UK Real Estate Overview

Q1 2022

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UK Economy

- While all COVID-19 restrictions have been lifted and mobility data suggesting that households have been more confident to leave their homes in recent months, other timely data suggest that the cost of living crisis is now taking its toll, dampening confidence and slowing spending
- GDP growth expectations have weakened as inflation continues to climb on the back of rising fuel, energy and food prices, in part linked to the Russian invasion of Ukraine. Inflation reached 7.0% in March and is likely to average 10.0% this year, potentially peaking in April due to the 54% rise in the energy price cap. Household spending as a result has been reined in which is hitting GDP growth
- UK GDP rose by 0.8% over Q1 2022, but the headwinds facing the economy could see GDP stagnating in Q2 and with price pressures still strengthening, the Bank of England may have no choice but to raise interest rates further
- At the MPC's May meeting interest rates were raised to 1.0% from 0.75%, up to a potential peak of 3.00% in 2023 as the Bank tries to stem the pace of rising prices and the rising cost of living. This is the highest interest rate have been since 2009 and the fourth consecutive increase since December 2021
- As the economy slows jobs growth will soften and unemployment is expected to rise from a 3.8% low this year, to around 5.0% in 2024. On the surface the labour market continues to show strength, but an extremely tight labour market will continue to cause

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.

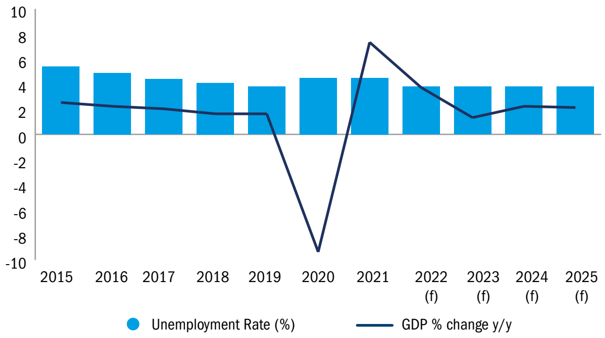
The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

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.

problems for firms who are finding it harder to fill job roles, hampering growth and risking further rises in inflation

- The Bank's traditional response to rising inflation is to raise interest rates. Typically benefitting savers, it means some with mortgages will see monthly payments go up. But, when inflation is caused by external forces, such as rising global energy prices, there is a limit as to how effective UK interest rate rises can be
in curbing it

GDP growth & unemployment rate (%)

