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UK Real Estate Overview

Q3 2023

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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.

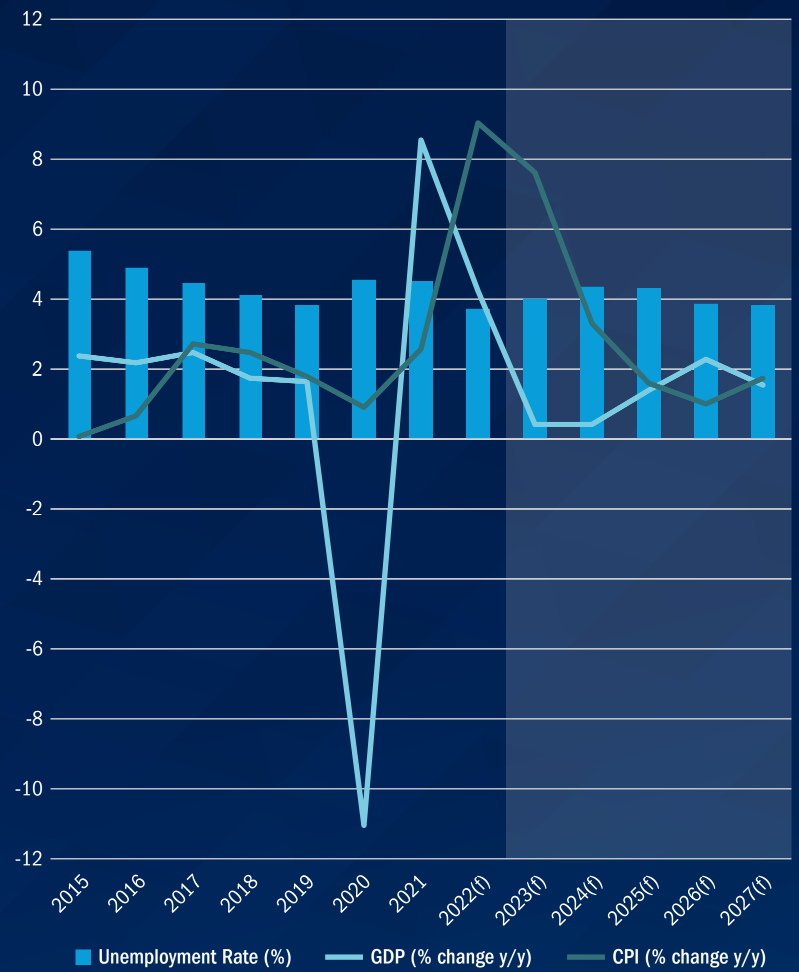
The value of directly held property reflects the opinion of valuers and is likely to be reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

Economy

UK economy

- GDP growth in September came in at 0.2% month-on-month, the second successive monthly increase, but a downward revision to growth in August and a weak start to Q3 meant the economy flatlined in the three months to September, down from growth of 0.2% in Q2. The economy should perform slightly better in the last quarter of the year as the impact of public sector strikes fade. But looking through the noise, the economy is struggling to generate growth on a sustained basis. Activity should gradually recover with GDP for 2023 estimated to be in the region of 0.6%.
- Inflation fell sharply in October to 4.6% due to falling energy prices and is now at its lowest level since 2021. However, despite the falls, inflation levels combined with rising debt servicing costs, particularly now that government support to help households pay energy bills has ended, will see household spending remains under pressure.
- The labour market has seen some recent softening and wage growth has slowed from record highs in recent months as higher interest rates weigh on economic activity. But most measures suggest the labour market remains very tight especially by historical standards due to strong labour demand despite GDP flatlining. The combination of a tight labour market, high inflation, and a rise in the national minimum wage has meant that pay growth accelerated in Q2. However, growth eased slightly in Q3 as hiring slowed resulting in annual growth in total pay slowing to 7.9%.
- The Monetary Policy Committee (MPC) remains concerned about the level of inflation and the strength of wage growth, but a recent softening in activity and evidence of looser labour market conditions have weakened the case for further rate hikes. This is evidenced by the Bank of England narrowly holding the rate at 5.25% at its September meeting, breaking the run of 14 consecutive hikes followed by no change at the November meeting. However, the Monetary Policy Committee continues to emphasise that once the cycle has reached its peak, rates will remain high for a prolonged period with the bank rate is expected to now stay at 5.25% until at least autumn 2024.

