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UK Real Estate
Overview

Q1 2023

COLUMBIA THREADNEEDLE
INVESTMENTS | REAL ESTATE PARTNERS

Contents

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 likely to be 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.

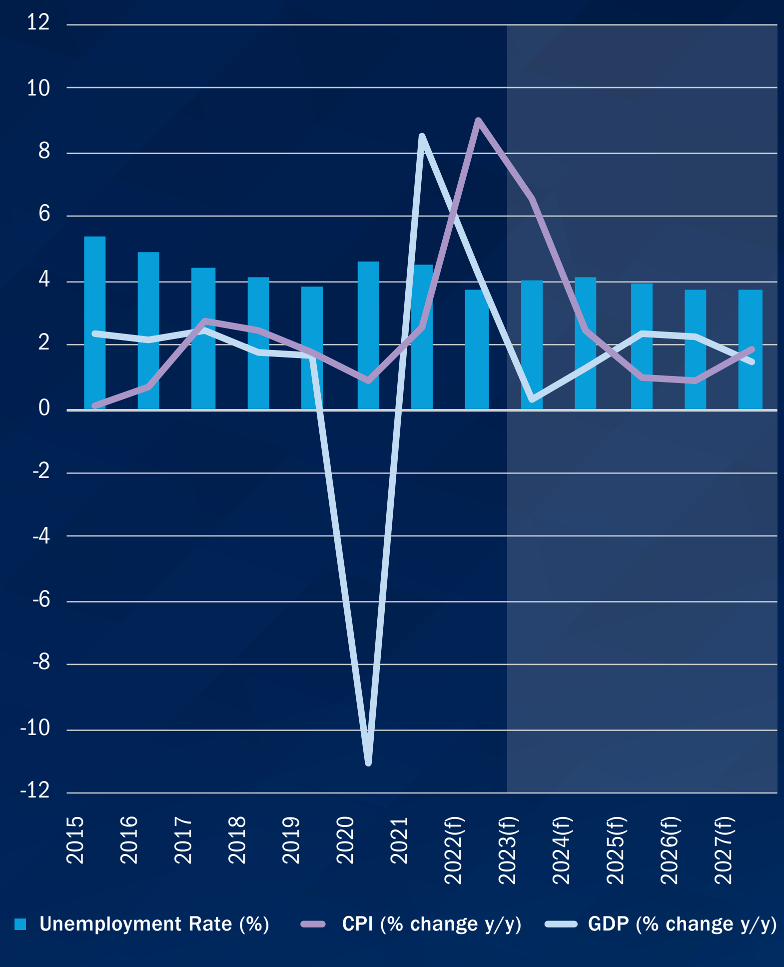
"In the first quarter of 2023 the economy continued to bump along the bottom posting growth of 0.1%."

Economy

UK Economy

- In 2022 the economy expanded by 4.2%, but with slowing momentum over the latter half of 2022 rolling over to 2023, UK GDP is expected to be flat in 2023, with GDP growth of just 0.3% over the year.
- In the first quarter of 2023 the economy continued to bump along the bottom with GDP in March contracting by 0.3% m/m partly due to the earlier strength in consumer facing sectors which has eased back, while industrial action continued to weigh on public sector activity. Over the quarter however, the economy still managed to post positive growth of 0.1%.
- The extra bank holiday in May for the King's coronation and more planned rail strikes means that GDP could fall modestly in Q2 2023. Activity should then recover over the second half of the year as lower inflation helps to bring about a recovery in household spending power.
- The labour market has seen some softening in recent months, but most measures suggest it remains tight and while labour demand will continue to ease as output stagnates, this is likely to push up unemployment to peak at 4.3% in late -2023. Pay growth strengthened during 2022, with average weekly earnings growth reaching 5.9% y/y in Q4 2022, though this still represents a heavy pay cut in real terms.
- The Bank of England increased the base rate by 25bps to 4.25% at March's MPC meeting, with seven of the nine MPC members who voted for the hike justifying their decision on the grounds that tight labour market conditions and more resilient activity could lead to greater inflation persistence.
- It raised the rate again by a further 25 bps at its May meeting to 4.50% with the rationale for the latest hike a combination of an unexpectedly resilient economy, persistent strength in domestic price and wage setting, and a tight jobs market.
- CPI inflation picked up sharply last year with the reopening of the global economy after the pandemic triggering large rises in commodity and global goods prices, compounded by Russia's invasion of Ukraine. Inflation has however, drifted down from its October peak of just above 11% on the back of recent falls in energy prices.

