For Professional Clients and/or Qualified Investors only

UK Real Estate Overview

Q2 2022

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UK Economy

- The UK economy saw a strong rebound in 2021, but growth has slowed in the face of rising inflation, persistent supply chain problems and elevated geo-political risks. Policymakers are taking steps that will slow growth, with the Bank of England hiking rates while the Treasury is increasing taxes, such as National Insurance. There is disagreement amongst economists on whether the UK will be dragged into a recession this year, but a period of low or negative growth is certainly ahead.
- July saw inflation reach 10.1%, potentially reaching 18% by year-end, peaking in October as Ofgem revealed the energy price cap is likely to rise by more than 80% in October. Despite a £15 billion (0.6% of GDP) fiscal support package, this still leaves households facing a significant squeeze on their finances. In reaction, at the MPC's August meeting the bank rate rose by a further 50 bps to 1.75% - the sixth successive increase. More hikes are anticipated given the priority is to fight inflation and the base rate could potentially reach 2.00% - 2.50% by year-end. Rate hikes are underpinned by a tight jobs market which could push up wage growth and keep inflation high, even after the impact of higher goods and energy prices has faded.

Risk Statement

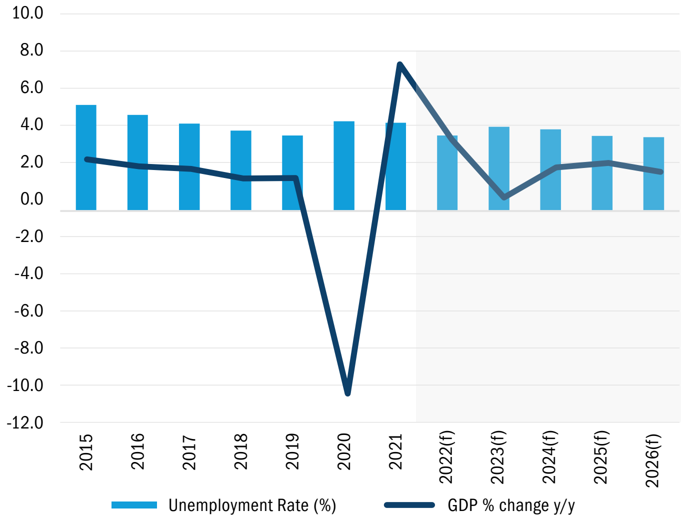
Our review and outlook is a marketing communication providing an overview of the recent economic and property market environment. It should not be considered as advice or a recommendation to buy, sell or hold investments. Nor is it investment research and has not been prepared in accordance with legal 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.

- The combination of high inflation and tighter policy means real household incomes are forecast to fall by 3.7% in 2022, the largest drop since 1963. Previously there was some scope for households to cushion the blow by taking on new credit and spending a portion of the excess savings accumulated in 2020-2021, but this is fading. While stronger wage growth has provided some mitigation, it is not been enough to offset the increasing drag from high inflation.
- July saw the resignation of PM Boris Johnson but markets seemed unperturbed by the news and the potential economic implications of his departure have been modest. While a new leader may promise tax cuts, those plans will likely be watered down when reconciled with calls for higher spending and fiscal discipline and they will need to factor in wider public opinion and calls to ease cost of living pressures and spend more on defence after Russia's invasion of Ukraine. Reconciling these priorities will be difficult, so any tax pledges could well be watered down in favour of more spending on support to households.

