U.K. Real Estate Strategic Outlook

Third Quarter 2022

IN A NUTSHELL

- The U.K. real estate market faces several immediate challenges. Slowing economic growth, alongside higher financing costs, have kickstarted a period of real estate price correction.
- The living sector should prove more resilient in the face of rising inflation and weaker economic growth. We continue to favour affordable residential in London and the major regional cities. Student housing in the largest student cities is also expected perform well over the coming years.
- Logistics continues to be well placed given strong fundamentals, although it is not immune from a slowing economy. The office sector is arguably more vulnerable, but as price corrections are realised, opportunities will likely emerge in the value-add space.

The first half of 2022 was shaped by significant changes to both the domestic economic landscape and the geopolitical situation in Europe. The U.K.'s post-Covid economic recovery slowed significantly, hindered by rapidly rising inflation and growing caution among both consumers and businesses. Sharp increases and volatility in the fixed income market have had a notable impact on borrowing costs and as a result, like elsewhere in Europe, there is growing evidence of an ongoing price correction in the U.K. real estate market. To date, the most evident repricing has been in logistics and City of London offices. However, over the coming months we anticipate outward yield movement across almost all sectors, and yields are now expected to peak much earlier in the cycle than we had previously predicted. Towards the back end of the ten-year forecast period, however, our outlook for property yields remains largely unchanged.

Economic challenges ahead

The U.K. faces an increasingly challenging economic environment, particularly in the short term. Inflation has increased sharply over the year to date, reaching 10.1% in July 2022, representing a 40-year high.[1] As household incomes begin to be squeezed, evidence of mounting cost-of-living pressures are now evident in both retail sales data and the sharp decline in consumer sentiment. In response to risks around heightened inflation, the Bank of England has raised interest rates several times so far this year, most recently to 1.75% in August. This represents the highest level since 2008 and further hikes are anticipated over the coming months.[2]

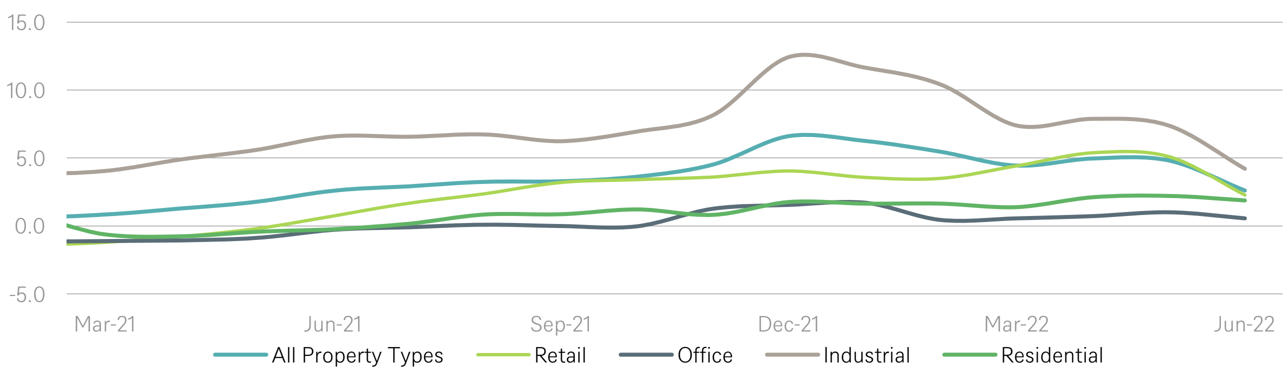
[1] ONS, July 2022
[2] Oxford Economics, July 2022

It is worth noting, that the threat of an inflation-induced recession over the coming year is not insignificant and an economic downturn is becoming an increasingly likely prospect. Over the longer term, in an environment of fairly modest growth across Europe, the U.K. economy is expected to outperform slightly.[3] London in particular should be a key driver of growth, supported by positive demographic and employment fundamentals.