GDP growth, CPI & unemployment rate



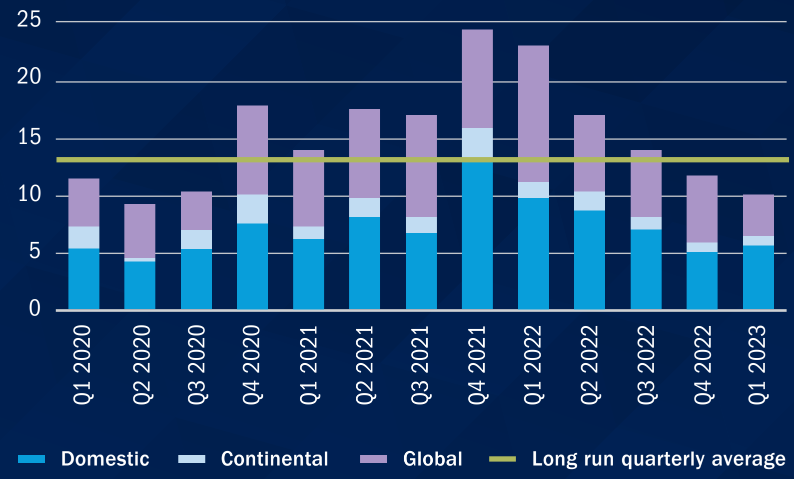
Source: Oxford Economics

> Activity should recover over the second half of the year as lower inflation helps to bring about a recovery in household spending power.

Investment Market

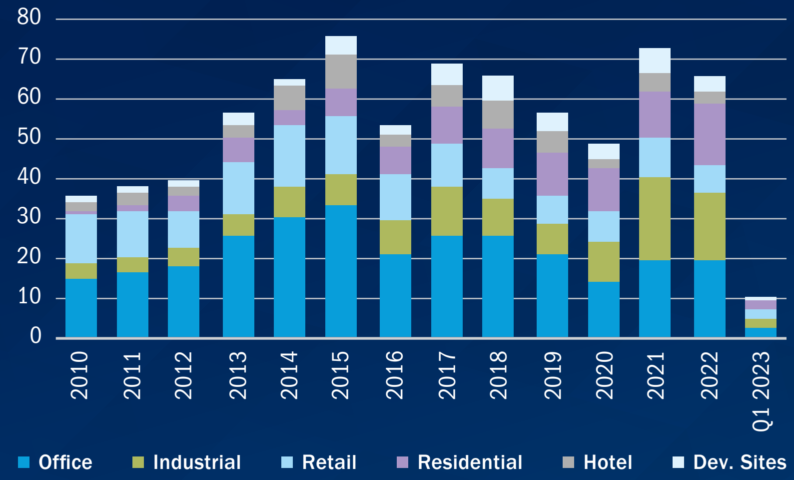
- The UK finished the first quarter as Europe's largest market, but nonetheless investment activity across the country in Q1 2023 was subdued with £10.2 billion exchanging hands as investors are still in 'wait and see' mode given the increase in debt financing, high inflation and the weak economic outlook.
- Q1 was the slowest quarterly volume since 2009, with the exception of the second quarter 2020 when the market was temporarily frozen by the onset of COVID. As 2023 progresses a pick-up in investment activity is expected although whilst volumes trend upwards, overall trading volumes for the year are not expected to match 2022 levels as the year got off to a very slow start.
- Offices were the most traded sector in Q1 with a 28% share of deals, followed not far behind by retail (26%) and then industrial rounding out the third spot with an 18% share (£1.8bn). Activity in the residential sector slowed in Q1.
- As was the case in 2022, the focus over the next 12 months will be on preserving income rather than capital growth. While occupier performance will be crucial, so will active asset management with landlords needing to raise their level of engagement with their tenant base – clipping the coupon is a thing of history.
- 2023 will be a challenging year for real estate as slower economic growth and more expensive capital weighs on investment activity. What is clear is that while the future looks murky, the ultra-low interest rate environment is over and cheap finance has come to an end, which will change market dynamics going forward.
- 2023 will be one of price discovery. While yields softened and valuations fell in the latter part of last year, progress will be slower than hoped as investors are, by and large, delaying the deployment of capital in order to see where pricing settles.
- There remains a mismatch between buyer and seller expectations and so yields will most likely continue to rise, although at a slower pace. However, with capital on the side lines, when the economic backdrop begins to improve, combined with pricing movements there is likely to be a pool of willing buyers but, for now, sellers remain in short supply.