GDP growth & unemployment rate

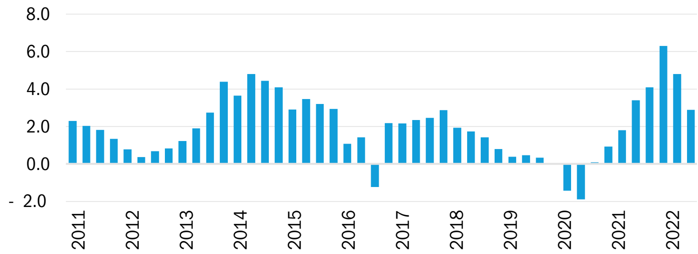


Source: Oxford Economics

Return performance

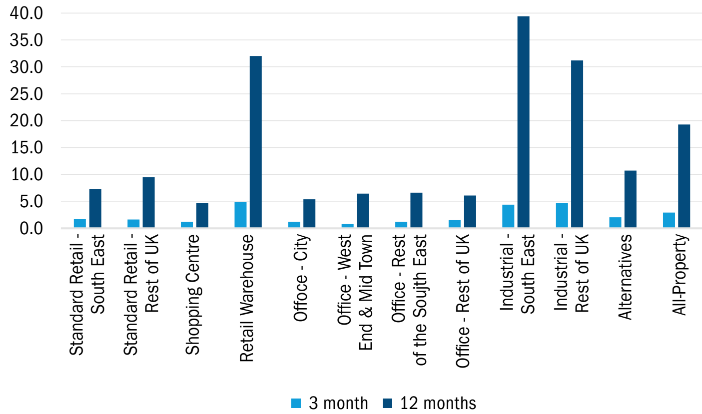
- The total return in the three months to June 2022 was 2.9% comprising a blend of rental growth, capital growth and income return. Despite this being the lowest over the last four quarters, performance was positive across all property segments. The annual return to the end of June 2022 has slightly declined from the first quarter, but is still posting 19.3% in the twelve months to end June.
- Positive rental growth has been seen across the board, albeit slowing from the performance of the recent past. There is also a clearer distinction now between a preference for prime, quality assets that are supporting the bulk of positive growth and the secondary market. This is not expected to change in the near-term.
- Industrial, once again, was the best performing sector. In the three months to June the total return was 4.5% and while lower then in the first quarter, performance underpinned by a blend of continued strong rental growth and yield impact. Over the twelve months to June a total return of 19.5%.
- The office market remains challenging and while there is evidence of more positivity towards the sector, there also remains a level of uncertainty as to the future of offices. There is general agreement on that they are needed, but their function could change somewhat and continues to unfold. However, the total return performance was positive over both the quarter and the year at 1.1% and 6.3% respectively.
- Retail posted a total return in the three months to June of 3.0% and while this was weaker than seen over the first three months of 2022 of 4.5%, it is the second best performing sector of the index after industrial in Q2. Of note is the total return for retail warehouses at 4.9% - the strongest sector in the quarter, including industrial.
- High streets and shopping centres are lagging but, shops in Central London turned positive in the quarter with a stronger performance in the West End of 1.3% boosted by higher tourist numbers visiting the capital.
- Residential returns slowed over the three months to June to 1.8% but maintained a healthy performance over the year to June at 11.1%. The leisure and hotel sectors continue to improve as tourist numbers rise, but this is likely to slow after the summer period.

