COLUMBIA THREADNEEDLE INVESTMENTS | REAL ESTATE PARTNERS

UK Real Estate Overview

Q4 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

- GDP surprised on the upside in November by rising 0.1% m/m following an increase in output in the services sector. But almost universally there are weaknesses in the data and the modest rise in GPD in November looks more like noise than a signal.
- December activity was hampered by widespread industrial action with a twofold impact – directly on output from the lost working days and indirectly as the disruption to the rail network prevented workers from getting to work.
- High inflation and the inability of wage growth to keep pace is causing consumers to struggle as household incomes are squeezed and much of the impact of the rate hikes seen in 2022 have yet to fully feed through to the economy. Plus, April 2023 will deliver a series of tax rises and a scaling back in the support to help consumers pay their energy bills.

Risk Statement

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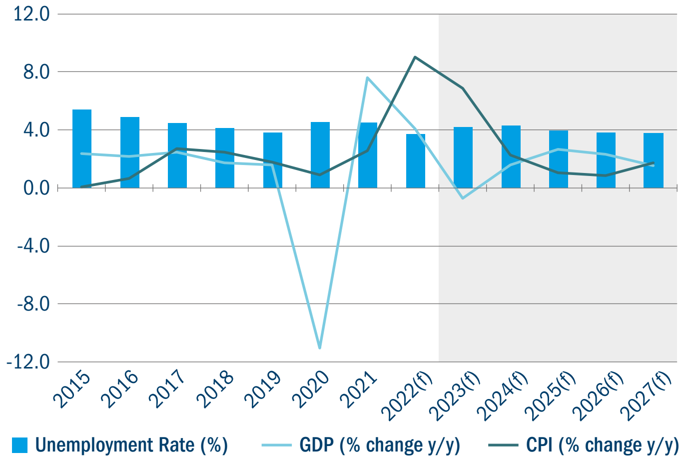
- So, while GDP in 2022 was 4.1% it was front-loaded and the slower second half to the year will roll-over into 2023 where the economy is expected to contract by 0.7% overall. Forecasts are improving, reflecting the fall in energy futures prices and further easing in supply bottlenecks which should mean inflation falls more quickly and activity is firmer from the middle of 2023, but it remains historically high.
- And the bigger picture remains one of the economy enduring a relatively shallow recession, as real household incomes fall further and tighter policy settings weigh on activity.
- The MPC, as expected, moved the interest rate out by a further 50bps to 4.00% at its February meeting, potentially now peaking at 4.00% – 4.25% rather than at 5.25% – 5.50% as previously thought. The MPC's message was that rates are now close to – or even at – their peak, perhaps with the possibility of a 25bp rise at the March meeting.
- Labour market developments will be crucial – a loosening should allow the MPC to pause hikes in early/mid 2023. Still, unemployment is still only expected to peak at 4.7% in 2023.

