Marketing Material

U.K. REAL ESTATE STRATEGIC OUTLOOK

Mid-Year 2021

IN A NUTSHELL

_ There is evidence that a steady recovery is now underway in the U.K. real estate market, with occupier and investor confidence expected to increase further over the second half of the year.

_ The Central London prime office market is forecast to be a top performer within Europe, although in general we remain selective towards offices globally.

_ Residential and urban logistics continue to be best placed to outperform, while the U.K. retail sector faces additional losses.

The U.K. economy has now entered a period of recovery, prompting a slow but steady upturn in the country's real estate market. Looking forward, short-term challenges remain, but we believe there are longer-term opportunities. A Brexit trade agreement has to a large extent alleviated the uncertainty that has held back the U.K. real estate market since 2016, confidence is recovering and there is increasingly evidence of international investors returning to the market. There has been a widespread and significant uptake of the Covid-19 vaccine and in mid-July, the U.K. government announced an end to all social distancing restrictions and a complete reopening of society.

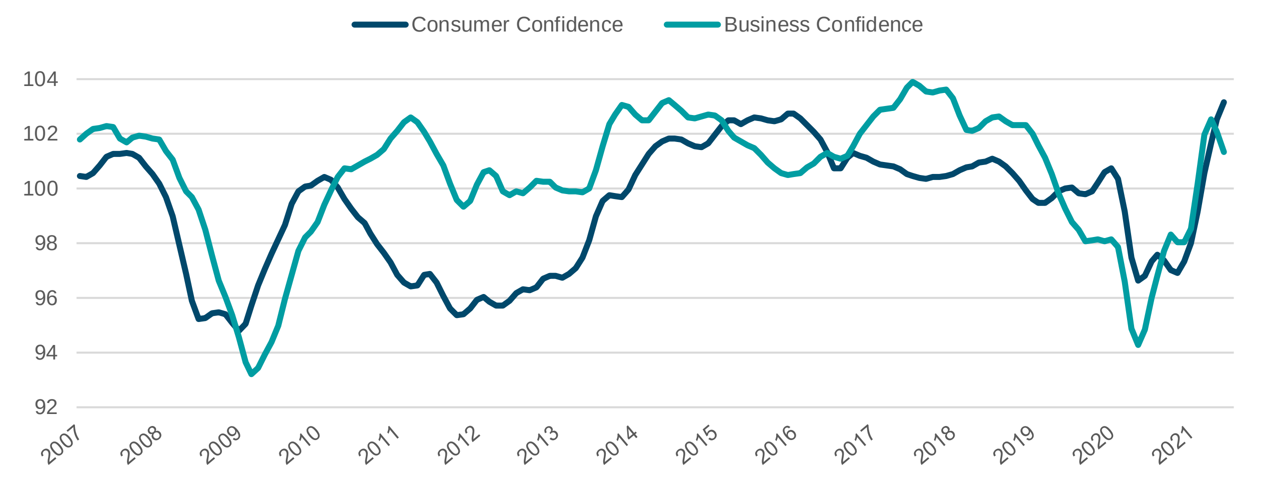
Recovery underway

Following a challenging start to the year for much of the U.K. real estate market, there are signs that a recovery is now underway. According to the MSCI monthly index, average commercial property values increased by 3.5% over the first half of 2021, compared to -0.1% in the second half of 2020.[1] The growth in capital values over the first half of this year was driven by double digit growth in the industrial sector. While values continued to fall across the other main sectors, the declines were far less severe than in the previous six months. In addition, monthly results would suggest that June saw positive growth in capital values across all sectors, albeit marginal.

In further positive news, consumer and business confidence indicators have recovered significantly since the lows of 2020 and are now running well above their long-term averages. This bodes well for a wider economic improvement in the second half of the year, alongside an improvement in real estate market fundamentals. Indeed, a sharp uptick in investment activity was evident in the second quarter, with the total investment volume exceeding the long-run quarterly average, despite ongoing international travel restrictions.[2].

[1] MSCI, July 2021
[2] RCA, July 2021

CONFIDENCE INDICATORS (100 = LONG-TERM AVERAGE)



Source: OECD, July 2021. Long-term average = 2000-2021.

It is important to note, however, that there are still immediate challenges for the U.K. real estate market. While the government announced an end to all social distancing restrictions in July, the country is currently in the midst of a fourth wave of infections. We anticipate that occupiers will continue to act with caution over the coming months. As such, reduced occupier activity is likely to continue in the short term, particularly impacting the office and retail sectors.

Furthermore, although both unemployment and business failures have been kept unexpectedly low to date, a number of government support schemes are likely to be withdrawn over the remainder of this year, potentially resulting in an increase in redundancies and bankruptcies. With vacancy having also increased, we do not expect to see any noticeable recovery in prime office rents until next year.