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



Source: MSCI UK Quarterly Property Digest June 2022

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

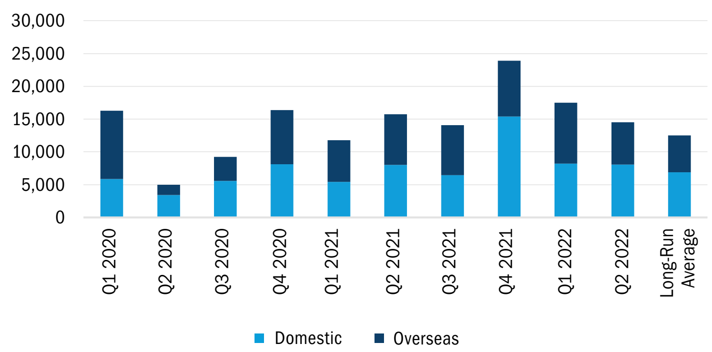


Source: MSCI UK Quarterly Property Digest June 2022

Investment Market

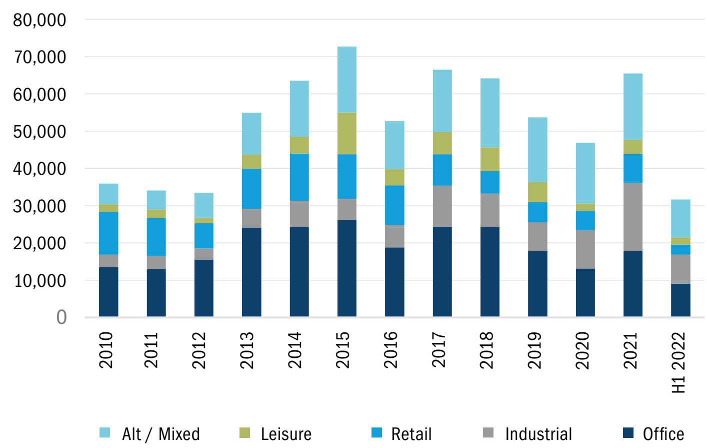
- With UK base rates rising to 1.75% from 0.1% in a little over six months and further rises seen as an inevitability, investment volumes are expected to slow as investors take stock and wait for evidence of market pricing.
- This about turn in sentiment is reflected in both levels of investment activity and lengthening deal times. While H1 2022 reached £32.0 billion and is 28% above the long-term average, monthly volumes have been trending downward since the start of the year with £14.5 billion transacted in Q2, the lowest level since Q3 2021.
- The jump in the cost of finance coupled with the risk of recession, investors will step back from the market and wait for it to re-price. It is difficult to know, at the moment, by how far and the pace the adjustment will take, but a 10% fall in capital values between now and end-2023 is foreseeable – compared to the GFC where values fell by 45%. The reason being that there is less speculative development and investors generally have lower levels of debt, so there is less risk of distressed sales depressing prices.
- Spreads between prime and secondary yields, given the uncertain economic environment, will widen across all sectors. Those sectors most likely to be seen as more defensive over the next 18 – 24 months are where steady levels of demand continue against good supply fundamentals and prospects for rental and income growth over the long-term.
- Thus, interest will be seen for bulky goods retail parks, centrally located offices with strong energy efficiency and well-being features and multi-let industrial estates. Those sectors benefitting from long-term structural changes will also be relatively defensive including life sciences, self-storage, social supported housing and purpose-built student accommodation.
- Overseas investment in UK real estate accounted for approximately 55% of all activity during the first half of the year. Interest is expected to continue, even if overall volumes slow, as the UK offers a large and diverse investable universe. Of note were global investors from North America and Asia.

Investment activity £m



Source: MSCI, July 2022

Investment activity by sector (£m)

