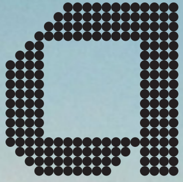


For professional investors only, in Switzerland for Qualified investors only – not for use by retail investors or advisers.

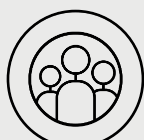
UK Real Estate Market Outlook

Q4 2022

abrdn.com

"The focus for this stage in the cycle should be to reduce risk in portfolios wherever possible"

Executive summary



- GDP growth surprised to the downside in August 2022 as the economy shrank by -0.3% in the month, suggesting that underlying momentum within the UK economy had continued to slow. With September's GDP also set to be hit by the further bank holiday for the Queen's funeral, the risk that the economy will post two consecutive quarters of contraction has risen.
- The Bank of England is expected to continue its hiking cycle in a bid to quell inflation and help re-establish its credibility. However, the UK government's 'u-turns' on fiscal policy may result in the terminal rate ending up slightly slower than previously forecast. Although the timing and speed remains uncertain at this time, we then expect the Bank of England to begin a cutting cycle in late 2023 in a bid to pull the UK economy out of recession.
- Transaction volumes fell in Q3 2022 to £10bn according to Real Capital Analytics as weaker sentiment spread throughout the UK real estate market. Rising debt costs, predominantly driven by swap rates moving out considerably since the start of the year, has proven to be a catalyst for a repricing in UK real estate and, along with rising government bond yields, has caused many investors to step back from the market.
- Q3 volumes, when compared to the same period in 2021, were down approximately 50% and, when compared to the Q3 ten year average, volumes were also down by 30%. Looking forward, we expect transaction volumes to see further falls into Q4 and early 2023 as investor concerns persist.
- UK real estate had a strong start to the year and performance was positive, with all property reporting a total return of 7.8% over the first six months of the year according to the MSCI Quarterly Index. However, the outlook has deteriorated and 2022 will be characterised as a year of two halves as a weaker macroeconomic environment weighs on the real estate market.
- UK real estate is now in the midst of a broad repricing, and performance for the remainder of the year and into 2023 will turn negative. This trend is already apparent as all property total return fell by -2.3% in September 2022, resulting in Q3 2022 total return numbers turning negative at -4.1%, the weakest quarterly performance recorded since May 2009 according to the MSCI Monthly Index.
- Whilst the sector impacts of a real estate repricing will be asymmetric, capital value declines are expected across all sectors and the pricing impact is expected to be greater and more prolonged on secondary assets which do not meet current occupational and investor demand.
- Construction cost inflation has been rising throughout 2022 and has resulted in the number of development projects falling across most sectors, as investors struggle with the financial viability of new developments. This will serve to further reduce the supply of UK real estate, which already remains more muted than at this stage in previous cycles.
- The focus for this stage in the cycle should be to reduce risk in portfolios wherever possible and protect income profiles. A repricing of UK real estate should provide opportunities in the medium term and so it is important to position portfolios appropriately in order to access the full benefit of a future recovery in real estate performance.
- Given the current energy crisis and drive towards net zero, integrating ESG strategies into investment decision making is paramount to ensuring assets are future fit and ready for a recovery in real estate performance.

