COLUMBIA THREADNEEDLE
INVESTMENTS | REAL ESTATE PARTNERS

UK Real Estate Overview

Q3 2022

Contact us

UK, London – Head Office
Columbia Threadneedle Investments
7 Seymour Street
London, W1H 7JW

020 7499 2244

Research

Joanna Tano

joanna.tano@columbiathreadneedle.com

Business Development

Angus Henderson

angus.henderson@columbiathreadneedle.com

Telephone calls may be recorded.

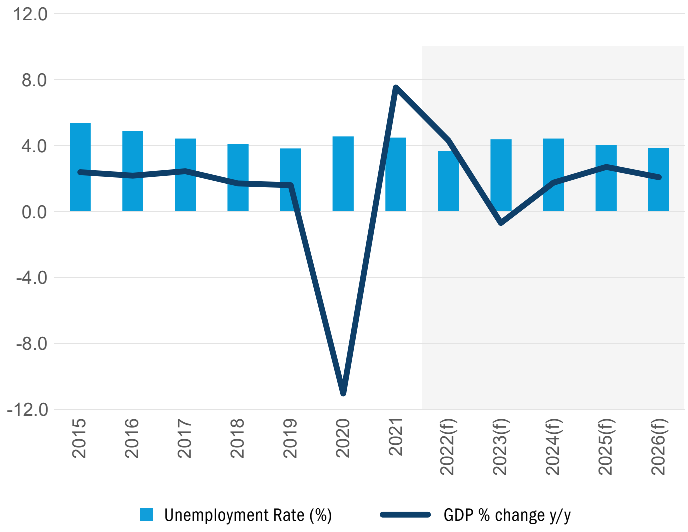
UK Economy

- The last three months has seen two prime ministers resign, reflecting the political and economic upheaval the market is having to deal with. While the future looks murky, what is clear is that the ultra-low interest rate environment is over and cheap finance has come to an end which will change market dynamics going forward.
- Following the disruption that ensued after Kwarteng's 'mini-budget', Jeremy Hunt, the new Chancellor restored some confidence in the financial markets with the reversal of most of the tax-cutting measures, with Sterling and gilts rallying.
- The appointment of Rishi Sunak as the new prime minister provided some further stabilisation, but the government has its works cut out for it to fully regain the trust it has lost with the Autumn Statement pivotal in providing this clarity.

Risk Statement

- Inflation was predicted to hit 13% - 14% by January 2023, brought down by the 'Energy Price Guarantee' rolled-out by the Truss-led government. But the Sunak government will end the utility price freeze in April 2023, rather than in October 2024, to reassure the markets about the government's fiscal disciple. So, while the energy price cap lowers inflation concerns in the short-term, the Bank of England is likely to fear that much looser fiscal policy could ultimately prove inflationary leaving the Bank with little choice but to raise interest rates.
- Interest rates are at 3.00% having seen a 75 bp hike at the November MPC meeting and with inflation still surging more hikes are expected, with rates potentially peaking somewhere between 4.00% - 5.00% in 2023.
- The UK economy is now more likely heading for a recession despite the unexpected 0.2% expansion of the economy in Q2 2022 as the economy unexpectedly shrank 0.3% in August m/m and PMIs pointing to a 0.5% q/q fall in GDP in Q3. Overall, 2022 will see GDP grow by 4.0%, front loaded in the first half of the year. A slowdown in the second half of the year is already evident and slower growth will roll into 2023 where GDP is forecast to be -0.5% overall.