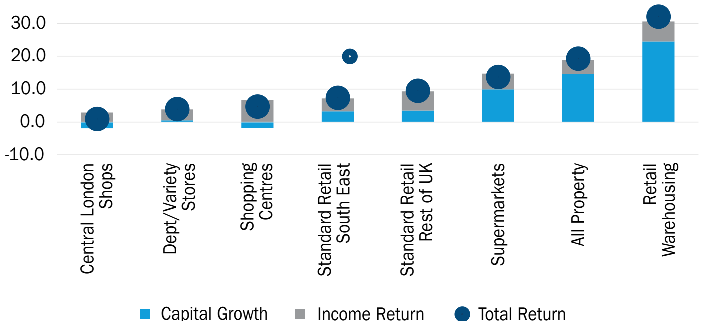


Source: MSCI, July 2022

Retail

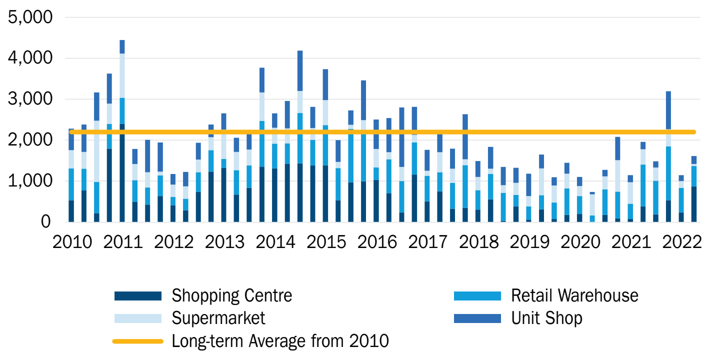
- The total return for overall retail in the three months to June 2022 was 3.0%, slower than the previous quarter as once again the retail sector faces challenges with high inflation squeezing household incomes and impacting retailer performance.
- Variations continue to exist across the sector with retail warehousing generating the highest total return of 4.9%, posting a better performance than industrial at 4.5%. Over the 12-month period the total return for retail warehousing was a staggering 32.0%.
- Capital inflows into the retail sector in Q2 reached £1.6 billion, bringing the half year's total to £2.8 billion which is 11% lower compared to investment over the same period last year at £3.1 billion. Domestic capital dominates and where international money has flowed in, it is typically from North America, Switzerland and Germany.
- Volumes remain generally subdued as the impact of the cost-of-living crisis dents investor confidence, coupled with the well narrated structural headwinds the sector is facing. The rising cost of borrowing in combination with a potential consumer recession have softened yields and there is no doubt that investors are more cautious about rental growth, but the sector has not shut-down, but slowed down.
- Shopping centre activity is up a meaningful 142% in H1 2022 compared to H1 2021, albeit from a low base. Declines were seen in the other retail subsectors with retail park investment volumes down 22% over the same period, partly linked to the lack of available stock given the sector has seen strong demand over the past few years.
- Dominant local schemes that have a community or convenience focus will continue to be of interest but despite demand there are limited prospects for yield hardening. Perhaps, yields will stabilise at the prime end of the given low vacancy and some upward pressure on headline and net-effective rents in the best of these schemes.
- Investors are likely to adopt a wait-and-see approach, waiting to see where pricing moves to over the next few months and what the Christmas trading figures look like. Active buyers will most likely be opportunistic ones, but they will look for higher yields to offset the current market uncertainty.

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



Source: MSCI UK Quarterly Property Digest June 2022

Retail investment activity (£m)