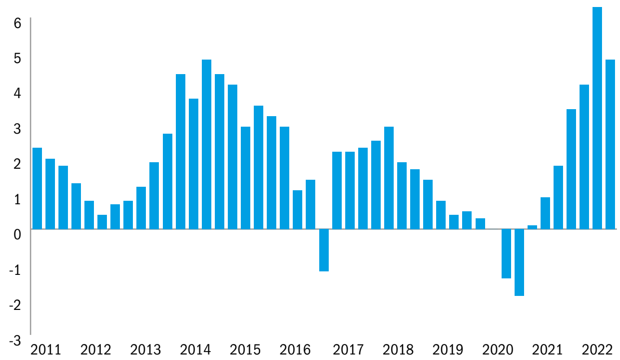


Source: Oxford Economics as at May-22

Highest annual total return in over a decade

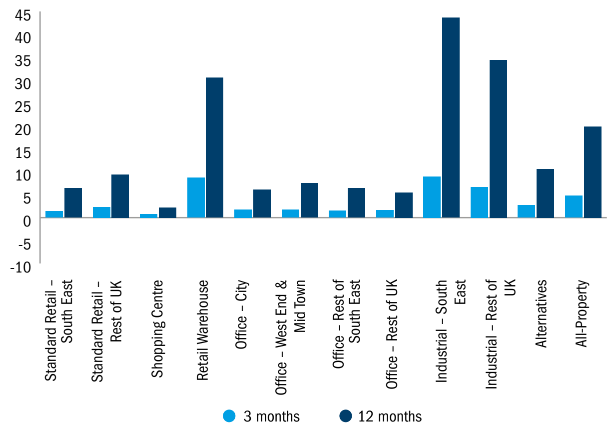
- The total return for Q1 2022 was 4.8%, the bulk of which was made up of yield compression, but rental growth was reasonably strong too, and while it is lower than the Q4 2021 performance,
it remains one of the strongest all-property three-months returns
- The twelve month return to March is 19.9% which is the highest all-property total return in an April to March twelve month period in well over a decade and a large increase on the 16.5% total return at the twelve months to the end of 2021
- Industrial continues to be the best performing sector with spectacular returns. In the three months to March the total return was 8.2% with performance underpinned by a blend of continued strong rental growth and yield impact. Over the twelve months to March a total return of 40.4% was posted – a level not seen before
- Offices lagged over 2021 as uncertainty shrouded the sector as to what the future looked like and how offices would be used. While the sector seems to have turned a corner and momentum is gathering pace, it remains subdued over the three months to March with a total return of 1.6%, but there is generally more positivity with regards to the sector
- Retail posted a total return in the three months to March similar to that seen over the last three months of 2021 of 4.5%. This however masks the nuances playing out behind the scenes whereby retail warehousing is widening the gap with high streets and shopping centres as the shift to hybrid working favours
local and retail warehouses have proven their resilience over the course of the pandemic in terms of value and footfall
- Residential returns slowed over the first three months to 2.4% but maintained a healthy performance over the year to March at 11.1%. The performance of the hotel and leisure sectors improved as COVID-related restrictions were lifted and people travelled more and spent more time and money doing leisure related activities

Three month all-property total returns to March 2022 (%)



Source: MSCI UK Quarterly Property Digest Mar-22

Total returns 3 & 12 months to March 2022 (%)