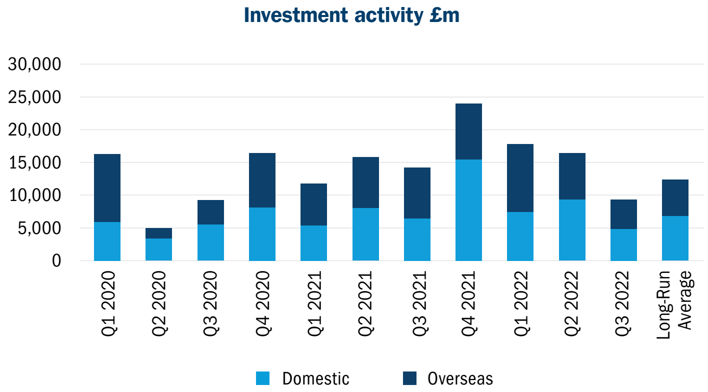
GDP growth & unemployment rate



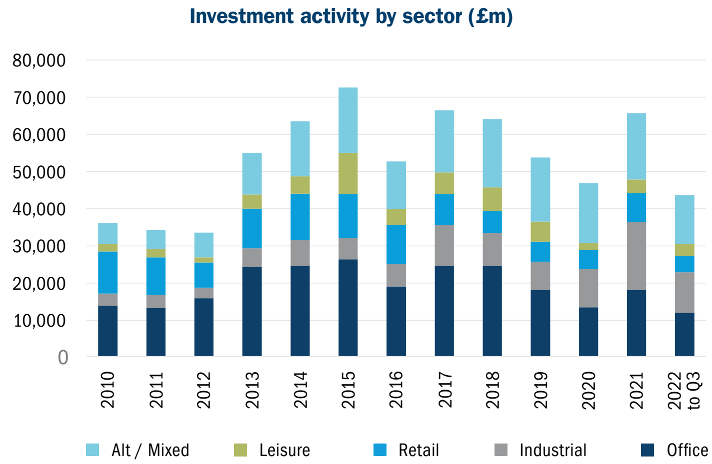
Source: Oxford Economics

Investment Market

- With UK base rates rising to 3.00% from 0.1% in a little over eight months and further rises seen as an inevitability, investment activity has slowed dramatically. Trading volumes in Q3 reached £9.4 billion, down 43% on Q2 levels.
- The industrial sector was the most active of the quarter with £3.1 billion exchanging hands, but over the year to September the office sector has quietly ploughed on, and perhaps surprisingly has been the most traded sector, accounting for a 27% share of deals.
- The recent rise in gilts has served to intensify the pressure on property yields with further outward moving noted in Q3, adding to the level of uncertainty in the market. The fall in capital values has also been accelerated with MSCI's all -property capital value recording a 5.1% fall over the three months to Q3 wiping out the majority of gains seen in the first nine months.
- Investors are taking stock, waiting for evidence of where market pricing will settle. The market correction has begun, but naturally not all parts of the market will be impacted to the same degree, some will prove to be more resilient. More significant falls are expected where an asset is structurally compromised or cannot deliver on the sough after ESG criteria and significant adjustments to value here will be needed to allow for viable repositioning.
- The uncertainty in the market did not scare off international buyers who were out in force in Q3 and despite lower levels of activity overall, foreign buyers played a large role in underpinning Q3 activity, accounting for just under half of all deals. North American investors in particular were very active, taking advantage of the weaker Sterling and with a clear focus on UK logistics.
- Investors are far less exposed today to debt costs than during the GFC and although there is a high degree of uncertainty in the current market and Q4 will be more subdued than Q3, with some more stability in the political space rolling over to the economy and the positioning of interest rates hopefully 2023 will see a return to more concrete levels of investment activity.