GDP growth, CPI & unemployment rate



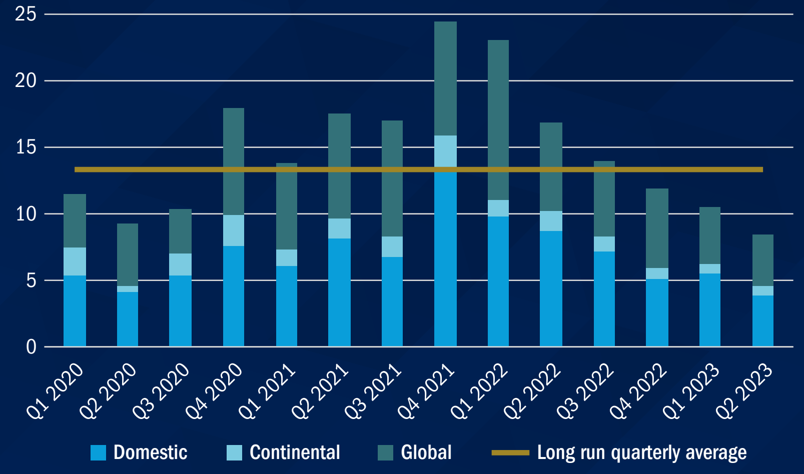
Source: Oxford Economics, November 2023.

> "The Bank of England held the rate at 5.25% at its September meeting, breaking the run of 14 consecutive hikes followed by no change at the November meeting"

Investment market

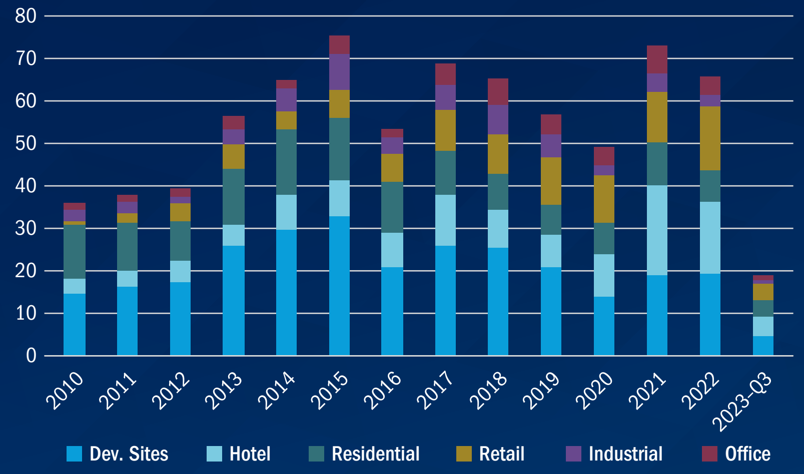
- Quarter three investment volumes were subdued with just £7.7 billion transacting nationwide reflecting the traditional slower summer period as well as the 14 consecutive interest rate hikes which served to raise the cost of debt substantially and slow investment activity. Rates do, however, appear to have peaked, and this will help to drive on stronger activity in the months ahead, albeit slowly.
- Going forward, the path ahead is not without its challenges. Investors whilst dealing with a certain amount of much needed clarity in terms of interest rates, the economy is weaker and a certain amount of caution is needed with regards to recent geopolitical events, how they will play out and their potential impact.
- Whilst all sectors declined volume wise when looking at Q1 – Q3 2023 compared to the equivalent period in 2022, offices bore the brunt of this and were the biggest drag on the overall volume falling by 58% as structural challenges continue to play out. This is creating a very two-tier market between centrally located, ESG enabled buildings and secondary assets be that secondary location and/or quality, some of which will simply fall into obsolescence.
- The outlook will be closely linked to when interest rates will start to fall following the assumption that they have now peaked. Despite the belief that rates will stay high for longer, undoubtedly a more stable interest rate environment is expected to support steadier pricing which in turn should help to support higher investment activity from the middle of 2024 onwards.
- Refinancing pressures will be persist providing some opportunity to acquire good quality assets as discounts as some landlords will be compelled to sell. This will set new benchmark pricing levels and signals the beginning of a new cycle. The UK has also seen a sharper and quicker correction than many of its European counterparts, representing considerable opportunity for early movers to find value.

Investment activity (£bn)



Source: MSCI, November 2023.

Investment activity by sector (£bn)



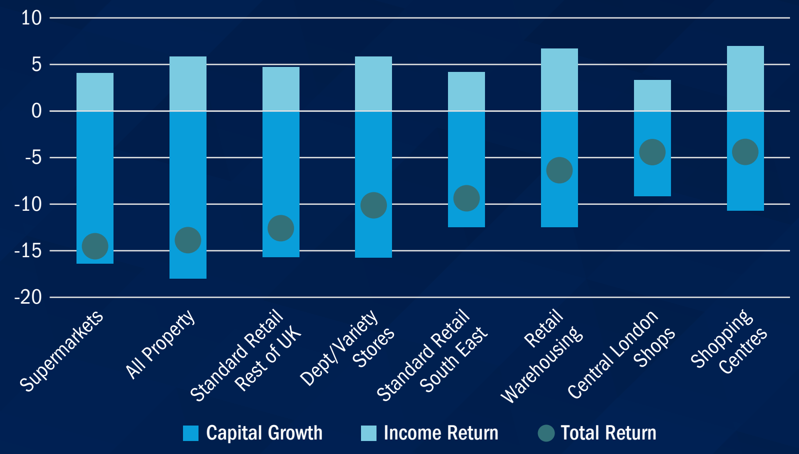
Source: MSCI, November 2023.