Investment activity (£bn)



Source: MSCI, April 2023

Investment activity by sector (£bn)



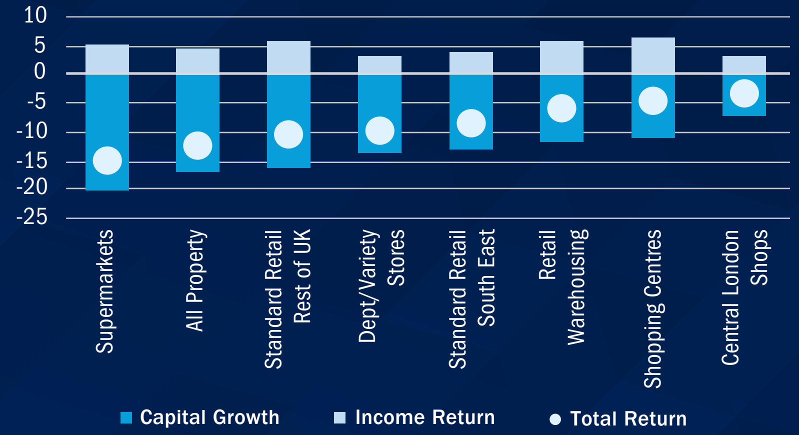
Source: MSCI, April 2023

Retail

Retail

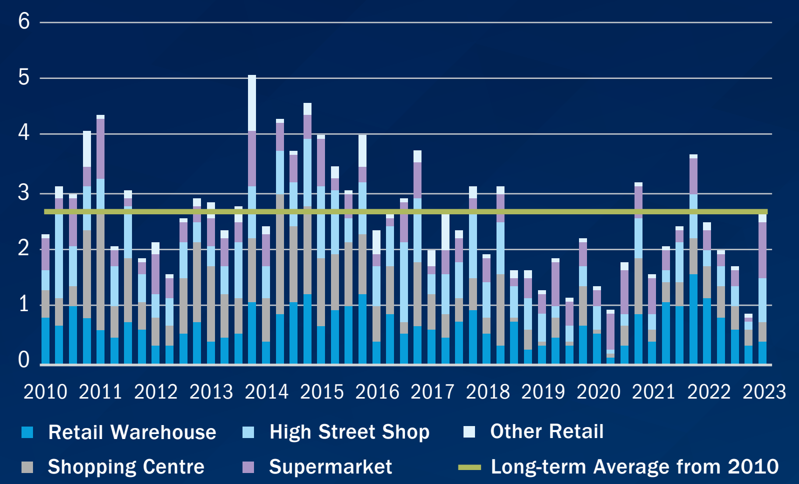
- Retail volumes reached £2.7 billion in Q1 2023, a marked increase on the very subdued last quarter of 2022. While the first quarter benefitted from a number of rollover transactions that did not conclude in the last quarter of 2022, the market is generally rather quiet.
- The total return performance for the retail sector over the year to March was -7.9%, turning positive over the quarter with a total return of 1.0%. But there are nuances behind the headlines with retail warehousing the bright spot. The subsector posted a total return of 2.4% in the three months to March, outperforming both all-retail (1.0%) and all-property (0.1%) over the same time period.
- The resilience and performance of retail warehouse parks over the last few years has enabled the sector to build up a strong investor following, with demand for retail warehousing the principal driver of investment activity in Q1.
- However, despite the weight of capital looking for opportunities in the subsector the quarter's investment activity was frustrated by a general lack of investment grade, available stock. The majority of sales seen over the quarter stem from vendors who are under pressure to dispose of assets.
- For those wanting exposure to the retail sector, retail warehousing is an attractive option given the rebased rents and low void rates. Against a backdrop of very limited new development and an increasingly positive occupier story, real positive rental growth is expected to follow later in the year.
- High street activity is focused on smaller opportunities in better quality locations in the south-east and key regional cities. Private investors are key buyers here, both domestic and international with £766 million concluding over the course of Q1.
- Just £379 million worth of shopping centre transactions closed in the Q1, despite the slow improvements seen in the occupier market which have not yet fed through to pricing where yields continue to move out. Investment activity is characterised by small lot sizes, reflecting the continued bias amongst purchasers towards private investors and small property companies.

Retail total returns by selected segments annual to March 2023 (%)



Source: MSCI UK Quarterly Property Digest March 2023

Retail investment activity (£bn)

