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UK real estate: half-year health check

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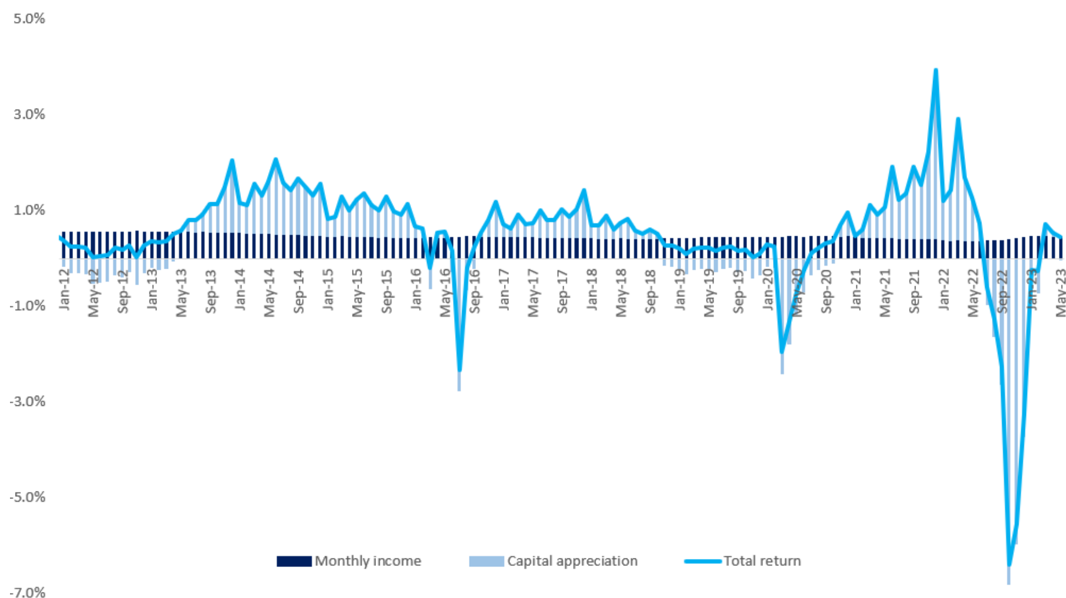
- **Following a difficult 12 months for UK real estate in which values declined 25%, deal evidence from March 2023 indicated a nascent pricing recovery**
- **Inflationary and interest rate headwinds persist, especially pertinent for debt refinancing, but occupier markets have been more resilient than expected**
- **On balance, we see growth opportunities in industrials, retail warehouses, some residential subsectors, and (very selectively) urban offices.**

It's been a volatile 12 months in UK real estate. The speed and extent of the capital market repricing, -25% from June 2022's peak through to February 2023's trough, was more severe than we saw during from 2007-09 during the global financial crisis[1].

Figure 1: capital market context – monthly valuations indicate nascent pricing recovery



Source: MSCI, May 2023

[1] Columbia Threadneedle analysis of the MSCI UK Property Monthly Index, May 2023

But the UK, consistently ranked the most transparent real estate market globally[2], repriced much quicker than either the US or Continental Europe. As such, valuations from March 2023 onwards, reflecting prevailing transactional evidence at the time, indicated the market entering a nascent recovery phase (Figure 1), with select sectors (industrials and retail warehousing) showing tentative capital growth.

More recently however, inflation has proved stickier than anticipated. Despite a fall in the rate of Consumer Price Index (CPI) inflation to 8.7% in April, down from 10.1% in March[3], it was unchanged in May, with core CPI inflation increasing month-on-month against expectation. While the Bank of England (BoE) response goes some way to restoring confidence in a downward inflationary trajectory, increased base rates continue to present downside risks to debt costs and to the resilience of the occupational market (the administration of Cineworld Group being the latest example[4]). With the BoE sending clear signals that further rate rises may be on the cards, there is a valid perception that a recession in the UK has perhaps been postponed rather than averted.

Capital market distress?

While we have reached the end of the "free money" era, we are not yet seeing signs of capital market distress. With the UK economy still adjusting to the effects of Brexit, Covid-19 and the Ukraine conflict, and policy response continuing to prioritise tackling inflation, this may seem surprising.

Within the institutional marketplace, a knock-on impact of higher rates was to reduce the present value of UK defined benefit pension scheme liabilities, accelerating the de-risking process and removing capital from growth markets, including property. Open-ended unleveraged funds managed their flows through a combination of selling at prevailing prices, and/or deferring redemptions. But there was no evidence of forced selling at steep discounts, which was the accusation levelled at "retail funds" following the Brexit vote in 2016, nor a return of Material Uncertainty Clauses, which were introduced during the Covid-19 pandemic.