Retail

Retail

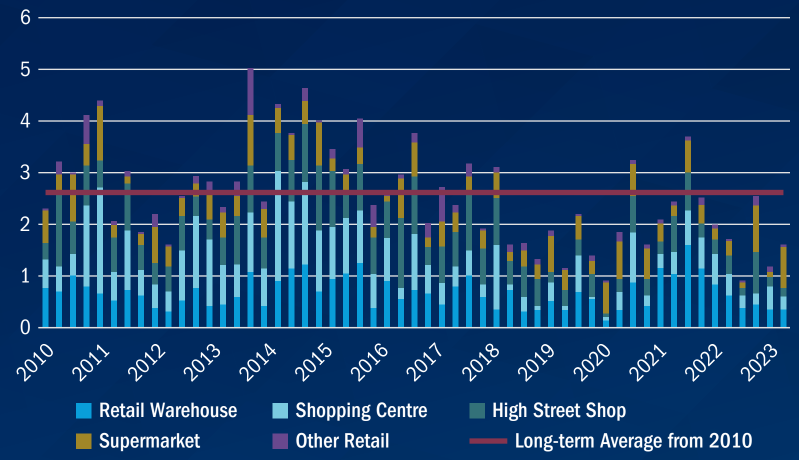
- The retail sector has been more resilient than many had expected in 2023. The total return performance for the retail sector over the twelve months to September was –7.9% with retail showing itself as one of the more resilient sectors and outperforming the all-property total return of -12.1% over the same period. The performance is largely driven by a strong income return, in fact, the highest of all major sectors. The quarterly total return for Q3 was -0.7%.
- Quarter three saw £1.7 billion of retail assets exchange hands, bringing the total trading volume for the first nine months of 2023 to £5.7 billion – down 9% compared to the same period in 2022. Perceptions of the retail sector are changing, and investors are re-evaluating their views of an area which has been through years of structural change and repricing.
- Retail warehousing is still the favoured segment supported by strong occupancy levels and demand from an increasingly broad variety of retailers. Prime yields moved out 25 bps in Q3 to 5.75% as investors adjust to higher debt costs. However, given limited new development and more positive news on the occupier front, low vacancy rates are translating into real rental growth, and this continues to attract investors.
- Yields have rebased significantly over the last 12 – 18 months. Pricing has however begun to stablise at the prime end of the market given the increasing acceptance that interest rates have peaked and should provide some comfort that pricing is not likely to be much more attractive in six to nine months. But there is room for further bifurcation with a clear focus on quality there is potential for further softening at the secondary end of the market.
- 2023 investment volumes are expected to be between 15% - 20% lower than 2022 trading volumes as deals are taking longer to complete and so a proportion of transactions in the pipeline now will roll over and boost 2024 volumes. In addition, the challenging consumer and retailer environment keeping some investors out of the market.

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



Source: MSCI UK Quarterly Property Digest, September 2023.

Retail investment activity (£bn)

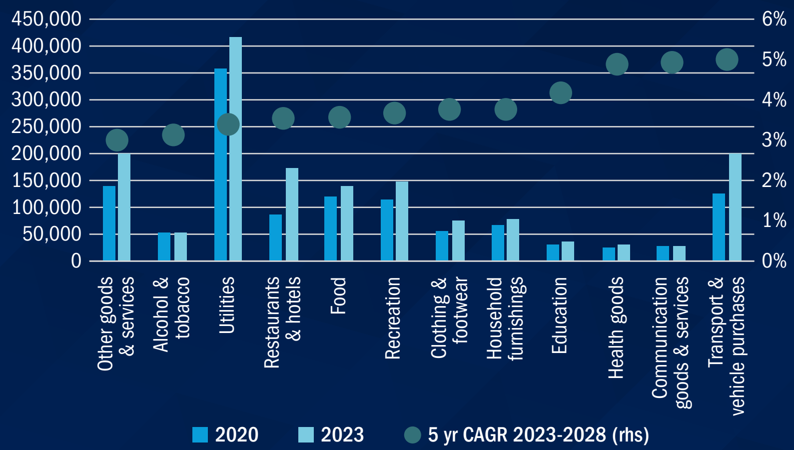


Source: MSCI, November 2023.

