Intelligent Investment

Mid Year Market Outlook 2023

REPORT

UK

REAL ESTATE

CBRE RESEARCH

Introduction

We entered 2023 under the spectre of a moderate recession, with high inflation and rising interest rates putting downward pressure on growth. And the UK economy remains under these clouds, albeit it has so far avoided a recession. As expected, the environment has been more challenging for the real estate sector due to higher debt costs which has resulted in lower investment volumes. Considering this complex backdrop, it is not surprising that each of our sectors have faced their own challenges, with some sectors performing better than others.

To assess how the year has progressed so far and the prospects for the remainder of the year, we present our Mid Year Outlook Update. Here, we review our 2023 Real Estate Market Outlook and consider:

- What we said would happen,
- What has happened, and
- What will happen next

Read on to explore our full analysis.

Contents

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Economy

01

ECONOMY

What we said would happen

- The economic downturn evident in the latter half of 2022 would continue into the new year, and we expected a moderate recession in 2023. This was in part driven by the inflationary backdrop and the policies in place to bring inflation back to its target level.
- Unemployment would rise from a historically low level, and job vacancies would decrease. Wage growth would not be able to keep up with inflation until late 2023, eroding consumer purchasing power.
- Having peaked, inflation would slowly recede throughout 2023. This would reflect a reconfiguration of supply chains, falls in commodity prices, and weaker consumer demand.
- During 2023, the Bank of England would continue to raise interest rates, which would be likely to peak at around 4.5%. As inflation began to cool, rates would begin to decrease, declining gradually to a ‘new normal’ of about 2% from 2026 onwards.
- Long-term interest rates would peak at 3.9% in early 2023 and slowly fall to 3% by the end of 2025. This decline partly reflected the movement expected for base rates, as well as by lower public spending and higher taxes, as outlined in the 2022 Autumn Statement. It would also follow the trajectory we expect in long-term global rates.

01

ECONOMY

What has happened

- Despite continued high inflation and rising interest rates, UK GDP grew by 0.1% in the first quarter of 2023. This partly reflects improving consumer and business confidence.
- Headline inflation declined to 8.7% in April and May, down from its peak of 11.1% in October. However, core inflation has remained stubbornly high, underlining the danger that high inflation remains persistent in the UK. The Bank of England has continued to increase rates in the first half of 2023; the rate has increased by 100bps since the start of the year.
- The labour market has remained relatively tight, although unemployment and vacancies have risen. At 3.9%, unemployment is still comparatively low, which has driven a healthy growth in nominal pay. Vacancies are still above a million, significantly higher than pre-pandemic numbers but below the 2022 peak.
- Increases in current and expected short-term interest rates have caused long-term interest rates to increase. The 10-year gilt yield has risen by over 50bps since the beginning of the year, from around 3.70% to around 4.50%. The credit environment is considerably tighter than at the end of 2022.

01

ECONOMY

What will happen next

- Higher interest rates, the squeeze on real disposable incomes and international headwinds means that the UK economy will be broadly flat in 2023 and may even go into recession. The prospects are better for 2024 as inflation comes under control. Lower inflation and restored consumer purchasing power in 2024 will help to drive recovery. Still, the lagged effect of interest rate rises will continue to drag on growth. We project GDP to grow by a modest 0.9% in 2024 and by 2.2% in 2025.
- We expect inflation to continue its slow decline and will end the year at 4.4%. It will continue this trend and get back to the target rate of 2% in early 2025.
- The Bank of England is projected to increase interest rates to a peak of 5.75% in Q4 2023. From early 2024, we expect the Bank to begin cutting rates, as inflation declines and priorities shift to supporting growth. Long-term interest rates will peak in the current quarter (Q2 2023) and then decline to around 3.75% by the end of 2023. By the end of 2025, they will settle at 2.50-3.00%, representing a new normal interest rate range.

