Real Estate House View
United Kingdom

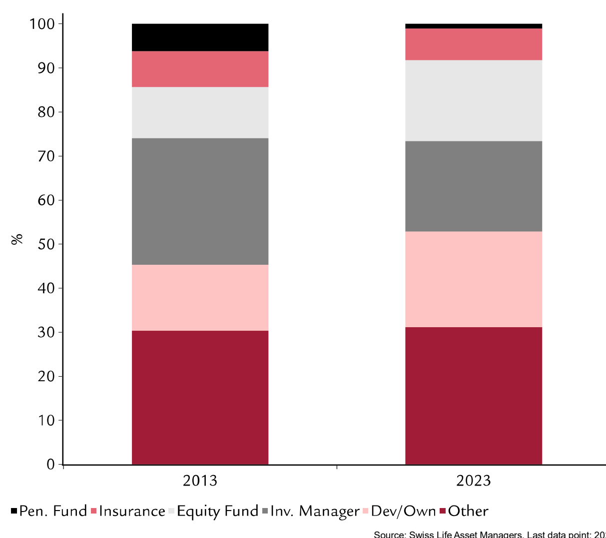
SwissLife Asset Managers

First half-year 2024

Key takeaways

- **Good news on the horizon:** As inflation edges closer to the Bank of England's 2% target, the possibility that interest rates have peaked becomes more likely. Although they may stay 'higher for longer', this is good news for real estate valuations and should support investment activity into the new year.
- **Super prime offices still showing resilience:** Demand for prime offices has been supported by the 'flight to quality', and a lack of super-prime stock may provide attractive refurbishment opportunities.
- **Normalising demand for industrial & logistics:** Despite the news of cooling occupier demand for industrial and logistics, long-term data suggests activity is normalising from post-pandemic highs, as opposed to reflecting a market-related slowdown, and good quality supply is expected to remain limited.
- **Retail not yet out of the woods:** Whilst falling inflation should ease current cost pressures, elevated debt costs will continue to limit disposable incomes, and therefore, sales volumes. Food, convenience, and value retail formats are expected to prove most resilient.
- **Investors consider their asset-allocations:** Owing to the new environment of higher interest rates and gilt yields, property investors are considering their allocation to real estate and the sources of active capital are changing. More investment stock is expected from those looking to exit or facing refinancing pressures, which should present investment opportunities in 2024.
- **A shift to active strategies:** Another implication of the change in macro-economic environment and active capital is demand for higher return strategies. Property managers will need to turn their attention to a more active management approach to deliver income growth and outperformance.

Chart in focus



Based on the view that interest rates and therefore gilt yields are unlikely to return to their cyclical lows, the outlook for real estate investment is changing. In addition to the active management styles that will be needed to drive outperformance of property portfolios, the composition of committed capital is also changing. Specifically, defined benefit corporate pension funds are exiting the market as they are now better able to meet their liabilities through fixed-income and other liquid investments. Instead, insurance companies, family offices and private equity funds are reviewing real estate opportunities but seeking higher returns from active management strategies. As investors rebalance their investment allocations, this is expected to result in buying opportunities during 2024.

The inflation/growth mix as the macroeconomic background for investment activity is set to improve in 2024. Yet, fiscal policy is likely to provide headwinds to the economic recovery as the government plans to cut spending and has started to scale back large infrastructure projects such as HS2. Monetary policy is still holding back economic activity as the Bank of England's inflation target remains out of reach. Into 2024, as the inflation outlook improves, policy rate cuts are likely to result in easier financial conditions. Coupled with rising real wages supporting private consumption, lower interest rates are expected to revive animal spirits and result in rising investment spend by the private sector. However, geopolitical hostilities remain a key downside risk to this otherwise improving picture.

A shift to a new environment

Over the year to September, the Bank of England raised the base rate by 175 basis points, from 3.50% to its current level, 5.25%. Rates have been increasing from their cyclical lows since December 2021, when they had remained below 1.00% since 2009. Following the consistent communication that rates will say 'higher for longer', investment strategists are now considering the possibility that long-dated gilts will not return to average levels of the past decade. This has had a negative impact on valuations. Accordingly, investment volumes have been in decline for six consecutive quarters, reaching GBP 7.9bn in Q3 2023, the lowest level in over ten years. Valuations have been adjusting since June 2022, declining over the period by an average of 23.7% (to November 2023). This should allow buyers' price aspirations to begin to align with sellers' expectations and support investment activity.