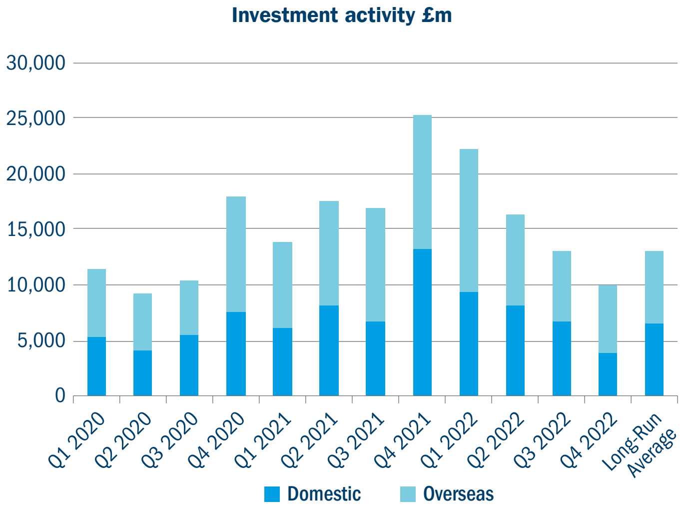
GDP growth & unemployment rate



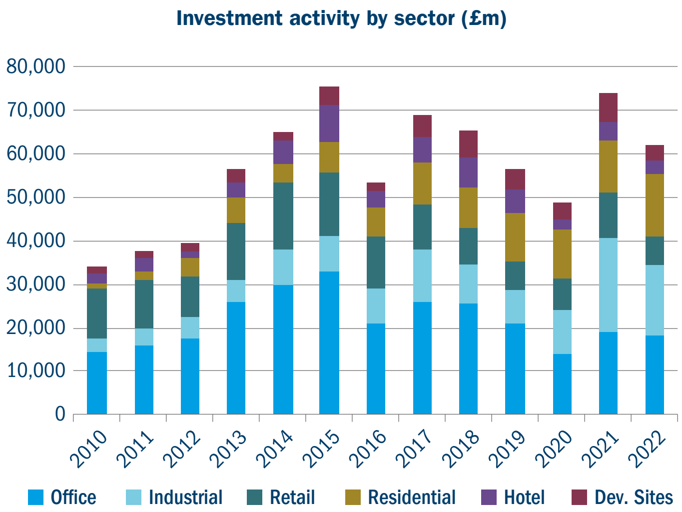
Source: Oxford Economics

Investment Market

- Investment performance has inevitably been affected by economic uncertainty and rising interest rates at the end of 2022 making debt more expensive and slowing real estate investment activity.
- The UK was Europe's largest investment market in 2022 well ahead of Germany, with around £61.8 billion invested into commercial real estate but overall activity in 2022 was 16% lower than 2021 reflecting the wider European trend.
- Quarter 4 volumes slumped to £10.1 billion, the lowest since the height of the recent health pandemic in Q2 2020. Fewer properties were sold in the fourth quarter than in any quarter since 2011 and only a handful of £100 million plus deals concluded. Residential accounted for 45% of the quarter's deals, followed some way behind by industrial (21%) and was the sector to be more active in 2022 compared to 2021.
- Capital values bore the brunt of the impact with income left to support total returns. The weaker economic environment will also weigh on occupational sentiment across the first half of 2023 and investors will want to focus on securing income underpinning any investment strategy with the relative strength of income and occupier covenant growing in importance.
- Quality will prevail across all sectors, with prime assets remaining far more resilient. Prime and secondary prices moved out in tandem during 2022, prime pricing is expected to see some stability in 2023 while secondary pricing will continue to see greater capital value decline.
- But the speed of repricing means that opportunities will arise over the course of 2023 as the path of monetary policy turns more accommodative. Undoubtedly challenges lie ahead but the extreme volatility seen at the end of 2022 has subsided somewhat giving way to a more stable environment. There is no doubt that there is still some way to go but the downturn will present opportunities to buy prime assets at renewed pricing levels.