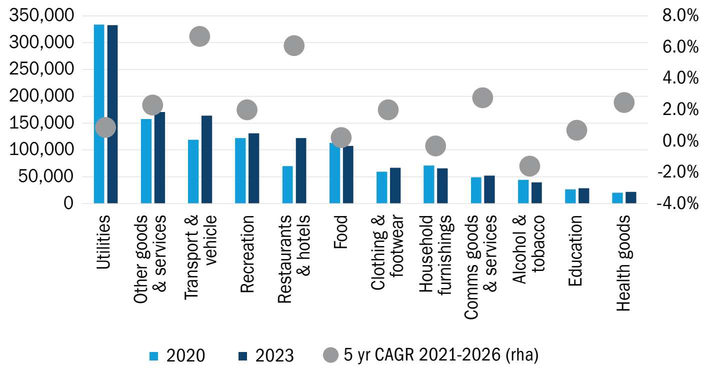


Source: MSCI, July 2022

Retail occupier market

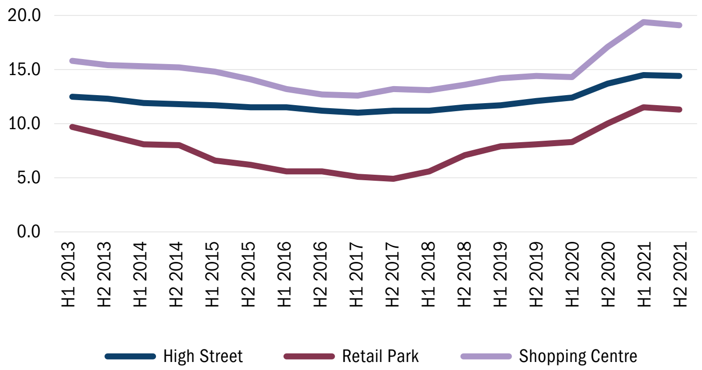
- Retail, having seen tides finally turn in quarter one, is now once again facing a challenging environment with volatile retail sales figures over the past few months as multiple factors impacting consumer behaviour continue to play out. These include supply-chain disruptions, shortages of goods and materials, rising inflation and interest rates all of which are weighing on consumer confidence.
- Macroeconomics headwinds are expected to slow rather than destabilise the recovery with the retail sector having developed a new-found resilience in navigating worse during Covid. Lockdown-induced closures, redundancies and supply chain issues will have presented a greater challenge than more readily forecastable inflationary pressures. Consumers may well trade down, perhaps delaying big ticket item purchases, but will not stop spending all together.
- Rents have been subject to downward pressure and retailer margins are squeezed. In the most resilient locations rental declines are slowing and levels are beginning to stabilise, at least for now. Turnover rents are becoming increasingly prevalent, particularly amongst fashion occupiers, which should help to provide a more sustainable trading environment for retailers going forwards.
- Online penetration levels have moderated recently, receding from the artificially inflated Covid-induced peak of 35.5% seen in February 2021 to a more normal 27.0%. While further growth is anticipated with forecasts suggesting levels rising to around 30% by 2026, the pace of increase is slowing, providing more clarity that an omni-channel approach will be a necessity for future-proofing income.
- The performance of the retail warehouse sector in particular has been supported by the structural changes to how we live, work and shop over the last couple of years. The convenience, accessibility, free parking and rising numbers of restaurants and convenience F&B will continue to feed the expected outperformance of the sector, although even here rental growth will slow as consumer incomes are squeezed.
- Visits to retail parks are currently hovering around 5% below pre-Covid levels. Footfall on high streets and shopping centres has improved but remains between 15% and 20% below pre-pandemic levels.

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



Source: Oxford Economics

Retail vacancy rates (%)

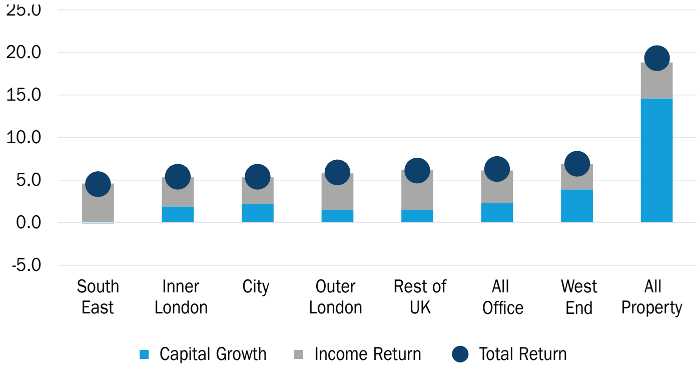


Source: Retail and leisure trends report 2021, LDC

Offices

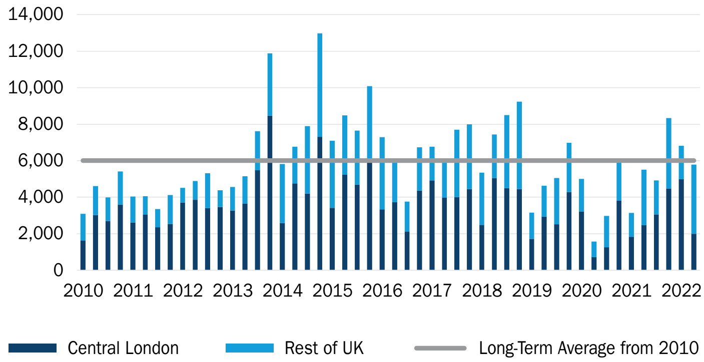
- Offices posted a 1.1% total return in the three months to June, slower than the 1.6% posted in the previous quarter as capital growth slows. Annually to June the total return was 6.3%.
- The office sector saw £5.8 billion invested in Q2 and while this is down 15% on Q1 activity is defying the negative headlines about hybrid working and the slower than expected return to the office. The office sector accounted for 29% of half year activity, behind the wider Alternatives sector.
- The Central London office market saw £2.0 billion transact in Q2 – 20% down on Q2 2021. The half year trading volume reached £7.0 billion and reflects the strongest first six months to a year since 2018. Of note however, is the higher proportion of larger lot sizes that contributed to the total while deal count fell to historic lows.
- Inflation concerns, rising interest rates and elevated construction costs will likely cool office investment activity in Q3 with a potential uptick in the final quarter as more stock comes to the market, on the basis that sellers are prepared to adjust their pricing expectations, otherwise disposals will be put on hold.
- Asian capital is notably more active, accounting for 32% of office deals in H1 2022, significantly up on the same period in 2021 when travel restrictions held back activity. Much of the activity can be attributed to a handful of large deals but underlines the attractiveness of the UK market, which continues to be driven by a need to source assets offering protection against inflationary pressures and changing ESG regulation.
- Given the ongoing structural changes in the market and the changing nature of demands made by occupiers, investors will need to be selective in their asset choices as occupiers prioritise quality over quantity, seek out efficient space, with strong ESG credentials.