Retail occupier market

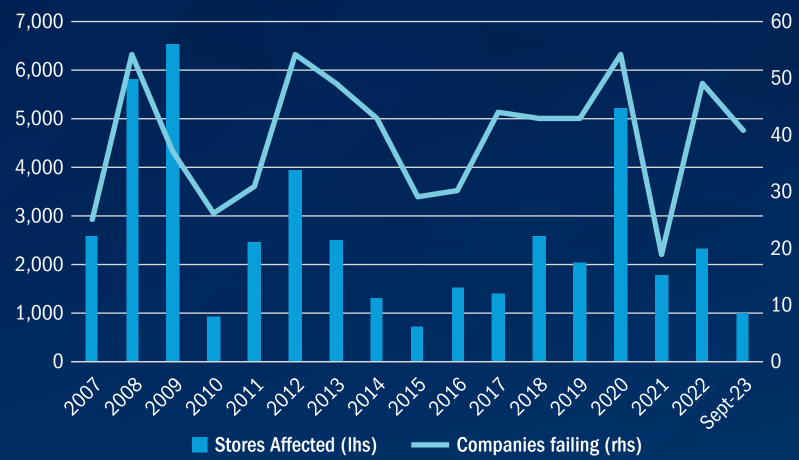
- The rate of inflation has more than halved from the highs of October 2022, falling sharply to 4.6% in October and it is now widely believed that interest rates have reached their peak and will plateau over the next 9 – 12 months. This greater clarity should begin to feed through to improving levels of consumer confidence, better sales figures and a much-needed boost to Christmas trading is now expected.
- Against a less volatile backdrop, some retailers are reviewing their strategies and cautiously executing them, readying themselves for when better conditions return. This should result in some, albeit moderate, pick-up in retailer demand over the next twelve to eighteen months.
- And so, 2024 is looking like it will be more positive for consumers and retailers alike, although economic growth is likely to be muted next year and so the performance of the retail market will not return to its pre-covid levels of activity until early 2025.
- Retailers will continue to take advantage of the rebased rental levels which, despite a recent stabilisation, are on average 23% lower than in 2019, and will move out of weaker pitches in favour of stronger ones where footfall levels are higher and more sustainable. This will result in a widening gap between strong and weak trading locations, in terms of not only rents, but vacancy levels as well.
- Vacancy rates are falling across the wider retail sector from the peaks seen just post-covid, but for shopping centres they are still high in an historic context with nationwide vacancy at 18%. Retail warehousing is still the most attractive segment where vacancy is below 5.0%.
- As oversupply falls and demand strengthens this is more positive news for landlords as rents, at both a headline and net effective level, are indicating modest positive pressure. The upward shift should continue as 2024 unfolds as consumer confidence improves and some of the cost pressures that have been challenging retailer's business models fall away.

Consumer spend (£m) and five-year annualised growth (%)



Source: Oxford Economics, September 2023.

Retail failures 2007 – July 2023



Source: Centre for Retail Research, September 2023.