Source: MSCI, January 2023

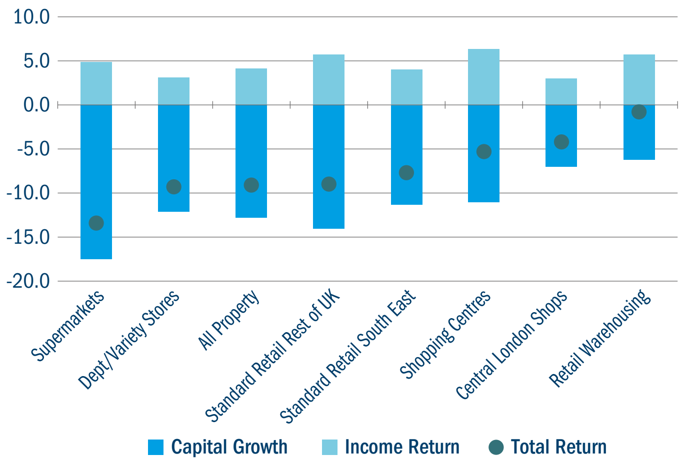


Source: MSCI, January 2023

Retail

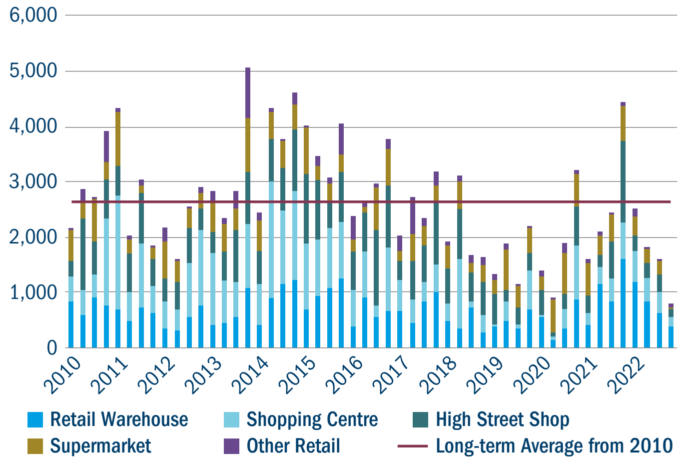
- Retail volumes reached £6.8 billion in 2022 but while the first half of the year reached £4.4 billion, economic headwinds slowed activity dramatically in the last six months with just £2.4 billion exchanging hands with Q2 the slowest quarterly volume since mid 2020.
- The total return performance for the retail sector over the year was -4.8% and -9.2% over the quarter as yields were hit harder by the rising in debt costs. But the story is not straightforward and there were nuances behind the headlines with retail warehousing the best performing of the traditional real estate sectors on an annual basis with a total return of -0.8% for 2022 driven by income return.
- Retail warehousing continues to see strong investor appetite but there is a noticeably widening divide between buyer and seller expectations on price, with yields moving out by 100 bps in six months to 5.75% for the best stock.
- Retail warehouses dominated investor activity with over £3.0 billion exchanging hands over 2022, equivalent to a 45% share of all deals. Given the current economic environment investors are expected to continue to focus on grocery and discounter occupiers keeping retail warehouses as the most active retail subsector.
- High street activity is focused on smaller opportunities in better quality centres in the south-east and key regional cities. Private investors are key buyers here, both domestic and international with £1.0 billion concluding over the course of 2022.
- Shopping centres saw a buoyant start to the year with equity investors making a reappearance, £1.7 billion transacting and prime yields settling between 7.75% – 8.00%%. However, the second half of the year as been notably slower as higher financing rates hold back larger deals in particular, and a drop in consumer spending once again bring the subsector back into the spotlight.
- Retail, when compared to other sectors, should be less effected by the wider repricing being seen in the market. Yields are already comparatively higher in retail and so should be better protected against the higher debt costs investors are facing and the impact of yield movements should be less significant than in other sectors.

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



Source: MSCI UK Quarterly Property Digest December 2022

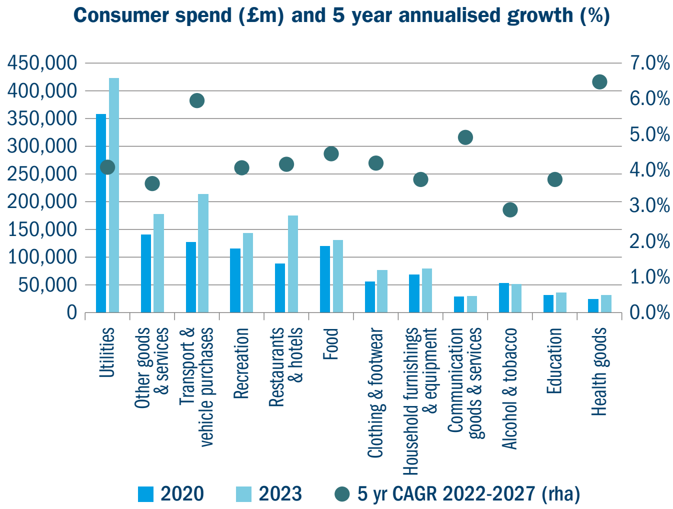
Retail investment activity (£m)



