Quality is key in real estate markets

by Kevin McCauley

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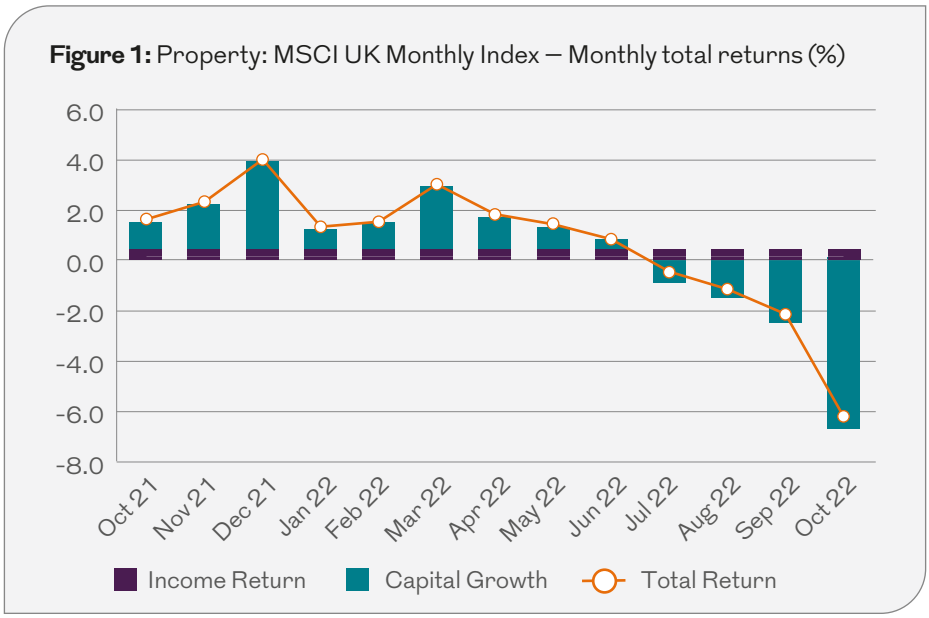
As Head of Strategy and Research, Kevin works with the RLAM Property team to enhance the strategic initiatives for the continued growth of the property business. Kevin spent 15 years at CBRE initially as head of London and South East Office Research and eventually head of UK Commercial Research. He also spent two periods as acting head of UK Research. More recently, he was head of Client Strategy and Strategic Projects. Throughout his career at CBRE, Kevin advised clients on single asset and portfolio strategy and wider strategic decisions. Kevin has also become a leading authority in real estate life science and technology sectors. His clients have included British Land, Landsec, Canary Wharf Group, The Crown Estate, CPPIB, CBREIM and Blackstone.

Investment markets in general have weakened quite significantly during 2022, as investors have grown increasingly concerned about the global economic slowdown, and by the deteriorating economic outlook for the UK.

The real estate market is no exception. A heightened level of uncertainty and pessimism has been affecting the price that investors are willing to pay for UK properties across the board, albeit with some sectors more heavily affected than others. As a result, investment volumes have dropped and pricing has moved out quite considerably.

The sectors most affected by this shift in investor sentiment are those that performed best some 6-12 months ago. According to MSCI, industrial values have fallen by 16.6% since June compared with 7.7% and 8.1% falls for offices and retail respectively. In the case of retail, it still hadn't recovered from its drawn-out retrenchment over the last decade, particularly during the pandemic. While the residential property sector has remained relatively resilient, there's been a noticeable deterioration in sentiment since September.

Overall, occupational markets have remained remarkably resilient, particularly for high quality or prime stock, and we're still seeing rental growth with pockets of strong growth in logistics where the fundamentals remain strong.



Source: MSCI UK Monthly Index – as at October 2022
Past performance is not a reliable indicator of future results.

Conditions to get worse before they get better

As we look ahead into 2023, our expectation is that investment sentiment toward property will remain weak. We are continuing to see relatively low levels of investment volumes, which suggests to us that pricing has further to fall. This is being reflected in valuations with yields seeing some large outward increases in October. Compounding this negative investor sentiment will be weaker occupational demand as a domestic and global recession fully takes hold and job losses start coming through. We are already seeing some early signs of weaker occupational demand which will lead to rental falls although we expect prime assets to show more resilience.

To borrow a football analogy, we see 2023 as a year of two halves. The first half should see a continuation of those sentiment-based trends experienced over the last few months, as investors draw back further. However, we expect to see some form of stabilisation in values as we move towards the latter part of the year or the early part of 2024.

Quality focus remains paramount...

There are several themes within property markets that will help lead this recovery phase, where we expect to see increased demand for new, high quality space, against a backdrop of limited supply of such space. For example, the demand for good quality office space will continue to gather momentum. Post-pandemic, employers have sought to encourage their workforce back to the office by improving the office environment in a process that has been described as 'magnetising the workplace'. This has involved giving employees a higher quality space to work in, making space more flexible and adaptable, enhancing wellness features such as light, air and opportunities for activity, and improving internal connectivity within a building. These outcomes are best delivered through a new or refurbished building.

The growing importance of ESG and commitment to net zero carbon targets are translating through to the demand for higher quality and efficient space. For office occupiers, their choice of building is closely aligned with their ESG strategy and is a crucial consideration when seeking to recruit and retain staff. Occupiers now expect buildings to be able to satisfy their firm's corporate responsibility strategies and demonstrate their sustainability and environmental credentials from an operational perspective. This theme is playing out across all sectors and is best satisfied through high quality prime buildings. Investors are similarly focused on investing responsibly with investment decisions guided by ESG global benchmarks such as GRESB. This is partially being reflected in premium pricing as investors look to 'future-proof' new investments. This is only likely to become more critical as we move through the current cycle.