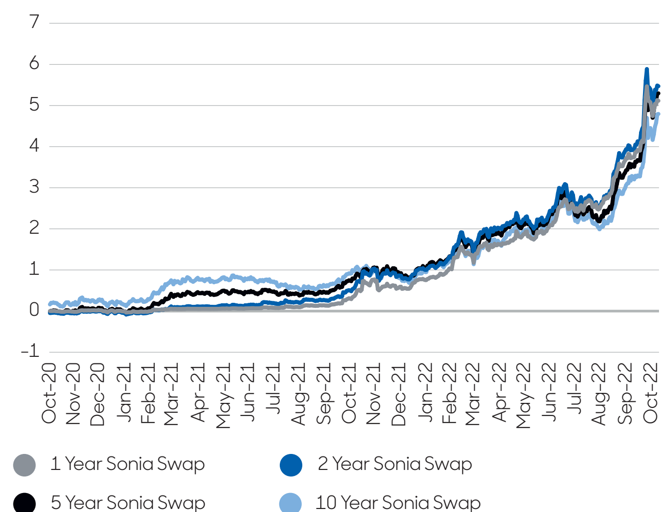
Economic Outlook

- Despite a positive start to the year, the UK economy is now facing multiple headwinds as a cost of living crisis and financial market volatility weigh on UK economic performance.
- UK Gross Domestic Product (GDP) declined over the second quarter of the year as expected, as activity fell by 0.6% in June largely as a result of the extra jubilee bank holiday. However, GDP growth surprised to the downside in August 2022 as the economy shrank by -0.3% in the month, suggesting that underlying momentum within the UK economy had continued to slow.
- With September's GDP also set to be hit by the further bank holiday for the Queen's funeral, the risk that the economy will post two consecutive quarters of contraction has risen. A revision of GDP data by the ONS also shows that the UK economy remains below its pre-pandemic peak, the only G7 member to remain in such a position. Beyond these various bank holiday quirks, the economy looks set to enter into a recession one way or another.
- UK financial markets have experienced a period of significant volatility in the wake of the UK government's erratic fiscal policies, which ultimately resulted in Kwasi Kwarteng being removed as Chancellor.
- Market turmoil began in late September 2022 as financial markets reacted negatively to the former Chancellor's 'mini budget,' which amounted to an unfunded fiscal loosening of approximately £45 billion per year.

“Imbalances in the UK economy mean further monetary policy tightening is to be expected”

- This announcement precipitated a fall in the Pound (GBP) of around 10% against the US Dollar (USD) and a large sell off in the UK gilt market, with the UK 10 year gilt yield peaking at 4.5% in late September 2022, the highest level since 2008. This forced the Bank of England to intervene in the gilt market in an effort to restore orderly market functions and protect exposed pension funds.
- The later ‘u-turn’ on the plan to scrap the 45% tax rate for top earners was welcomed, but failed to settle markets and the combination of market moves acted as a clear signal of a loss of confidence amongst investors.
- Following pressure from both financial markets and her own MPs, the Prime Minister subsequently announced a further ‘u-turn’ on her corporation tax policy and removed the Chancellor, a long-time friend and ally, from government. The appointment of Jeremy Hunt as Chancellor looks to be an attempt to placate more moderate members of the Conservative Party, as the Prime Minister tries to suppress further party unrest which may imperil her premiership.
- The new Chancellor proceeded to reverse almost all the tax measures announced by his predecessor, including a scaling back of the energy price support scheme, which helped to settle markets somewhat; however, we expect the risk premium demanded on UK assets to remain elevated relative to peer markets for some time.
- Despite the change of fiscal direction, imbalances in the UK economy mean further monetary policy tightening is to be expected. UK inflation, as measured by the consumer price index (CPI), rose to 10.1% in September 2022 from 9.9% the month previous, slightly ahead of consensus and equalling a 40 year high. Inflation is set to rise further in October 2022 to around 10.5% despite the government’s energy price cap.
- As a result, over the next few meetings, the Bank is expected to continue its hiking cycle in a bid to quell inflation and help re-establish its credibility. The UK government’s ‘u-turns’ on fiscal policy however, may result in the terminal rate ending up slightly slower than previously forecast. Although the timing and speed remains uncertain at this time, we then expect the Bank of England to begin a cutting cycle in late 2023 in a bid to pull the UK economy out of recession.
- A UK recession has now become more likely, and the UK economy is forecast to enter a recession in Q4 2022. Whilst this had been the base case scenario previously, the market volatility and political uncertainty created by incoherent government policy now puts the likelihood of a much sharper drop in UK activity higher.

Chart 1: SONIA swap rates have increased over the course of the year and was the catalyst for a repricing in the UK real estate market. The Government’s ‘mini budget’ exacerbated this rise.



Source: Refinitiv, abrdn, October 2022.

Occupier Trends

- From an occupational perspective, demand has remained robust for the industrial sector up to this point and take up over the first half of the year was above the 10 year H1 average. However, rising costs and signs of weaker demand can initially be seen by the rising UK industrial vacancy rate which, while remaining near historic lows, has risen to 3.4% according to CoStar. Tight supply and limited new development should allow for rental value growth in the prime end of the sector, albeit at more normalised levels.
- Within the office sector, occupational demand has historically been closely correlated with GDP growth and, given the poor economic outlook, office take up levels are expected to fall. This will be more patently felt in the secondary end of the market, while demand for best in class assets should prove more resilient. Tight supply of best in class accommodation should insulate Grade A rental values, but a decline in secondary office rents is to be expected.
- The cost of living crisis and subsequent squeeze on household disposable incomes will be most acutely felt in the retail sector, and particularly within discretionary led retail schemes. While fiscal support measures will likely soften the blow, data already suggests that consumers are cutting back on non-essential spending and seeking savings wherever possible. As a result, occupational demand from discretionary retailers is

"Investment into the alternatives sector has seen growth, with over £15bn already transacting YTD 2022"

