Property outlook: Buyers' market?

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As 2023 draws to a close, the outlook for the property sector appears gloomy to many investment commentators. We acknowledge that there are several factors posing significant challenges to real estate investors, but we also believe that these generate attractive opportunities for the best to generate long-term value. Some of these factors – such as rising interest rates – are broad macroeconomic trends affecting multiple asset classes, but some are more specific to – and nuanced within – the property market.

Rising interest rates

Rising interest rates are a clear challenge for almost all asset classes. From a returns perspective, the higher risk-free rate will always make some investors move to less risky assets. Real estate markets are more sensitive to changes in the interest rate than other sectors. The fact that many buyers rely on debt financing is crucial when considering how interest rates affect capital values. As the cost of debt increases, the expected return for final investors also increases, which then pushes prices down. In this environment, being a 'fully funded' buyer can be a huge advantage – allowing a longer-term view rather than one driven by the cost of debt.

The drive to net zero

The shift to net zero carbon is a new challenge in this cycle. The last major rise in interest rates happened before the global financial crisis. Back then, understanding the carbon footprint of a building was a relatively minor concern.

Today, climate change is a key issue for tenants, investors, and policymakers. Consequently, it is a sizeable consideration in most property decisions: evaluating the lifecycle carbon footprint of a building – its embedded carbon, the energy and water efficiency, the potential for on-site renewable energy generation and end-of-life carbon implications – are now a standard part of the development, acquisition, and management process. Investors are placing as much emphasis on impact and sustainability as financial returns in their investment decisions.

The office sector is a clear example of how this can affect value. The cost of (re)developing or retrofitting office stock for a net zero carbon world varies widely – generally speaking, the older the building, the higher the cost. By itself, uncertainty around the capex requirement would lower prices, but how companies use offices is evolving too. In a post-Covid world, most companies are not uniformly requiring employees to be back in the office five days a week. However, more are requiring more office attendance, whether that is three, four or five days a week. It's true of the public sector and the private sector too, with some of the very biggest businesses now linking promotions to attendance.

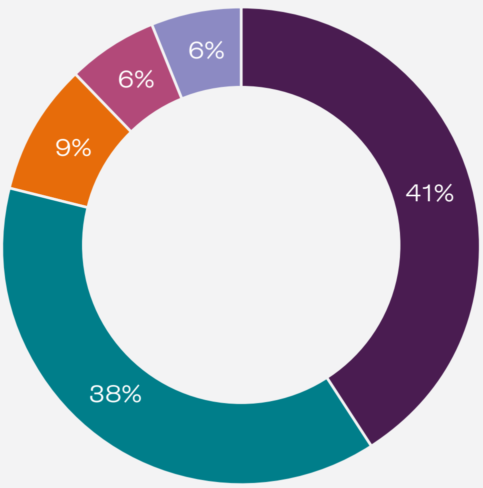
> "The cost of (re)developing or retrofitting office stock for a net zero carbon world varies widely."

As occupiers respond to this, office quality is now of paramount importance. High quality, amenity-rich space with strong green and wellness credentials are a major part of incentivising people to return to the office. Modern, well-located, prime office space continues to let well and is an investible proposition. However, demand in markets outside of large cities and dynamic innovation clusters has reduced sharply.

One bright spot is the curtailment in development due to the higher costs of debt and construction. This will lead to a supply crunch which should underpin rental growth for prime stock. We would expect lower quality space to struggle.

Our office strategy reflects these trends. We will continue to focus on creating and acquiring best-in-class stock in core markets such as London, Birmingham, Bristol, Manchester, Oxford and Cambridge.

Impact and sustainability are becoming as important as financial returns in my organisation's investment decision making



Source: KPMG, survey of global real estate investors at the RE-Invest summit at MIPIM in March 2023

The need to diversify beyond traditional sectors

Historically, a property portfolio would have high weightings in offices, industrial (with logistics an increasing element in recent years), and retail. We expect to be able to find value in these sectors going forward, even with the cyclical headwinds and tailwinds that these sectors face.