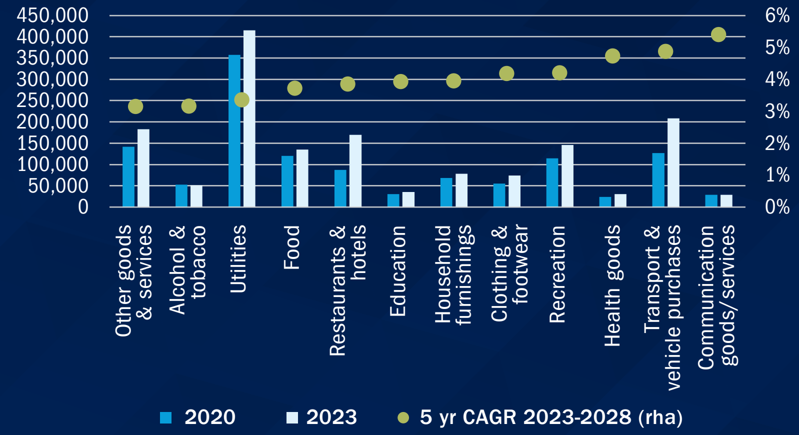


Source: MSCI, April 2023

Retail occupier market

- The first three months of 2023 continued to be challenging for the consumer but, the news that high inflation is expected to ease by a fair margin later this year is beginning to feed into consumer confidence, suggesting that the outlook will begin to improve.
- In March CPI inflation was 10.1% and whilst down 0.3% on the levels recorded in February is still running at historically high levels. The largest contributions continue to be housing and household services (principally from electricity, gas and other fuels), up 26.1% year-on-year, and food and drinks, up 19.1%.
- While rising prices of essential goods and services are largely unavoidable, this does mean that the pain of the squeeze on consumer spend is being felt in the sectors that are reliant on discretionary spend. Having said that as wages lag inflation, but with unemployment at historic lows and not expected to dramatically increase, many are still enjoying income security.
- Online sales have fallen quicker than expected since the height of the pandemic and going forward are expected to hover around the 25% mark indicating that consumers still have a desire to visit physical stores. But consumers are wanting more of an experience when they do visit stores. Having said that online remains an important channel and the future of retail is firmly an omni-channel one.
- Vacancy rates across the three main retail subsectors are beginning to nudge down from the recent high seen at the beginning of 2021. Retail park vacancy, for example, dropped from 11.3% in 2021 to 9.0% at the end of 2022 – marking the largest improvement across the wider retail market.
- The figure is now only 0.9% higher than the pre-pandemic level of 8.1% as retail parks continue to prove themselves as desirable destinations given that they are able to offer a combination of convenience, ease of access and ability to serve as last-mile delivery hubs.

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



Source: Oxford Economics

Vacancy rate by type (%)

Source: Local Data Company

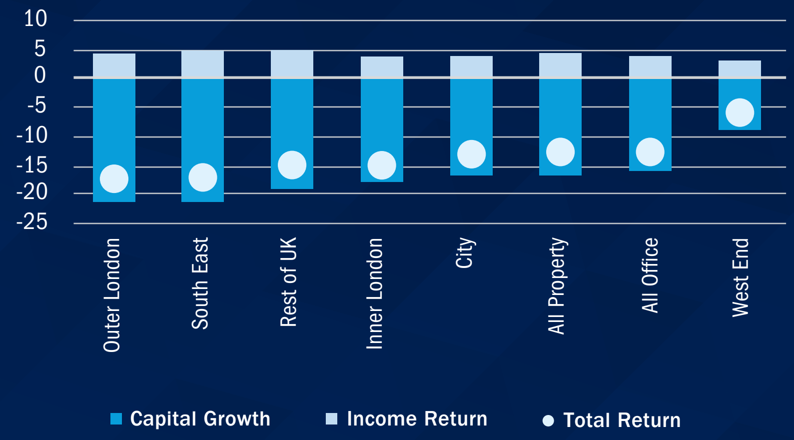
Offices

Manchester, aerial shot in the central area of the city

Offices

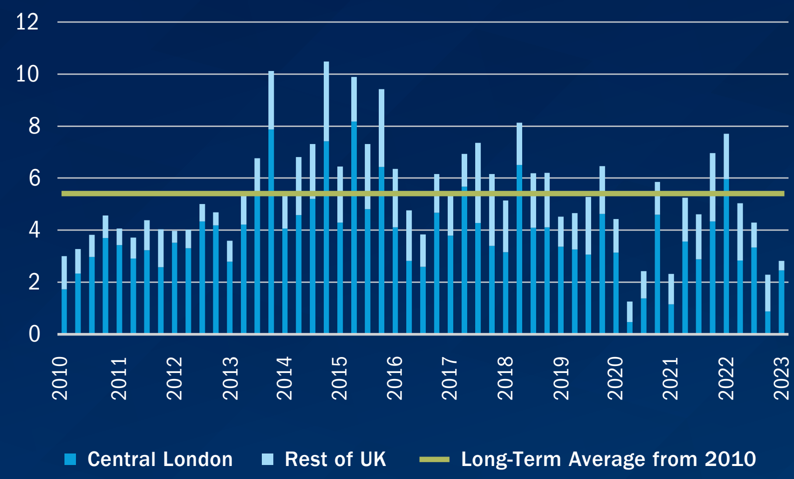
- The turbulence and volatility that the market had to deal with over the latter part of 2022 dented confidence, pricing and investor appetite for real estate, slowing investment activity severely.
- There were signs of cautious optimism in Q1 with £2.8 billion worth of offices trading, a 25% rebound from the very subdued Q4 2022. But activity is still some way below both the five and ten year quarterly average trends and while the market appears to be more stable, it is coming from a low base. Challenges most certainly lie ahead, and investors are understandably wary of the structural slowdown in occupier demand.
- Central London drove the uptick in investment activity seen in the first quarter with £2.5 billion exchanging hands. Outside the capital however appetite for offices continues to be very subdued.
- The sharp repricing that played out in H2 2022 has largely run its course with more clarity on the path of interest rates helping to clear the fog. With this, 2023 will arguably bring with it a once-in-a-cycle set of opportunities to acquire prime assets at renewed pricing levels.
- As pricing stabilises towards the end of 2023 this will help to stimulate more investment activity. There is capital, both domestic and international, looking for opportunities, and as refinancing pressures mount this could see some quality assets released for sale driving stronger transactional activity in H2 2023.
- Despite the anticipated increase in activity the annual trading volume is expected to be in the region of 20% down year-on-year in 2023 with the bulk of deals occurring in the second half of the year and momentum then picking up in 2024.
- When weaker market conditions come to the fore it comes as no surprise that better quality assets are expected to outperform the wider market and will have lower overall void periods, more demand and higher liquidity and core assets will be where rental income is regarded as most secure.