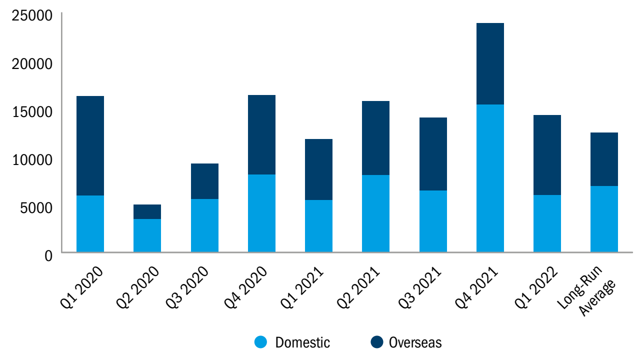


Source: MSCI UK Quarterly Property Digest Mar-22

Investment Market

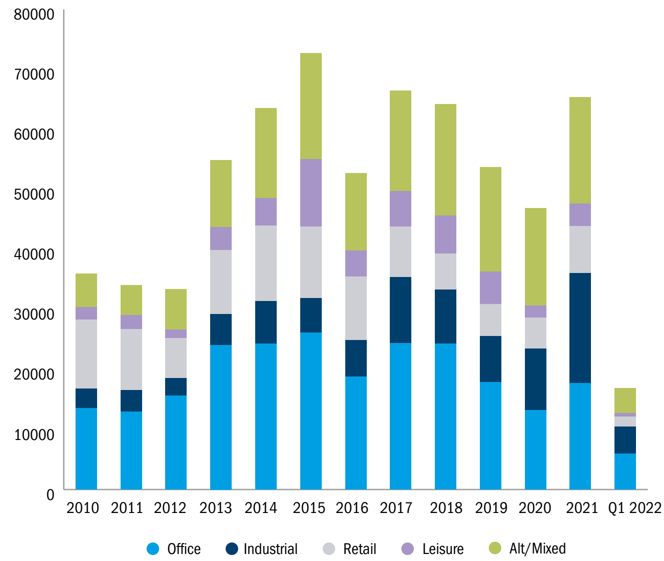
- UK real estate had a strong start to 2022 with capital inflows amounting to circa £16.9 billion over the first quarter of the year, a comfortable 25% above the long-run quarterly average of £13.5 billion. Q1 2022 was the best first quarter of the year since 2015
- Demand for the office sector has strengthened notably as investment volumes rose to £6.7 billion in Q1 2022 compared to £3.1 billion seen in the comparative quarter in 2021. Trading activity was however boosted by some sizeable deals such as NPS's acquisition of the UBS HQ at 5 Broadgate for £1.2b which is the largest office deal in London since 2017 and the second largest on record and Alphabet's acquisition of its Central St Giles office for £738 million
- Appetite for industrial assets continues unabated with £4.7 billion concluding in the first quarter which was the second most active quarter on record, surpassing the previous record set in Q4 2021. Domestic and international buyers continue to look for opportunities across the UK against a backdrop of tight supply and limited speculative development which is not only sharpening yields but pushing up rents
- Retail seems to be turning a corner, but investment is selective within the sector. Retail warehousing and convenience shopping are pulling away from high streets and shopping centres. Although the strong performance of retail warehousing last year is beginning to turn opportunistic investor's eyes towards shopping centres
- Cross-border capital accounted for approximately 55% of all activity during the quarter. Of note were global investors from North America and Asia as the removal of travel restrictions made the flow of global capital easier
- The Russian invasion of Ukraine is having a limited impact on direct inflows into UK real estate as Russian capital constituted a very small amount of cross-border capital. The more likely consequence is a shift in investor demand away from Central & Eastern Europe towards safe haven markets such as London. The wider reaching consequences are macroeconomic with rising inflation and higher borrowing costs

Investment activity £m



Source: MSCI as at May-22

Investment activity by sector (£m)

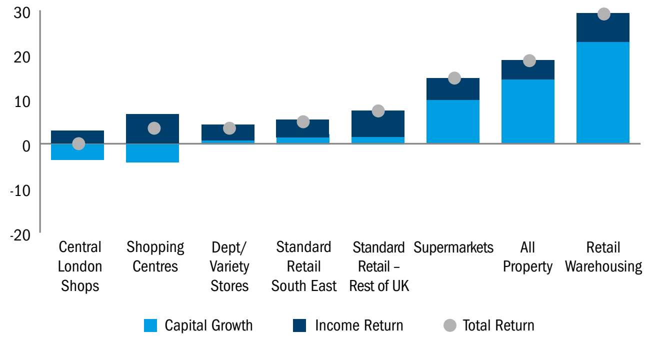


Source: MSCI as at May-22

Retail

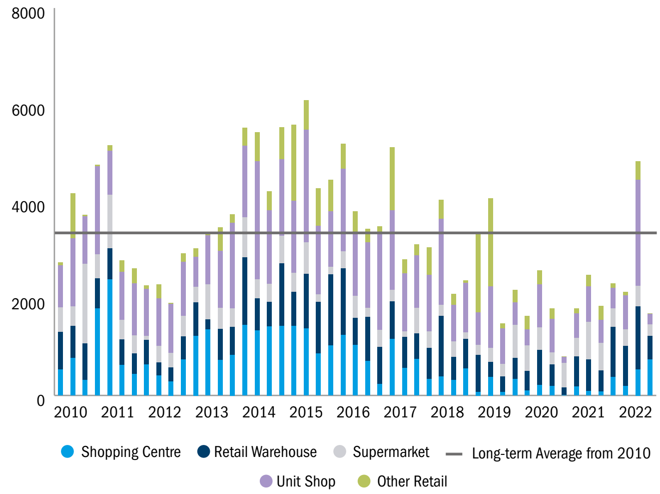
- The total return for overall retail in the three months to March 2022 was 4.5%, the second best performing quarter since the beginning of 2010. There are nuances within the sector with retail warehousing generating a significant total return of 8.7%, posting a better performance than industrial at 8.2%. Over the 12-month period the total return for retail warehousing was a staggering 30.5%
- Generally the regions outside the capital are faring better while Central London is still struggling with a negative total return over both the three and twelve months to March 2022 as working patterns continue to settle into a new norm
- Retail investment began slowing in 2022 with £2.3 billion exchanging hands. Retail warehousing remains a popular choice although Q1 volumes were down against Q4 2021. With the ability to offer local convenience, a resilient tenant mix, and redevelopment opportunities, retail warehouses should remain of interest
- But rising levels of interest were noted for shopping centres this quarter as more opportunistic investors turn to the sector given the tighter pricing in other parts of the retail market. Q1 was the strongest first quarter since 2016
- Community, local and convenience focused centres are proving to be more resilient and the most popular with investors where demand has seen yields already edge in by 25 – 30 bps over the latter part of 2021. A mismatch between buyer and seller expectations is evident as buyers hold out for more of a discount
- Repurposing transactions are likely to fall as higher borrowing and construction costs will make some projects less attractive, although if the end use is housing or logistics then the numbers can still stack up
- The improvements seen in high street investment may slow given worsening consumer sentiment. Hopefully it will not linger for long enough to have a damaging effect on void levels and retailer failures. Institutions will be the main sellers with private investors on the buy side expected to be the most active