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



Source: MSCI UK Quarterly Property Digest June 2022

Office investment activity (£m)

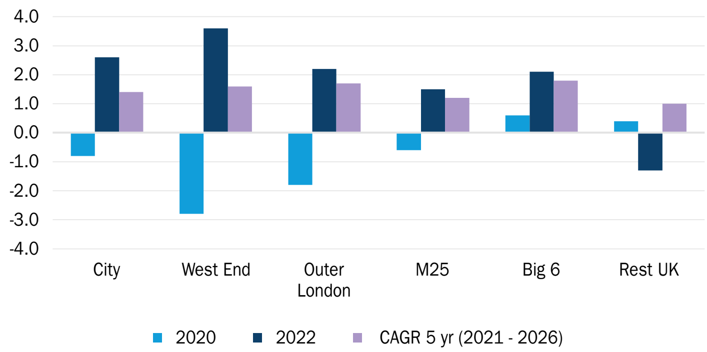


Source: MSCI, July 2022

Office occupier market

- Office demand is expected to slow over the second half of the year despite the low unemployment rate, as the weaker economic outlook slows employment growth and some occupiers are likely to put their occupational decision making on hold as they digest the impact of economic headwinds.
- Corporate strategies on return to work have also not been fully executed and while office occupancy rates have improved relative to 12 – 18 months ago they are still behind pre-Covid levels and are sensitive to any rises in the infection rates.
- Requirement levels have declined but are still relatively robust for the moment, but questions remain as to whether downward revisions to total occupational requirements spread as hybrid working patterns crystallise while flexible office operators continue to attract high-profile leasing agreements.
- Quality and well-located assets are key in preserving capital value, coupled with a focus on ESG credentials which is ever more evident with energy efficiency regulations in particular leading to more demand for new, high-quality space. This is further polarising the market between in-demand and undersupplied quality space and the rest.
- Central London saw 2.6 million sq.ft of take-up in Q2 which followed a robust first quarter of the year, of which 45% was pre-leasing activity. Q2 levels were 3% ahead of the 10-year quarterly average and the fourth consecutive quarter where leasing activity surpassed the 2.0 million sq.ft mark.
- Against a reined in development pipeline as development timescales are being pushed out by high cost inflation and the lack of availability of materials, the overall vacancy rate is 7.8%, above the long-term average of 5.3%. But, given the preference for new build space, vacancy here is tight at 1.4%.
- In the regional office market, vacancy has fallen to 9.4%, 300bps lower than the long-term average and occupier demand is edging towards pre-Covid levels for the first time since the onset of the pandemic.

