For Professional Clients and/or Qualified Investors only

62 Threadneedle Street, London

UK Real Estate Overview

Q2 2024

COLUMBIA THREADNEEDLE ALTERNATIVES

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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.

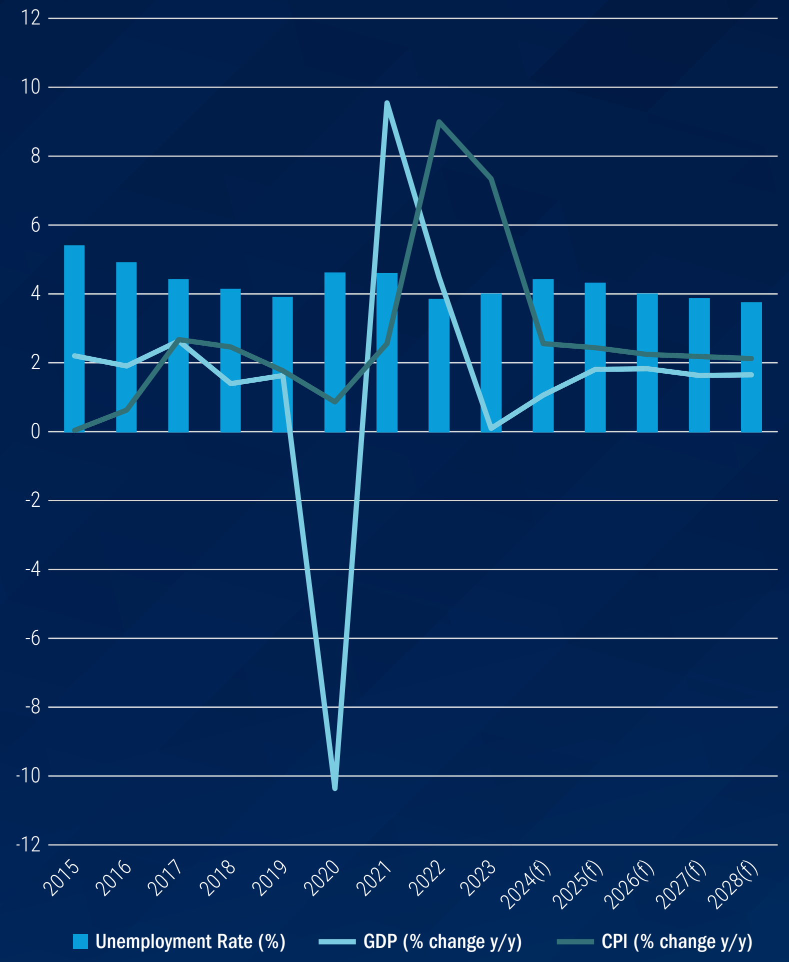
The value of directly held property reflects the opinion of valuers and is likely to be reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

Economy

UK Economy

- The UK economy recorded strong growth in the second quarter, with GDP growing by 0.6% in the 3 months to June, primarily led by growth in the services sector. This is the second successive strong outturn after a couple of years of very muted activity.
- Headline inflation remained unchanged at 2.0% year-on-year to June, down from the 3.2% recorded in the 12-months to March. July saw an uptick, the first in eight months, but inflation rose less than expected to 2.2%.
- Core inflation and service inflation, which are a good indication of domestic price pressures and are closely watched by the Bank of England (BoE), edged down, opening the door for the potential for more rate cuts over the remainder of the year. Services inflation declined more than expected from 5.7% in June to 5.2% in July – the lowest since June 2022.
- The Monetary Policy Committee (MPC) voted to hold the base rate at 5.25% at its June meeting but with the recent downward trajectory of inflation (from the high of 11.1% recorded in October 2022) the Bank cut the rate the for the first time in over four years by 25bps to 5.00% at its August meeting. The upside risk for further immediate cuts is services inflation, and its persistence is likely to reinforce the concern of the hawkish members of the MPC. The widely held expectation is that the MPC will vote to keep the bank rate at 5.00% in September, before delivering another 25bps cut in November.
- The labour market is still constrained by historical standards with unemployment at 4.2% in June whilst average total pay (excl. bonuses) grew by 5.4% in the 12-months to June – its lowest in almost two years.
- Retail sales volumes are estimated to have risen by 0.5% in July m/m, following a fall of 0.9% in June. The consumer outlook remains relatively upbeat, although the lagged impact of past interest rate rises will continue to weigh on spending power. However, sustained real wage gains should boost real household income growth and, provided consumer confidence continues to gain momentum, retail sales are expected to strengthen further in H2 2024 and into 2025.
- The UK electorate went to the polls on 4 July, resulting in a landslide victory for the Labour party who have a majority of 172 seats. The outcome was in line with expectations and so given this, the reaction from the financial markets has been minimal. A key question is whether the new government sticks to its limited manifesto pledges on fiscal policy or is emboldened to undertake more comprehensive reform.

