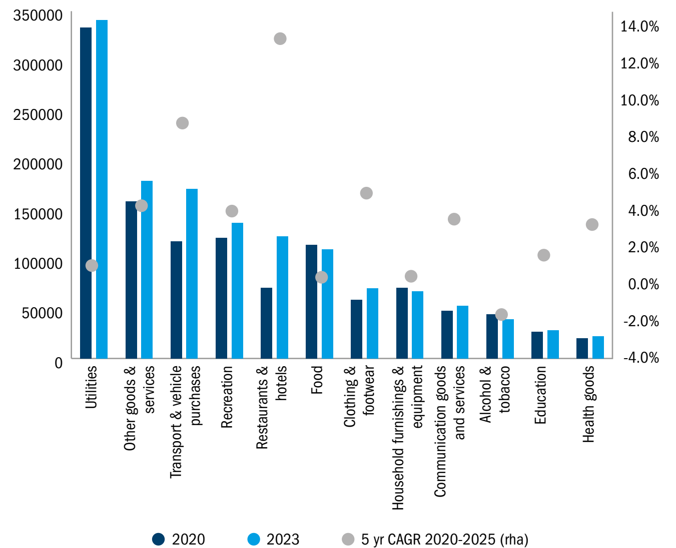


Source: Property Data as at Jan-22

Retail occupier market

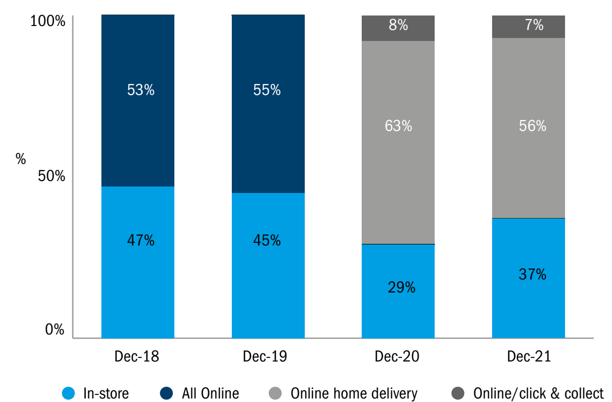
- Activity throughout the health crisis predominantly focused on restructuring occupier existing portfolios. However, with improving consumer metrics, occupiers have regained some confidence in the market and the later half of 2021 saw an uptick in requirements which is expected to continue into 2022.
- Activity was spurred on by Black Friday deals and supply chain disruption concerns drove consumers to shop early for Christmas which was reflected in a fall in retail figures of 3.7% m/m in December, yet were still 2.6% higher than their pre-COVID-19 February 2020 levels.
- With the consumer price index rising 5.5% in January, the highest rise for thirty years, retailers are struggling to absorb the rising costs associated with manufacturing, transport and staff wages with most being passed onto the consumer. However, it is likely that in the face of rising inflation consumer behaviour has the potential to shift back to more cautious spending patterns.
- The last twelve months once again emphasised the importance of an omni-channel offering with online sales providing a significant boost to revenue growth for many retailers and this is despite online sales penetration falling to 26.9% and continuing the downward trend since its peak in February 2021 at 36.8%. Online sales have seen a strong uptick on average across all sectors, unlike in-store sales which saw a fall.
- Looking ahead, while the outlook is generally more positive, albeit cautiously so, retailers will be weighing up their strategy towards physical retail. Leasing activity could be supported by retailers taking advantage of higher availability and lower rental levels as the oversupply of space will continue to push down rents in 2022 – albeit at a reduced pace compared to 2021.
- Some may postpone decisions until there is more certainty around inflationary pressures, supply chain costs and more positive consumer sentiment.