Offices total returns by selected segments annual to March 2023 (%)



Source: MSCI UK Quarterly Property Digest March 2023

Office investment activity (£bn)

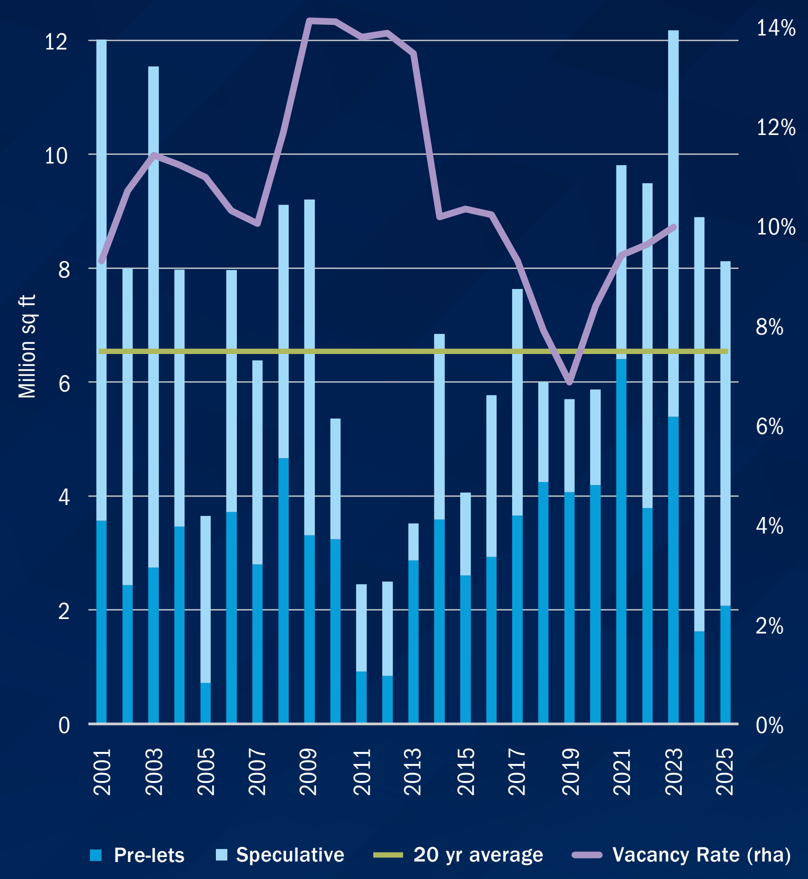


Source: MSCI, April 2023

Offices occupier market

- The weaker economic environment is impacting business confidence with many firms putting any leasing plans on hold, slowing overall levels of leasing activity. Office based employment is anticipated to fall in 2023 and this will further constrain leasing activity.
- The rise of flexible offices has promoted corporates to consider and incorporate hybrid models of working as the new-normal offering to employees. As more corporates embed their hybrid working models, quality and location are evidently more strategic decisions that ever before. The one-size-fits-all approach will not work, and companies are still looking to find the best solution that fits them.
- There is a clear preference for centrally located offices close to transport hubs with amenities either in or near the building. These also need to be ESG “readied” as corporates look for efficiency gains and employees look for corporates that meet their changing aspirations as to what a workplace needs to deliver. Such buildings are undersupplied.
- Offices that are non-core will suffer from a fall in occupancy and the inability to push-on rents and those that require significant capital expenditure to prevent the assets from slipping into obsolescence to meet the environmental criteria will also be challenging.
- Pressure will begin to shift from financing costs as interest rate rises slow, to occupational risks and what is clear is that preserving income will dominate rather than capital growth implying there will be a clear focus on active asset management and on the financial performance of occupiers in order to help sustain occupancy levels.
- Leasing activity across Central London and the Big Six cities reached 2.8 million sq.ft in Q1 2023. This was 11% down on Q1 2022 and 19% below the five-year quarterly average. There are clear signs that occupiers are turning to Grade A space as they seek to entice employees back into the office, align their property portfolio with sustainability target, and attract and retain talent. From a rental perspective, the continuing flight-to-quality and falling availability of prime space is likely to put further upward rental pressure across the regions.