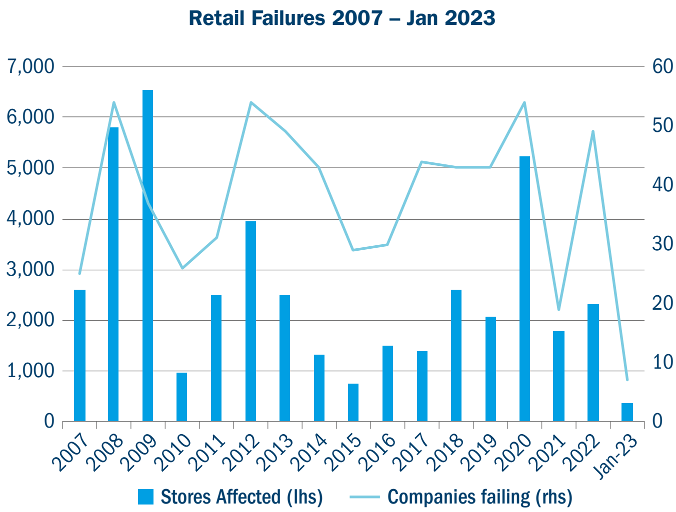
Source: MSCI, January 2023

Retail occupier market

- Consumer spending witnessed a recovery after the pandemic but that has now been derailed by a sharp rise in inflation and tighter financial conditions, which combined, have seen household incomes squeezed and spending reined in. Retail spending, in volume terms, is expected to fall by 3.3% for 2022 as a whole with household goods, clothing and other discretionary products the most challenged.
- 2023 will be another painful year for household finances and will remain so until inflation begins to fall which is expected to be in the second half of the year. But underlying prices will remain high, and inflation is likely to outpace earnings again. Any mortgage holders on variable rates or those coming to the end of fixed rate deals face a sharp increase in the cost of servicing the debt, further squeezing income.
- Unsurprisingly the retail real estate sector is not immune to the weakening economy and mounting headwinds. Retailers are already in cost saving mode scrutinising their physical networks for possible savings. This is holding back expansion plans which will be modest at best, and only enacted by well capitalised occupiers in the best locations.
- Vacancy rates will remain stable as many occupiers have already undertaken portfolio restructuring over the course of the pandemic. Retailers are also generally better positioned than during the pandemic and the volume of casualties is expected to be less severe than in the recent past.
- Online sales have fallen quicker than expected since the height of the pandemic fluctuating at around 26% indicating that consumers still have a desire to visit physical stores. Levels of online penetration in 2023 are expected to stabilise at around current levels. But consumers are wanting more of an experience when they do visit stores. Having said that online remains an important channel and the future of retail is fundamentally omni-channel.