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



Source: Oxford Economics as at 20-Dec-21

Proportion of spend online vs in-store

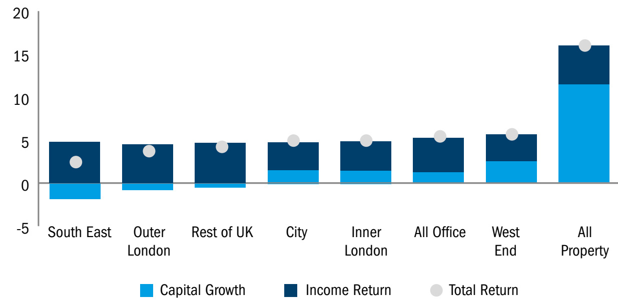


Source: PwC Consumer Survey, Dec-21

Offices

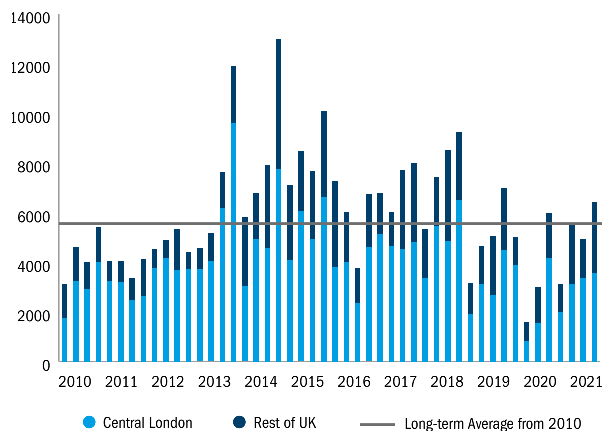
- The performance of the office sector continues to gain momentum posting a 2.0% total return over the quarter to December, a figure not bettered since the end of 2017. Over the year the total return was 5.3%.
- The outlook is for the all-office total return to accelerate to 7.0% in 2022 as yields continue to come under downward pressure and rental growth picks-up, averaging 4.8% per year between 2022 and 2026.
- Almost £20 billion was invested into the UK office market across 2021, with the last three months the most active with £6.4 billion exchanging hands – overall not a bad result given the international travel restrictions preventing some overseas investors from visiting the UK. The Q4 volume was 8% above the long-run quarterly average and is the first time the quarter's performance has run ahead of quarterly average for two years.
- Demand for core product has seen yield compress, although they remain higher than in many counterpart European capitals. So, while UK offices provide more attractive returns to cross-border investors, many investors will find it difficult to hit their return levels. This will lead many purchasers to move up the rick curve to higher yielding prime office property in non-core markets or cities outside of London, or perhaps by assuming development or leasing risk.
- London continues to attract the bulk of capital retaining the number one spot for office investment across the UK by a fair margin and there is a breadth of investors looking for opportunities, ranging from Germany, North America, Singapore and Hong Kong the most acquisitive.
- The rising levels of activity in recent months in the regional office markets underlines the positive investor sentiment. Activity targeted the 'Big Six' and there is a growing mismatch between buyer and seller expectations and with a clear focus
  on prime and value-add, the gap between prime and secondary is widening.

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



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

Office investment activity (£m)

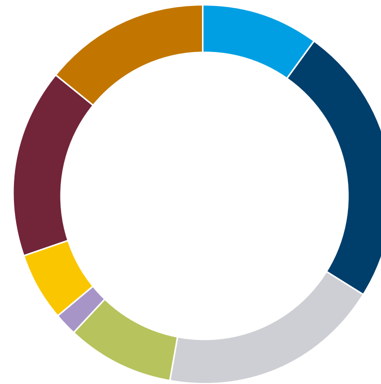


Source: Property Data as at Jan-22

Office occupier market

- Appetite for offices is finding its equilibrium with a clear focus on higher quality space in central locations, as companies look to welcome employees back to a more structure hybrid model of operation. But, while there is more clarity, the debate on the pros and cons will continue for some time.
- Leasing activity is beginning to pick-up supported by job growth and pent-up demand as corporates reactivate shelved office plans over the past 18 – 24 months. This resulted in take-up across the main markets nationwide reaching approximately 1.5 million sq.ft in the last quarter of 2021, the strongest over the year as momentum built along with the removal of work-from-home guidance.
- As the ESG agenda is more front and centre, demand is very much focused on Grade A space and as occupiers asses their accommodation strategies and sustainability goals become more important in the decision making process.
- So, while some occupiers may be downsizing their footprints, they are upgrading the quality of their office accommodation. This will be at the expense of lower quality stock where obsolescence is expected to increase, and the sector is likely to see the emergence of a two-tier market, reflected in both pricing and rents.
- Between 2022 and 2024 approximately 4.8 million sq.ft of space is due to be delivered, of which 35% has already been pre-let, and a level that is expected to rise as the search for quality space intensifies.
- In London, things are continuing to improve and while the vacancy rate is 8.0%, albeit lower in the West End and higher in the City, prime rents have risen 4% over the past twelve months as the amount of quality availability declines and demand kicks on a gear. There is also mounting anecdotal evidence that incentives are tightening for the first time since the health crisis began.