Source: MSCI, November 2022

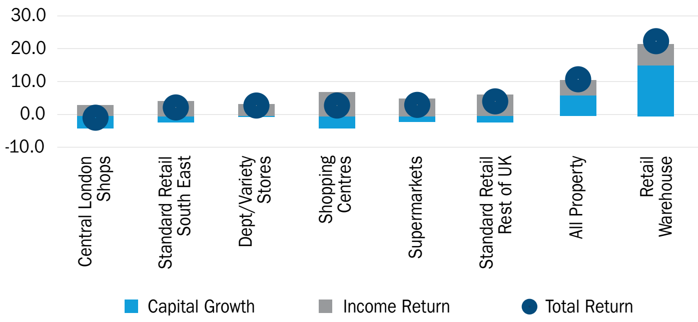


Source: MSCI, November 2022

Retail

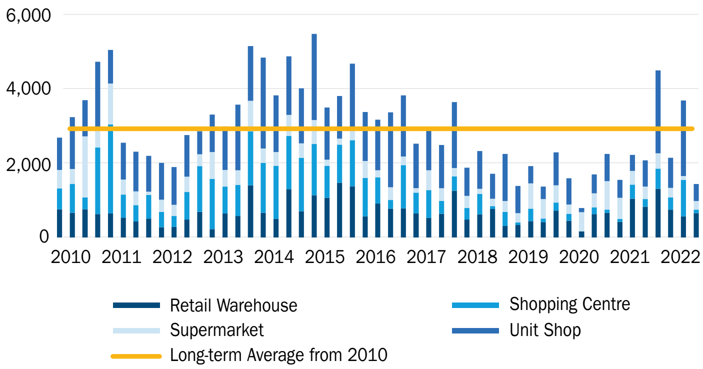
- The total return for overall retail in the three months to September 2022 was -2.6%, slower than the previous quarter with yield falls making the most impact on the total return performance, eating into some of the much-improved performance of the last twelve months posting an annual total return of 9.7%.
- Investment into the retail sector had rallied over the first six months of the year but Q3 saw a notable slowdown in investor demand as the retail sector continues to face challenges with high inflation squeezing household incomes and impacting retailer performance. £1.4 billion transacted in Q3, bringing the year to Q3 total to £7.3 billion, 24% over the comparable period in 2021.
- The robust performance of retail warehouses appears to have continued, especially those that are food anchored or can provide an alternative end use should retail no longer be viable – be that residential or logistics. £653 million trading in Q3, bringing the year-to-date total to £2.0 billion. Retailers located in parks have, by and large, performed relatively well over the pandemic, well placed in terms of accessibility and the ability to serve consumer trends that have embedded since the pandemic.
- As more spend moves online, physical units have had to work even harder to attract footfall, offering a level of convenience and experience that cannot be replicated on the internet. Retail parks for example can use their large formats to showcase product and establish click-and-collect hubs.
- £1.4 billion worth of shopping centre traded in the first nine months of 2022 boosted by deals that closed in H1 as the third quarter saw a slowdown with just around £100 million trading. Current pricing has already factored in little or no rental growth as headwinds persist. Pricing has softened over the past few years and is currently relatively opportunistic so a marked softening in the prime yield is not anticipated.
- Investor sentiment for high streets had been steadily improving over H1 2022. A lot of stock has been put onto the market for sale and generally met with a positive reception. However, deal volumes have been hit in Q3 by the weakening economy and chaos in the wider property market. £457 million transacted in Q3.

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



Source: MSCI UK Quarterly Property Digest Sept 2022

Retail investment activity (£m)