Retail total returns by selected segments annual to March 2022 (%)



Source: MSCI UK Quarterly Property Digest as at Mar-22

Retail investment activity (£m)

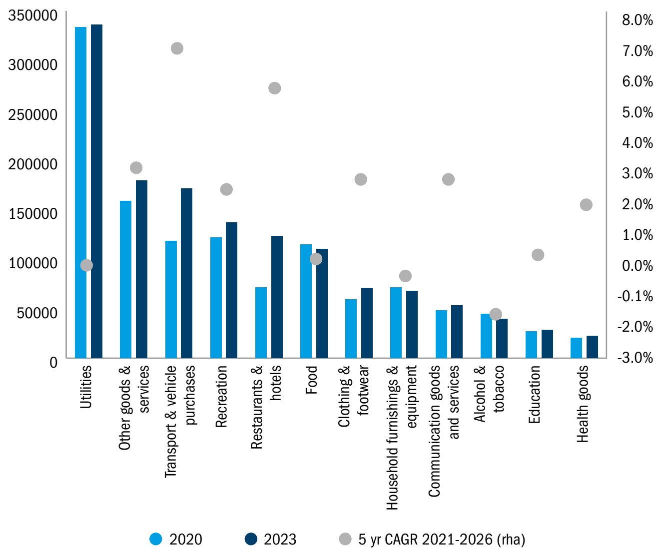


Source: MSCI as at May-22

Retail occupier market

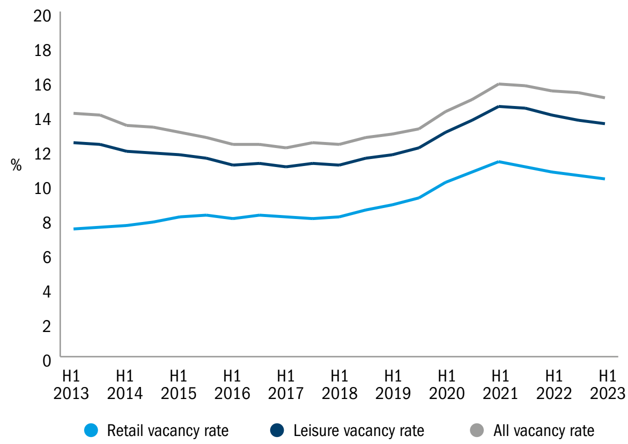
- With restrictions lifted and COVID largely behind us, the initial shock of the health crisis has receded. Consumers emerged from the crisis with higher than normal levels of savings, but the household saving ratio has already fallen below its pre-crisis level, plus these savings were also concentrated in higher-earning families leaving middle and low-income households with little or no cushion against rising prices
- UK households are facing new challenges as inflation surges coupled with a rising tax burden that needs to be shouldered, while real disposable incomes decline which will inevitably have a negative effect on spending behaviour at a time when retailers desperately need it and who are also facing higher costs
- Vacancy rates across the UK have started to recovery with a drop in rates in late 2021 - the first decline in three years. Rates should fall further in 2022 as redevelopment and repurposing of retail space continues. Wales was the only region to see a decline in vacancy between 2020 and 2021, from 19% to 18.8%. Greater London was resilient with a 0.2% increase in the same period
- Luxury and high-end brands have been consolidating their store networks, focusing on prime locations that they need to be in for brand positioning and strategic purposes
- There is evidence of retailers repositioning by building efficient multichannel operating models as they develop a greater understanding of multichannel retailing and the co-dependencies of online and store-based retailing in the 'new normal' marketplace
- Prime rents are set to grow this year as pandemic effects fade, but the consequences of the war in Ukraine mean growth is likely to be slower than previously expected. Rental prospects are better further ahead, supported by a slowing in online penetration