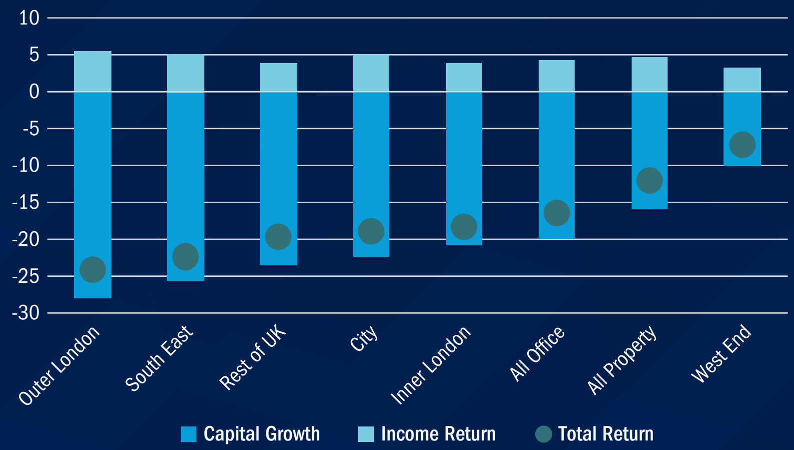
Offices

Manchester, aerial shot in the central area of the city

Offices

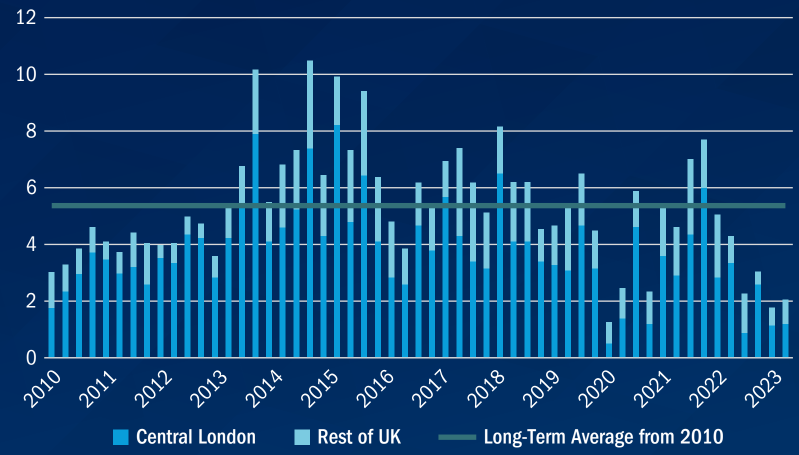
- As the office sector continues to deal with major structural shifts, yields are expected to see further outward movement over the remainder of the year and possibly into early 2024. This will result in a further decline in capital values before stabilising in 2024 and then rising again from 2025. The office total return in the three months to September was -3.4%, the worst performing of all sectors and underperforming the all-sector total return of -0.6%.
- The £2.1 billion worth of offices transacting in Q3 was similar to Q2. This brings the total for the year to September to £7.1 billion, a dramatic 58% below the same period in 2022 reflecting the more cautious approach investors are taking to the sector linked to low staff occupancy rates, the mitigation of ESG costs and the gap between buyers' and sellers' expectations on price.
- A three-tier market is emerging, ranging from centrally located prime assets, to good-quality assets in need of some capex to bring their ESG criteria up to the needs of today's occupiers and thirdly, secondary grade/quality stock, a proportion of which will fall into obsolescence as capex costs are close to or above replacement cost.
- Investor activity is focused on smaller lot sizes of below £30 million where either no leverage or limited leverage is required as investors steer clear of larger lot sizes and the need to borrow capital given the sharp rises in interest rates. London is still the market attracting the bulk of capital inflows into the office sector and accounted for 63% of office deals in Q3.
- More stability in terms of pricing for prime will come with the greater certainty around interest rates. It may not be enough for to see investors immediately pile back into the sector but enough to make some feel they may need to be ready to act in the near-term as the bottom of the market draws closer. Equity driven investors will lead the charge and be in a strong position to take advantage of market opportunities while those more reliant on debt are likely to be constrained by the higher cost of finance.

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



Source: MSCI UK Quarterly Property Digest, September 2023.

Office investment activity (£bn)

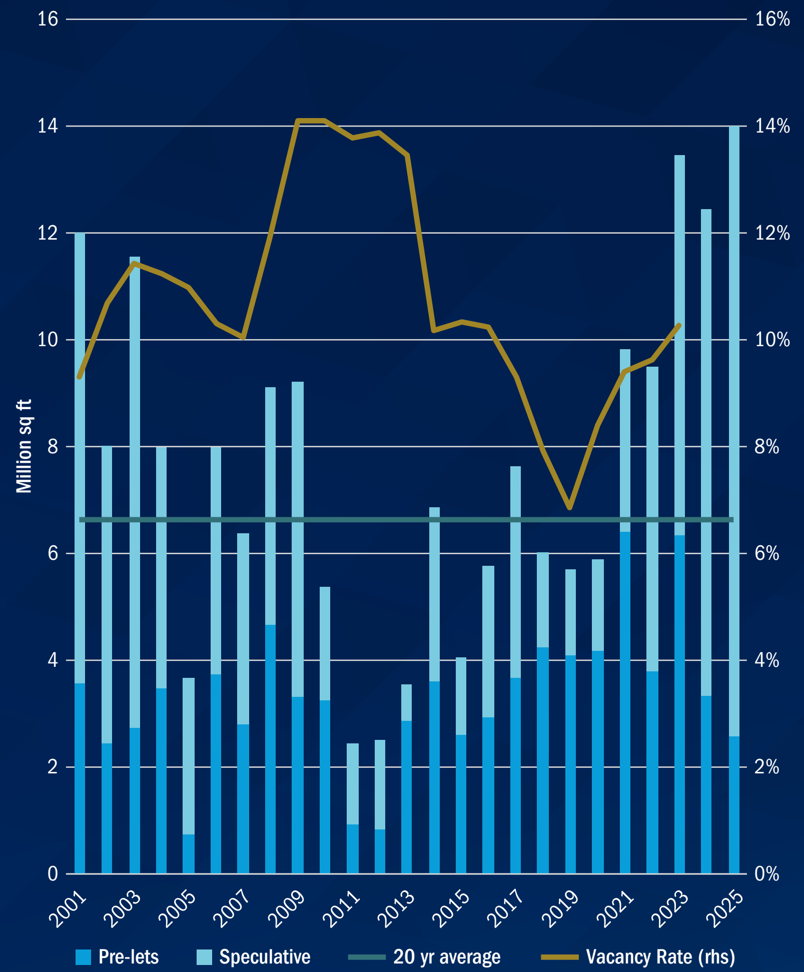


Source: MSCI, November 2023.