Leverage is a more likely candidate for distress, as while average real estate leverage is vastly lower than historic levels – according to CBRE the average loan-to-value at market level as at the end of June 2022 was 48%, comparatively low against 72% at the end of 2007 – impending loan maturities will doubtless bring pain. With the base rate rising from 0.25% at the end of 2021 to 5.0% in June 2023[5], and with markets pricing further rises in, many refinances will not be viable. Both borrowers and lenders will have to decide on the relative merits of either extending loan terms and topping up equity, or selling at book losses. Anecdotal evidence suggests at least some lenders are already heading for the exit door, and more are likely to follow.

Where will performance come from?

Headline annualised rental growth of 3.7% to end-May indicates a trailing occupational resilience at market level[6]. The inflation picture and ongoing interest rate rises undoubtedly

[2] JLL Global Real Estate Transparency Index, 2022

[3] The Guardian, Bank forecast to raise rates above 5% as UK inflation falls by less than expected, 24 May 2023

[4] Reuters, Cineworld to file for administration in UK as part of restructuring, 26 June 2023

[5] Bank of England data, June 2023

[6] MSCI UK Property Monthly Index, May 2023

place additional strain on corporate occupiers, but the lead indicators for real estate are vacancy rates and insolvencies – both of which remain low by historic standards. Remember that rental cash flows are asset backed so in the extreme scenario of elevated insolvencies, real assets fare better than fixed income.

We retain a high conviction towards industrials, where rental growth is moderating from a high of 13% annualised seen in August 2022, back towards its pre-Covid-19 average of around 3.3% annually[7]. Retail warehouses, which feel occupationally resilient, have benefitted from the recent rates revaluation, and with national vacancy levels at around 5% could be at a tipping point of more sustained rental growth – which is currently 1.6% annualised to May[8].

Residential subsectors, in particular student accommodation, continue to provide opportunities to increase rents, however this sector did not experience any meaningful price correction and so values based on forward-looking net operating incomes need careful interrogation on a case-by-case basis. Also under the umbrella of residential, there is a place for single-family housing, albeit at scale, offering granular and relatively sticky income with strong growth potential. Finally, we think other alternative sectors, including life science, still have a valid place within forward-looking portfolios.

Where are the risks?

Offices continue to go through a transformational structural change towards flexible/hybrid working patterns, which has reduced overall demand levels. However, occupational densities post-Covid have also trended down, which has acted as a mitigator against more severe downsizing. On the supply side, in spite of new development, net office supply has actually reduced by 6% from its 2014 peak, as secondary stock has been demolished or converted to alternative uses faster than new stock is being built[9]. While "best-in-class" offices will continue to thrive in an increasingly discerning occupational marketplace, market vacancy levels of around 20% are unsustainable in the medium term. There will be a growing divide between the best and the rest and further price falls will reflect these risks. Leisure also looks challenged, as Covid-19 piggy banks are whittled away and discretionary consumer spending decreases (here again, Cineworld is a case in point).

What about decarbonisation?

Decarbonisation continues to represent one of the biggest structural drivers of returns, as investors, occupiers and valuers come to terms with legislative requirements and the risks and opportunities they present – something we covered in depth earlier in the year[10].

In June 2019 the UK became the first major economy to pass emissions laws requiring all greenhouse gas emissions to be net zero by 2050. As it stands, only 22% of commercial property energy performance certificates logged in the past three years are rated B or better, which is the requirement under the Minimum Energy Efficiency Standards (MEES) by 2030[11].

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[7] MSCI UK Property Monthly Index, May 2023

[8] MSCI UK Property Monthly Index, May 2023

[9] Savills and Columbia Threadneedle Investments, December 2022

[10] Columbia Threadneedle Investments, Delivering sustainable returns in real estate investing, 20 March 2023

[11] Energy Performance Certificates for Buildings Register for England and Wales, as at 31 December 2022

The cost of implementing environmental improvements creates both opportunities and risks for those in real estate. We believe a pro-active approach to environmental and social risk management provides the best opportunity to deliver sustainable outcomes aligned with financial performance. This is via direct asset interventions – asset refurbishment and the introduction of renewable energy sources – and via engagement with occupiers who increasingly recognise the value of shared initiatives.

Conclusion

UK real estate continues to offer a favourable investment environment: a generally benign political landscape, a clear operating environment, an established legal framework and a favourable ownership and leasing structure. It has a diverse investor base, with overseas investors increasing their market share to around 60% in London[12]. And it's a market that offers consistently attractive returns: grossing an average 8.2% per annum since 1987 (unleveraged) with approximately 80% of total return derived from rental income[13].

Real estate has been particularly affected by societal changes accelerated during Covid-19, and the dust continues to settle. There will be winners and losers over the coming years as this plays out. But this recalibration is creating a value premium for assets that retain functional relevance to occupational business operations: we favour industrials, retail warehouses, residential, and (very selectively) urban offices, and we believe dynamic, thematic allocation and experience in stock selection will prove key to delivering positive returns in this environment.

[12] Who Owns the City, Colin Lizieri, Jan Reinert and Andrew Baum & JLL, 2022

[13] MSCI UK Property Monthly Index, May 2023

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