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



Source: Oxford Economics as at Mar-22

Retail vacancy rates (%)

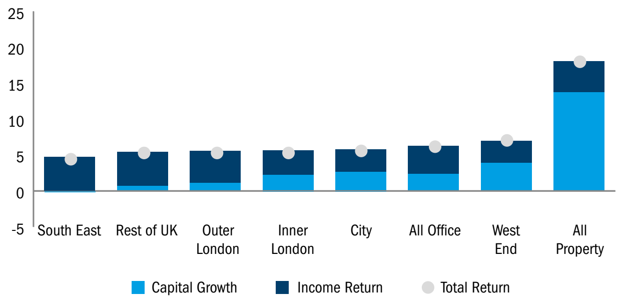


Source: Retail and leisure trends report 2021, LDC

Offices

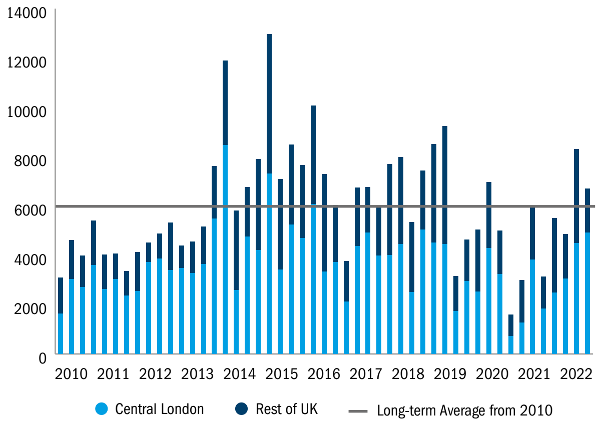
- Offices posted a 1.6% total return in the three months to March. Annually, the total return of 6.5% in the twelve months to March is much improved on the comparative period to March 2021 where the total return was -1.2%. Much activity is being driven by official working from home restrictions having been lifted and companies continuing to implement new working patterns, part of which involves workers returning to office as part of a hybrid model
- In a change of fortunes the office sector was the most sought after across the UK in the first quarter of 2022 with £6.7 billion worth of assets exchanging hands, equating to a 35% market share and nudging industrial into second spot
- London was by far the most targeted area with around three-quarters of deals taking place in the capital, although activity was supported by a few large deals indicating a renewed belief that offices still have a significant role to play and that London offers a level of resilience
- The Southeast was the next most popular area along with key cities such as Bristol, Edinburgh and Leeds with investor demand following areas where the occupier base is expanding, notably in the scientific, innovation and technology sectors. This is evidenced by the demand for assets in Oxford and Cambridge, which has resulted in prime yields compressing to 4.50% - 4.75%
- Overseas investors were the most active in Q1, responsible for deploying capital for 76% of deals into the UK office market and was the second highest amount in the last ten years underlining the strength of conviction for the sector. International capital is expected to remain active in 2022 with regional offices providing an attractive yield spread to London offices and European cities
- With ESG firmly on the agenda of both occupiers and investors, those assets which can immediately satisfy ESG criteria and provide medium to long term income have experienced high levels of investor demand

Offices total returns by selected segments annual to March 2022 (%)



Source: MSCI UK Quarterly Property Digest as at Mar-22

Office investment activity (£m)