Source: Oxford Economics

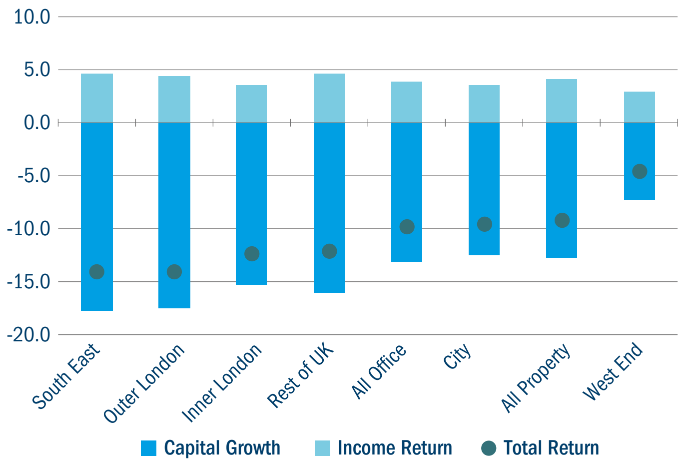


Source: Centre for Retail Research

Offices

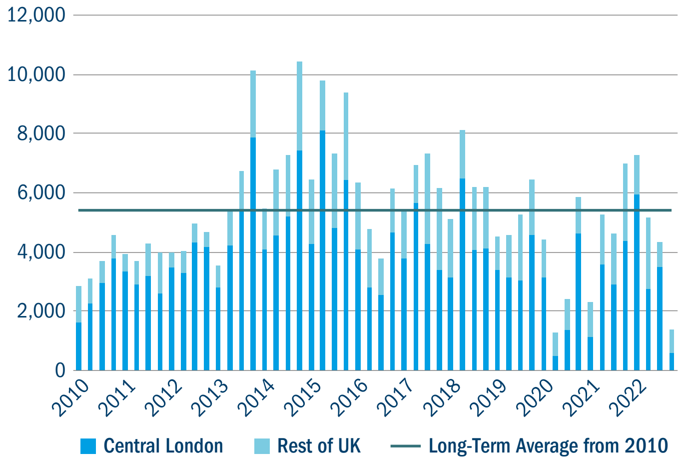
- Offices posted a -9.7% total return in the three months to December as yields move out and capital value growth slows. This inevitably influenced the annual return which, to December was -9.8%.
- Q4 was the quietest of the year as yields moved out with rising interest rates slowing the investment market. Just £1.4 billion was transacted nationwide, 42% of that was in Central London equating to only £575 million – the slowest quarterly level of activity since the middle of June 2020 and the height of the pandemic.
- Full year office investment reached £18.1 billion and as with other sectors, it was a year of two very distinct halves. The first six months recorded £12.4 billion with activity slowing dramatically over the latter six months with £5.7 billion concluding.
- Yields in all office markets have shifted outwards with prime moving between 20 – 50 bps in Central London and by as much as 100 – 150 bps in the regional centres. The price correction will impact across the sector but for secondary space it will be more noticeable. A sufficient shift could see interest towards secondary space tick up with a view to refurbishing and repositioning well-located assets.
- Pricing should stabilise towards the end of 2023 which will help to stimulate more investment activity, but volumes are anticipated to be in the region of 20% down year-on-year in 2023 with the bulk of deals occurring in the second half of the year and momentum then picking up in 2024 where yields will stabilise.
- When weaker market conditions come to the fore it comes as no surprise that better quality assets are expected to outperform the wider market and will have lower overall void periods, more demand and higher liquidity and core assets will be where rental income is regarded as most secure.
- Overseas investors were slightly more active over the year than domestic buyers, investing £11.6 billon (57% of the total). Asia-Pacific buyers, particularly those from Singapore and Hong Kong and US and Canadian were active in 2022 and expected to remain so in 2023.

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



Source: MSCI UK Quarterly Property Digest December 2022

Office investment activity (£m)