GDP growth, CPI & unemployment rate



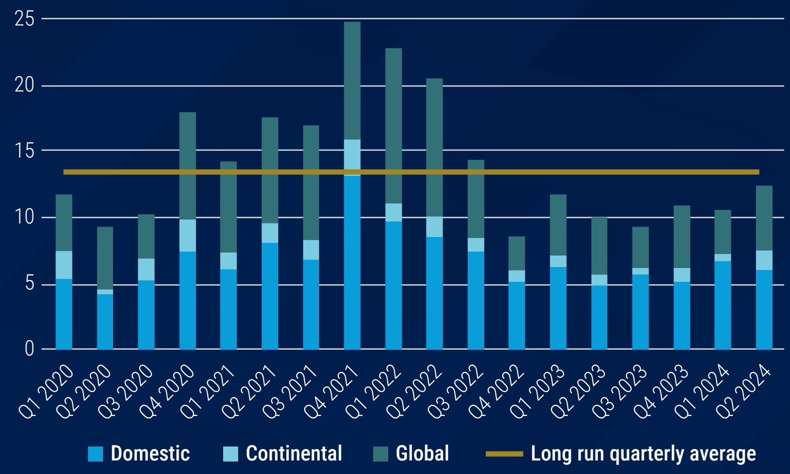
Source: Oxford Economics, August 2024

> UK economy recorded strong growth in the second quarter, with GDP growing by 0.6% in the 3 months to June

Investment Market

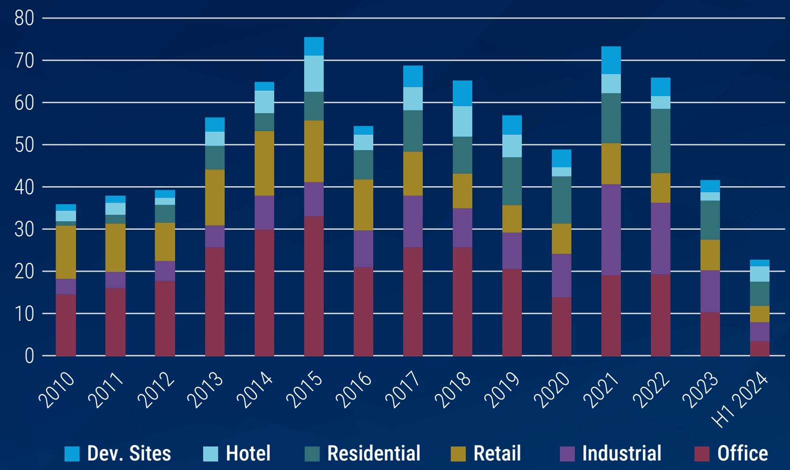
- Second quarter investment activity showed a volume of £12.4 billion, 18% higher than the Q1 level. Transaction activity has been slow to improve, with investment volumes below their 10-year average but there are signs that investor interest is returning, although this has not yet crystalised into a notable rise in transactions.
- Real estate debt markets remained relatively liquid and, while higher interest rates have weighed on activity, the cost of debt has eased over the last six months. Loan originations continue to be dominated by refinancing rather than new investments, but there is competition among lenders to refinance high quality assets.
- Capital values for favoured sectors has turned a corner with positive growth in Q2 for the retail and industrial sectors. Retail warehousing is leading the way in terms of the recovery, followed by industrials (the latter driven more by rental growth than yield compression). The preference for quality stock in prime locations or those assets that can be repositioned to higher value uses has not diminished either.
- Consensus is shifting towards the view that pricing is bottoming-out, especially for favoured sectors such as retailer warehousing, logistics and residential. Some further asset repricing is anticipated in non-favoured sectors, for example offices, where limited prime stock is available and vacancy continues to rise, particularly for larger lot sizes over £50 million.
- The market has been notably short of investment stock by historic terms owing to costly leverage and the anticipated cut in interest rates delaying investor decisions. The situation is beginning to ease, for example with competitive bidding in the out-of-town retail sector which has encouraged more stock to the market. Distressed sales to resolve more difficult situations are still relatively uncommon and a deluge of distress is not anticipated.
- Transaction activity is expected to improve in H2 2024 following 18 months of relative inactivity. Liquidity will continue to be provided by investors required to meet redemption or debt obligations with UK defined benefit pension funds likely to be the greatest net sellers as more schemes transition towards buyouts. In contract open LGPS schemes will likely continue be the sharpest capital in the market as they continue their pooling journey, actively deploying capital within core UK commercial real estate markets offering long term stable returns.

Investment activity (£bn)



Source: MSCI, August 2024

Investment activity by sector (£bn)