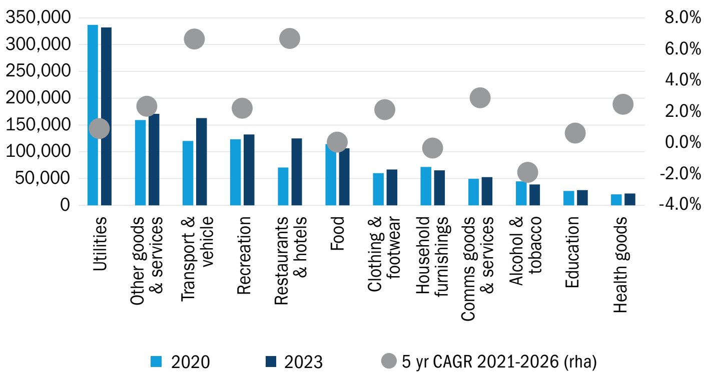


Source: MSCI, November 2022

Retail occupier market

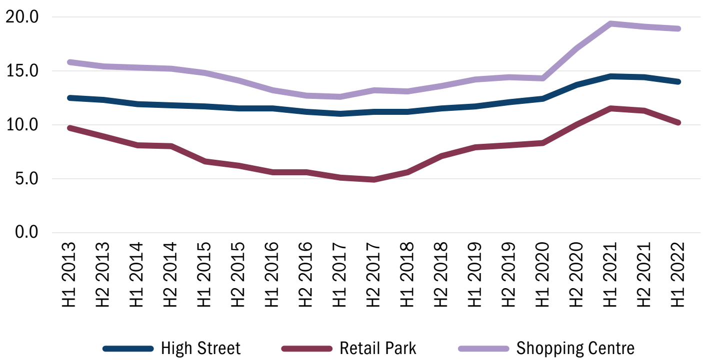
- Consumer spending habits are beginning to show behaviours more typical of a recessionary environment as high inflation squeezes household spending and dents consumer confidence. Retail sales volumes in September are down 1.4% m/m compared to August and -6.9% over the year. October levels could be supported as households look to spread the cost of Christmas.
- Consumers have already started to cut back and while this will be felt across all sectors, it is most likely the bigger ticket items such as household goods and appliances, and non-essential goods such as clothing and footwear that will experience the more pronounced falls as disposable income is reined in.
- Inflation is expected to stay high, potentially peaking in Q1 2023, and while this is somewhat dependent on what measures are put in place to replace the energy cap in April 2023, a more pronounced decline in discretionary spend could come though in 2023. Current forecasting is for a 6.1% y/y fall in real retail spend in Q1 2023, turning positive in late 2023 as household disposable income returns to positive growth.
- Operational costs are continuing to rise impacting retailer profitability. The squeeze on profit margins will intensify as utility, staffing and supply chain costs rise along with weaker consumer spending. This may potentially be too much for some retailers to cope with, while some may have enough momentum to carry over into 2023, but insolvencies may climb after that.
- Expansion plans are on the cards for some retailers but by and large most are assessing their strategic plans, and the majority putting them on hold until both the economic backdrop improves as well as consumer sentiment and spend. However, while there are fewer deals, headline rent levels do not appear to have followed suit given the rebasing that has already taken place over the last few years.
- There is some positivity around and despite rising inflation as 2022 will be the first Christmas in a few years not to be affected by Covid related lockdowns and so more events pre and post-Christmas will help to boost some spend.

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



Source: Oxford Economics

Retail vacancy rates (%)

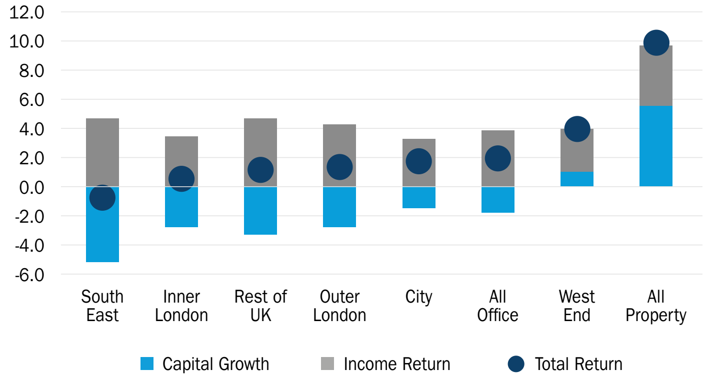


Source: Retail and leisure trends report H1 2022, LDC

Offices

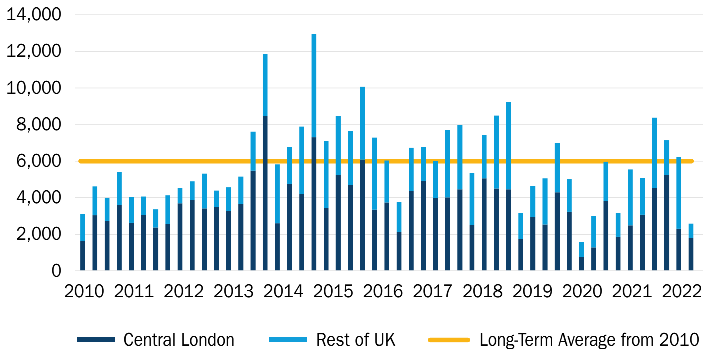
- Offices posted a -2.8% total return in the three months to September, the first negative return since the end of 2020 as yields move out and capital value growth slows. Annually to September the total return was 1.9%.
- £2.6 billion was invested into UK offices in Q3, and even as more deals trickle in with volumes potentially reaching £3.4 billion, the third quarter will still be the slowest quarter of the year so far.
- Aside from domestic capital, Australian and American investors have been active in Q3, added to the inflow from Asian capital seen earlier in the year.
- Despite the muted activity in Q3, the year-to-date volume of almost £16 billion was 15% above the same period in 2021. Slow momentum from Q3 will roll over into Q4 where investment activity is expected to slow sharply as the combination of economic headwinds, rising financial costs and a general weakening of values begin to impact appetite and confidence and acts as a break on activity while the market enters price discovery mode.
- Prime yields in both the City and West End submarkets of London moved out by 25 bps to 4.25% and 3.75% respectively. Regional office yields in strong Tier I locations are 100 bps to 150 bps higher than the capital, moving out a further 175 bps to 200 bps for secondary stock.
- When weaker market conditions come to the for 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.
- While a price correction will impact all parts of the market, a sufficient movement in yields could see ore interest towards the secondary office market with a view to refurbishing and repositioning well-located assets.