Offices occupier market

- Central London office leasing, despite the negative headlines around the sector, remained resilient in the third quarter with 2.2 million sq.ft of take-up, the highest quarterly volume of the year. This brings the total year-to-date total take-up for the capital to 6.3 million sq.ft. The flight to quality continues with a significant proportion of the total space currently under offer was for pre-let, newly built, or refurbished/repositioned stock, re-emphasising occupiers focus on high quality space able to offer ESG criteria which are increasingly demanded by corporates.
- Despite the uptick in Q3, overall levels of occupier demand are lower than long-term averages as the weaker economic environment is impacting business confidence with some firms putting leasing plans on hold temporarily. This has seen the vacancy rate rise to around 9.5% in Central London with tenant-controlled space representing a significant part of the market, equating to 28% of total availability.
- The trend across the key regional UK office markets was similar in that take-up strengthened in the third quarter with approximately 1.9 million sq.ft of leasing deals concluding, bringing the year-to-date total to 5.2 million sq.ft, marginally behind the same period in 2022. Likewise, demand is focused on best-in-class space as occupiers right-size their footprints in response to structural changes and hybrid working models, often exchanging lower quality space for higher quality, taking advantage of the rebased rental levels. But, across the main regional cities, quality space is typically in short supply and the undersupply is a key driver of positive rental growth.
- Developers continue to act with caution, putting some schemes temporarily on hold due to the challenges of not only securing funding, but funding at a level that still makes the scheme viable. This is coupled with construction costs which are still elevated, and the situation will hold back the much-needed high-quality supply in 2024 and 2025.
- Landlords are scrutinising their portfolios to identify schemes that have sufficient existing EPC ratings and those projects that could be easy wins in terms of upgrading and/or refurbishment. Landlords are less willing and indeed able to take on office buildings that require substantial upgrades given the high cost of capital expenditure.

Key UK office markets – development pipeline



Source: Colliers, November 2023.

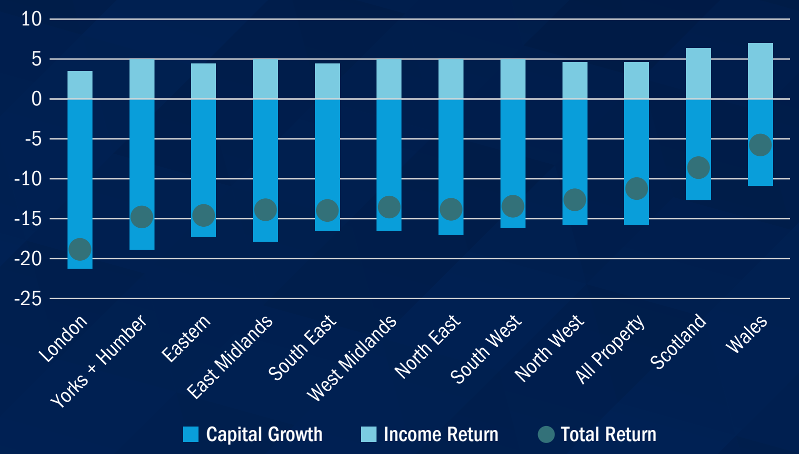
> Landlords are scrutinising their portfolios to identify schemes that have sufficient existing EPC ratings