Key UK office markets – take-up by sector (2021)



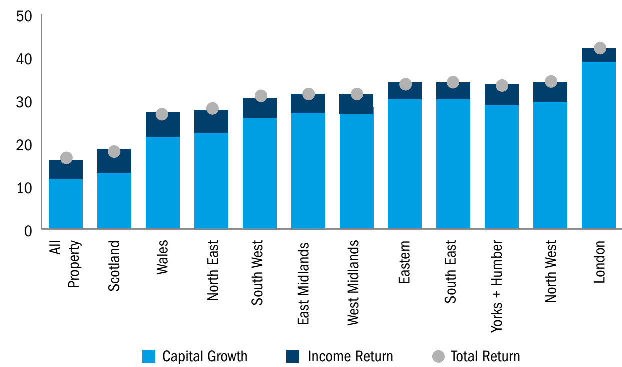
Sector	Share
Banking & Finance	10%
Business Services	24%
Creative Industries	19%
Consumer Services & Leisure	9%
Insurance	2%
Manufacturing, Industrial & Energy	6%
Professional	16%
Public Sector	14%

Source: CBRE

Industrial

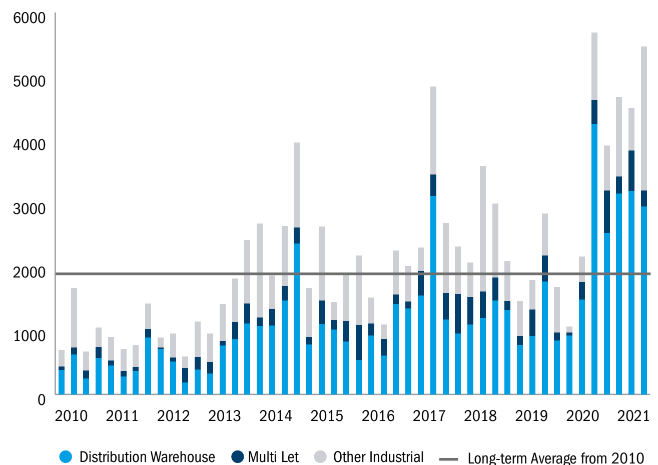
- Industrial has been the stand out sector over the past twelve months with a total return of 36.4%. There is no material divergence between logistics and standard industrial with
activity continuing to be fuelled in part by the onward march of e-commerce and restructuring of supply chains.
- All regions of the UK saw strong returns over the quarter, but London continues to lead the way with a 15.3% total return, setting a new record. Annually to December 2021 the capital posted a total return of 43.1%, another record. Outside London
the South East and Eastern regions were the next best performing with returns in excess of 12.0%.
- The strength of the occupational market and current imbalance in supply and demand is driving on positive rental growth which is underpinning positive investor sentiment towards the sector in unprecedented levels and investor appetite continues unabated. Q4 volumes for the industrial sector reached £5.5 billion, bringing the 2021 total to £18.5 billion, a staggering 75% above the previous record of £10.6 billion set in 2020. Industrial investment deals in 2021 equated to a 32% market share, marginally ahead offices.
- The dearth of supply against the strength of occupier demand for the sector means that strong rental growth is anticipated in 2022 across all key regional hubs and this will continue to support appetite for the sector. Investors are fiercely competing for the best assets which will result in a further tightening of yields. Although with continued upward pressure on inflation and further interest rate rises this may limit the extent of yield compression in 2022 when compared to previous years.
- International capital is targeting the UK and accounted for 60% of 2021 deals, the highest proportion ever recorded and well above the 36% fifteen-year annual average. This has largely been at the expense of UK institutions who, in 2018, accounted for 32% of the market falling to just 16% of the market in 2021.

