UK Economic Changes: What it Means for Real Estate

November 2022

IN A NUTSHELL

- Through October, the UK's political and economic position has been exceptionally volatile. From the government's 'mini-budget' in September, through to the U-turn in almost all announced policies and the resignation of a prime minister, the recent disruption could well exacerbate the repricing of UK real estate.
- However this repricing, alongside the devaluation of sterling could well provide attractive investment opportunities for overseas buyers.
- In particular we see the best investment opportunities arising in Central London, specifically prime energy-efficient offices, hotels and student accommodation.

Over recent weeks, a series of political events shook the UK's economy and undermined the stability of the country and its government. The resulting volatility in currency, swap rates and gilts has been disruptive and could well have implications for the UK real estate market. The purpose of this note is to address the impact of changes to fiscal policy and the UK's economic position, and to highlight where real estate investment opportunities could arise in this period of uncertainty.

The turmoil began on the 23rd September when a series of misjudged tax cuts and fiscal measures were announced as part of a 'mini-budget' aimed at promoting economic growth and investment. The impact was immediate; concerns over the debt requirements and inflationary impact of unfunded tax cuts saw the value of sterling deteriorate rapidly, falling to the lowest level ever recorded against the dollar. Bond yields jumped dramatically, with 10-year UK government bond yields surging from 3.3% to 4.5% in the days following the announcement.[1]

The majority of these proposals have since been withdrawn following a change in Chancellor of the Excequer. Less than one week later, on the 20th October, Liz Truss resigned as Conservative Party leader and Prime Minster to be replaced by Rishi Sunak a few days later. Thus far, the markets have on the whole reacted positively to these more recent events, with Gilt yields falling and sterling recovering slightly. However, questions over political stability have undoubtedly raised concerns for real estate investors.

While we need to be careful about drawing too many long-term conclusions from these recent events, economic and political uncertainty may dampen real estate performance over the coming year in the form of weaker demand. In addition, despite the fiscal U-turn, further hikes in interest rates are still to be expected over the coming year, as the Bank of England continues to

[1] Trading Economics, September 2022

fight inflationary pressures. With the outlook for UK government bonds now ‘higher for longer’, this will most likely place additional pressure on commercial property yields over the coming quarters.

While there are undboutedly short-term headwinds to UK commercial property, as real estate investors it is important to look over the longer term. Here, the outlook for the UK remains supportive, particularly in larger cities such as London where we expect stronger population and GDP growth over a longer horizon. In addition, on the whole prime UK real estate fundamentals look relatively healthy, particularly relative to past economic downturns.

Furthermore the recent devaluation in sterling should improve the attractiveness of property pricing to overseas investors. While the fall in sterling had begun well before the ‘mini-budget’ turmoil, it’s decline escalated significantly after the announcement. At its lowest point, the value of sterling against the US dollar was 20% lower than it was at the beginning of 2022. The pound has since recovered slightly, but the value of sterling against the dollar remains well below the long run average.

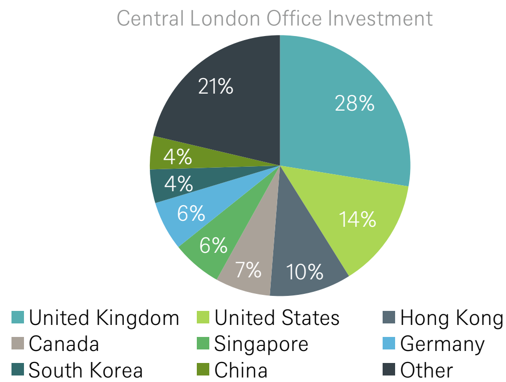
Exhibit 1: British Pounds (GBP) To US Dollars (USD) Exchange Rate

Source: XE, November 2022.

Looking back, evidence of currency fluctuations supporting UK real estate investment volumes is limited and the correlation between the two is relatively low. However, in conjunction with current real estate repricing, parts of UK real estate should present an attractive opportunity for overseas investors to capitalise on both weak sterling and property price corrections, particularly for those that have a lower reliance on debt.