Industrial

Industrial investment market

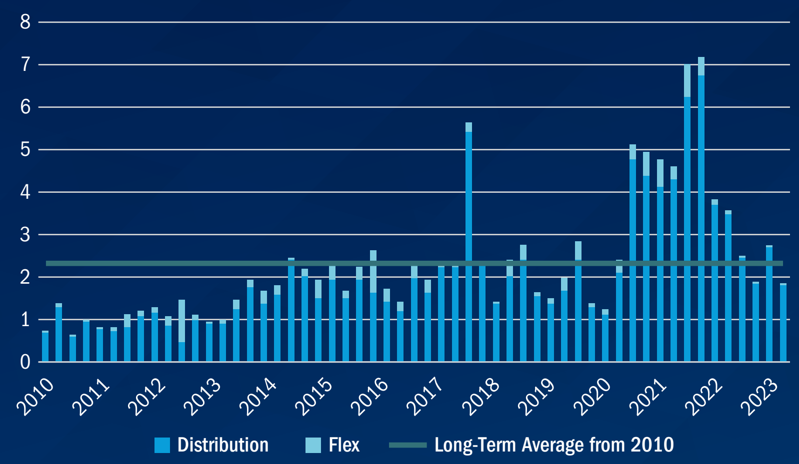
- The third quarter saw a significant slowdown in the amount of industrial space transacting with £1.9 billion exchanging hands in Q3 - bringing the year-to-date total to £7.0 billion. Quarter three is the slowest quarter of the year so far and approximately 23% below the long-run quarterly average. Nonetheless this is a respectable result given the dramatic pricing correction seen in the sector and its associated impact on value.
- Despite the positive fundamentals of tight supply and positive rental growth the sector is suffering from a lack of stock which will serve to hold higher volumes of activity back. There is a significant amount of capital tracking the sector and investor confidence has been sustained for prime logistics, but investor appetite has been restrained by volatile financial markets and rising borrowing costs.
- Investors will be much more selective, predominantly focusing on protecting income especially as vacancy rates begin to rise, albeit from historic lows although expected to stay well below previous downturns. Rental growth remains positive, albeit lower than the very strong rates in 2021 and 2022.
- The interest rate rises have also narrowed the buyer pool as debt-backed buyers are effectively ruled-out, whilst aggregators finding it more difficult and protracted to raise capital. Institutional buyers have been the most active in 2023 although scaled back their activity in Q3 with private buyers filling some of the void created.
- Following significant repricing in 2022 and into early 2023 yields at the prime end of the market appear to have stabilised over the last couple of quarters at 4.75% in London, 5.00% in the Southeast and 5.25% in the main regional markets of the UK. There still appears to be a substantial gap between buyer and seller expectations which will impact secondary pricing more and which could come under further pressure.

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



Source: MSCI UK Quarterly Property Digest, September 2023.

Industrial investment activity (£bn)

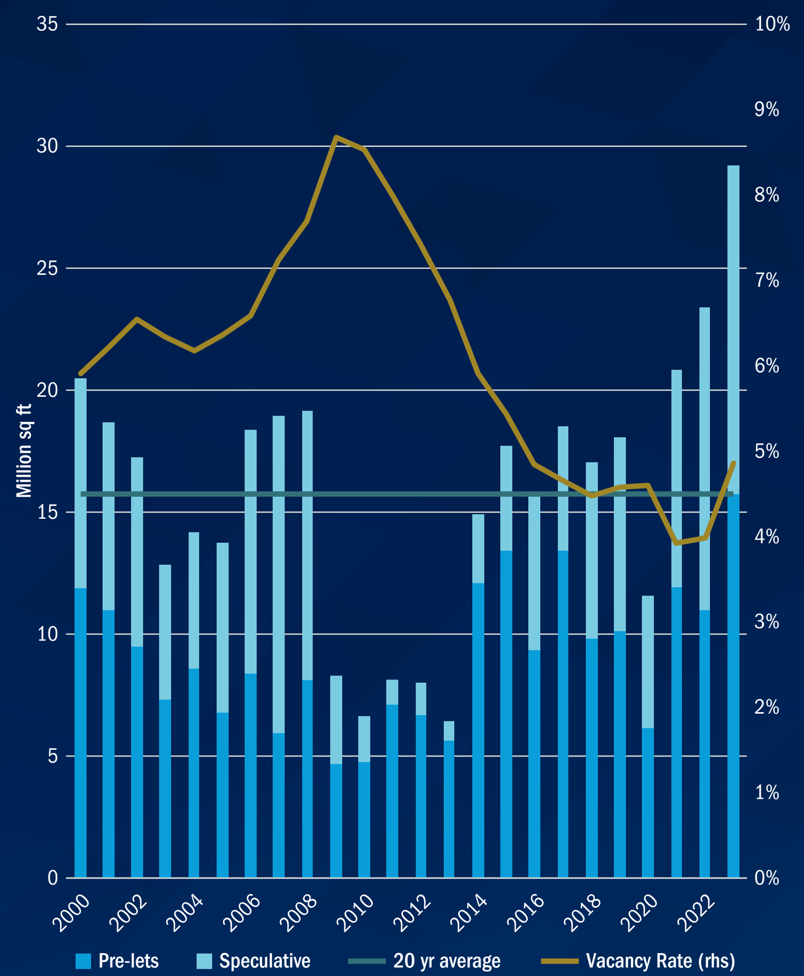


Source: MSCI, November 2023.