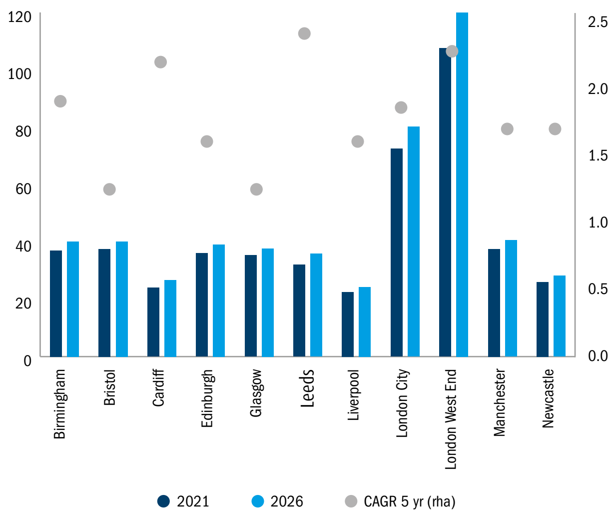


Source: MSCI as at May-22

Office occupier market

- The health crisis has been a catalyst for people and companies to assess and reassess working practices and while not all the answers are yet known, occupier activity levels in the first quarter of 2022 substantiate the need for offices and that they have a place
- Demand levels are healthy, partly driven by requirements previously on hold that have now been reactivated and are committing to space. There remains a clear focus on securing higher quality, centrally located space as hybrid models become the norm and with this demand for the best quality space, rents continue to come under further upward pressure
- With vacancy rates for the best quality at critical lows in some locations this is fuelling rental growth and the need for higher levels of speculative space. But, supply chain bottle necks and the rising cost of materials and labour will see some planned schemes push out start and thus completion dates
- Across the key nine regional office markets leasing activity is picking up with Q1 seeing 1.1 million sq.ft let as professional services firms in particular secured space. Bristol, Cardiff and Newcastle were particularly active as a number of larger deals previously in late-stage negation concluded
- Vacancy is around 8.3% with 4.6 million sq ft office development under construction across the Big Nine markets. Glasgow is the most active, with 1.1 million sq ft currently being built but with 97% of this already pre-let occupiers with new requirements have very limited options and premiums on rents will be asked for
- Take-up in Central London totalled 2.8 million sq.ft in Q1, in line with the long-term first quarter average. Momentum should gather pace given the above long-term trend of space under offer and underlines the desire from occupiers for quality space as they continue to commit to space that is either under construction or proposed

