Alternatives Research
Real Estate

February 2022

U.K. REAL ESTATE STRATEGIC OUTLOOK

First Quarter 2022

IN A NUTSHELL

- _ The U.K. real estate market recovery is now well underway. Despite short-term headwinds to both economic and real estate performance, we see longer-term growth and opportunities ahead.
- _ There has been a notable rebound in Central London's prime office market. We are forecasting London City and West End to be top performing European office submarkets.
- _ We continue to see value in urban logistics and expect further strong rental growth in this sector. Nevertheless, with pricing increasingly expensive, access to this market is difficult.
- _ The residential sector offers attractive investment opportunities, particularly in London and key regional cities.

The U.K. economy continued to recover over the summer and autumn months, driven by the success of the vaccination programme and lifting of Covid-19 restrictions. The improved economic and social conditions boosted the U.K. real estate market and there was a healthy rebound in the office sector, particularly in Central London. In addition, the logistics and residential sectors saw further strong growth. Looking ahead, there are short-term challenges, particularly the emergence of the highly transmissible Omicron Covid-19 variant. Nevertheless, with the U.K. government reluctant to enforce stricter social distancing rules, and the booster vaccine programme well underway, we remain positive about the economic recovery in 2022 and believe there are longer-term opportunities and growth ahead for the U.K. real estate market.

Real estate rebound

Following a challenging start to 2021 for much of the U.K. real estate market, the recovery picked up as the year progressed. According to the MSCI monthly index, average commercial property values increased by 10.6% over the 12 months to November 2021, which compares to -7.1% over the same period in the previous year. Capital value growth was boosted significantly by a record annual increase of 26.7% in the industrial sector, while on a half-yearly basis, capital growth was positive across all sectors including retail.[1]

There are, however, short-term challenges ahead. Alongside the aforementioned Covid-19 risk, a recent dip in consumer confidence reflects caution on the economic outlook and concerns over rising inflation. Like elsewhere in Europe, inflation trended higher over the second half of 2021, reaching its highest level in a decade,[2] and resulting in the Bank of England raising interest rates for the first time in three years. These factors may well dampen the consumer-led recovery over the coming months. At present, however, the consensus view remains that higher inflation will be short-lived and will most

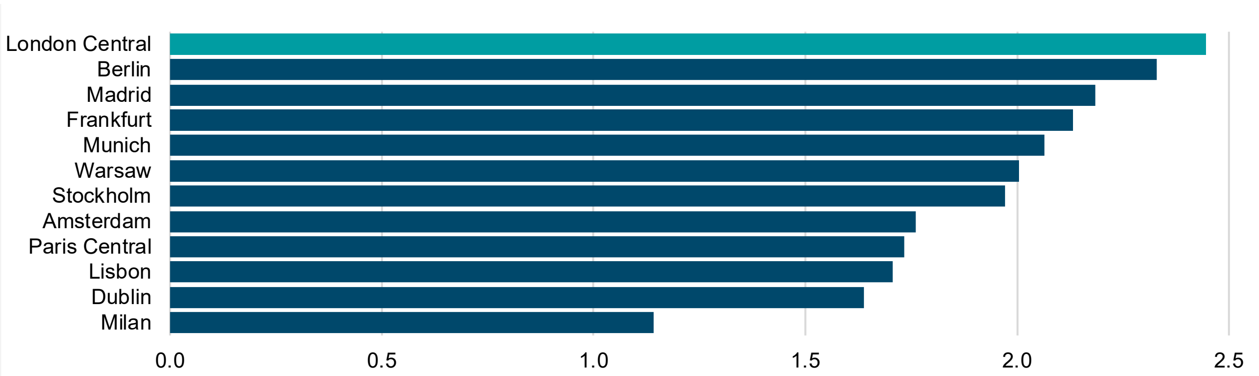
[1] MSCI, December 2021
[2] ONS, December 2021

likely fall back in-line with trend levels by the end of 2023.[3] In the longer term, we believe the U.K.'s growth fundamentals look encouraging, and the economy is expected to outperform the E.U. average over the next ten years.[3]

Confidence returns to London offices

As 2021 progressed, confidence returned to the London office market and there was a rebound in both occupier and investment activity. The recovery in office demand over the second half of the year was driven by the prime end of the market and we anticipate this trend will continue going forward as occupiers look to attract staff back to the office. The divergence in rents between prime and secondary stock was already evident, with prime Central London rents recovering by 4% in 2021, while secondary rents recorded yet further declines.[3] Given the increasing preference towards well-located, grade A and highly sustainable office stock, we believe prime London offices will be able to sustain higher rental levels going forward. Supported by low grade A vacancy and a reduced development pipeline, we therefore expect London to be one of Europe's strongest performers over both the five and ten-year forecast period.

Prime Office Rental Growth Forecasts, 2022-31F (% p.a.)



Source: DWS, December 2021.
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.

In the investment market, international investment returned to Central London offices over the second half of 2021. As such, prime yields moved in by 25 basis points in both the West End and City submarkets,[4] representing the first movement in yields since the E.U. referendum in 2016. Despite this downward pressure, prime London offices still offer a considerable premium over both government bonds and other European markets such as Berlin and Paris.

We expect the combination of strong rental growth and yield compression in the Central London prime office market to lead to returns well in excess of the European average. However, in order to access even higher risk-adjusted returns, we see the best opportunities in the refurbishment of old, but well-located office stock into best-in-class product, focusing in particular on London's West End and City submarkets. These Next Generation offices should cater to a full range of requirements including flexible floorplates, smart technologies, bike storage, a focus on employee wellness and the highest standards in ESG. As such, the environmental case for office refurbishment is also strong.