On a relative basis, longer-term growth fundamentals are encouraging. The U.K. economy is expected to grow faster than the E.U. average over the coming decade and employment growth prospects look positive, with London in particular set to outperform. In addition, regardless of the anticipated reduction in E.U immigration post-Brexit, the national population is still expected to grow.[3]

Prime London offices offer attractive opportunities

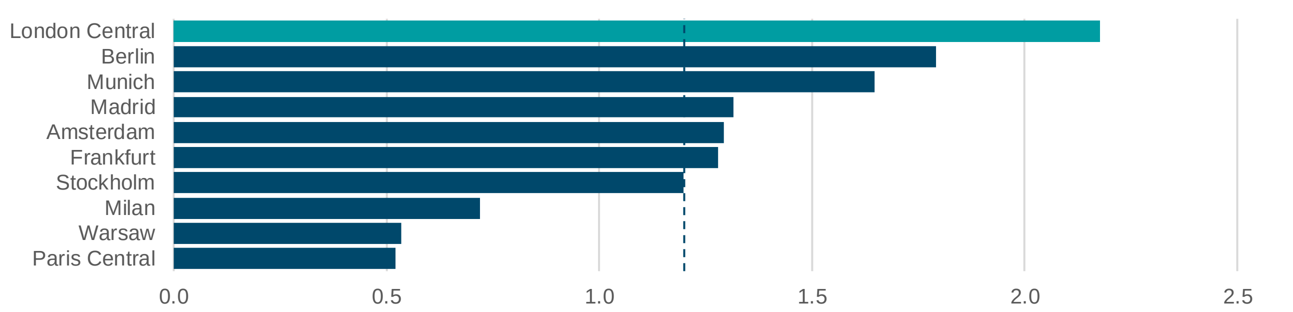
While future occupier space requirements remain unclear at present, we do expect that the acceleration of remote working could dampen office demand over the longer term and our rent growth outlook is now somewhat weaker than prior to the pandemic. Nevertheless, we maintain the belief that the office will remain an important and necessary space for businesses, and 'next generation' office buildings are expected to outperform as occupiers increasingly seek quality over quantity. ESG considerations will also be at the forefront of both occupier and investment decisions.

Despite a somewhat weaker rental outlook for offices more generally, over both the five- and ten-year forecast, we still see London as a strong outperformer. Having underperformed since the referendum, rental affordability has improved, and with low grade A vacancy, a reduced development pipeline and positive longer-term growth fundamentals, we anticipate positive prime rental growth from 2022 onwards. Over the next five years, we are forecasting prime rents to increase by an average of 2.2% per annum, well in excess of the European average.[4]

[3] DWS, Oxford Economics, July 2021

[4] DWS, July 2021

PRIME OFFICE RENTAL GROWTH FORECASTS, 2021-25F (% P.A.)



Source: DWS, July 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.

As travel restrictions are loosened and fundamentals improve, we anticipate that international investors will increasingly target London offices. With yields remaining flat in recent years, prime London offices now offer a considerable premium over both government bonds and other European office markets. By the end of 2020 a 90 basis point premium had opened up between the City of London and the Core European average,[5] while the City's spread over 10-year Gilts currently stands at more than 300 basis points, despite a notable rise in bond yields during the first half of 2021.[6]

We anticipate that the weight of international capital will compress yields by close to 50 basis points over the medium term, resulting in returns well in excess of the European average. However, the window of opportunity for significant excess returns may prove short-lived as yields could compress sharply once overseas capital can invest more freely. In fact, there has already been evidence of this over the first half of 2021, with examples of assets achieving significantly more than the quoting price, in some cases setting new price benchmarks.

Residential and logistics remain the top performers

We continue to have a strong call on the rapidly institutionalising residential private rented sector (PRS), favouring affordable schemes in Outer London (Zones 2-6) and surrounding commuter locations, alongside the U.K.'s major regional cities. Across these markets, a limited supply picture, together with a positive outlook for medium-to-longer-term disposable income growth, should drive strong future rental appreciation. In addition, we see opportunities in operational residential assets, including student accommodation, co-living and senior housing. We believe these assets are well positioned to benefit from long-term demand drivers, improving operational efficiencies and increasing investor interest.

Following a record year for U.K. logistics take up in 2020, the strong performance has continued unabated into 2021. The success of the sector has encouraged developers, and construction activity has increased in many corridor locations. While demand is currently still outstripping supply, further development could limit rental growth over the longer term. As such, we continue to favour urban logistics – locations within a city's inner ring road, such as Park Royal in London or Trafford Park in Manchester – where supply is often far more constrained. Urban logistics is further supported by access to notable population catchments and a large volume of online spend. However, access to this part of the market is challenging and pricing increasingly restrictive, with prime urban logistics yields in London expected to fall below 3.00% by next year.[7] Development may offer a viable entry, but building scale in this sector will likely prove difficult.

Conversely, challenges remain for the U.K. retail sector and we anticipate further losses over the coming years. With average prime shopping centre yields reaching 8.50%, the market does look oversold, particularly as rents have already seen a considerable adjustment. Nevertheless, a return to the market comes with considerable risk.

[5] PMA, July 2021
[6] Macrobond, PMA, July 2021
[7] DWS, July 2021

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