Signs of a slowing real estate market

Higher financing costs and weaker economic growth present several immediate challenges. Following a strong end to 2021 and solid performance in the opening months of 2022, there is increasing evidence that the U.K. real estate market is now slowing and a price correction is underway. According to the MSCI monthly index, average commercial property values increased by 4.4% over the first three months of 2022, and while quarterly value growth remained positive in the second quarter, it slowed to 2.6%.[4] Furthermore, CBRE's latest Monthly Index suggests that capital values across all U.K. commercial property declined by -0.5% in July, with the industrial sector recording an even sharper decline of -1.4%.[5]

Capital Growth (3 month rolling, %)



Source: MSCI, July 2022.

U.K. real estate investment activity has fallen in recent months, as investors adopt a 'wait-and-see' approach. Preliminary data shows that all property investment volumes totalled £12.8 billion in the second quarter of this year, a 38% quarter-on-quarter decline and below the long-term pre-pandemic quarterly average. Residential was the only sector to record a quarterly increase in investment volumes.[6]

Real estate brokers are increasingly acknowledging the outward movement of yields. Both Savills and CBRE for example have reported a 25 basis point outward shift in both U.K. logistics and City of London offices.[7] At present, although we are aware of several large U.K. real estate transactions that have been agreed with a price reduction, evidence of a major price movement is still largely anecdotal. However, we expect the true extent of price corrections to come through in the data over the second half of this year. We anticipate that yields will move out across all sectors, perhaps with the exception of the highest-yielding retail segments where a significant correction has already been realised. Prime values are forecast to decline by up to 10%, with the office sector expected to see the largest correction given its exposure to wider structural trends such as remote working.

[3] DWS, July 2022
[4] MSCI, July 2022
[5] CBRE, August 2022
[6] RCA, July 2022
[7] Savills, CBRE, July 2022

Supported by stronger rent growth, prime logistics and residential will likely see much more modest value declines; however, secondary, low energy-rated properties could well see far greater falls.[8]

The residential sector remains a top pick

According to PMA's most recent investor preference survey, conducted in the second quarter of 2022, the traditional core sectors have fallen out of favour. Sentiment towards the alternative sectors, on the other hand, remains positive, with the likes of residential, student accommodation and healthcare still viewed positively.[9] Indeed, we continue to have a positive call on affordable residential, which is expected to prove one of the more resilient segments in the face of economic uncertainty and persistent inflation. In particular, London (Zones 2-6) and the regional cities of Bristol and Manchester should continue to perform well, supported by solid demographic trends and a persistent undersupply of new housing. The U.K.'s private rental residential market remains one of the most unregulated in Europe and typically short lease lengths provide opportunities for regular rental uplifts.

The United Kingdom is Europe's most mature student housing market and given the anti-cyclical nature of the sector, we anticipate that it will remain a top pick for investors over the coming years. The 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 student numbers, largely driven by Indian and Chinese nationals. The supply of student accommodation has become increasingly constrained, with a notable undersupply of student beds in many cities. Such positive fundamentals should support healthy rental growth over the coming years, particularly in large student cities with top-tier universities, such as London and Bristol.

Prime assets should outperform, but opportunities in value-add

In a weaker economic environment, prime assets are expected to outperform the wider market, supported by lower void periods, stronger occupier demand and higher liquidity. However, in the event of a sufficient price correction within the Central London secondary office market, we see a potential opportunity to refurbish well-located assets into best-in-class office stock. On the whole, Central London office fundamentals remain solid. Pre-letting is increasingly common as a shortage of prime available office space increasingly limits occupier choice. Indeed, a preference for premium quality office space with top ESG credentials continues to be evident in leasing activity, driving a growing divergence in rental performance. In London's West End, for example, prime rents increased by 7% over the first half of 2022, while average grade B rents fell by -6.7% over the same period.[10] Going forward, the shortage of prime supply will likely be exacerbated as today's high construction costs and economic uncertainty deter developers. As such, we expect healthy rental growth as the economy moves into recovery mode, and Central London remains one of our top performing markets over the forecast period.