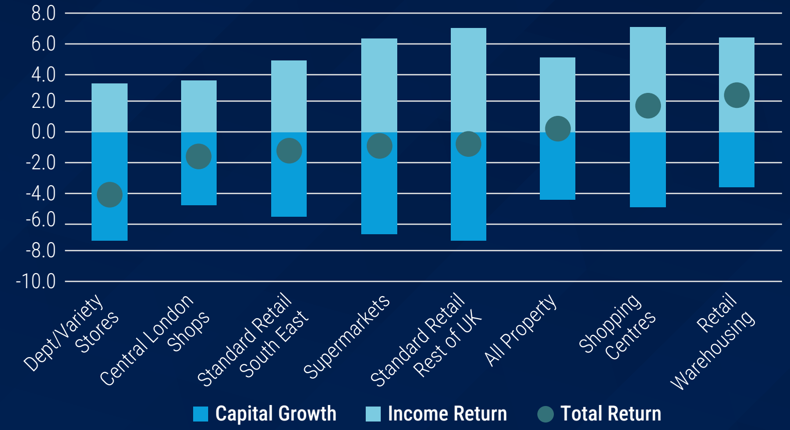
Source: MSCI, August 2024

Retail

Retail investment market

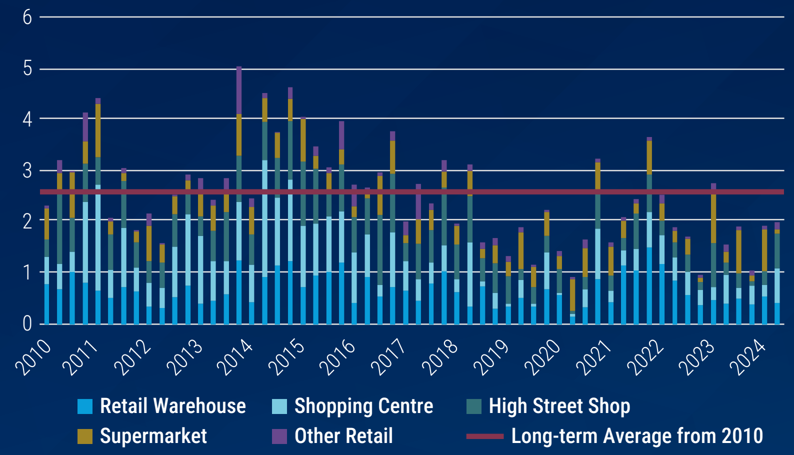
- Retail was the best performing sector in the second quarter delivering a total return of 2.0%, bolstered by a healthy income return of 1.5% and capital value growth of 0.5%. Retail warehousing was the standout sub-sector with a total return in the second quarter of 3.1%, split equally between 1.5% capital value growth as strong investor demand fed through to market pricing and an income return of 1.6%.
- Investment volumes are recovering in line with confidence in retail and the opportunity to capitalise on record high yields. Quarter two recorded £2 billion in terms of investment activity with a similar level seen in Q1, bringing the half year total to £3.9 billion across the wider retail market. The bulk of activity took place in the high street and shopping centre sub-sectors, accounting for 34% each of Q2 retail transactions.
- Retail warehousing was the most traded sub-sector across the year so far and is a clear target for investors. Interest is supported by robust occupier demand from an increasingly broad variety of retailers. Prime yields sharpened in Q2 by 25bps to 5.75%. Negligible levels of new supply and low vacancy rates are translating into real rental growth, which continues to attract investors.
- Renewed interest is being seen for prime shopping centres reflected in a higher level of investment activity in H1 2024 when compared to H1 2023, underpinned by a general belief that peak pricing has been reached and now could be the window of opportunity to capitalise on the weak pricing. More stock is being released with a rise in the number of institutional quality assets being brought to the market, although this is unlikely to be a sustained trend. Purchases of lower quality stock where change of use could be an angle is also limited given the current cost of debt and construction.
- Investor sentiment is expected to remain relatively positive in the second half of the year. Reducing finance costs could see further pricing improvements and more stock coming to market for certain retail sub-sectors. But activity will continue to be selective at an asset level and diversified at a sub-sector level. Retail warehouse parks are expected to remain a top pick for investors but accessing stock will be difficult with limited opportunities being offered up to the market for sale.
- Pricing in the retail sector is still attractive compared to other sectors, perhaps with the exception of retail warehousing where pricing has already sharpened. Opportunistic investors will continue to be drawn to parts of the retail market by high yields, a stable income return, value-add opportunities, and the scope for capital growth.

Retail total returns by selected segments annual to June 2024 (%)



Source: MSCI UK Quarterly Property Digest June 2024

Retail investment activity (£bn)