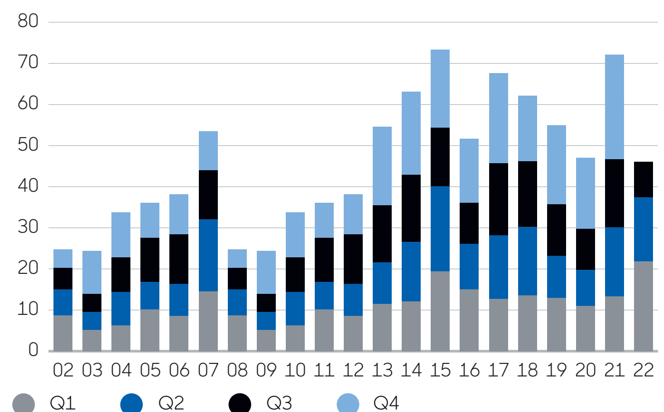
likely to fall whilst those retailers deemed to be essential (such as budget supermarkets) will perform better in this environment. DIY and housing related retailers are also likely to face tougher trading conditions in the period ahead as the UK housing market comes under pressure. The prospect for rental growth in the retail sector is limited.

- As a result of rising costs and mortgage rates, the PRS (private rented sector) is expected to see rising demand over the next 12-18 months. This is likely to help support rental value growth in the residential sector, but ensuring rents remain affordable will be paramount in securing a stable income profile.
- Overall, the direction of occupier demand is uncertain at this point and will be heavily dictated by macroeconomic factors; however, it is clear that a greater focus on occupational strength is paramount as we move into a more challenging economic environment.

Investment Trends

- Transaction volumes fell in Q3 2022 to £10bn according to Real Capital Analytics as weaker sentiment spread throughout the UK real estate market. Rising debt costs, predominantly driven by swap rates moving out considerably since the start of the year, has proven to be a catalyst for a repricing in UK real estate and, along with rising government bond yields, has caused many investors to step back from the market causing liquidity to reduce as a result. Increased market volatility in September 2022 has also ensured that investor conviction on asset pricing levels has fallen.
- The speed of this change in sentiment is characterised by the fact that H1 2022 transaction volumes were the second strongest since 2002 and totalled just under £40bn. The strong performance in the first half of the year is likely to support transaction volume figures for the year, disguising some of the market weakness in Q3/Q4 '22.
- Q3 volumes, when compared to the same period in 2021, were down approximately 50% and, when compared to the Q3 ten year average, volumes were also down by 30%. Looking forward, we expect transaction volumes to see further falls into Q4 and early 2023 as investor concerns persist.
- Despite a record breaking Q1 2022, during which over £7.1bn transacted in the industrial sector, transaction volumes have been falling and a total of £2.5bn transacted in Q3 2022, down -64% from Q1. Investor sentiment towards the industrial sector has been falling, primarily as a result of the tightening margin between the risk free rate and low industrial yields, and this trend is anticipated to continue.
- Transaction volumes have also fallen in the office sector, with £3.3bn having transacted in Q3 2022, 41% below the Q3 10 year average. Office transactions in Central London once again drove the market and accounted for 59% of total Q3 volumes. However, the sale of the uncompleted Deutsche Bank HQ in September 2022 for £809m skews the quarterly figures significantly.
- Retail volumes have also seen steady declines since the start of the year, whereas investment into the alternatives sector has seen growth, with over £15bn already transacting YTD 2022, ahead of the calendar year total in 2020 and only 6% behind that in 2021. Investment into the residential sector is the largest contributor to this rise with over £11bn transacting so far this year, already a record year according to RCA data and 10% ahead of the previous record set in 2020.

Chart 2: Transaction volumes have fallen in Q3, despite a very strong start to the year, and the outlook is more negative for Q4 2022.



Source: Real Capital Analytics, abrdn, October 2022.

Performance Outlook and Risk Tolerance

- UK real estate had a strong start to the year and performance was positive, with all property reporting a total return of 7.8% over the first six months of the year according to the MSCI Quarterly Index. However, the outlook has deteriorated and 2022 will be characterised as a year of two halves as a weaker macroeconomic environment weighs on the real estate market.

"A repricing of UK real estate should provide opportunities in the medium term"

- UK real estate is now in the midst of a broad repricing, and performance for the remainder of the year and into 2023 will deteriorate. This trend is already apparent as all property total return fell by -2.3% in September 2022, resulting in Q3 2022 total return numbers turning negative at -4.1%, the weakest quarterly performance recorded since May 2009 according to the MSCI Monthly Index.
- Capital value declines have been the principal driver in slowing performance as yields have begun to move out, particularly in lower yielding areas of the market. For example, industrial capital growth fell by -8.1% in Q3 2022, with south east industrials reporting the steepest monthly capital value decline since December 2008.
- Whilst the sector impacts of a real estate repricing will be asymmetric, capital value impacts are expected to be greater on secondary assets which do not meet current occupational and investor demand.
- Construction cost inflation has been rising throughout 2022 and has resulted in the number of development projects falling across most sectors, as investors struggle with the financial viability of new developments. This will serve to further reduce the supply of UK real estate, which already remains more muted than at this stage in previous cycles.
- We expect the repricing of UK real estate will act as a similar adjustment to that experienced by other asset classes over Q3 2022. However, the income resilience which UK real estate should provide as a result of the current positive occupational environment, is likely to help soften the impact on performance through the anticipated economic downturn.
- The focus for this stage in the cycle should be to reduce risk in portfolios wherever possible and protect income profiles. A repricing of UK real estate should provide opportunities in the medium term and so it is important to position portfolios appropriately in order to access the full benefit of a future recovery in real estate performance.

