DWS

UK Real Estate Strategic Outlook

First Quarter 2023

IN A NUTSHELL

— Rising bond yields, higher financing costs and a weaker economic outlook have led to a rapid and significant repricing of UK real estate, yet this may provide attractive opportunities for both core and value-add investment strategies.
— Despite the likelihood of further challenges in the short term, the longer-term outlook is positive. Central London remains one of our top-performing European office markets, while logistics remains well placed given strong fundamentals.
— We continue to favour the living sectors, particularly student housing in the largest student cities. Affordable residential in London and the major regional cities also looks well positioned to withstand weaker economic growth and higher inflation.

The second half of 2022 proved a turbulent period for the UK economy, government and real estate market. The combination of a challenging economic environment, rising interest rates and political volatility led to a significant slow down in real estate investment and a rapid repricing across almost all sectors. There are certainly still headwinds facing the real estate market, but we believe that most of the total price correction has now happened. This should create attractive opportunities for both core and value-add investment strategies, particularly in the living sectors, corridor and urban logistics, and Central London prime offices.

2023 set to be a challenging year

The UK economy began to shrink in the third quarter of 2022, and although we expect a relatively shallow recession this year, the downturn may still prove more pronounced than elsewhere in Europe.[1] In addition, while the consensus view is that UK inflation has now peaked, it remains elevated compared to historical standards and is expected to descend only gradually, persisting for longer than in many other European countries. The Bank of England has responded by aggressively hiking interest rates, and at 3.5% the base rate is now at its highest level since October 2008, with a further hike expected in early 2023. We anticipate that interest rates will remain high over the short term, with no rate cut expected before 2024.[1]

However, the outlook over the longer term is more positive. We expect long-term bond yields to fall steadily from 2025, and GDP growth is forecast to comfortably outpace the Eurozone over the forecast horizon.[1] London should be a key driver of growth, supported by positive demographic and employment fundamentals.

A rapid and significant repricing has already occurred

Higher financing costs and a weaker economic outlook have already had a profound impact on the UK real estate market. Investment activity fell sharply in the final quarter of 2022, with preliminary data showing that all-property investment volumes totalled £8 billion

[1] DWS, December 2022

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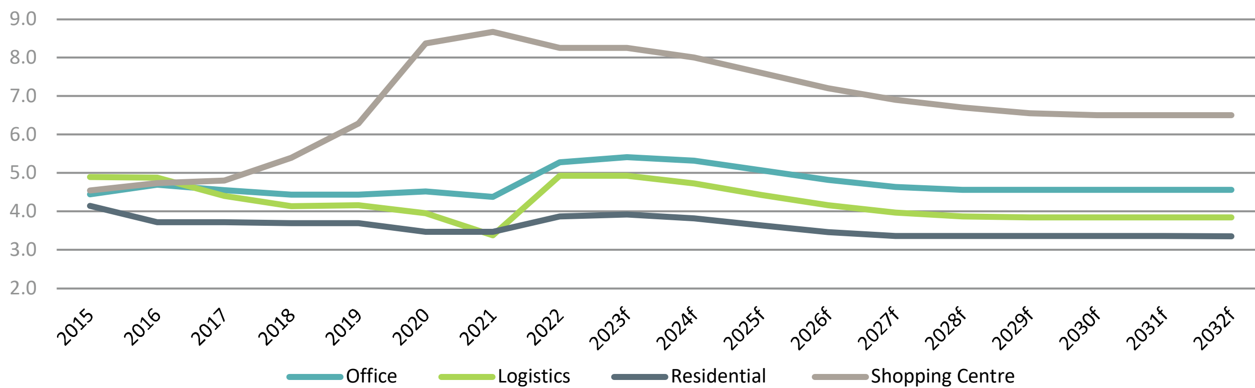
– a decline of 32% quarter-on-quarter and 65% year-on-year. Investment over the full year totalled £55 billion, broadly in-line with the 10-year average but almost 20% below the previous year's total.[2] The slowdown was particularly marked in the logistics sector, which recorded a 26% annual decline in investment activity. On the other hand, the residential sector was the only sector to see continued growth, with a record level of capital invested.

The repricing in UK real estate has been more rapid and severe than was initially expected. With the exception of retail, which has already suffered significant value correction in recent years, all core commercial property sectors recorded outward yield movement over the second half of 2022. The office and logistics sectors were most severely impacted, with prime yields moving out by between 75 and 150 basis points. The residential sector has proved more resilient though, as yields moved out by just 40 basis points in the final months of 2022.[3] As such, prime UK real estate capital values fell by an average of close to 10% over 2022, ranging from slightly positive growth for shopping centres and residential to a decline of -20% for logistics. The MSCI monthly index further highlights the shift, with average commercial property values falling -20% in the second half of 2022, following growth of 7.2% in the first six months of the year.[4]

Looking forward, we believe the majority of the total price correction has already been seen, although prime yields will likely continue to edge out over the first half of 2023. Thereafter, yields are expected to stabilise, before gradually moving back in from 2024 onwards. Ultimately, however, our long-term outlook has seen little change, and our predicted exit yields are only marginally higher than in our previous forecasts.

UK Prime Yield Outlook (%)



Source: DWS, January 2023.

Price correction offers opportunities in UK logistics and Central London offices

The significant repricing of logistics offers an attractive (re)entry point into the sector. To date, the UK has recorded some of the most severe price corrections across Europe and prime logistics yields are now roughly back in line with their 2016 levels. Importantly, market fundamentals remain solid. Continued healthy demand should be supported by further growth in e-commerce, alongside a shift to 'just-in-case' supply chains and greater focus on near-shoring. In addition, structurally low vacancy should support further rental growth over the coming years, although we do expect this to fall back from the historical highs witnessed over the pandemic. We continue to see urban logistics as a rental outperformer, boosted by exceptionally tight supply, competition from other land uses, and strong demand as occupiers look to be closer to consumers. We expect prime urban yields to sharpen again as the market recovers, supporting returns over a 10-year hold period.