...as do themes driving growth in some areas

Urbanisation remains another core theme. We believe that major UK cities, including Manchester, Birmingham and Bristol, as well as London, will continue to see their economies outperform relative to the rest of the UK. Agglomeration effects – whereby clusters of business activity and people thrive due to proximity to one another – are one of the main drivers of productivity and economic growth. The competitive advantages of these knowledge hubs will persist and serve as one of the key drivers of outperformance of larges cities over the rest of the UK.

Another positive trend in the UK is the sustained focus on life sciences, most notably in mature markets like Oxford and Cambridge, but also more recently in London. UK cities have a very strong life sciences asset base in terms of research hospitals, universities and research institutions, as well as the availability of highly educated staff. Increasingly, UK life sciences – thanks in part to a hugely 'successful' pandemic – are benefitting from venture capital funding that is helping to fund and drive research and innovation.

The dynamics of the life sciences sector are compelling, both from an investment and an occupational perspective, and we see this being reinforced throughout 2023 and beyond.

Another enduring theme – part-cyclical and part-secular – is healthcare. The UK population is not just growing, it is also ageing. People living longer is putting further stress onto existing health provision, and there is a notable lack of quality fit-for-purpose housing and care facilities for the elderly. We believe healthcare presents a huge repositioning opportunity.

As mentioned, the retail sector has experienced significant consolidation and repricing for much of the past decade. Should 2023 be dominated by recession, we expect the sector to continue to be buffeted by economic headwinds, leading to some modest falls in values and further adjustments in rents. That said, while much of 2023 is likely to be a period of reconsolidation, we expect to see good value further out once the sector eventually stabilises.

Focus on the long term

During periods of economic uncertainty, we like to remind property investors to think beyond the cycle. While capital values will fall over the next few months, there are long-term, investible trends that investors can look to capitalise on. Greater demand for higher quality, attractive and sustainably built spaces will increasingly drive occupational decisions especially for office occupiers and determine where investors choose to place their money. Many logistic and industrial companies (and retailers with a strong multi-channel approach) should continue to enjoy the structural advantages presented by e-commerce, while the life sciences and healthcare sectors will benefit from longer-term secular trends. These factors give us greater optimism for the latter half of 2023 and the beginning of 2024.

> “While much of 2023 is likely to be a period of reconsolidation, we expect to see good value further out once the sector eventually stabilises.”

Figure 2: Multi asset historic returns (% pa)

Source: Property from MSCI UK Monthly, August 2022 and UK Gilts (FTSE A All Stocks Gilt), Equities (UK FTSE All Share Index TR), Cash (IBA Libor 1w), and Commodity (Bloomberg Commodity Index GBP) from Refinitiv DataStream 10th October 2022.

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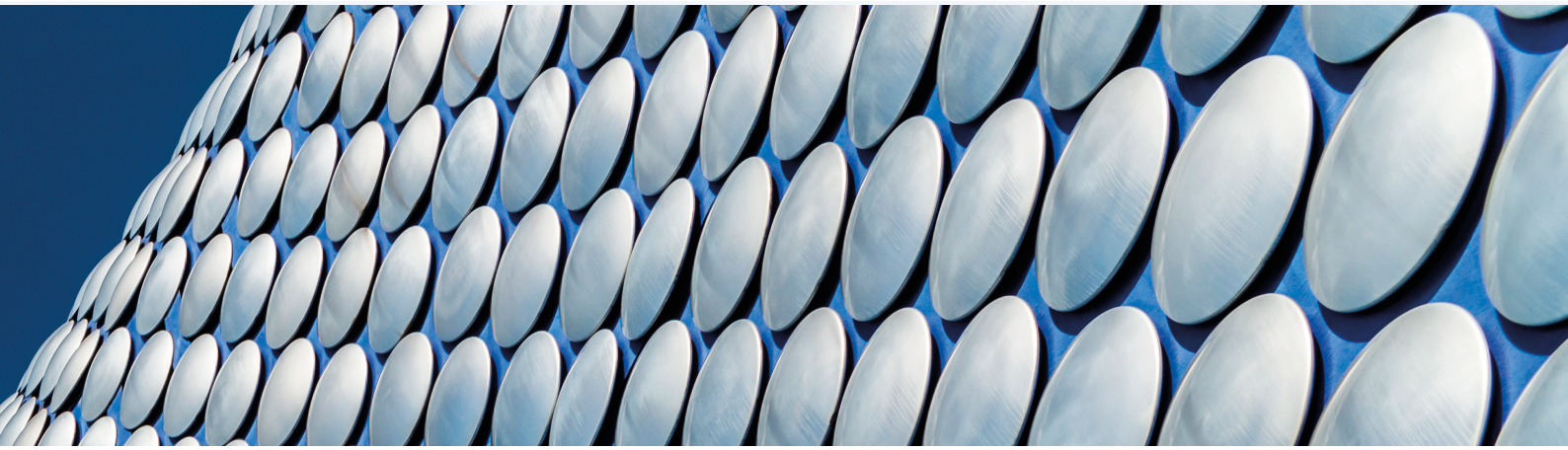

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