Office rents & growth forecasts

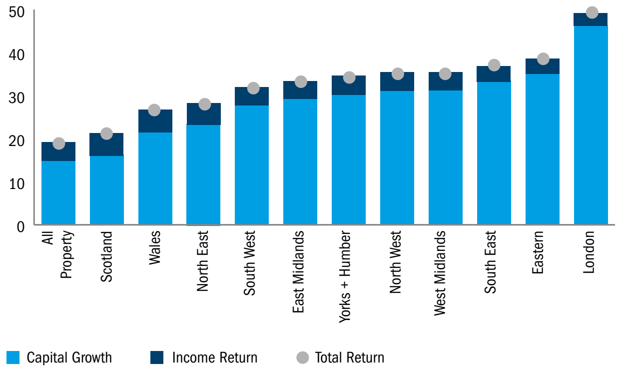


Source: PMA

Industrial

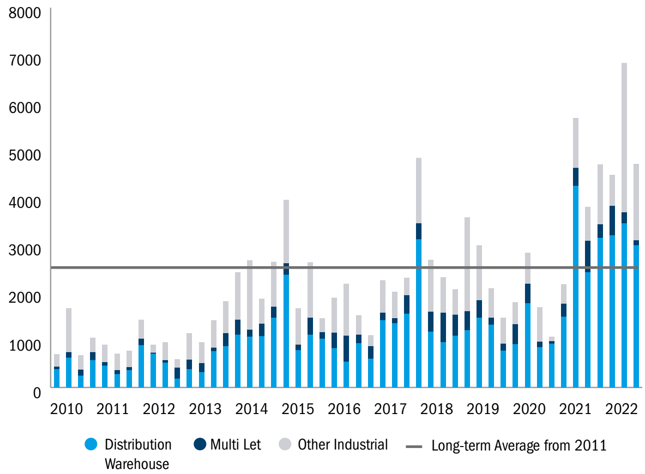
- Industrial continues to be the star performer and the only sector to outperform the all-property total return in the three months to March of 4.8%, posting a performance of 8.2% and a staggering 40.4% over the twelve months to March – a level that has never been seen and one that will be hard pushed to be matched
- All regions of the UK saw strong returns over the quarter, but London continues to lead the way with a 10.8% total return. Annually to March the capital posted a dramatic return of 50.5%, a record, surpassing the last high of 24.6% in March 2018. Outside London the South East and Eastern regions were the next best performing with returns in excess of 38.0% over the last quarter
- £4.8 billion worth of industrial assets exchanged hands in Q1 2022 which equates to a 30% share of all transactions that concluded in Q1, and well above the average of 14% long-run annual average, reflecting the sector's position as a sought after defensive asset class of choice in the current market
- There was an even split between domestic and international capital targeting the industrial sector in Q1. Global investors from North America, China and Singapore were particularly active, while Continental European investors scaled back their level of activity in the first quarter
- Geographically the Greater London and the Southeast are attracting the majority of deployed capital, although key strategic cities such as Northampton, Birmingham, Bristol and Manchester are seeing rising levels of interest, all of which run close to major motorway arteries
- Investor appetite for the sector is not expected to wane, but overall trading volumes for 2022 are unlikely to match those recorded in 2021 given the lack of suitable and available stock. Some supply may come from investors looking to cash in on rising prices, but many more will continue to hold their assets, looking to take advantage of the additional upswing in rental growth

Industrial total returns by selected segments annual to March 2022 (%)



Source: MSCI UK Quarterly Property Digest as at Mar-22

Industrial investment activity (£m)

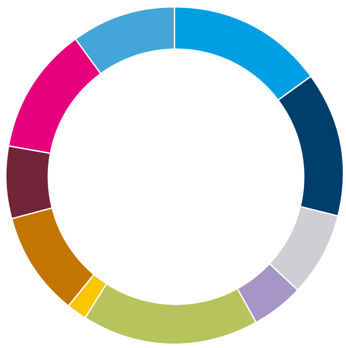


Source: MSCI, May-22

Industrial occupier market

- The occupational market continues to surprise although the pace of leasing activity has seen some easing over the first three months of 2022, but this is against a record breaking 2021. Demand was strong over the quarter with 15.8 million sq.ft of take-up – this was down on Q4 2021, but above the five year average
- The ramification of COVID-19 has been the fast-forwarding of structural changes that existed before the onset of the health crisis resulting in swathes of occupiers focusing on the adaptation of their supply chains and expansion of their online fulfilment capabilities. This was coupled with a greater desire for on-shoring to mitigate for the lingering impact of Brexit, all of which has fed through to robust take-up levels
- Supply is at critically low levels with the country-wide vacancy rate around 3.5%. Developers are responding by bringing more speculative space online but are facing rising construction, labour and material costs and supply chain bottlenecks and those occupiers with immediate requirements have limited standing stock options
- Currently approximately 20 million sq.ft of speculative warehouse space is under construction and due to complete by the end of 2023. This is a level not seen for over a decade and a half, and which a significant proportion will be taken-up before completion. Given the unrelenting levels of new occupier requirements rents continue to be pushed up across the UK
- While rising costs, or at least a proportion of them will be passed to occupiers, rents, at a national level are expected to continue to rise over the next five years, with growth front loaded. Rental uplifts have been uneven across the country and this will remain the case, but the overarching trend is a positive one
- A question remains around how sustainable the recent past levels of take-up are and how much further rents can grow. Having said that, it is the lack of stock that will have the greatest impact on the outlook for 2022, with volumes expected to be lower this year than last, despite developers pushing for more schemes to be launched