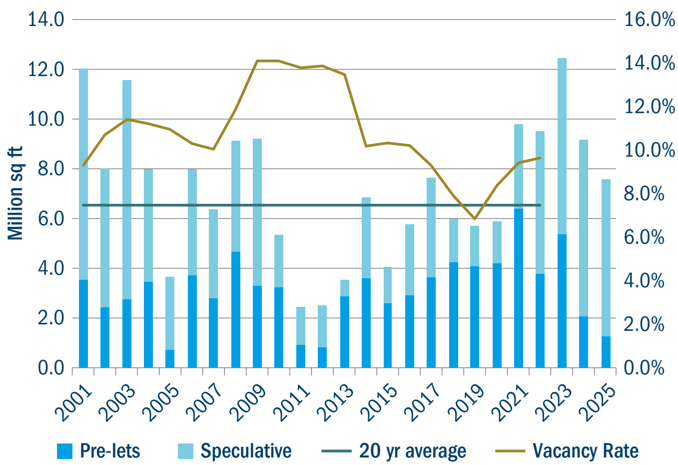


Source: MSCI, January 2023

Office occupier market

- The weaker economic environment is impacting business confidence with many firms putting any leasing plans on hold, slowing overall levels of leasing activity. Companies are continuing to assess the best hybrid working strategy that fits their business needs and holding back on signing new leases until there is more certainty about the way forward, how they will use their space and how much space they will need.
- Q4 take-up across the capital reached just over 2.1 million sq.ft – 20% below the previous quarter. Across Central London the annual leasing volume reached 10.1m sq.ft. This was about 15% ahead of the level reached in 2021 but marginally lower than the long-term annual average of 10.3m sq.ft.
- The flight-to-quality is still very much à la mode with occupiers continuing to focus on best-in-class buildings with the bulk of deals in the pipeline either pre-let in new space soon to complete, in newly built or newly refurbished stock. Demand in 2023 will be below-trend but interest for the best quality space should remain robust.
- The banking & finance sector dominated occupier activity accounting for just over 25% of annual take-up followed by the professional services sector with 24%. TMT firms have scaled back on activity accounting for 15% of 2022 transactions, down from double that in 2021.
- The overall vacancy in Central London is 8.4%, rising for the second consecutive quarter as total supply increased to 21.0 million sq.ft as new supply in the City came online. This level is now higher than during the GFC but over 60% of the availability is second-hand which will underperform in 2023 and likely to experience lengthy voids in 2023. Over time some proportion will be converted to alternative uses and/or repositioned to meet the demands of current occupiers.
- The trends in the key regional UK cities was no different with falling office-based employment and a recessionary environment constraining activity in the office leasing market. Some firms have confirmed planned to move into smaller buildings with better environmental credentials so overall demand levels will be lower in 2023 than 2022.