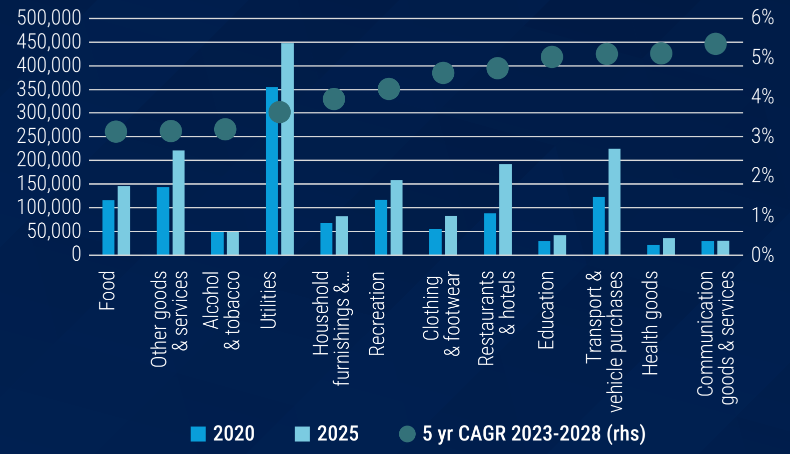


Source: MSCI, August 2024

Retail occupier market

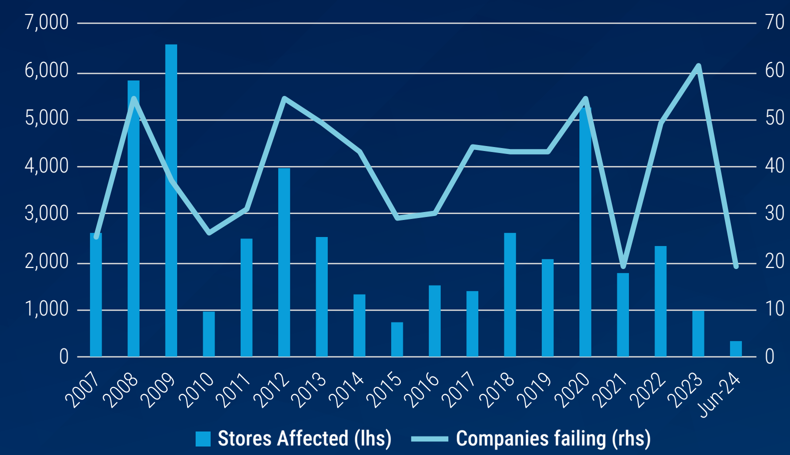
- As inflationary pressures ease, falling from the annual rate that reached 11.1% in October 2022 – the highest it had been in 41 years – this will provide a boost to consumer confidence. Progress will be slow nonetheless, and from a low base with underlying prices still high despite the falls in inflation and meaningful growth not anticipated until the second half of the year.
- Retail sales rebounded in July supported by higher spending in department stores and on sports equipment after wet weather deterred shoppers earlier in the summer with the quantity of goods bought rising by 0.5% in July m/m.
- The consumer outlook remains relatively upbeat and whilst tighter fiscal policy and the lagged impact of past interest rate rises will continue to weigh on spending power, sustained real wage gains should boost real household income growth and, provided consumer confidence continues to rise, retail sales should follow suit and strengthen in H2 2024 and 2025.
- In the retail warehouse sector, there is a demand:supply imbalance with demand for space at record highs against an historic low vacancy rate of 4.4%. Unpicking the vacancy rate highlights an even more acute supply challenge. Approximately 62% of currently available space has been vacant for more than three years and has probably either been caught up in lengthy planning obligations or the space is no longer fit for purpose in terms of what occupiers are currently looking for.
- Removing this space moves the 'active' vacancy rate to around 1.7% nationwide and this, coupled with re-based rents, will be a lever in helping to sustain a level of positive rental growth. Any voids handed back often re-let quickly, offering landlords the opportunity to take advantage of any under-renting scenarios.
- Retail failures and insolvency risk continue to fall back to reasonable levels and the expectation is for that further insolvencies and CVA's will be limited over coming months. However, retailers are acutely aware that the retail environment is very competitive and that physical stores remain crucial to overall performance.
- Retailers continue reinvest, right size, relocate and refit their store networks as they look to encourage store visits and raise footfall numbers, in part by offering in store experiences and in part by offering free returns, against an increasing number of brands who are now charging for returns to fulfilment centres as costs here rise.