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



Source: MSCI UK Quarterly Property Digest Sept 2022

Office investment activity (£m)

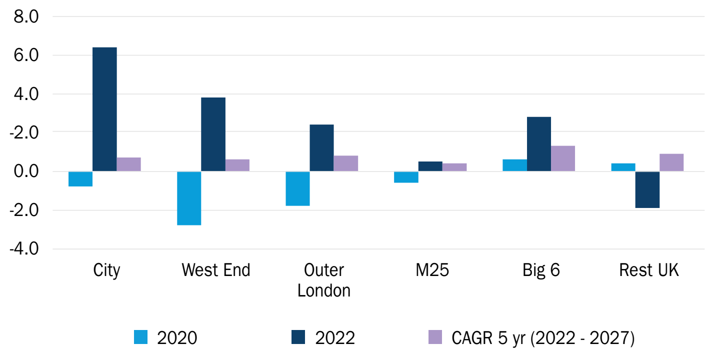


Source: MSCI, November 2022

Office occupier market

- The Central London leasing market was remarkably resilient in Q3 despite mounting economic headwinds in the form of higher inflation and interest rates. H1 2022 recorded a robust performance in terms of leasing activity and while volumes fell in Q3 2.4 million sq.ft was transacted.
- The banking & finance sector was the most active over Q3, with a 35% share of total deals. Activity was however supported by the 225,000 sq.ft pre-let deal which saw Blackstone take space at Lansdowne House. The site has secured planning permission with an expected completion date of 2028.
- Occupiers continue to focus their searches on best-in-class product and with availability here falling to reflect demand, the vacancy rate is just 1.3% across the capital, putting pressure on asking rents. Positive growth is still anticipated, the strength of which has been scaled back, however.
- Decision makers cannot ignore the lasting impact of the pandemic and a hybrid working model on their organisation and the framework will be crucial in not only attracting but retaining talent too. Although the more immediate challenges to hand for occupiers are related to the impact of the economic headwinds, which will most likely serve to speed up their strategies as they look to ways to deal with rising costs, be that supply chain costs, labour and/or utilities.
- While 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.
- Office demand is expected to slow over the remainder of the year 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 – this could see subdued growth in rents in 2023.