Key UK office markets – development pipeline



Source: Colliers

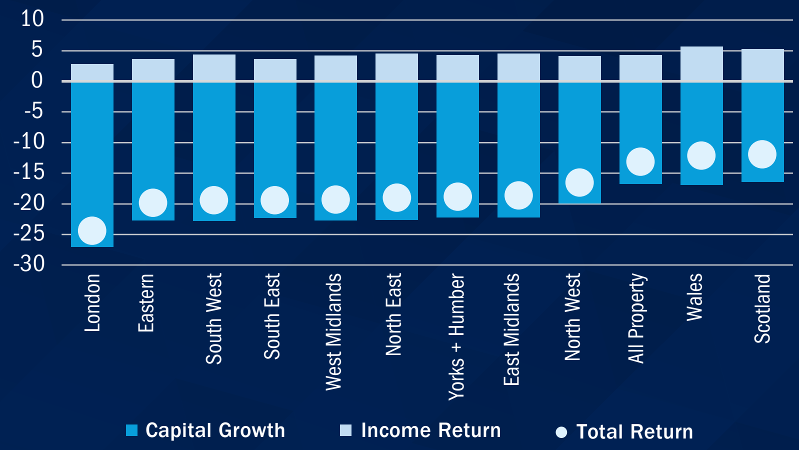
“The rise of flexible offices has promoted corporates to consider and incorporate hybrid models of working as the new-normal offering to employees.”

Industrial

Industrial

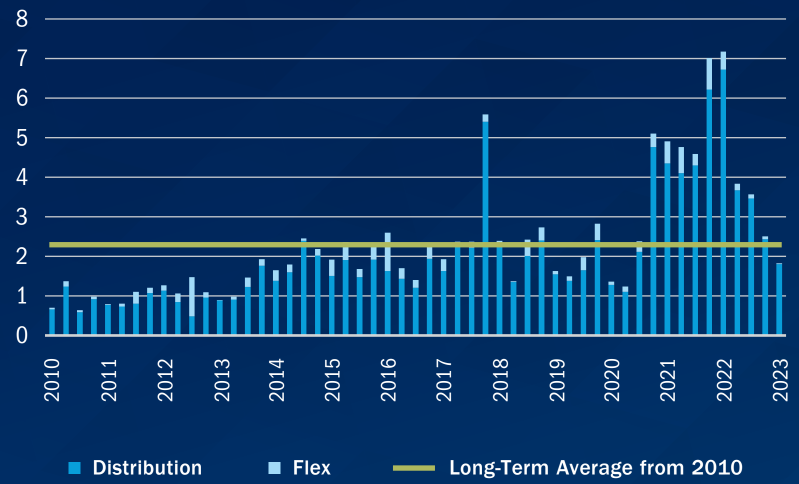
- The past nine months has seen rapid repricing and negative capital growth in the logistics sector resulting in negative returns. The MSCI UK Quarterly Index reports logistics recorded an annual total return of -20.5% in the year to March 2023. This compares to -7.9% in retail and -12.7% in the office sector. The expectation however is that the logistics sector will start to rebound from mid-2023 onwards.
- Prime yields moved out by 200 bps in just six months to around 5.50%. Early indications across Q1 2023 have shown no further outward movement with prices appearing to have stabilised, at least for the best assets. There will, no doubt, be some variation in performance depending on location and the specifics of an asset, but the possibility of a slight hardening in prime yields this year is rising.
- Investor activity in Q1 reached £1.8 billion transacted in Q1 2023 – the slowest quarter since the onset of the pandemic. The lack of available stock is one of the factors contributing to slower activity levels as some sellers are reluctant to accept current (re)pricing levels and are not releasing product to the market. Greater levels of uncertainty in financial markets and some banks tightening their lending standards as they adjust their risk appetite will also contribute to slower activity.
- There is a more definitive two-tier market emerging. For the moment, most investors are focusing on core markets and good quality assets which could drive some yield compression over the course of 2023. Meanwhile, demand for non-core assets is very limited as the risks such as potentially higher vacancy, the need for higher rental incentives and lower rents could lead to further yield softening.
- The rising importance of ESG factors for investors is in line with shifting occupier preferences and is contributing to the divergence in the performance of assets. High quality, Grade A assets that are well-specified are outperforming secondary ones. These older assets are facing a greater risk of obsolesce as rising construction and financing costs means that where redevelopment or refurbishment projects might have been undertaken in the past they are now not.