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



Source: Oxford Economics, August 2024

Retail Failures 2007 – June 2024



Source: Centre for Retail Research, June 2024

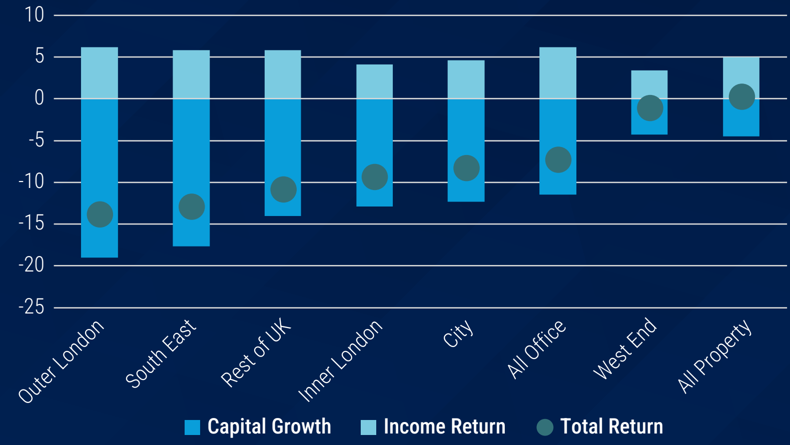
Offices

Manchester, aerial shot in the central area of the city

Office investment market

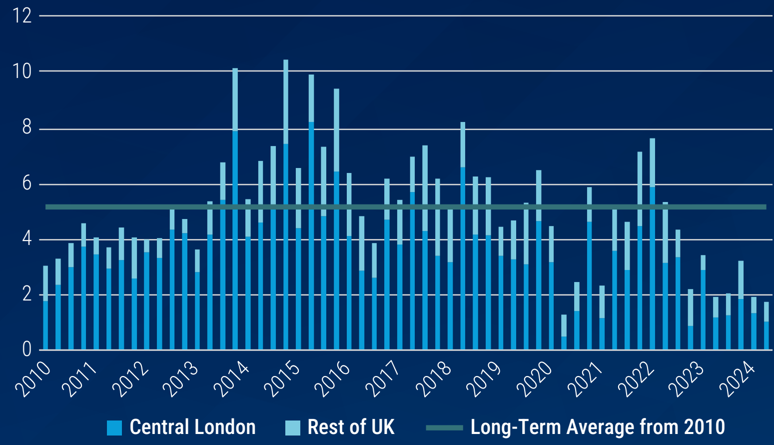
- The office sector continues to work through major structural shifts and these, together with the cost of financing given the rapid rise in interest rates over the past two years or so, has seen yields shift outwards and capital values decline. In the three months to June the office sector recorded a total return of -0.6% and is the weakest performing sector over the quarter owing to the impact of continued structural headwinds as corporates continue to adopt hybrid working patterns.
- Capital values declined by 1.8% in the second quarter which was a similar level to the -1.7% recorded in Q1 2024, but an improvement to the -4.0% seen in Q4 2023. Demand for the best quality office space within well located, high specification, and sustainable buildings remains strong but at the expense of more secondary locations and lower quality buildings.
- Investment volumes in Q2 totalled £1.7 billion, bringing the half year total to £3.6 billion. However, as prices stabilise in the wake of a significant correction in pricing over the past 18 months, the second quarter brought with it signs of improving opportunity-driven appetite.
- Central London, where volumes in the second quarter reached just over £1.0 billion, was a forgettable quarter. Conversely South East offices appeared to buck the trend, with the Q2 volume significantly up on Q1. Approximately half of the investment volume was driven by an opportunity to change the use of the asset, typically to residential, aided by a relaxation of Permitted Development rules.
- With the significant repricing that the office sector has seen, for example prime yields in the City of London are around 5.75% which is a similar level to that seen just after the global financial crisis, this offers investors the opportunity to buy best-in-class and repriced trophy assets at attractive prices.
- Continue divergence between pricing on quality stock and secondary stock where the chance of obsolescence continues to rise. This is especially the case where the cost of refurbishing or repositioning the building to align with what today's occupiers are looking for, outweighs the potential income that could be achieved from the asset. Where repositioning is taking place this trends to be in city centres where occupational demand is the strongest.

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



Source: MSCI UK Quarterly Property Digest June 2024

Office investment activity (£bn)