Industrial occupier market

- Take-up in the third quarter reached 11 million sq.ft and whilst this was up on second quarter levels, leasing activity is seeing signs of slowing down with demand now back to the pre-pandemic trend and businesses hampered by the weaker economic environment persistent high inflation, rising interest rates, squeeze on corporate margins.
- A notable change from the past few years is the breadth of occupiers looking for space, insulating the sector somewhat from any over-reliance on one sector. Whilst retailers continue to take space overall demand levels have slowed with manufacturing occupiers, linked to green energy production, automotive, pharmaceuticals and construction, going some way to fill the post-pandemic void left behind.
- The rental tone of the market is relatively robust at the headline level, largely supported by low, albeit rising vacancy. Weaker overall demand leaves occupiers with active requirements more opportunities to be selective when securing space with a clear focus on the best quality space, both new-build and refurbished secondary and stock with ESG credentials. This is leading to a widening gap between prime and secondary rents.
- Occupiers are placing greater emphasis on quality and ESG credentials – a similar trend to the rest of commercial real estate. This is driven by several factors from cost saving initiatives, to attracting and retaining staff to third-party logistics providers (3PLs) trying to stand out from their competitors and win customer loyalty.
- Availability nationwide has been rising slowly up from 5.3% last quarter to 6.0% this quarter. The rise stems mainly from speculative schemes completing with a smaller proportion relating to sublease space being returned as some occupiers look to offload excess space that was perhaps needed during the pandemic but is now surplus to their requirements. But vacancy is coming from a low base and so any uplift will be capped.
- Going forward, speculative development levels will fall further given the high cost of construction and debt, both set against the post-pandemic softening of occupier demand. But landlords and developers need to carefully monitor the evolving two-tier rental market as if good quality stock pulls much further away there is a comprehensive case for redevelopment of stock to meet rising demand for ESG requirements.

Key UK industrial markets – development pipeline



Source: PMA, Q3 2023 data.

> There is a breadth of occupiers looking for space, insulating the sector somewhat from any over-reliance on one sector

Alternatives

London, balcony of modern residential building

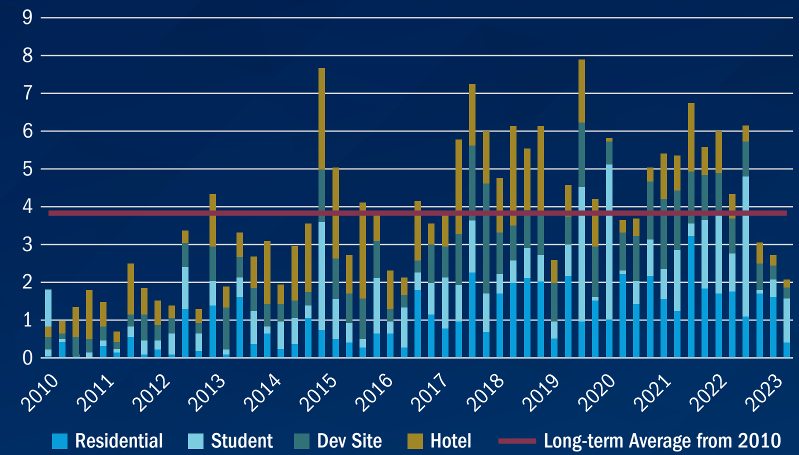
Alternatives

- The second quarter of 2023 recorded approximately £2.1 billion invested across the UK outside the traditional commercial sectors of offices, retail and industrial. The living sector, despite facing the quietest quarter in 24 months saw £1.3 billion invested in Q3, 50% down on the same quarter in 2022. Deals are taking longer to complete as the monetary environment has tightened. Some investors have renegotiated live deals while others have put acquisitions on hold, waiting to see how macroeconomic conditions evolve and the impact on pricing.
- UK living continues to prove its resilience amidst difficult market conditions that have hit the entire commercial real estate industry and a key reason for this is the unabating investor appetite for residential which is underpinned by strong fundamentals and risk-adjusted returns. Undersupply is supporting positive rental growth.
- With close to £300 million worth of hotels transacting in Q3, this was the slowest quarter of the year and brings the total volume of hotel deals in 2023 so far to £1.3 billion. The market is still in price discovery phase which is slowing overall investor activity with further yield softening expected. Sentiment towards the hotel sector is, however, generally positive but challenges remain such as higher debt costs and these are holding back liquidity. Investor activity is concentrated in strong urban, tourist orientated locations and typical buyers are those who are investing for the long-term.
- Purpose built student accommodation is still a sought-after, but trading volumes have slowed as there is a mismatch in buyer and seller expectations and a lack of opportunities being brought to market. Occupational demand continues to outpace supply, supporting rental growth. However, new schemes are slower to break ground due to high construction costs, a squeeze on operational profitability given high inflation, not all of which can be passed through to occupiers.

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

Source: MSCI UK Quarterly Property Digest, September 2023.

Alternatives investment activity (£bn)



Source: MSCI, November 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, JLL, Knight Frank, Local Data Company, LSH, Oxford Economics, Property Market Analysis, Savills, and MSCI (www.msci.com/notice-and-disclaimer) 5888041 | WF536395 (11/23)