Office rental growth forecasts

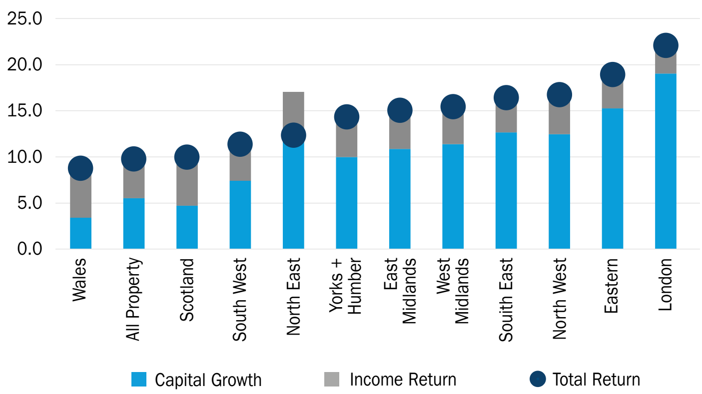


Source: PMA

Industrial

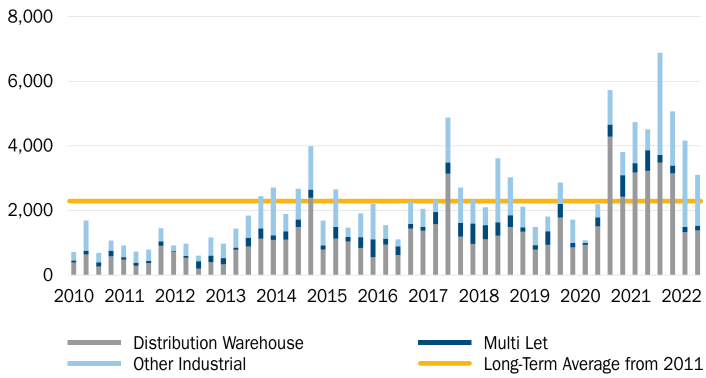
- Industrial saw the sharpest falls in total returns in the three months to September, posting a -7.4% fall largely attributed to the outward shift in yields. Over the twelve months to September, the total return for industrial was 17.6%, boosted by the solid performance over the first half of 2022. 36.5%, with standard industrial outperforming distribution warehouses.
- £3.1 billion transacted in Q3 bringing the year-to-date total across the wider industrial sector to £12.3 billion, slightly behind activity levels in the comparative period of 2021. Distribution accounted for the largest share (45%), followed by multi-lets mirroring the quarter 2 trend.
- Overseas investors dominated activity in Q3. Of note were the inflows from the United States, but Singaporean and Australian investors were also competing for stock. London and the South East captured the bulk of deals, followed by the West Midlands and Yorkshire & the North East.
- Given the heightened level of uncertainty some deals were postponed for an indefinite period of time whilst others were pulled all together. This has impacted the overall investment volumes for Q3, but the full force is expected to be felt in the last quarter of the year where trading activity will be slow.
- A number of funds have suspended dealings and/or have imposed redemptions limits in order to prevent fire sales and undergo an orderly process of selling some assets. But the pressure to sell will continue in order to meet the redemption requests, with some funds now looking overweight in real estate. Some occupiers exposed to high levels of debt are seeking opportunities to raise capital via sale-and-leaseback transactions.
- Following a lengthy period where yields tightened in the logistics sector, the average prime logistics yield moved out by between 75bps and 100 bps in Q3 – one of the largest outward shifts seen with the sharp correction reflecting significant uncertainty in the financial markets as well as in the economy and the low-yielding sector's exposure to rising debt costs.

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



Source: MSCI UK Quarterly Property Digest Sept 2022

Industrial investment activity (£m)

