Real Estate House View

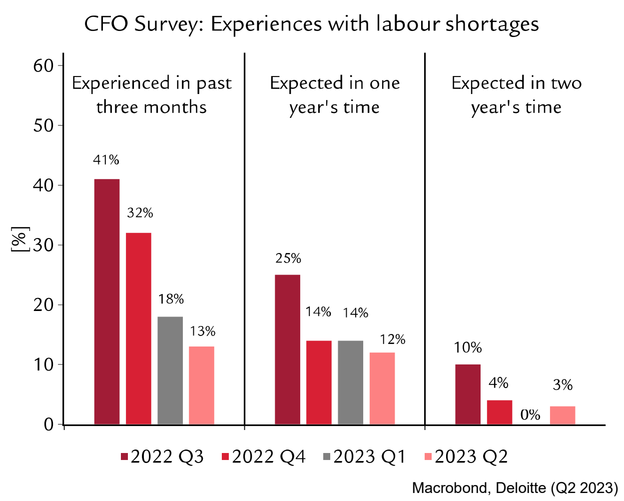
United Kingdom

Second half-year 2023

Key takeaways

- **Early signs of a softening labour market:** Businesses are recording an easing of labour shortages and recruitment challenges, both currently and expected over the next two years. This forward-looking indicator suggests that wage inflation pressures are beginning to ease.
- **Resilient investment volumes for UK living sectors:** Despite investment volumes declining over the first half of 2023 for traditional real estate sectors, investor appetite remains positive for living sectors, including BtR, student accommodation, and senior housing.
- **Performance for "super prime" offices:** Flexible working behaviours and tightening ESG regulations continue to stretch the required risk premium for offices. "Super prime" offices, however, remain in favour and offer scope for attractive returns, although stock selection is critical.
- **Turnaround for industrials:** No sector was immune from the capital value correction experienced over H2 2022. Since then, industrials have demonstrated a gradual turnaround in valuations as favourable structural trends continue to support the occupier market and prospects for rental growth.
- **Non-discretionary spending supports retail:** Investment conviction for supermarkets, retail parks and convenient grocery remains as footfall and consumer spending in these segments show resilience despite sustained cost pressures.
- **Focus on creating tailwinds:** Whilst headwinds persist in the market, a shift in perspective to identify tailwinds is recommended. We believe operational real estate strategies which unlock income potential and growth can be developed to maximise performance.

Chart in focus



The latest CFO Survey by Deloitte reports early signs that the labour market is beginning to cool. When asked to describe experiences with labour shortages and recruitment, the proportion of CFOs reporting significant or severe difficulties declined for the fourth consecutive quarter. Moreover, perception of recruitment and labour availability is expected to recover over both a one- and two-year time horizon, reducing the pressure on firms to meet wage expectations to fill vacant positions. As the labour market cools, so will wage growth inflation, and domestic demand should fall as a result. Hopefully then, inflation will more quickly move in alignment with the Bank of England's 2% target.

The risk of stagflation in the UK remains significant. Unlike in other developed economies, inflationary pressures have so far eased little, which could force the Bank of England to raise key interest rates for even longer than we expect from the ECB. In our base scenario, we expect zero growth in real GDP on average in 2023. The recovery in 2024 is also likely to be rather hesitant, meaning that the British economy will continue to grow less than its long-term potential in the coming quarters.

A shift to alternative strategies

In the wake of tighter monetary policy, portfolio managers are paying close attention to their real estate investment strategies. This is especially true for debt-backed buyers, who are being restricted by higher financing costs and have been less active as a result. Despite transaction volumes trending downwards for 'traditional' real estate sectors, investment into UK living sectors has demonstrated greater resilience. Favourable fundamentals, including demographic shifts and low levels of available supply, suggest rental growth performance will be robust. We expect investors will continue to consider alternative investment strategies into H2 2023, where structural tailwinds provide strategic opportunities.

Offices: Super prime, and the rest

The office sector continues to face several challenges, first relating to hybrid-working and secondly to tightening ESG regulations. As a result, both occupiers and investors alike remain focused on 'super prime' space, which can provide flexible working spaces, and a high level of amenity, in well-connected, vibrant, and mixed-use locations. Whilst total returns over H1 2023 have been reflective of these challenges, rents have recorded positive growth for each segment over the period and may be reflective of improving office occupancy. Although still at an early stage and far from pre-pandemic levels, the occupier market is demonstrating signs of a shift back towards office-centric working. We expect this trend to materialise in steady rental growth over the medium-term, however this will be concentrated on 'super prime', of which there is a marked shortage.

