Real Estate House View

United Kingdom

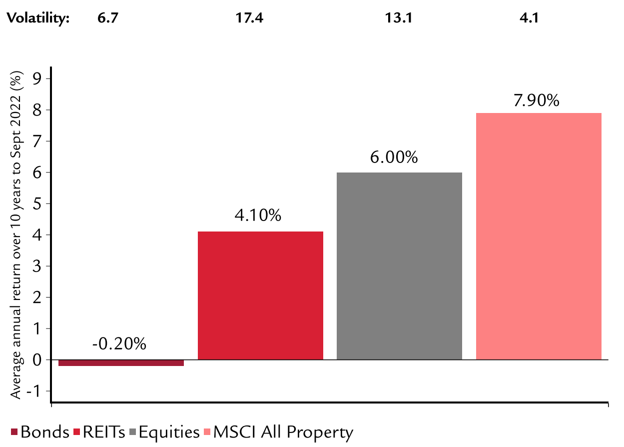
Swiss Life Asset Managers

First half-year of 2023

Key takeaways

- **Occupational market resilience:** Rental values are continuing to increase as occupational market fundamentals remain robust, particularly in sectors with constrained supply, such as industrials. MSCI All Property rents increased 1.7% in H2 2022, with industrial assets delivering 4.0% growth over the same period.
- **Confidence returning to the investment market:** The resilience in the occupier market combined with greater visibility on monetary policy means confidence is returning to the market. This is improving liquidity as investors see opportunities to acquire assets at attractive pricing.
- **Investors target industrial assets:** Historically low vacancy rates and a slow development pipeline mean rental growth prospects are robust. Current pricing presents an attractive investment opportunity for good-quality assets, and this sector is anticipated to recover most rapidly.
- **Best-in-class offices offer potential for growth:** There remains a shortage of modern office stock in the UK's largest regional cities. As occupiers continue to pivot towards high-quality stock, these assets are expected to offer potential for income growth over the medium-term.
- **Retailers ready for round two:** Having already been forced to adapt their business models during the pandemic, retailers are better equipped for another economic downturn. Consumer spending is shifting back to physical stores, and those with a convenience and value focus will offer sustainable income yields.
- **Active strategies expected to outperform:** Those adopting active management strategies are likely to outperform in a higher interest rate environment. This not only applies to traditional initiatives but also opportunities to provide a positive ESG impact.

Chart in focus



Macrobond, MSCI, FTSE

Real estate remains an important diversifier in an investment portfolio. Not only has the asset class performed well on a relative basis over the long term, but its returns have been less volatile, and poorly correlated with both bonds and equities. Investors in the real estate market can take comfort in property's strengths when making long-term investments. These strengths include, first, an attractive income return which offers regularity of income and embedded growth. And second, as a physical asset, commercial property allows investors to drive income and capital growth through active asset management.

In recent weeks we have lifted our projections for real GDP growth through 2023 from -1.0% to -0.5%. The UK economy will exit the mild recession triggered by higher energy prices and financing costs by mid-2023. Early signs of improving economic dynamics can be seen in the latest readings for the manufacturing sector's purchasing managers index and consumer confidence. Like other regions, the economic slowdown is having a very limited impact on the labour market. The private sector continued to create jobs at the beginning of the year. Investment activity should find support from more planning security once the Bank of England (BoE) ends its monetary policy tightening cycle. Our projections for inflation in 2023 are slightly below the consensus view. We expect average inflation to ease slightly from 9% in 2022 to 6.5%. By December 2023, the inflation rate is expected to be 3.2%.

Improving confidence

Occupational market fundamentals are proving resilient, with rental growth of 1.7% recorded in H2 2022. This is particularly true for sectors with constrained supply, such as industrials. This resilience combined with the expectation that monetary tightening is coming to an end means confidence is returning to the market. This is improving liquidity as investors see opportunities to acquire assets at attractive pricing following a 12% decline in capital values over 2022. We expect values to recover as a result, although polarisation will remain a key feature across the market.