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



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

Industrial investment activity (£m)

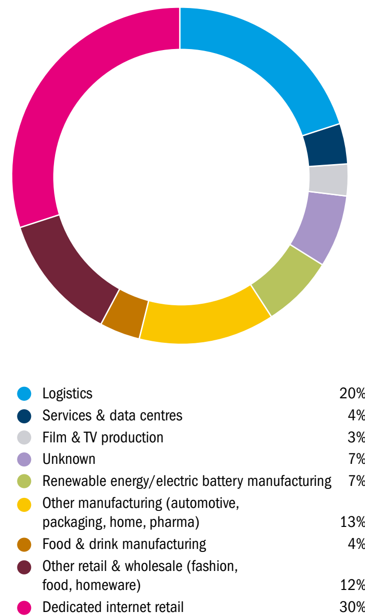


Source: Property Data as at Jan-22

Industrial occupier market

- Quarter four deals totalling 16.0 million sq.ft boosted annual take-up resulting in 2021 being a record year for leasing activity with 55.0 million sq.ft let across the country. There is a depth and breadth to occupier demand that has not been seen in the past and while big players such as Amazon continue to let space, there are new entrants establishing themselves as well.
- As online consumption continues apace 3PLs and logistics players are positioning themselves for the future, securing the highest proportion of space they ever have with 12.5 million sq.ft leased in 2021. Retailers continue to assess their needs as they look to streamline their platforms to establish a truly omni-channel approach.
- Amidst the unprecedented levels of demand and leasing activity and occupiers acting with immediacy this is eroding speculative supply with the vacancy rate country-wide falling to just below 3.0%, setting another record, and equates to 17.4 million sq.ft, of which approximately 40% is Grade A.
- Developers are reacting to the dearth of supply, but the availability of materials and labour is slowing down completion rates and the high cost of construction is likely to be borne by the occupier. Currently there is around 19 million sq.ft under construction. With larger schemes far and few between, occupiers with large floorplate requirements are likely pursue a built-to-suit route.
- A question mark remains around how sustainable these record levels of take-up are. With levels exceeding 50 million sq.ft for a second consecutive year, from an average of 32 million sq.ft before the health crisis, but with active requirements broadly stable over the last 18 – 24 months this indicates that there enough demand for the market to continue to operate at the amplified levels of recent times for a while yet.
- The market has its challenges, including planning, labour availability and rising construction costs. As we enter a new green world, sustainability and carbon reduction are now a given as part of developer's specification proposals.