Office rental growth forecasts



Source: PMA

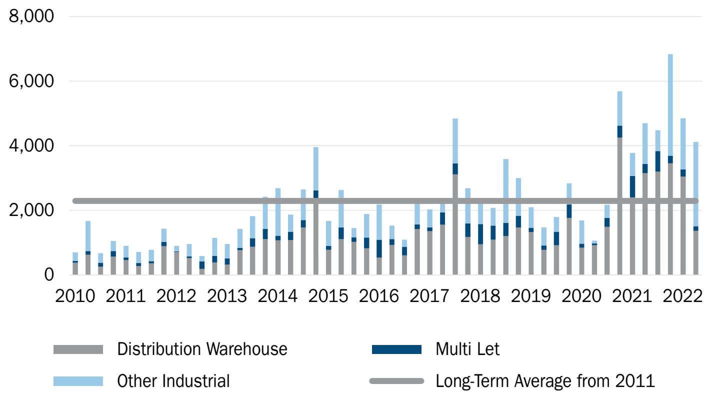
Industrial

- Industrial continues to be the best performing sector across the MSCI quarterly Index and along with retail were the only sectors to outperform the 2.9% all-property total return in the three months to June, posting a performance of 4.5% - weaker than by recent historic standards. Over the twelve months to June, the total return for industrial was 36.5%, with standard industrial outperforming distribution warehouses.
- All regions of the UK saw strong returns over the quarter, with all but three regions in excess of 4.2%. London continues to lead the way on an annual basis posting a total return of 45.4% in the twelve months to June. Outside London, the South East and Eastern regions were the next best performing with returns in excess of 34.0%.
- Over the first half of 2022 logistics investment volumes reached £4.4 billion which is one of the best first half volumes ever recorded. This level of activity however masks weaker market sentiment that emerged at the end of the period as investors are now notably taking stock of the rising cost of debt and knock-on impact on pricing and thus buying decisions.
- The majority of capital deployed so far this year was over the first three months of the year, before the outbreak of the war in Ukraine which disrupted supply chains, challenged energy supplies and pushed up inflation, unsettling markets and causing an economic slowdown.
- Investor confidence in the market is still evident and underpinned by relatively solid demand against low vacancy rates, and while this will help to support investor appetite, activity will slow with some attention turning to opportunities where rental growth can be captured through active asset management or lease events.
- The outlook is for a slower second half of the year as the market takes stock and regroups over the summer months, waiting to see where pricing levels end up. The buyer pool has narrowed and bidding has thinned out, and with fewer buyers and arguably more stock as many have brought forward their plans to sell in Q4 this year when the market is typically most active. Yields have moved out for the first time since the uncertainty brought on by the Brexit referendum on Q3 2016, moving out by around 25 – 30 bps nationally.

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

Source: MSCI UK Quarterly Property Digest June 2022

Industrial investment activity (£m)

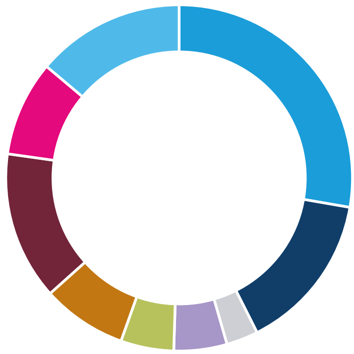


Source: MSCI, July 2022

Industrial occupier market

- The stoic performance of the industrial sector seen in the recent past will be hard to replicate. Demand looks set to continue but the pace of activity will slow over the summer as occupiers look forward with more caution, some adopting a wait-and-see approach while others struggle to find suitable sites, both from a quality and location perspective, with limited options available to them.
- Vacancy remains structurally low at around 3.0% and despite some temporary jitters as Amazon announced its decision to rein in its previously rapid expansion, even if they returned 10% of their stock to the market, which is not anticipated, vacancy would still be below the five-year average. But, the lack of immediate supply and a scaled back pipeline are reality and will serve to support rents.
- H1 2022 saw take-up in the logistics market reached 28.6 million sq.ft, 90% above the long-term average and setting a new record in the process. Activity was spread nationally with the West Midlands capturing the largest share, boosted by a large number of deals in Q2. The East Midlands, North West and Yorkshire & North East followed closely behind.
- The increasingly diverse occupier base is providing a layer of resilience. Online retailers are active but their market share has dropped significantly to 18% of H1 deals, with 3PLs filling the gap (25% share of H1 2022 take-up). Alongside this there has been a notable uptick in demand from the manufacturing and automotive sector where around 7 million sq.ft has been let – 10% more than the whole of 2021.
- Tight vacancy has seen interest rise for build-to-suit units which took a 54% share of take-up in H1 2022 - the highest proportion this segment has ever accounted for. Appetite for speculative space is strong but the notable trend is the decline in demand for lower quality space which does not meet ESG expectations, and given rising running costs occupiers are gravitating to better quality, more efficient space.
- With take-up for industrial and logistics space rising to record highs, land supply has become a crucial piece of the puzzle, especially critical in urban areas that have seen long-term decline in their industrial stock land due to competition from other uses, most recently housing.