Demand for best-in-class offices

Leasing demand in the office sector remains focused on good-quality assets with strong ESG credentials in well-connected locations. This reflects the longer-term impact of the shift to hybrid working. There remains a severe shortage of this type of stock, particularly in the UK's largest regional cities. Consequently, this style of asset is expected to recover most rapidly, delivering resilient income returns and offering potential for income growth over the medium-term. The outlook is more subdued for poorer quality assets, although repositioning strategies may offer attractive returns as pricing adjusts.

Industrials remain in favour

Long-term structural changes supporting demand in the sector, including changing supply chain patterns and a higher penetration of online shopping, are persisting, and there continues to be a shortage of suitable stock to meet this need. With high construction costs, new development will be constrained, and prospects for rental growth therefore remain robust. Capital values have declined by 25% over the six months to December, presenting an attractive investment opportunity for investors taking a longer-term view, particularly as a resilient occupational market contributed to 4% rental growth over the period. As such, we expect values to improve as the market becomes more competitive.

Retail: survival of the fittest

Retail operators are expected to show more resilience now than during previous economic downturns, having been hardened by the pandemic. Those that have an omnichannel presence will outperform, particularly as the share of online shopping has trended downwards since the re-opening of physical stores. Retail assets have the potential to deliver relatively high-income yields, however, as with other sectors, performance will be polarised. Retail warehousing in urban locations, supermarkets, and convenience retail are anticipated to outperform other segments, especially in prime, affluent locations with a shortage of land supply. As footfall and spending behaviour becomes increasingly home-centric due to hybrid working, high street retailers may also see a recovery over the medium-term.

An active strategy is critical

Performance is expected to be driven by income, with those adopting active management strategies likely to outperform. This not only applies to traditional initiatives such as physical extensions, refurbishments and lease renegotiations to improve value, but also the opportunity to provide a positive ESG impact through reducing carbon emissions or pursuing a social value strategy to benefit the community in which the asset is located.

Chart 1: All property returns (Q4 2022)

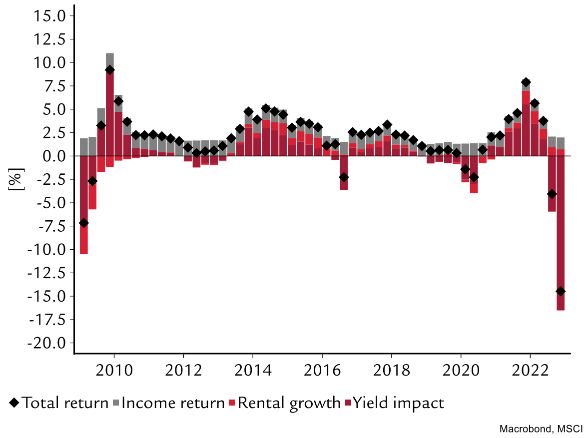
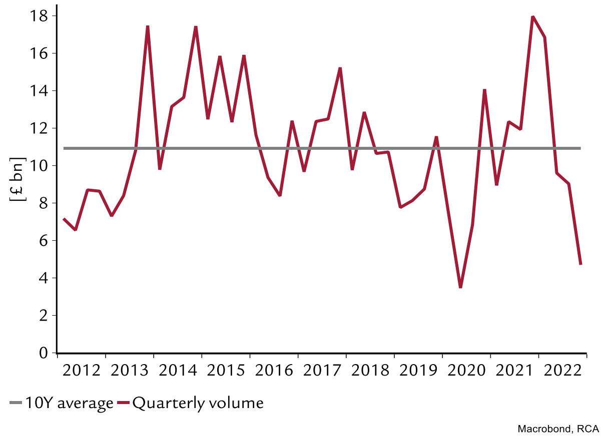


Chart 2: UK property investment volumes (to Q4 2022)



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