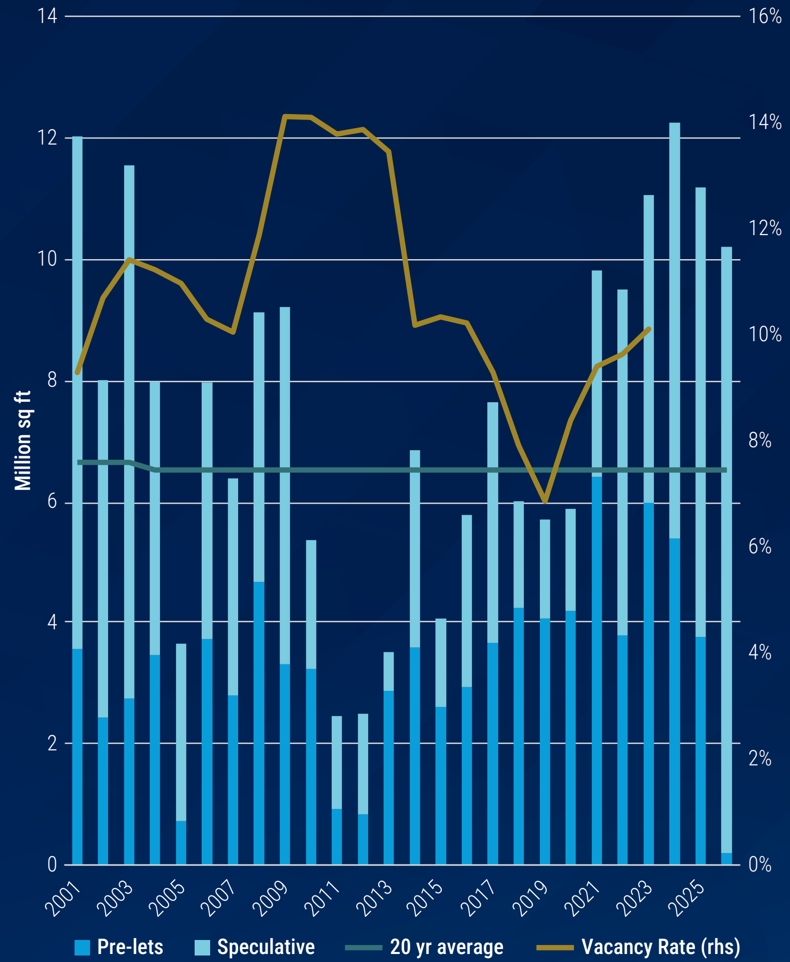


Source: MSCI, August 2024

Office occupier market

- The continued shift towards flexible hybrid working patterns has resulted in lower levels of overall demand across the UK office market. The trend of active requirements to focus on best-in-class space in well-connected locations is evident. This has also seen landlords scrutinise their portfolios to identify schemes that have sufficient existing EPC ratings and those projects that could be easy wins in terms of upgrading and/or refurbishment. Landlords are less willing and indeed able to take on office buildings that require substantial upgrades given the high cost of capital expenditure.
- In Central London leasing activity in the second quarter reached 2.4 million sq ft and brought the H1 take-up total to 4.4 million sq ft. Whilst activity has been muted it has the potential to gain momentum over the remainder of the year given the 4.2 million sq ft of space currently under offer, a level that is 21% above the 10-year quarterly average.
- But this will only materialise if occupiers can find suitable accommodation that meets their needs, especially as new supply in the capital is being absorbed with relative ease as occupiers seek out quality space, often upgrading in what is still a pressurised rental market. In addition, about 60% of the development pipeline in Central London is currently pre-let and occupiers with active requirements are facing a staring down a significant drop-off in deliveries from 2026.
- Across the key regional office markets take-up reached approximately 1.6 million sq ft in Q2, circa 15% below Q1. Similarly to London, most leasing activity is targeting central locations where about 65% of deals took place. Given the slowdown in the amount of space under construction and the 38% of the pipeline that is already pre-let, leasing activity has eroded some of the availability which fell by 14% over the quarter to reach 12.0 million sq ft. Liverpool and Edinburgh remained the most restricted markets, recording the lowest levels of availability at circa 5.2% and 4.8% respectively.
- Construction costs have seen large increases over recent years in tandem with rising inflation. Although cost pressures have eased somewhat, rental growth has not risen sufficiently enough to warrant new construction. As quality supply dwindles even further, this will help to support a pick-up in prime rental growth in the most constrained markets.
- A three-tier market is emerging, ranging from centrally located prime assets, to good-quality assets in need of some capex to bring their ESG criteria up to the needs of today's occupiers and thirdly, secondary grade/quality stock, a proportion of which will fall into obsolescence as capex costs are close to or above replacement cost.

Key UK office markets – development pipeline



Source: Colliers, August 2024

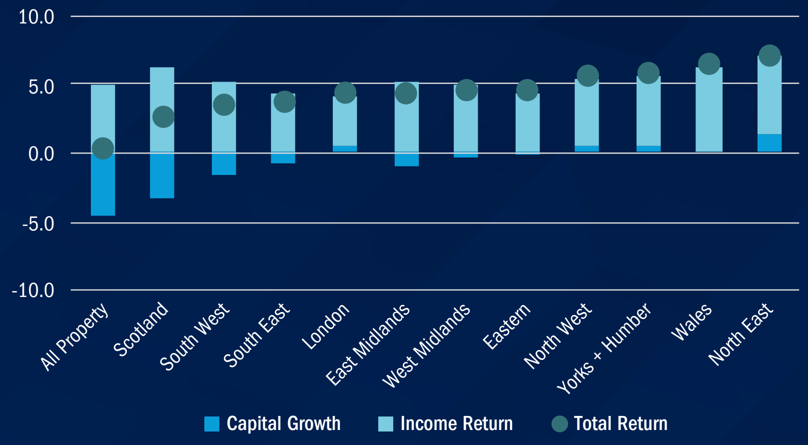
> The trend of active requirements to focus on best-in-class space in well-connected locations is evident.

Industrial

Industrial investment market

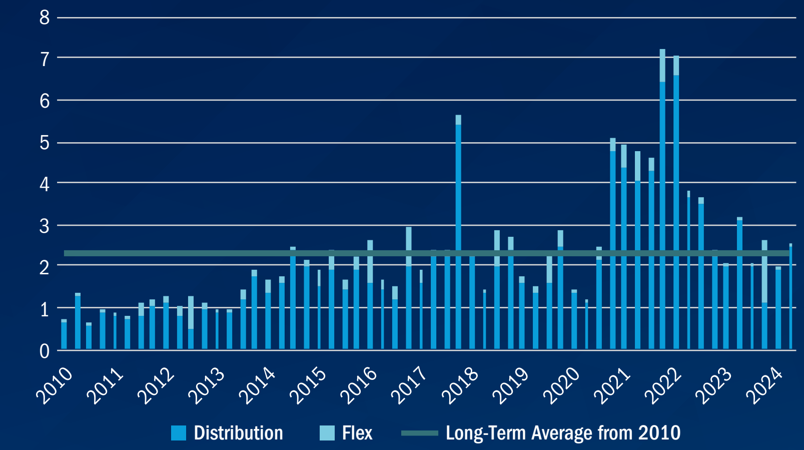
- The first half of the year has seen £4.5 billion transact with marginally more activity recorded in the second quarter which accounted for 56% of H1 transactions. This follows a challenging 2023 for logistics capital markets with few sellers bringing product to market at the price point that buyers were prepared to pay for assets.
- The industrial sector recorded a total return of 1.8% in Q2 with an income return of 1.1%. Capital values strengthened in the quarter at 0.6%, having turned positive in the first quarter (0.1% capital growth). There is still investor appetite for the sector, underpinned by strong occupational fundamentals, low vacancy and the potential for positive rental growth.
- Underpinned by a strengthening occupier market, sentiment for industrial and in particular logistics assets, is expected to continue to improve especially as the macroeconomic environment looks brighter. The fall in the base rate, coupled with a more widespread belief in sustained positive rental growth should help to support a narrowing in the bid/ask spread which has been one of the main challenges to more investment activity over the past twelve to 18 months.
- But investors will be selective, predominantly focusing on protecting income with mid-box, modern future-proofed logistics along arterial routes and around infrastructure nodes such as airports and ports are favoured.
- Quarter two saw an inward shift in prime yields of between 15bps and 25 bps. The general view is that Q4 2023 was the bottom of the investment market with the last six months seeing a slow improvement. Sentiment is improving as is the depth of the buyer pool which has increased since the beginning of the year.
- Investment supply has been constrained and this has been a limiting factor in higher transaction volumes since the start of 2024. More product should start to be released and will most likely stem from a number of sources that include defined benefit pension funds who are looking to de-risk and recycle capital from real estate into bonds to cover liabilities, retail funds, some of whom may be facing further redemption pressure and thus needing to offload some stock to fulfil the redemption requests or those facing maturing loans.