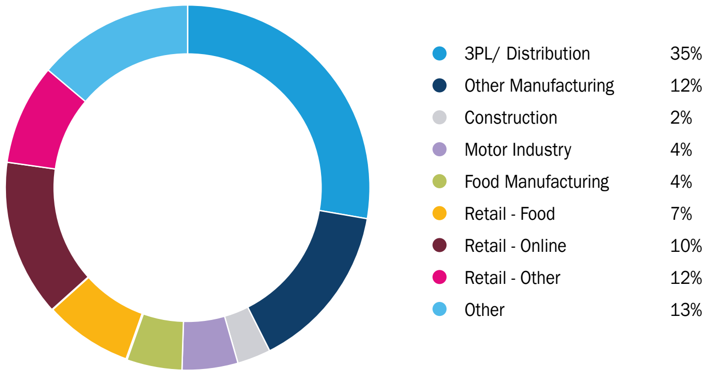


Source: MSCI, November 2022

Industrial occupier market

- The heightened levels of occupier activity seen during the pandemic slowed in the third quarter as some occupiers took the decision to put the signing of new leases on hold. Logistics take-up in Q3 reached 14.0 million sq.ft – the slowest quarter since the onset of the pandemic in March 2020 – and down by about 22% on the 18.0 million sq.ft that leased in Q2.
- Of note was the slowing down of pure play internet retailers as they feel the effects of cash conscious consumers many of whom are reining in spending given the high inflationary environment and the squeeze on disposable income levels.
- With the economy open and the pandemic behind us, leasing activity going forward is likely to drop back to more traditional patterns and less linked to the surge in online pandemic-linked requirements. E-commerce will remain a key driver of demand as will food-retailers, but the urgency with which occupiers took space over the last few years appears to have subsided.
- The outlook for rental growth remains relatively positive despite the slowing occupier market as existing availability is extremely low with the overall vacancy rate hovering around 3.5% and will be kept in check by less development given the more expensive development finance and construction costs.
- While positive rental growth was noted over Q3, the pace has slowed with negotiations generally taking longer, some deals not recaching conclusion and a number of occupiers putting new leases on hold until the outlook has some more clarity.
- While there has not been a total halt to new deliveries the overall volume will fall over the next 12 – 18 months. Developers who locked in build costs and cheaper financing will continue with their schemes while those who are looking to develop out now will find it increasingly difficult to make the income cover the construction costs.
- Occupiers are coming under pressure from not just the commanding rent levels in the sector but rising costs relate to weaker consumer spending, the cost of living crisis, rising operational costs including staff and utilities.

Logistics take-up by sector YTD Q3 2022

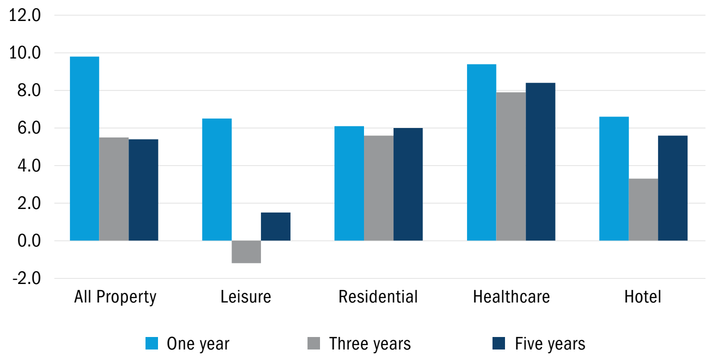


Source: CBRE

Alternatives

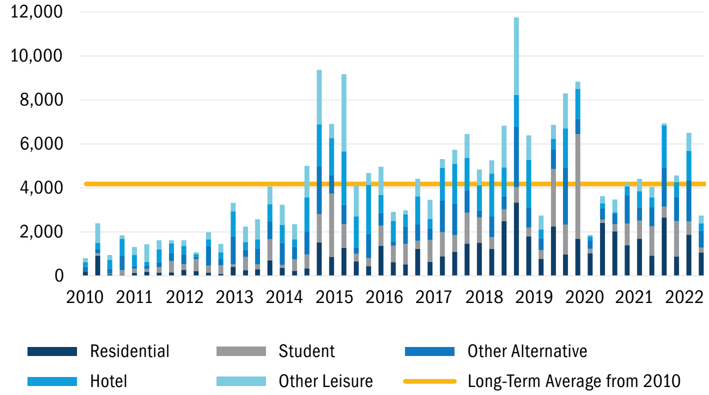
- The Alternatives sector saw a slowdown in activity across Q3 with just £2.7 billion invested bringing the year to date trading volume to just over £13.7 billion, which was 9% above the equivalent period in 2021 due to the solid Q2 volume. The residential sector was the most active accounting for 38% of all Q3 deals.
- Residential investment reached a total of £1.17 billion in Q3 2022, up 95% on Q2 2021, with activity underpinned by a few sizeable deals. The sharp rise in interest rates has pushed up the cost of borrowing only serving to exclude more people from home ownership, turning them to the rental market for accommodation. Given that demand outstrips supply strong rental growth is expected, although the market is facing some challenges such as debt and construction costs, but there are a number of institutional investors who remain active in the market.
- 2022 has seen hotel performance largely recover, with Covid-19 restrictions now in the past, pent-up domestic demand continuing and a return of international travel and large events. Investment activity in 2022 rolled over from the strong finish in 2021 with a total £2.4 billion investment year to September. London is the most active market, but deals closed in Leeds, Manchester and Birmingham.
- The current rising interest rates and inflationary pressures will slow activity over the remainder of 2022 and into 2023. Some owners may look to keep their assets and 'weather the storm' until trading conditions are more stable. Others however, who are perhaps less well capitalised will feel the pressure of rising operating and debt costs squeezing margins and be pushed to sell at a discount.
- PBSA continued to demonstrate its resilience through Q3 and while volumes were lower than in Q2, demand is apparent, and the lack of suitable stock is slowing activity. Rising inflation will see operators look to increase rents to cover rising utility bills and staff wages, which coincides with students seeing real term cuts in their maintenance loan. Going forward the sector will see more demand, especially in locations that are home to universities and cities where HMO numbers are falling due to the tax and regulatory environment, putting more pressure on the PBSA sector.