Favourable trends for industrial

The industrial sector is a good example of why investors should consider structural trends to underpin their investment strategies. Industrials have many: e-commerce, the rise of urban logistics, deglobalisation, near or re-shoring, automation, the list continues. Therefore, despite recent fluctuations in capital values witnessed across all real estate sectors since year end 2022, over the first half of this year, industrials have exhibited a turnaround in both capital and rental growth, driven by continued investor demand and strong occupier fundamentals. New supply is expected to be delivered over the second half of the year, and, although this may apply some upward pressure on vacancy rates, an over-supply relative to demand is not expected, and rental growth performance is expected to show resilience.

Retail: For income return

Retail performed well over the first half-year, where returns exceeded those of all-property driven by strong income returns. This is especially true for shopping centres, which returned 2.8% over H1 2023, despite capital values declining 1.1%. Whilst pricing drifts outwards, favourable lease structures, often with index-linked uplifts, are supporting overall performance. Pricing for some retail segments have come into alignment with fair value as yields remain well above the risk-free rate. As such, investment activity is focused on segments where consumer spend has demonstrated remarkable resilience to increasing cost pressures. These include supermarkets, discount-anchored retail parks and convenience grocery. Performance of the retail sector will continue to be distorted by these segments.

Looking for tailwinds

Structural headwinds to real estate have been widely reported, but despite this challenging environment, opportunities remain. Fast-paced technological advances are facilitating new services and enhancing tenant experiences in the buildings they occupy. We expect that operational real estate, including living and self-storage, will witness strong income growth as investors can scale their operational platforms across property portfolios whilst maintaining a low cost-base.

Chart 1: All property returns (Q2 2023)

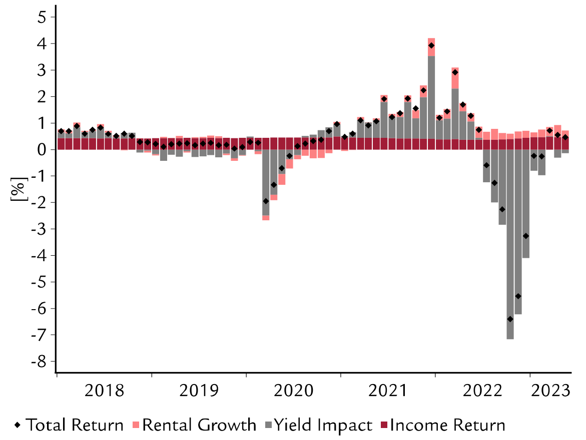


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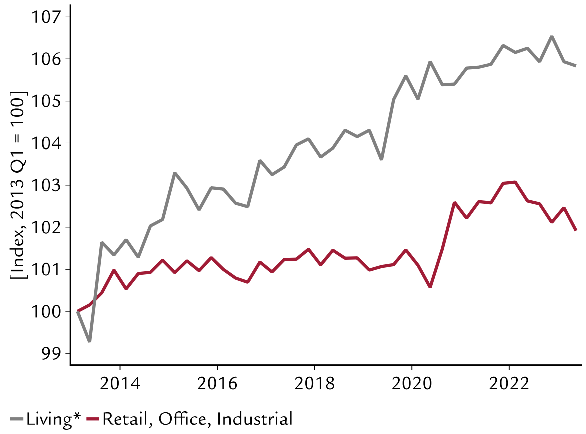
Chart 2: Quarter-on-quarter investment growth for UK living



Macrobond, RCA
*Hotel, Apartment, Senior Housing & Care

Authors

Swiss Life Asset Management UK

Frances Spence
Head UK Research, Strategy & Risk
frances.spence@swisslife-am.com

Rachel Singleton
Analyst, UK Research, Strategy & Risk
rachel.singleton@swisslife-am.com

Swiss Life Asset Managers

Francesca Boucard
Head Real Estate Research & Strategy
francesca.boucard@swisslife-am.com

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife-am.com

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