Industrial total returns by selected segments annual to March 2023 (%)



Source: MSCI UK Quarterly Property Digest March 2023

Industrial investment activity (£bn)

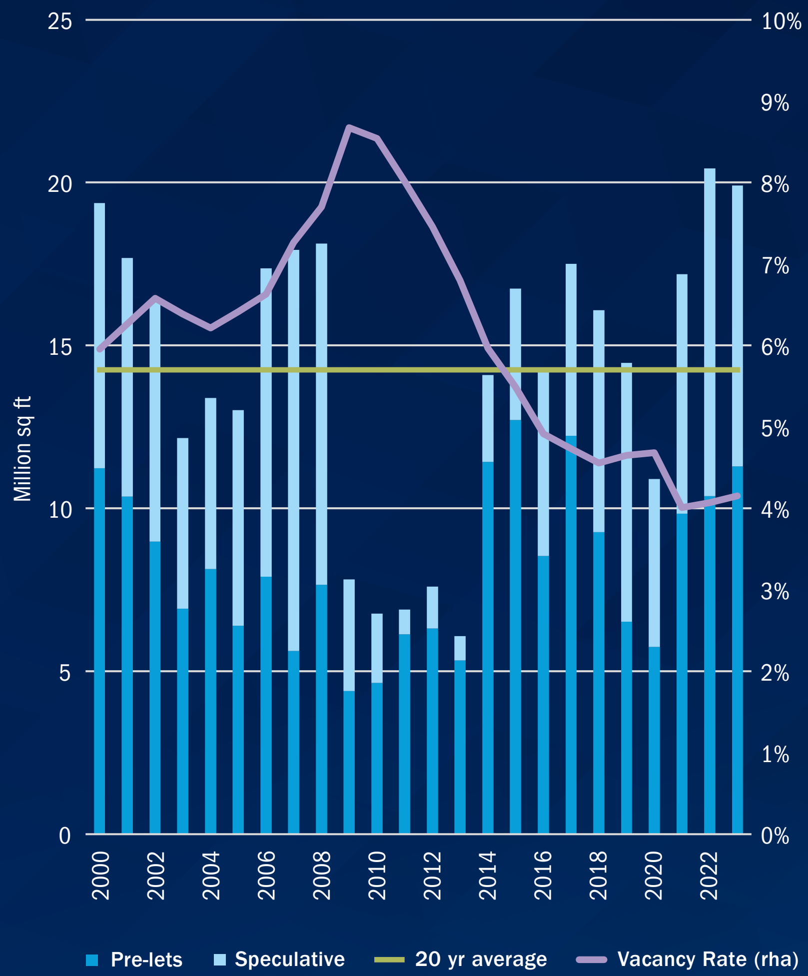


Source: MSCI, April 2023

Industrial occupier market

- Leasing activity in Q1 2023 reached 11.7 million sq.ft, the lowest level since the onset of the pandemic in early 2020 with slowing demand reflecting the continued challenges that occupiers are facing in relation to the broad economic slowdown and cost increases due to high inflation.
- The encouraging headline is that there is a breadth of occupiers taking space in the sector reflecting the increasingly diverse nature of demand, in particular since the pandemic. Traditional high street retailers who are establishing an online presence have signed for space for example. Likewise, companies looking to strengthen their supply chains by reshoring or bringing some manufacturing or processing tasks back onshore is another factor influencing demand for space.
- Availability nudged up to 4.7% at the end of March but is still below the five-year average of approximately 5.5%. The overall rise is primarily driven by a combination of development completions and a rise in grey space as some occupiers look to offload current excess space that was perhaps needed during the pandemic.
- The choice of Grade-A buildings is much more limited with vacancy around 2.5%. Demand is increasingly focused on well-located, well-specified units where occupiers can maximise their operational efficiencies. Total take-up this year is expected to reach 35.0 million sq.ft and whilst below the levels seen over the past three years, is in line with the pre-pandemic 5-year average.
- Going forward the fundamentals underpinning the sector are not expected to change dramatically partly supported by the lack of speculative development. The slowdown is a reflection of the high cost of development linked to inflation, the high cost of debt due to the steep rise in interest rates and the softer exit yields. In addition, slowing demand has reined in some developer appetite to break ground on new schemes at the moment.
- The outlook for rents remains positive despite the reduced levels of occupier demand as the market remains supply constrained both in terms of built stock and the development pipeline, and this will help support positive rental growth for the best schemes, but the rate will be slower than in the recent past.