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



Source: MSCI UK Quarterly Property Digest Sept 2022

Alternatives investment activity (£m)



Source: MSCI, November 2022

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

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

Important information

FOR PROFESSIONAL INVESTORS ONLY (not to be used with/passed on to any third party). For marketing purposes.

- Your capital is at risk. This material should not be considered as an offer, solicitation, advice or an investment recommendation. This communication is valid at the date of publication and may be subject to change without notice. Information from external sources is considered reliable but there is no guarantee as to its accuracy or completeness. Actual investment parameters are agreed and set out in the prospectus or formal investment management agreement.
- Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. Your capital is at risk.
- This document contains strategies managed by Threadneedle Asset Management Limited (TAML) which is authorised and regulated in the UK by the Financial Conduct Authority.
- Where references are made to portfolio guidelines and features, these are at the discretion of the portfolio manager and may be subject to change over time and prevailing market conditions. Actual investment parameters will be agreed and set out in the prospectus or formal investment management agreement. Please note that the performance targets may not be attained.
- The analysis included in this document has been produced by Columbia Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice and should not be seen as investment advice. Information obtained from external sources is believed to be reliable, but its accuracy or completeness cannot be guaranteed.
- Any opinions expressed are made as at the date of publication but are subject to change without notice.
- This presentation includes forward looking statements, including projections of future economic and financial conditions. None of Columbia Threadneedle Investments, its directors, officers or employees make any representation, warranty, guaranty, or other assurance that any of these forward-looking statements will prove to be accurate.
- The mention of any specific shares or bonds should not be taken as a recommendation to deal.
- This presentation and its contents are confidential and proprietary. The information provided in this presentation is for the sole use of those attending the presentation. It may not be reproduced in any form or passed on to any third party without the express written permission of Columbia Threadneedle Investments. This presentation is the property of Columbia Threadneedle Investments and must be returned upon request. This presentation is not investment, legal, tax, or accounting advice. Investors should consult with their own professional advisors for advice on any investment, legal, tax, or accounting issues relating an investment with Columbia Threadneedle Investments.
- In 2015, the Columbia and Threadneedle group of companies, which includes multiple separate and distinct GIPS-compliant firms, began using the global brand name Columbia Threadneedle Investments.
- In the UK: Issued by Threadneedle Asset Management Limited, registered in England and Wales, No. 573204. Registered Office: Cannon Place, 78 Cannon Street, London EC4N 6AG. Authorised and regulated in the UK by the Financial Conduct Authority.
- In the EEA: Issued by Threadneedle Management Luxembourg S.A. Registered with the Registre de Commerce et des Societes (Luxembourg), Registered No. B 110242, 44, rue de la Vallée, L-2661 Luxembourg, Grand Duchy of Luxembourg.
- In the Middle East: This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). For Distributors: This document is intended to provide distributors with information about Group products and services and is not for further distribution. For Institutional Clients: The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Market Counterparty and no other Person should act upon it.
- Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies
- Along with Columbia Threadneedle Real Estate Partners in-house Research, a variety of sources have been used in the production of this document including CBRE, Colliers, Gerald Eve, Knight Frank, Savills, Avison Young, Property Market Analysis (PMA), Local Data Company, Oxford Economics and MSCI (www.msci.com/notice-and-disclaimer)