Q1 2022 take-up by occupier sector



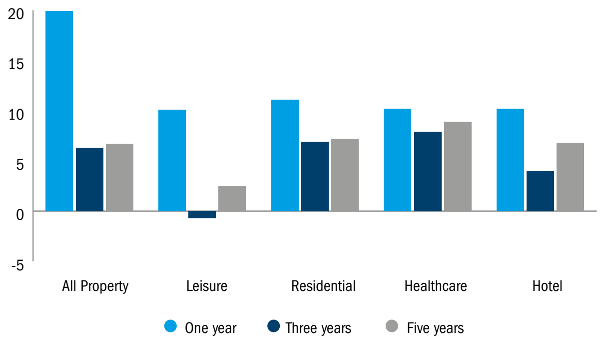
Dedicated internet retail	15%
Home improvement and furniture retail	14%
Other retail & wholesale	8%
Renewable energy/recycling	5%
Logistics	17%
Pharma and healthcare	2%
Manufacturing (inc packaging, automotive)	10%
Food manufacturing, retail & wholesale	7%
Unknown/ confidential	12%
Services (inc document storage, data centre, film & TV)	10%

Source: Gerald Eve

Alternatives

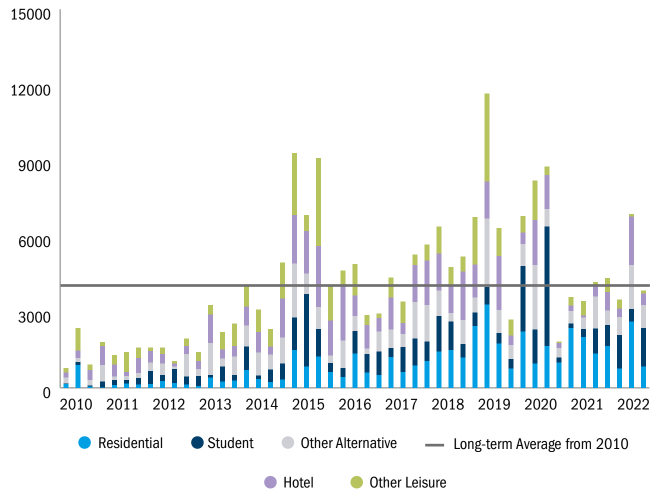
- The alternative sector delivered a quarterly total return of 2.7% to March 2022 underperforming the all-property total return which was skewed by the stellar performance of the industrial sector over the recent past
- The Alternatives sector saw £3.9 billion invested in the first quarter. Student accommodation was the standout single sector with activity boosted by two large portfolio deals equating to £788 million of the £1.5 billion that exchanged hands
- Interest in the residential sector is growing, especially so for good quality assets which is continuing to put yields under downward pressure. Investment in the built-to-rent segment was heavily weighted to London and the South, but there is rising interest in new locations such as Southampton
- Affordable housing is in the headlines more and robust demand from investors has been noted. Competition is increasing for both developments and standing stock, the latter more so as it provides immediate income streams, but also driven by the increased prioritisation of ESG factors and inflationary pressures pushing up the prices of the development of new stock
- Hotel activity in Q1 was underpinned by a generally more positive outlook as restrictions were lifted and travel, both domestic and international, picked-up. The short-term outlook has been somewhat clouded by the conflict in Ukraine and the rising cost of living impacting spend generally. This will also feed into higher operational costs with supply chain disruption and labour shortages additional challenges
- Healthcare and senior living have been moved into the spotlight by the health crisis. Plus, life expectancy is rising due to advances in medicine, technology, diet and lifestyle choices and this means an increasing number of people living longer. There is limited current choice with less than 3% of the UK's housing stock geared towards the retirement market, much of it built as traditional sheltered housing

Alternatives total returns by selected segments annual to March 2022 (%)



Source: MSCI UK Quarterly Property Digest as at Mar-22

Alternatives investment activity (£m)



Source: MSCI as at May-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.

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