Logistics take-up by sector H1 2022



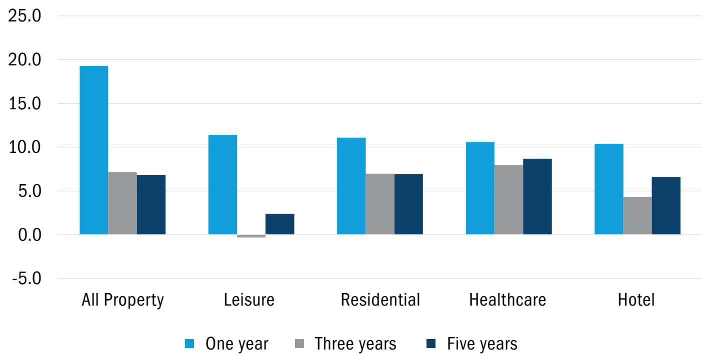
3PL/ Distribution	28%
Other Manufacturing	15%
Construction	3%
Motor Industry	5%
Food Manufacturing	5%
Post & Parcels	0%
Retail - Food	8%
Retail - Online	14%
Retail - Other	9%
Other	14%

Source: CBRE

Alternatives

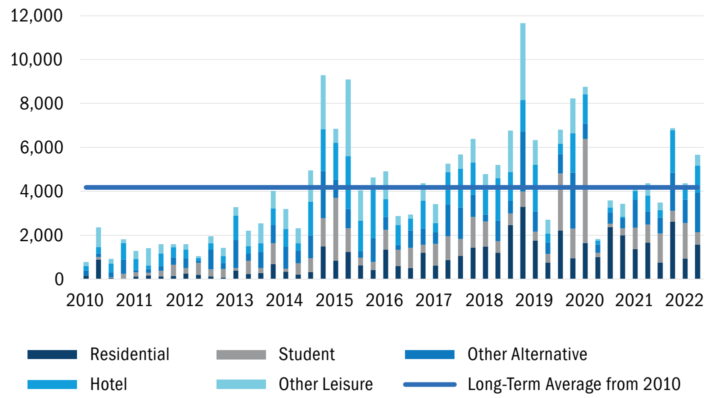
- The alternative sector delivered a quarterly total return of 2.0% to June 2022 underperforming the all-property total return which was skewed by the robust performance of the industrial sector over the recent past.
- The Alternatives sector saw £5.7 billion invested in the second quarter, bringing the half year trading volume to just over £10 billion. This quarter the residential and hotel sectors were the stand out performers, between them accounting for almost half of all Q2 transactions.
- Residential investment reached £1.6 billion of which build-to-rent was by far the largest proportion and highlights the defensive nature of the sector despite the economic headwinds. Demand is expected to remain strong over the remainder of 2022, and against limited quality stock, yield compression cannot be ruled out.
- £1.2 billion worth of hotel transactions were recorded in Q2 - the strongest second quarter since 2018 - as hoteliers welcomed the rise in occupancy levels as both leisure and business travel increased. The regional hotel market continued to be dynamic, while slower activity was noted in London albeit there was some evidence of Central London activity. There is active capital looking for opportunities but, caution has been creeping in towards the end of Q2 given the rising cost of capital and the impact on pricing.
- There is more capital looking to enter the Purpose Built Student Accommodation market than available opportunities. Interest is from a diverse geographical base with North American capital the most active in Q2. Supply constraints coupled with a slowdown in development activity will impact the ability of investors to gain market share and will slow investment volumes.
- Retirement living is a growing sector under the wider Alternatives umbrella. Initially it bridged the gap between, mainstream housing and care homes but now the emphasis is on the quality of the build, range of facilities and amenities and range of services and products offered to residents. Investment reached £770 million in Q2 and with no real liquidity issues in the living debt markets, activity is expected to continue, albeit debt is more expensive.

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



Source: MSCI UK Quarterly Property Digest June 2022

Alternatives investment activity (£m)



Source: MSCI, July 2022

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