Given its position as a global city, Central London’s office market has historically proved popular to international investors, with overseas capital accounting for over 70% of transaction volumes over the last ten years. We anticipate London’s prime office market could prove more resilient to the current economic and political headwinds, supported by a range of features such as a global occupier base and less dependence on the wider UK economy.

Exhibit 2: Office Investment Transactions (2012-2022)



Source: Real Capital Analytics, October 2022.

Like elsewhere in Europe, faced with rising interest rates and all-in financing costs, the Central London office market is currently going through a period of repricing. At the time of writing, broker data suggests that prime yields in the West End have moved out 25 basis points to 3.25% and there has been a larger 50 basis points correction in the City, bringing the prime yield to 4.25%.[2] In both submarkets, we anticipate further outward movement, especially in light of expected higher interest rates as a result of last month's mini budget. Incorporating the additional discount from currency fluctuations prime central London offices look attractive. For a US investor, for example, if prime Central London office values decline by 20%, a correction in pricing that we believe quite possible, a prime asset could be purchased at around a 35% discount to pricing at the beginning of the year.[3]

Over the short to medium-term, a boost in international tourist numbers could be evident as the UK becomes a more affordable travel destination. In 2016, a VisitBritain survey concluded a favourable exchange rate has a positive impact on intent to travel to Britain, particularly amongst those from India, China and the USA.[4] Indeed, in the year following the UK's vote to leave the European Union, sterling fell 13% against the dollar and US visitor numbers reportedly increased close to 19%.[5] Higher visitor numbers would support the performance of Central London hotels, particularly those considered more upscale or luxury.

Similarly, we anticipate the devaluation in sterling could increase demand from international students, encouraged by more affordable university fees and living costs. London's student accommodation market is already supported by exceptionally strong fundamentals, particularly regarding a lack of supply and quality of universities. The sector has historically proven anti-cyclical and resilient in economic downturns: The tougher the job market, the more likely the decision to study. A repricing on a similar scale to other sectors is therefore unlikely. However, an additional boost to demand through higher student numbers would further limit supply, placing even greater upward pressure on rent levels.

To conclude, UK real estate is currently in a period of repricing and there are undoubtedly challenges ahead for all parts of the market. The recent economic and political instability could well have detrimental effects on the health of UK real estate occupier markets in the short term. However, the longer term outlook for the UK and London remain positive. Given sufficient price corrections, alongside the weakness of sterling, we expect investment opportunities will still arise over the coming year. The

[2] JLL, CBRE, Savills, October 2022
[3] DWS, October 2022
[4] VisitBritain, July 2016
[5] Financial Times, July 2017

logistics sector, for example, continues to be supported by strong market fundamentals and has already seen notable yield expansion. Given the recent devaluation of sterling, we now see added impetus for international investors to seek selective opportunities in UK property, particularly with regards to Central London. Tactically, Central London prime offices, hotels and student accommodation are increasingly key investment strategies.

Real Estate Research Team

Office Locations

Chicago
222 South Riverside Plaza
34th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
Winchester House
1 Great Winchester Street
London EC2N 2DB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
20th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000

Teams

Global

Kevin White, CFA
Global Co-Head of Real Estate Research

Simon Wallace
Global Co-Head of Real Estate Research

Americas

Brooks Wells
Head of Research, Americas

Liliana Diaconu, CFA
Office Research

Ross Adams
Industrial Research

Joseph Pecora, CFA
Apartment Research

Ana Leon
Retail Research

Sharim Sohail
Property Market Research

Europe

Ruben Bos, CFA
Property Market Research

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Carsten Lieser
Property Market Research

Martin Lippmann
Property Market Research

Asia Pacific

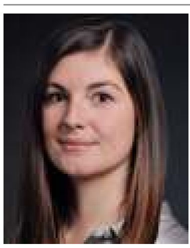
Koichiro Obu
Head of Real Estate Research, Asia Pacific

Natasha Lee
Property Market Research

Hyunwoo Kim
Property Market Research

Seng-Hong Teng
Property Market Research

AUTHOR



Rosie Hunt
Property Market Research

Important information