Offices: Finding opportunities

The flight to quality has remained a key theme, as occupiers remain focused on attracting their staff back into the office. Consequently, take-up has been resilient in the face of slowing economic growth. This is providing some competitive tension for prime rental growth, particularly in the West End, where record rents are being achieved. A lack of supply of high-quality grade A, green office buildings in London and key regional cities may lead to some interesting opportunities for landlords looking for double-digit returns by refurbishing buildings in strong thematic locations.

Industrial & logistics: normalisation, not slowdown

The industrial and logistics sector has not been immune to the slowdown in activity throughout 2023, in both the investment and occupier markets. Investment volumes over the year to September were down 45.5%, reaching GBP 8.7bn, and take-up activity was also broadly half the levels seen in 2022. Yet, this illustrates a moderation from the post-pandemic 'boom', rather than a slowdown; investment volumes over the year to September were 5% above the long-term pre-pandemic average. In addition, a constrained development pipeline is expected to suppress vacancy rates next year, although supply of second-hand space may increase as occupiers become more discerning. Going into the new year, demand will be supported by businesses efforts to strengthen supply chain resilience by holding greater levels of inventory. As such, we expect moderate prime rental growth for under-supplied regional markets.

Pressures persist for retail

Consumer price inflation has been falling steadily from its peak, retreating to +3.9% in November 2023 compared to the same month last year. Although this has eased price pressures somewhat, households still face significant financing burdens which will limit any recovery in retail sales volumes, which are currently down 30% on the year. High street retail remains plagued with store vacancies. However, some segments have shown resilience, namely supermarkets and retail parks, particularly those located in mixed-use, convenient locations, and able to service online orders.

Active management essential for performance

A higher gilt yield environment means that real estate performance will unlikely be supported by yield-driven capital growth. Instead, investment managers should adopt active management strategies to drive income return and income growth. Not only does this include increasing exposure to operational real estate formats, but also identifying opportunities to drive income through asset management initiatives.

Chart 1: Quarterly investment volumes, UK Real Estate

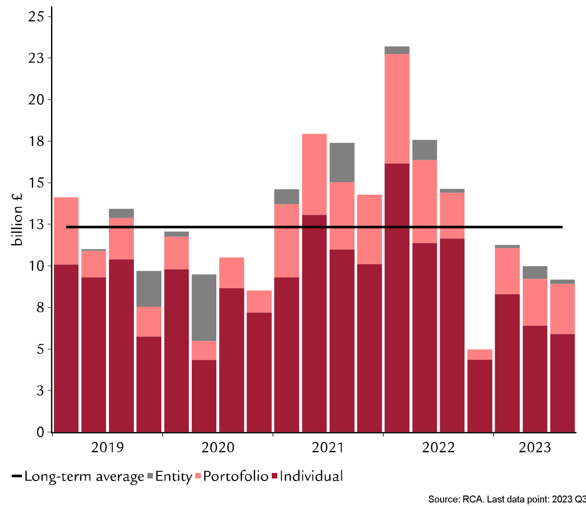
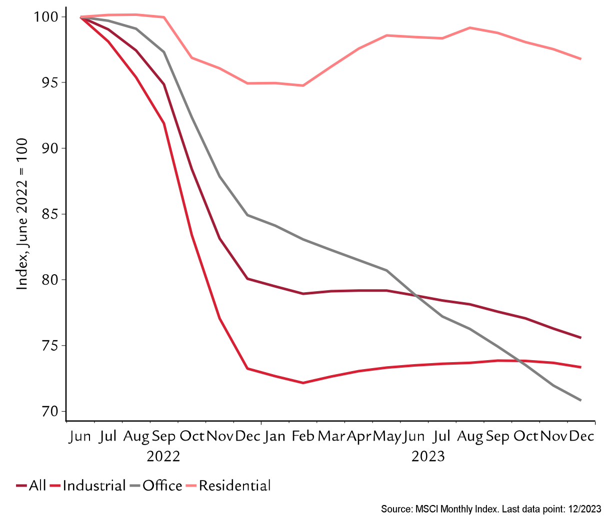


Chart 2: Capital value performance since June 2022



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