Take-up by occupier sector – 2021

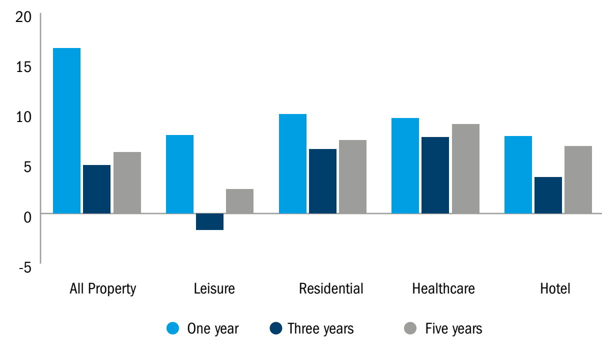


Source: Gerald Eve

Alternatives

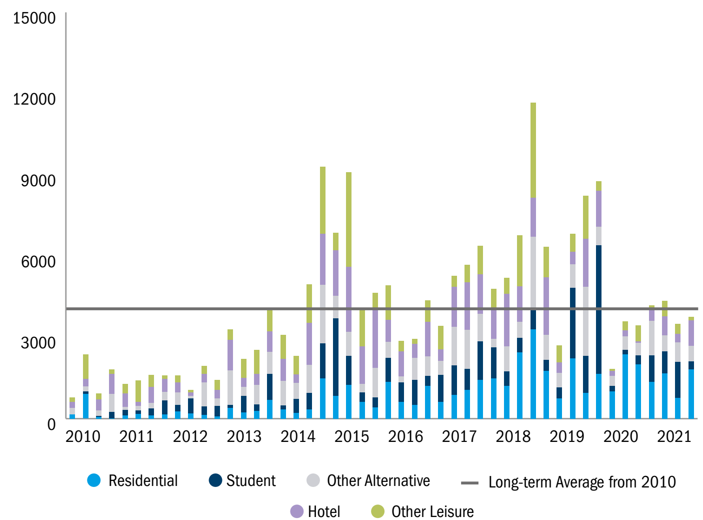
- The alternative sector delivered a quarterly total return of 3.2% to December 2021 underperforming the all-property total return which was skewed by the outstanding performance of the industrial sector over the recent past.
- The light touch restrictions towards the latter end of quarter four, combined with the promise of a more 'normal' 2022 has seen all segments of the wider alternative sector show signs of improvement. Residential and healthcare which have benefiting from the health crisis have demonstrated their long-term inherent resilience as well, posting quarterly total returns in the region of 3.3%. Leisure and hotels continue to improve, albeit from a low base as the positive impact lifting of restrictions is filtering through to performance.
- £3.8 billion was invested into the alternative sector in Q4, bringing the trading volume for the full year to £15.8 billion. Residential was the standout sector with £1.8 billion exchanging hands in Q4, followed by hotels where close to £1 billion in Q4 was acquired.
- Appetite for residential remains strong with record levels of activity in 2021 driven by low interest rates and the stamp duty holiday. 2022 may see levels moderate as interest rates rise affecting affordability. The build-to-rent sector, underpinned by solid fundamentals will continue to perform with emerging interest in single family homes in more peripheral locations. Investors see the sector as a good diversifier to commercially-heavy funds and one that provides counter cyclical protection.
- The anticipated return of international visitors will boost hotel revenues, but some of the margin will be offset by rising payroll costs and other inflationary pressures. London and UK Gateway tourist focused cities will see the most benefit from renewed levels of interest in the sector in 2022 and while domestic tourism drove demand in 2021 this may loose some steam as travellers return to foreign holidays, but this will in turn support international inflows into the UK.

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



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

Alternatives investment activity (£m)



Source: Property Data as at Jan-22

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.

Legal information

This document:

- has been issued and approved by, and is the sole responsibility of, BMO REP Asset Management plc of 7 Seymour Street, London W1H 7JW ("BMO REP") which is authorised and regulated by the Financial Conduct Authority in the United Kingdom (registration no. 119283).
- is for professional investors/advisers only and the information in it may not be appropriate for all persons in all jurisdictions in the world. By accepting this document, you represent and warrant to BMO REP that you are an appropriate person to receive such information.
- should not be considered as nor constitute as any investment, tax, legal or other advice and you should obtain specific professional advice before making any investment decision. Nor is it an offer or solicitation to deal in any of the investments or funds mentioned in it, by anyone in any jurisdiction in which such offer or solicitation would be unlawful or in which the person making such offer or solicitation is not qualified to do so or to anyone to whom it is unlawful to make such offer or solicitation.
- contains confidential information belonging to BMO REP and/or third parties and is supplied to you solely for your information and may not be forwarded to any other person, reproduced or published in whole or in part for any purpose.

No representation or warranty, express or implied, is given by BMO REP or any other person as to the accuracy or completeness of the information or opinions contained in this document. Save in the case of fraud, no liability is accepted for loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information or opinion contained in this document.

To find out more visit **columbiathreadneedle.com**

©2021 Columbia Threadneedle Investments. BMO REP Asset Management plc is a subsidiary of BMO Real Estate Partners LLP. It was formerly part of BMO Financial Group and is now a wholly owned subsidiary of Columbia Threadneedle Investments UK International Limited. BMO REP Asset Management Plc is trading as Columbia Threadneedle Investments whilst currently using the "BMO" mark under licence in its legal name.

213050 (11/21) UK, CH.