[2] RCA, December 2022
[3] CBRE, January 2023
[4] MSCI, January 2023

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Elsewhere, Central London remains one of our top-performing European office markets over the forecast period. In this weaker economic environment, we believe that London's prime office market should prove more resilient than elsewhere in the UK, supported by a range of features such as a global occupier base and less dependence on the wider UK economy. In addition, market fundamentals remain solid on the whole. The current shortage of available prime office space is likely be exacerbated by high construction costs and economic uncertainty. As such, while short-term rent growth will likely be hindered by the economy, over the medium term we anticipate healthy rental growth in both the West End and City submarkets.

Within the office sector, prime assets are expected to outperform the wider market, supported by lower void periods, stronger occupier demand and higher liquidity. Indeed, a preference for premium quality office space with top ESG credentials continues to be evident in leasing activity. With prime yields in the City of London now 100 basis points higher than the at same time last year,[5] opportunities to purchase best-in-class trophy assets at attractive prices will likely become available. On the other hand, given the notable price correction within the Central London secondary office market, and with the yield spread between prime and secondary office stock widening further, the refurbishment of well-located grade B assets into Next Generation office stock may offer a solid opportunity for excess returns.

Prime Total Return Forecast, 2023-2032f (% p.a.)

Source: DWS, January 2023. Note: f = forecast. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

The living sectors offer resilience to economic disruption

UK student housing looks particularly well placed for outperformance. The sector is well positioned in this period of market stress, with student numbers typically increasing during economic downturns. In addition, in many of the UK's largest cities, the sector is supported by exceptionally favourable market dynamics, including a significant supply-demand imbalance. An upward trend in student numbers looks set to continue, driven by both a demographic increase in the number of domestic 18-year-olds and strong growth in international students. Meanwhile, the devaluation in sterling could further increase demand from international students, encouraged by more affordable university fees and living costs. The student housing sector therefore offers significant rent growth potential, particularly over the short-to-medium term. Large student cities with top-tier universities such as London, Edinburgh and Bristol are expected to perform particularly well. Furthermore, while the yield spread between multi-family and student accommodation has narrowed in recent years, it still sits between 50 and 75 basis points.

We also see an increasingly strong case for the co-living segment, which has seen growing interest from institutional investors. Typically attracting graduates and young professionals, the co-living tenant pool is expanding to include international students, expats and

[5] CBRE, January 2023

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contingency workers, who often favour flexible housing solutions and simple movement processes. London's tight housing market, as well as a high share of young population, graduates, and single person households, makes it a key target market for this strategy.

The affordable residential sector is expected to prove one of the more resilient segments in the face of economic uncertainty and persistent inflation, supported by solid demographic trends and a persistent undersupply of new housing. In addition, the significant increase in mortgage interest rates in recent months, exacerbated by the 'mini-budget' fiasco, will likely push additional people into the rental segment. London (Zones 2 to 6) and the regional cities of Bristol and Manchester should continue to perform well. That said, further price correction may still be necessary in order to achieve target returns.

Central London's luxury hotel market could also receive a boost from the recent fall in sterling, at least over the short-to-medium term, as the UK becomes a more affordable travel destination for international tourists. London is historically a popular tourist destination with visitors from the United States, Middle East and Asia. We see the best opportunities in assets under a management contract with a reputable brand. These investments could benefit from revenue per available room (RevPAR) growth and are typically traded at a 100-150 basis points premium to standard leased hotels.[6]

The retail sector continues to face many challenges and in the short term will likely be hindered by waning consumer spending, alongside rising energy, labour and transport costs. That said, we anticipate prime retail rents to find a floor over the course of this year, following several years of severe decline, and a steady rental recovery is anticipated over the medium term. In addition, the correction in values is several years ahead of the rest of Europe and we expect a gradual fall in yields over the forecast period. As such, the UK retail sector appears to offer a strong return potential, yet at present the market still comes with considerable risks and should be approached in a highly selective manner.

Potential strengthening of energy efficiency standards for existing buildings

In early 2023, the UK government announced a new Department for Energy Security and Net Zero with a goal to "*Improve the energy efficiency of UK homes, businesses and public sector buildings to meet the 15% demand reduction ambition".*[7] This indicates that previously consulted on energy efficiency policy proposals will be implemented. In addition, refreshed focus on energy efficiency may result in additional policies or incentives affecting real estate investors.

Specifically for real estate investors, the 2020 Energy White Paper set a goal that non-domestic properties will face a regulation of reaching Energy Performance Certificate (EPC) level B by 2030, a substantial tightening on the current regulation that makes it unlawful for a landlord to grant a new tenancy or to extend or renew an existing tenancy unless the building has an EPC of at least E. From April 2023, the regulation will apply to all private rented peoperty, including where there has been no change in tenancy. The EPC B target in 2030, as well as the interim EPC C requirement by 2027, is estimated to affect around 1 million buildings across England and Wales.[8] However, as the government has not yet formally responded to this consultation or passed regulations, the timing of the regulation may change from the original proposal.

A separate but linked consultation focused on addressing the shortcomings of Energy Performance Certificates which the real estate industry has communicated to governments for many years. The second consultation focused on creating a national performance-based policy framework for rating the energy and carbon performance of large commercial and industrial buildings. The proposal is to draw on National Australian Built Environment Rating Scheme (NABERS).

[6] CBRE, January 2023
[7] HMG, February 2023
[8] Simmons and Simmons 2021

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