Investment Themes

- It is clear that the UK investment market has cooled considerably over the course of Q3 2022 as investors took a more risk off approach towards UK real estate in response to a volatile macroeconomic environment. A fall in capital values, particularly in the prime end of the market, has become evident and most areas of the market have seen outward yield shifts according to CBRE. Investors are expected to continue to take a risk off approach and market liquidity for secondary assets is now weaker than earlier in the year.
- The industrial sector has driven the market over the previous 24 months but is now at the forefront of a change in real estate fortunes as the margin between prime industrial yields and the risk free rate has narrowed considerably. This, and the rising cost of debt, has resulted in yields shifting by between 100 – 125bps since June 2022. Further capital value declines are expected but the medium to long term fundamentals for the sector remain well balanced at this time.
- The outlook for the office sector has also deteriorated. Best in class assets will prove more resilient, whereas secondary assets are under significant pressure and are expected to see capital value declines as occupier and investor demand narrows on assets with strong ESG and wellness credentials.
- The PBSA and healthcare sectors, while not immune from the weaker environment, will benefit from thematic tailwinds and are expected to outperform the wider market over the next 12 months. The PBSA sector in particular has often run countercyclical to economic downturns, with UCAS data indicating increasing demand for university places in the 2022/2023 academic year.
- Looking forward, best in class assets are likely to prove more resilient in a weaker macroeconomic environment and a focus on ESG considerations is becoming ever more important to both occupiers and investors. As a result, and given the current energy crisis and drive towards net zero, integrating ESG strategies into investment decision making is paramount to ensuring assets are future fit and ready for a recovery in real estate performance.

The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested. Real estate is a relatively illiquid asset class, the valuation of which is a matter of opinion. There is no recognised market for real estate and there can be delays in realising the value of real estate assets The information contained herein including any expressions of opinion or forecast have been obtained from or is based upon sources believed by us to be reliable but is not guaranteed as to the accuracy or completeness. Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use abrdn*. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates. * abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 3 October 2022)

United Kingdom (UK): abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa
[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions.

Belgium, Cyprus, Denmark, Finland, France, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany:** abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland:** abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM"):** Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa:** Aberdeen Asset Managers Limited ("AAML"). Registered in Scotland (SC108419) at 10 Queen's Terrace, Aberdeen, AB10 1XL AAML is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. AAML operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

Asia-Pacific
Australia and New Zealand: abrdn Australia Limited ABN 59 002 123 364, AFSL No. 240263. In New Zealand to wholesale investors only as defined in the Financial Markets Conduct Act 2013 (New Zealand). **Hong Kong:** abrdn Hong Kong Limited. This document has not been reviewed by the Securities and Futures Commission. **Malaysia:** abrdn Malaysia Sdn Bhd, Company Number: 200501013266 (690313-D). This document has not been reviewed by the Securities Commission of Malaysia. **Thailand:** Aberdeen Asset Management (Thailand) Limited. **Singapore:** abrdn Asia Limited, Registration Number 199105448E.

Americas
Brazil: abrdn Brasil Investimentos Ltda. is an entity duly registered with the Comissão de Valores Mobiliários (CVM) as an investment manager. **Canada:** abrdn is the registered marketing name in Canada for the following entities: abrdn Canada Limited, abrdn Investments Luxembourg S.A., abrdn Private Equity (Europe) Limited, abrdn Capital Partners LLP, abrdn Investment Management Limited, Aberdeen Standard Alternative Funds Limited, and Aberdeen Capital Management LLC. abrdn Canada Limited is registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada as well as an Investment Fund Manager in the provinces of Ontario, Quebec, and Newfoundland and Labrador. **United States:** abrdn is the marketing name for the following affiliated, registered investment advisers: abrdn Inc., Aberdeen Asset Managers Ltd., abrdn Australia Limited, abrdn Asia Limited, Aberdeen Capital Management LLC, abrdn ETFs Advisors LLC and Aberdeen Standard Alternative Funds Limited.

For more information visit abrdn.com

abrdn.com

0001349179 | 1022 | DH: GB-131022-182114-14