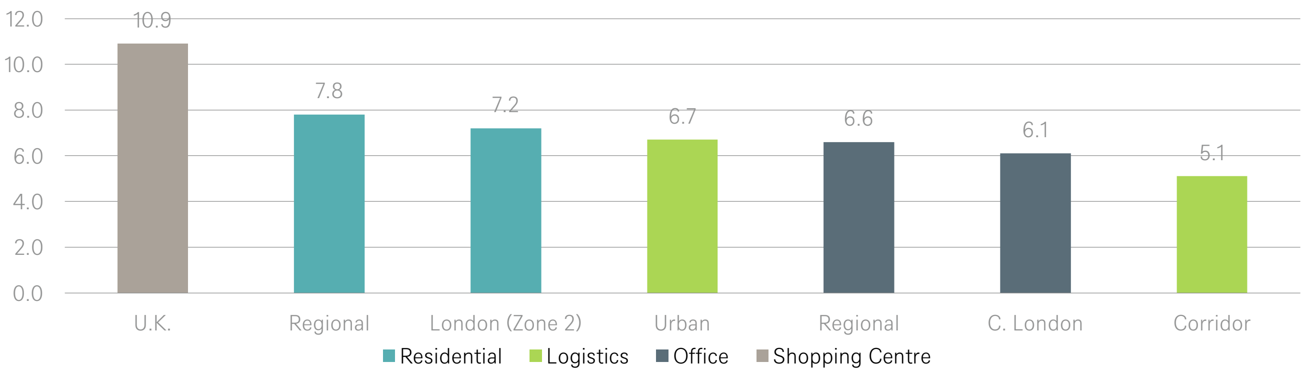
The U.K. logistics market is well-placed to withstand economic disruptions, with vacancy currently at a record low and strong occupier demand continuing over the first half of 2022. However, going forward the logistics sector must also contend with lower consumer spending and slowing e-commerce growth. Furthermore, a substantial rise in business rates from April 2023 onwards will squeeze already thin operating margins. As such, while market fundamentals should support further strong rental growth in the short term, we are forecasting rental growth to fall back in line with inflation over the longer term. The exception here is urban logistics, where exceptionally tight supply and competition from other land uses is expected to drive strong rental growth over the whole forecast period.

The retail sector has suffered yet further setbacks, and in the short term its recovery will likely be hindered by waning consumer spending, alongside rising energy, labour and transport costs. That said, vacancy rates are slowly beginning to stabilise or even edge down in some cases as retail units are converted to other uses, and we do anticipate prime retail rents to find a

[8] DWS, July 2022
[9] PMA, July 2022
[10] PMA, Savills, August 2022

floor by the end of 2022, following several years of severe decline. Over the medium term, we anticipate a slow rental recovery and a fall in yields from their current highs.[11] As such, the sector appears to offer a very strong return potential. However, at present the U.K. retail market still comes with considerable risks and should be approached in a highly selective manner.

Prime Total Return Forecast (2022-2031f, % p.a.)



Source: DWS, July 2022. 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.

[11] DWS, July 2022

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

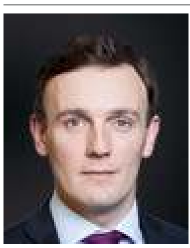
Koichiro Obu
Head of Real Estate Research, Asia Pacific

Natasha Lee
Property Market Research

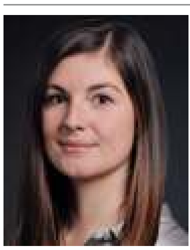
Hyunwoo Kim
Property Market Research

Seng-Hong Teng
Property Market Research

AUTHORS



Simon Wallace
Global Co-Head of Real Estate Research



Rosie Hunt
Property Market Research

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