Key UK industrial markets – development pipeline



Source: PMA, Q1 2023 data

> Leasing activity in Q1 2023 reached 11.7 million sq.ft, the lowest level since the onset of the pandemic in early 2020

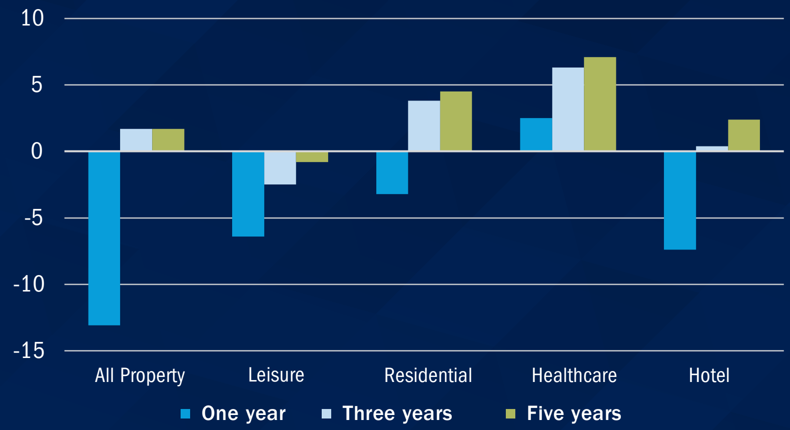
Alternatives

London, balcony of modern residential building

Alternatives

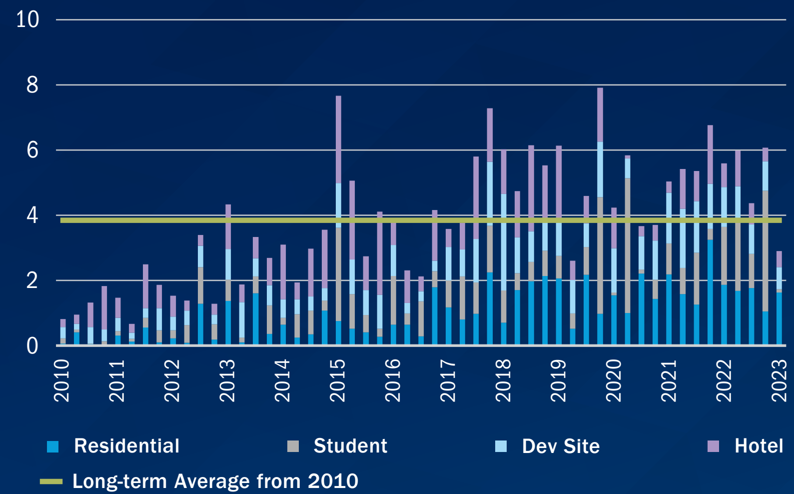
- The first quarter of 2023 recorded approximately £2.9 billion invested across the UK outside the traditional commercial sectors of offices, retail and industrial.
- The residential sector and specifically the build-to-rent sector is proving remarkably resilient to the current economic headwinds. The sector is expected to remain a bright spot and will continue to establish itself as a core asset class, in particular for income-focused investors.
- As many private landlords exit the market as the cost of capital and therefore mortgages repayments rise, along with additional taxation and regulatory pressures there is a supply gap that is being left behind for BtR landlords to fill indicating that there is growth potential in the sector. One trend that is being increasingly noticed is the rising appetite for single family housing.
- Investment appetite for hotels is expected to be relatively strong over 2023. The main challenges will be the availability of debt and securing it at an affordable cost, but lending appetite for the sector has improved since the pandemic. There remains no shortage of buyers seeking hotels which offer value add opportunities. With many hoteliers having benefitted from robust trading off the back of a strong leisure market, more stock is likely to come available as exit strategies are deployed.
- There has been a greater focus on life sciences since the onset of the pandemic and the sector has benefited from a wave of VC funding. This has in turn seen record levels of occupier and investor demand for lab space and offices. The established markets of Oxford and Cambridge have most definitely benefitted from this surge in interest but government support for the sector is seeing rising levels of activity in London and other emerging hubs such as Manchester and Leeds.
- Purpose built student accommodation continues to excite investors, underpinned by transparent demand and supply fundamentals and a positive yield spread to mainstream residential. Student numbers are rising and coupled with changes to student preferences and pressures on local housing stock means increasing number of students are looking to purpose-built accommodation to service their needs.

Alternatives total returns by selected segments annual to March 2023 (%)



Source: MSCI UK Quarterly Property Digest March 2023

Alternatives investment activity (£bn)



Source: MSCI, April 2023

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Along with Columbia Threadneedle Real Estate Partners in-house Research, a variety of sources have been used in the production of this document including BNP Paribas, CBRE, Colliers, Gerald Eve, Knight Frank, Local Data Company, LSH, Oxford Economics, Property Market Analysis, Savills, and MSCI (www.msci.com/notice-and-disclaimer).

391705 (05/23). UK.