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



Source: MSCI UK Quarterly Property Digest June 2024

Industrial investment activity (£bn)

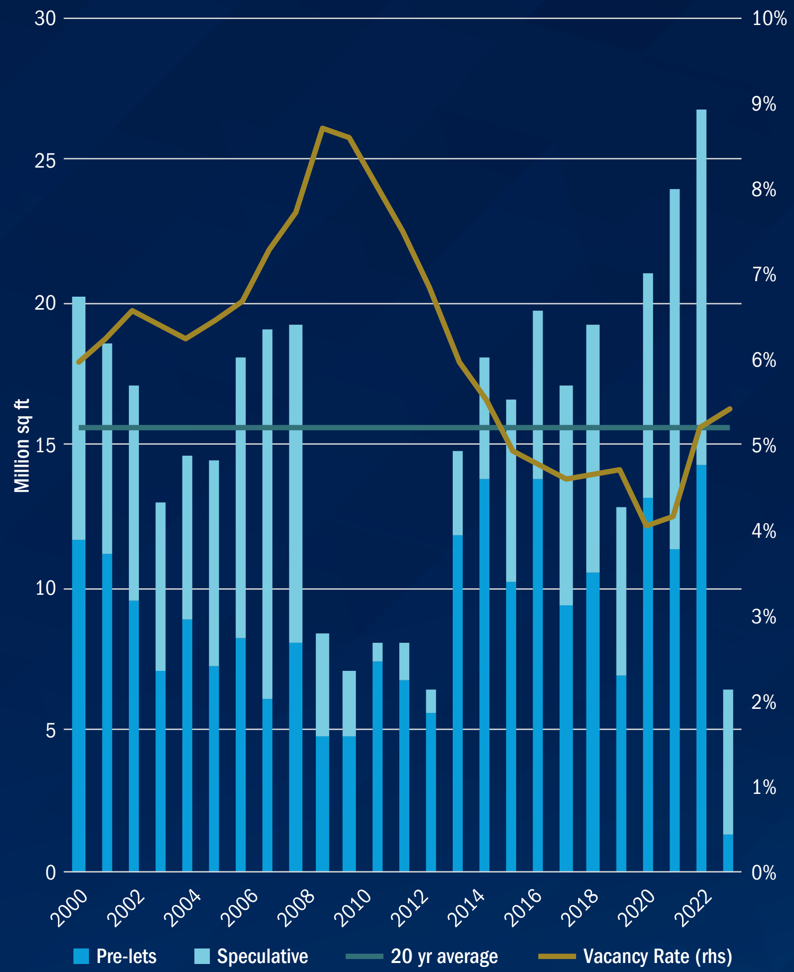


Source: MSCI, August 2024

Industrial occupier market

- Occupier demand has improved since the beginning of the year, but there remains some caution in the market with companies conscious of cost and mindful of weaker trading conditions and so have typically shelved, albeit temporarily any expansion plans.
- But with emerging signs that the economy is improving and with most occupiers having resized their portfolios since the pandemic and released and excess space, there is now greater confidence around re-visiting expansion plans which will help to boost take-up levels. Leasing activity in the second quarter was circa 12.0 million sq ft, 15% higher than Q1 and brings the first half year total to approximately 22.3 million sq ft.
- The key long-term trends underpinning leasing activity continues to be the growth in online penetration, and although this has moderated recently it is still rising, and nearshoring as companies continue to look for both efficiency gains and resilience across their supply chains against a backdrop of geopolitical events.
- Having said that manufacturers have been the more immediate driver of the improvement in demand, in particular in the automotive, food & drink and construction industries. In the quarter the manufacturing sector accounting for circa 30% of deals with 3PLs just above this level with a share of circa 35%.
- The vacancy rate registered its sixth consecutive rise, albeit from historic low levels. This is attributable to a mixture of almost 6.0 million sq ft of speculative completions delivered over the first six months of the year and just over 12.0 million sq ft of second-hand space returned to the market. In response however, the development pipeline has moderated and against the current level of space under offer and active demand requirements the expectation is for the nationwide vacancy rate to trend downwards over the next twelve months.
- Rental growth is expected to remain positive for the best quality space, space that is power rich, offers ESG credentials and is zero-carbon compliant and is influencing a widening gap between prime and secondary rents. Landlords are keen move headline rents on but there is evidence that they are more flexible on incentives. Rent-frees moved out in Q2, taking the average to just under 12 months on a typical 10-year lease.