However, economic, regulatory, and societal changes are also shifting trends in real estate that is reflected in greater investment into alternative sectors. Three areas that we think property investors should consider are life sciences, Build-to-Rent (BTR) and care homes.

The UK has a strong competitive edge in life sciences, a rapidly expanding field. The 'golden triangle' of London, Cambridge and Oxford is the hub of this sector, where life sciences firms benefit from the presence of highly skilled graduates and cutting-edge research.

Compared with similar clusters in the US, which are supported by a significant stock of lab space, the UK still has plenty of room for growth.

Private rental residential is something many people are more aware of due to the popularity of buy-to-let over the past two decades. However, tax changes and rising interest rates mean it is no longer particularly advantageous for a private landlord. In both owner-occupier market and the private rented sector (PRS), there is a fundamental undersupply. If we look at the PRS sector, some stock is low quality: currently 23% of private rented homes do not meet the Decent Homes Standard, creating an opportunity for professional landlords to offer an improved product. We believe that BTR is a better option for both investors and tenants: we can create high quality homes at scale and cater to the demand of a growing rental population that is not well served by the current market. It is one with significant growth opportunities in the UK.

Finally, we would highlight care homes. We all know that the UK population is aging, but again, a high proportion of existing care home capacity is not really suited to how we age. Only 28% of homes have a wet room, while 81% of homes are older than 20 years and 40% of homes are converted from other uses and many will be outdated, according to research by Knight Frank. Preferences have changed, and residents expect more from a care home including high quality design environment and amenities.

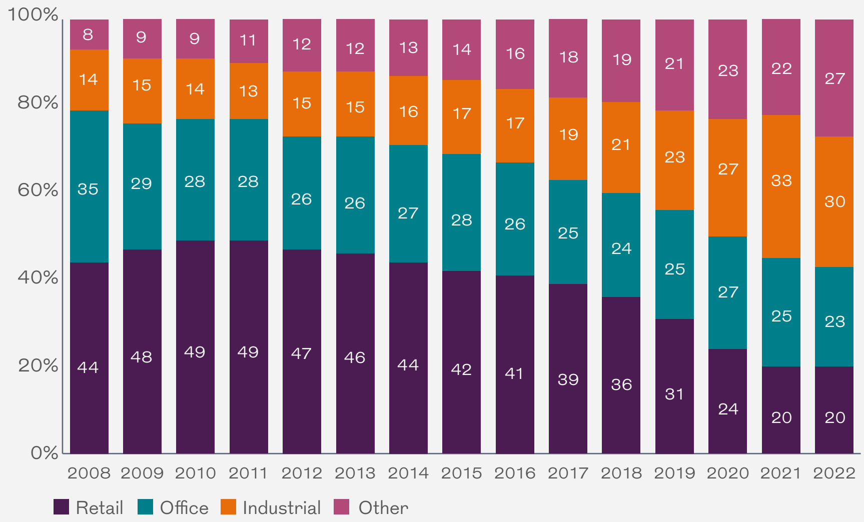
We prefer to partner with developers or operators who can build and run care homes that offer a longer and better quality of life for each tenant and align with our goals of net zero and environmental sustainability.

> “We can create high quality homes at scale.”

Positive sentiment

Property asset managers are often optimistic about their asset class. We have seen significant falls in value in 2022 and see a continuation of this trend for some sectors – especially offices – in 2023. That said, the capital value cycle is finely poised as we head into 2024. While there are plenty of areas where we would exercise caution – such as secondary stock in the office and industrials sectors – we are still in the early stages of seeing huge growth in new sectors that we feel could generate very attractive long-term returns for investors and help create solutions to some of the long-term issues facing us today.

Total capital value UK by broad sector, 2008-22



Source: MSCI UK Annual Property Index
Percentages subject to rounding.

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