Key UK office markets – development pipeline

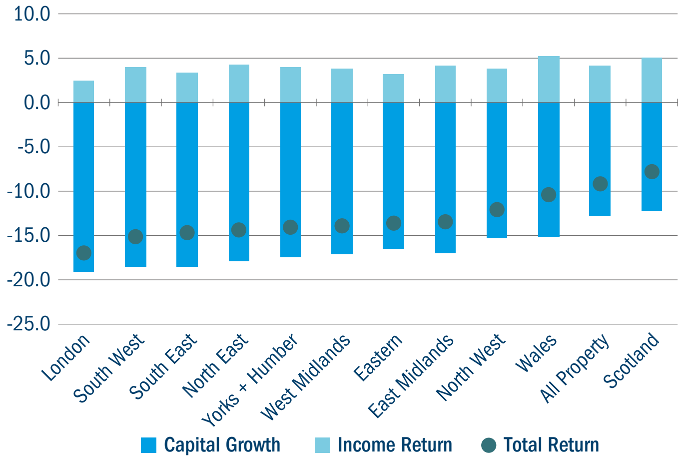


Source: Colliers

Industrial

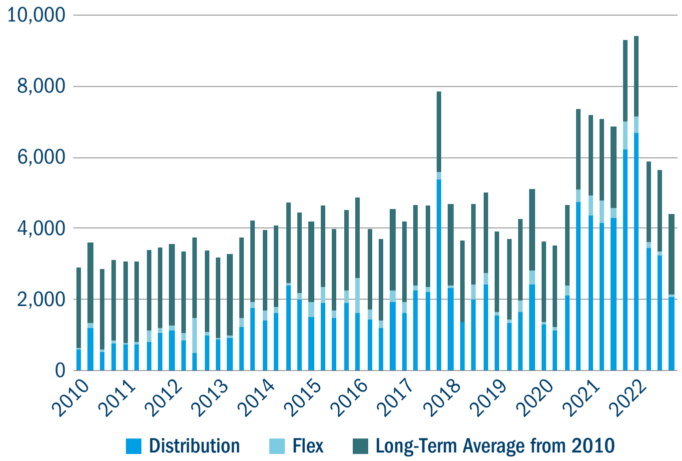
- Industrial saw sharp falls in total returns in the three months to December, posting an -18.4% fall largely attributed to the outward shift in yields due to the impact of rising interest rates in the wake of the ill-fated mini-Budget in September 2022. Over the twelve months to December the total return for industrial was -14.6%.
- £2.1 billion transacted in Q4 bringing 2022's overall level of activity across the wider industrial sector to £16.2 billion. Even though 2022 will be recorded as the second strongest year ever (to date) after 2021 it as a year of two very distinct halves with two-thirds of deals taking place in the first half and activity slowing dramatically from June onwards with quarter 4 the slowest of the year overall.
- Yields moved out dramatically over the last three months' reflecting changes in monetary policy and the wider global bonds market. They are now in the region of 5.00% having moved out by 275 bps in just five months and 25 bps in Q4 alone.
- Some stabilisation is beginning to appear in the opening months of 2023 but interest rates have not yet peaked and so yields are likely to see a further outward shift in the first half of 2023. The price correction to date has seen increased numbers of buyers return as there are more buy-side opportunities around.
- While some sellers are reticent to sell at what they are receiving to be the bottom or close to the bottom of the cycle, others will pushed to sell given as some funds will need to meet redemptions.
- Further falls in values are expected in 2023 and this will particularly be the case for non-prime assets as investors take the lead from occupiers and look for quality stock, preferably ESG 'enabled' as they look to minimise operational costs where possible.
- The low vacancy rates and resilient demand for logistics space, even if dampened by the weaker economic backdrop, will serve to maintain investor interest and confidence in the sector – but deals will be slower to negotiate and those acquiring will be specific with regards to the quality for assets that are being sought.

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



Source: MSCI UK Quarterly Property Digest December 2022

Industrial investment activity (£m)