Key UK industrial markets – development pipeline



Source: Property Market Analysis, Q2 2024 data

> “Occupier demand has improved since the beginning of the year”

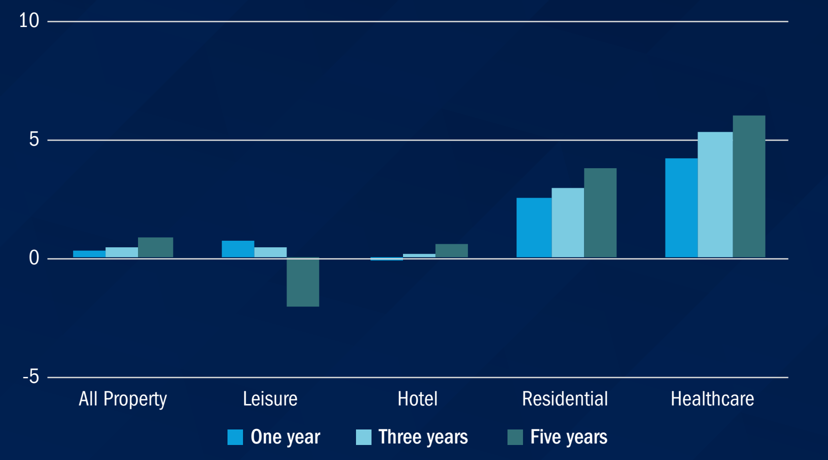
Alternatives

London, balcony of modern residential building

Alternatives

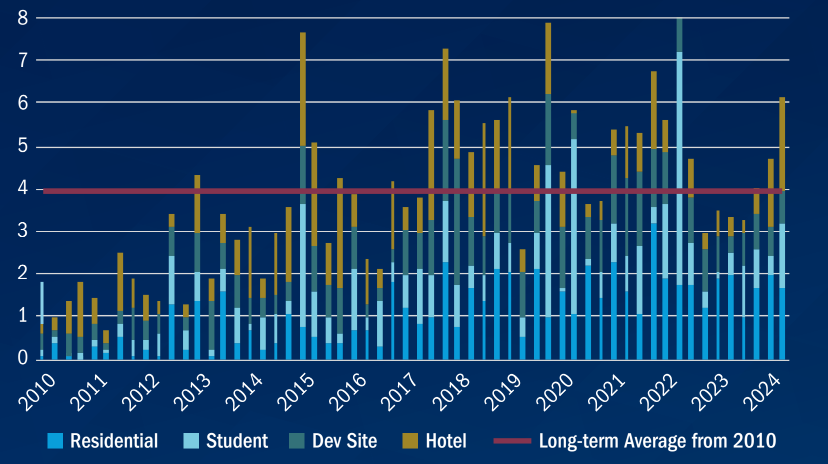
- Quarter 2 recorded £6.1 billion worth of investment activity across the Alternatives sector including residential, student housing, hotels and development sites. This is the strongest quarterly performance for two years with volumes boosted by student housing and hotels in particular.
- Build-to-Rent (BtR) and Single-Family Housing (SFH) have both attracted significant investor interest in Q2 with the investment volume reaching approximately £1.5 billion, boosted by one significant Blackstone acquisition. Supply is restrained and given rising demand levels positive rental growth is expected to continue.
- Activity, which is primarily development-led, continues to be challenged by a combination of the cost of debt, planning issues and the regulatory environment. But as activity into different sub-sectors within the wider BtR sector grows the expectation is for an increasing share, currently weighted to multifamily to be taken by SFH and co-living.
- £2.1 billion worth of hotel deals concluded in Q2 with leisure hotels more sought after as travel demand returns ahead of business travel, so investors are targeting key tourist cities such as London and Edinburgh. Inflation, despite the downward trend, is impacting operational margins, in particular labour costs.
- Demand for higher education has been robust, in particular from domestic and non-EU international students. Supported by this strong demand and limited stock of purpose-built student accommodation investor appetite has been sustained given positive rental growth prospects. The long-income play coupled with strong operational performance, track record and a supply:demand imbalance underpin investor appetite for the sector.
- Investment activity has been strong so far with Q2 recording £1.6 billion worth of deals, although could be held back by the abolition of Multiple Dwellings Relief, higher debt costs and planning constraints and partly by viability challenges in terms of development given the cost of construction and financing.

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



Source: MSCI UK Quarterly Property Digest June 2024

Alternatives investment activity (£bn)



Source: MSCI, August 2024

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