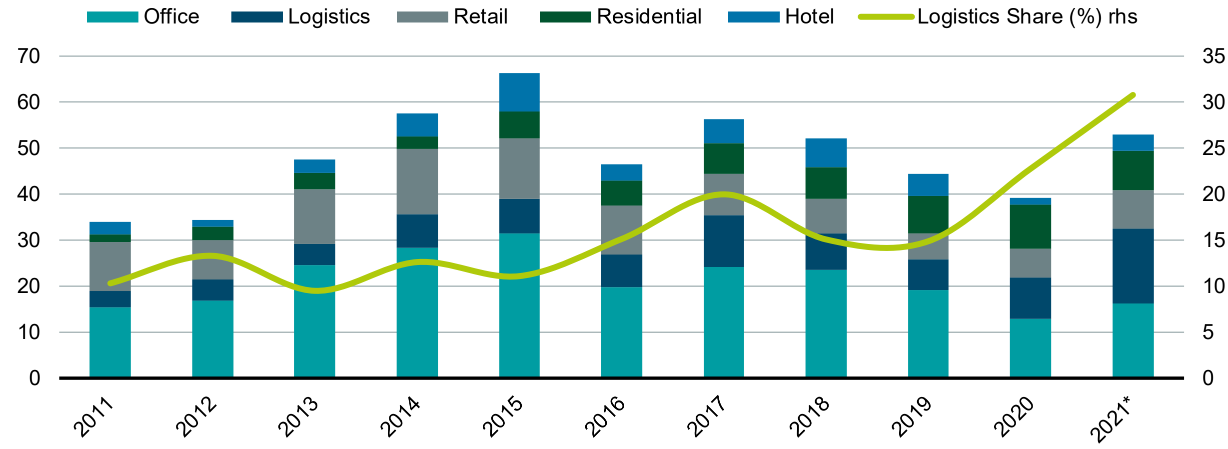
Logistics proves a top pick for investors

Despite an uncertain start to the year, investor sentiment towards the U.K. market improved greatly as the year progressed. According to preliminary data, all property transaction volumes reached £60 billion in 2021, more than 40%

[3] PMA, DWS, December 2021
[4] PMA, December 2021

above the previous year and the highest level recorded since 2017.[5] The industrial sector enjoyed an extraordinary year for investment, achieving a record level of transactions and accounting for close to a third of total investment volumes.[6]

Transaction Volumes by Sector (£bn)



Source: RCA, January 2022.
Note: *Preliminary data.

The U.K. logistics sector has enjoyed a period of exceptionally strong performance. Demand has been boosted to record highs, driven by further growth in online sales accelerated by the Covid-19 pandemic, and vacancy is currently at record lows. With investors increasingly targeting the sector, the weight of capital led to corridor logistics yields moving in by around 50 basis points to sit at or below 3.75% in many regions.[7]

Supported by extremely strong demand and supply fundamentals, the urban logistics sector has recorded even greater yield compression. By the fourth quarter, schemes traded at yields of close to 3.25% in the regions and a handful of deals achieved sub-3.00% in London, a level lower than West End offices.[8] As such, we believe many parts of the logistics market now look fully priced. Although strong fundamentals will likely drive further healthy rental growth over the five-year forecast period, it is becoming increasingly difficult to meet returns targets. With that in mind, we would consider a value-add investment strategy, including the speculative development and refurbishment of warehouse stock in undersupplied locations, particularly within close proximity to urban centres.

Investors also continued to target the rapidly institutionalising private rented sector (PRS) in 2021. The sector has developed significantly in recent years and in the last two years has accounted for over 20% of total real estate investment volumes, almost double the pre-pandemic five-year average.[9] A supply-demand imbalance and disposable income growth is expected to drive healthy rental appreciation over the next ten years.

We favour affordable and mid-market residential schemes in Outer London (Zones 2-6) and the surrounding commuter locations, and increasingly we see opportunity in selected major regional cities. Bristol in particular is expected to benefit from attractive economic and demographic growth, and with a notable shortage of supply, this should encourage healthy rental growth over the coming years. With U.K. regional cities currently commanding around a 50 basis point yield premium to London, those with strong growth fundamentals, such as Bristol and Manchester, offer the potential for higher risk-adjusted returns.

[5] RCA, January 2022
[6] DWS, December 2021
[7] PMA, December 2021
[8] PMA, CBRE, DWS, January 2022
[9] RCA, January 2022

The retail sector had another difficult year, with yet further declines in both rental levels and capital values. Looking forward, challenges are likely to persist over 2022 but we do anticipate a bottoming out of prime rents by the end of the year, following three years of severe decline. Over the medium term, we anticipate prime schemes may see a slow rental recovery and the reduction of yields from record highs. Indeed, with average prime shopping centre yields reaching close to 9.00% last year,[10] there is evidence that liquidity is returning to the market – particularly for retail parks. However, at present a return to the U.K. retail market still comes with considerable risk and should be highly selective in nature.

[10] Cushman & Wakefield, DWS, December 2021

Research & Strategy—Alternatives

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

TEAM:

Global

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

Simon Wallace
Global Co-Head of Real Estate Research

Gianluca Minella
Head of Infrastructure 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

Europe

Ruben Bos, CFA
Property Market Research

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Martin Lippmann
Property Market Research

Carsten Lieser
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

The authors

Simon Wallace

Global Co-Head of Real Estate Research

Tom Francis

Property Market Research

This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Investments come with risk. The value of an investment can fall as well as rise and your capital may be at risk. You might not get back the amount originally invested at any point in time. Source: DWS Investment GmbH

IMPORTANT INFORMATION