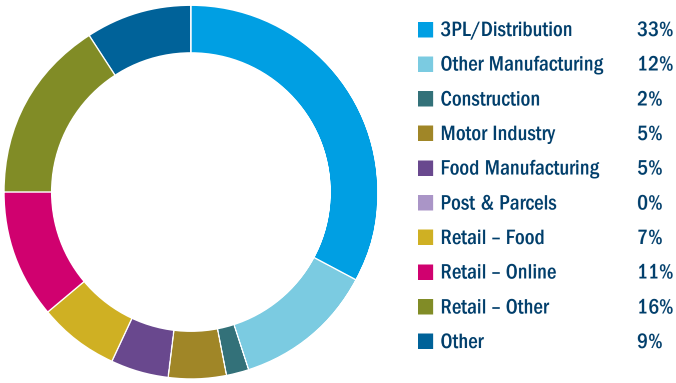


Source: MSCI, January 2023

Industrial occupier market

- Almost 15.0 million sq.ft of space was let in the last quarter of 2022 and while slow for what is traditionally the most active quarter of the year it was marginally above the level seen in Q3. The first half of the year was by far the more active with deal volumes falling away quite steeply over the last six months of the year.
- Some internet retailers are feeling the knock-on effects of consumers cutting back on spending given escalating costs and continued pressure on household budgets, and so in a bid to cut costs have offloaded some warehouse space.
- 2022 as a whole saw take-up just shy of 50.0 million – this was down by around a quarter compared to the record breaking 2021, but 2022 was still the third most active year for leasing on record. Longer-term e-commerce is still a structural driver of logistics demand. But as shoppers return to bricks and mortar retail and the impact of the economic slowdown is more intensively felt demand driven events due purely to e-commerce will lessen.
- Lack of supply continues to characterise the market with the nationwide vacancy rate just below 4.0% and with limited new levels of speculative completions and demand focused on new/quality stock any good quality space released will be into a market with strong fundamentals and thus expected to let reasonably quickly.
- There is less demand for secondary space given often it does not meet the rising demand for ESG compliant space. More secondary and sublease space is expected to be released as online sales levels dip from the height of the pandemic, occupiers tighten their belts and rationalise their portfolios.
- Development activity will slow in 2023 as build costs escalate and yields move out making speculative construction less viable, especially where debt is needed to finance a scheme. The weakening in occupier demand has seen rental growth slow although it remains positive given the backdrop of very low levels of supply, especially quality supply, and will serve to support rental levels when the economy recovers as not only will supply be low, but there will be a slim pipeline of completions.

Logistics take-up by sector 2022



Source: CBRE, United Kingdom Logistics Q4 2022

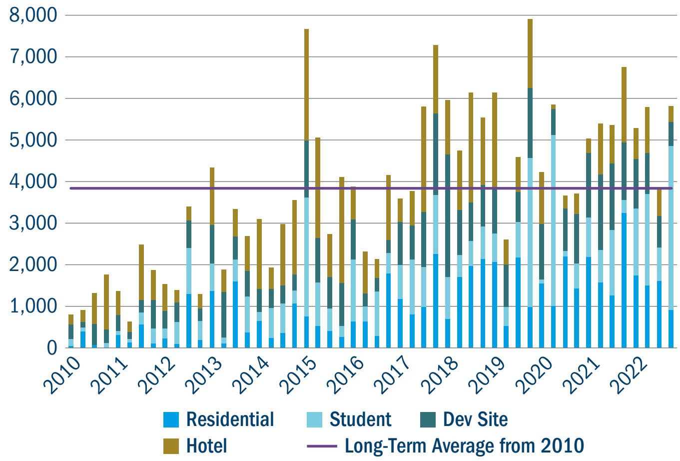
Alternatives

- Following the slowdown in the Alternatives sector seen in Q3 there was a pick-up in activity in the final quarter of the year with £5.8 billion invested bringing the year-to-date trading volume to £20.7 billion. This was 9% below 2021 but 19% above 2020. Student accommodation was the most active segment in Q4 accounting for over 65% of all transactions.
- The residential sector continues its dominance with the Alternatives sphere seeing £5.8 billion invested into the sector across 2022. But challenges lie ahead in 2023 as borrowers face significant rises in their cost of living and will find it more difficult and expensive to get a mortgage so activity in the housing market will reduce, but it is not expected to be a dramatic, cliff-edge fall.
- Occupier demand for the build-to-rent sector will remain strong and rental growth in 2023 will be supported by not only the challenges in the sales market, but the acute imbalance between supply and demand, with new completions hampered further over the next 12 – 18 months by high build cost inflation. High inflation level will also help to push up rents, but it cannot wholesale be passed down to tenants who are already struggling with the cost-of-living crisis.
- The speed with which the hotel sector has rebounded caught many off-guard with the luxury/leisure and economy brands leading the way. However, only £381 million transacted in Q4 and the subdued level of deals over last summer will roll over into the first half of 2023. Willing buyers are on standby but current market pricing needs to move further for them to commit to any acquisitions. Sellers on the other hand are reluctant having enjoyed a strong 2022 in terms of performance.
- Student accommodation was the most active sector within Alternatives in Q4 with £3.9 billion trading as the sector continued to demonstrate its resilience through Q4. Student numbers are hitting record highs, and this is supporting the strong demand for PBSA which in turn, given the lack of standing stock and the inability of new supply to keep pace, rental growth prospects for the sector are strong.

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

Source: MSCI UK Quarterly Property Digest December 2022

Alternatives investment activity (£m)



Source: MSCI, January 2023

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