02

Investment

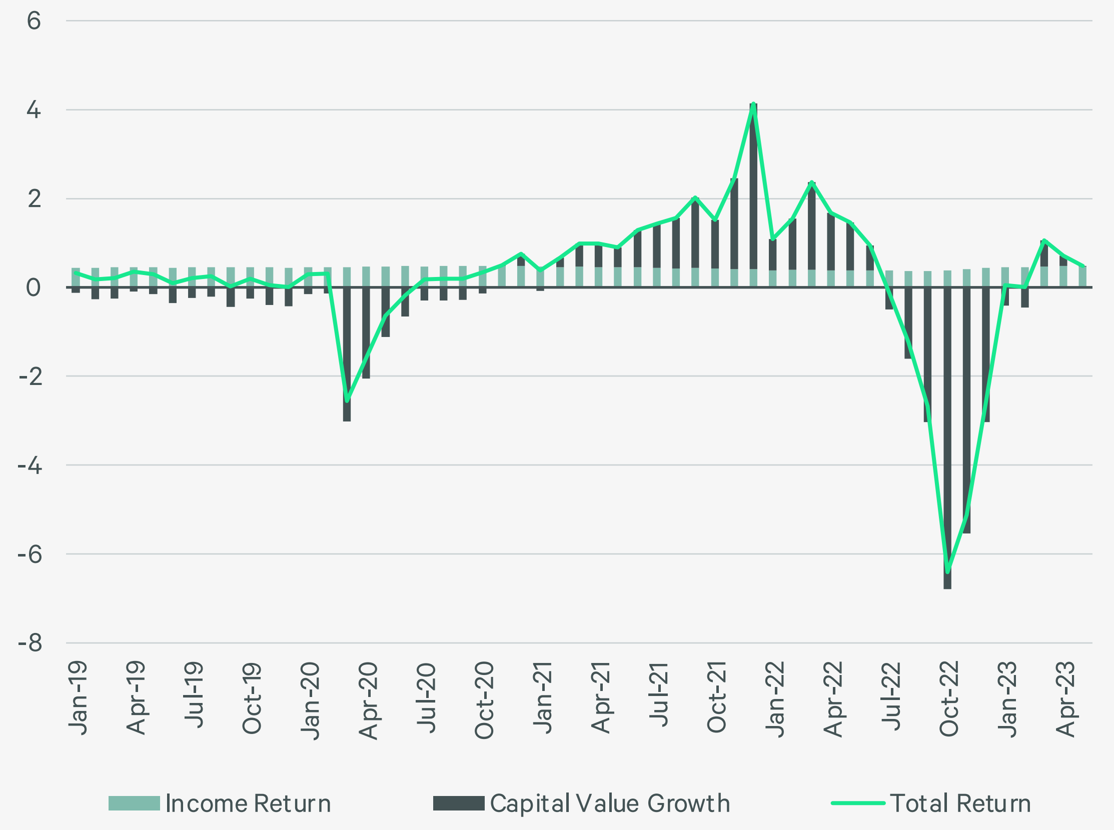
02

INVESTMENT

What we said would happen

- Real estate prices would stabilise in 2023. Real estate yields would not rise to the same extent as Government bond yields and going forward, the spread over gilt yields would be tighter than in the last decade
- Income returns, rather than capital growth, were likely to drive commercial real estate returns. This meant more focus on asset management, and on the financial performance of occupiers as key factors that affect income and occupancy at the asset level
- The performance of other asset classes would affect capital flows to real estate in 2023, as multi-asset investors would be underweight in bonds and overweight in real assets, based on how values moved throughout 2022
- Transaction volumes would be lower in 2023. Still, constraints impacting some investors mean opportunities for others, and private capital awaiting deployment could have been one of the beneficiaries.
- The debt market would remain resilient as UK real estate is less leveraged than in the Global Financial Crisis and features a wider range of lenders. Yet higher debt costs, together with lower asset values, would pose challenges for investors that need to refinance next year.

Figure 1: UK commercial real estate month-on-month returns, %



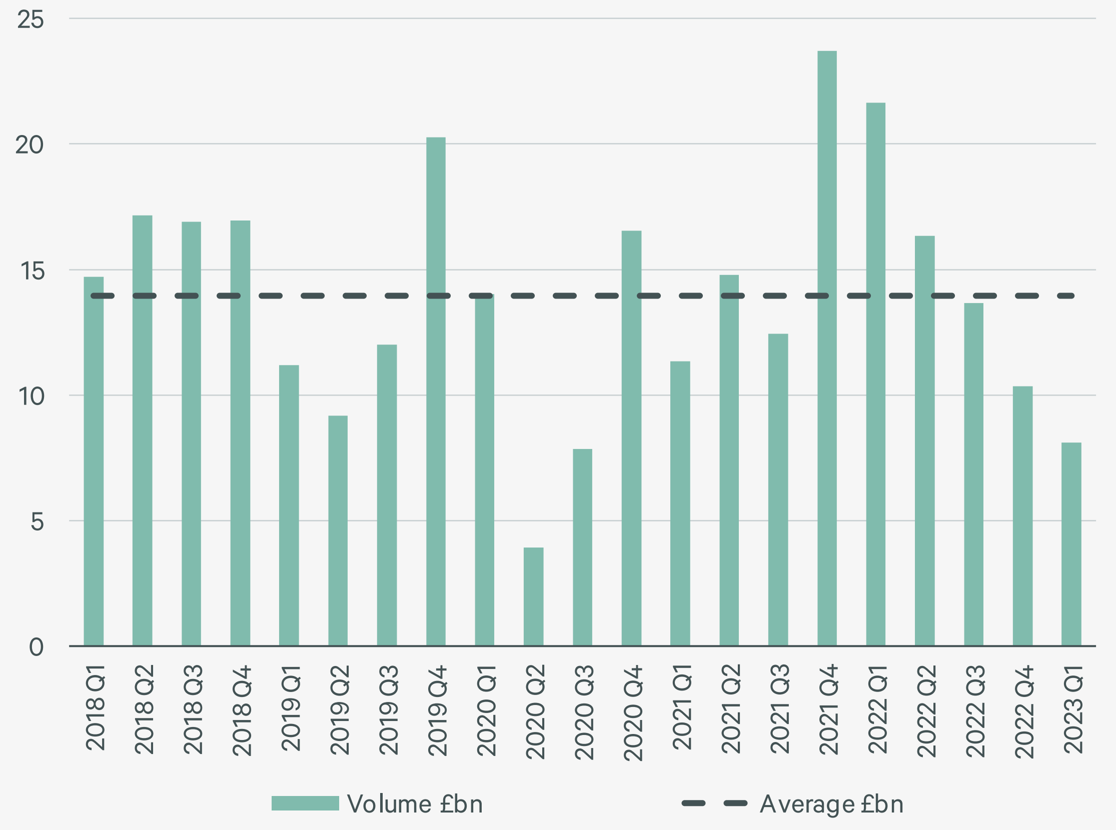
Source: CBRE UK Monthly Index May 2023

02
INVESTMENT

What has happened

- According to CBRE's monthly Index, capital values for commercial real estate saw little change in the first part of the year (this follows a fall of c. 20% in the latter half of 2022). Real estate yields stabilised, but Government bond yields fluctuated in 2023 so far, reflecting the uncertain outlook for inflation and interest rates
- In the absence of any capital growth, total returns for the year-to-date have been driven by income returns, while some parts of the real estate market have also seen rental growth, notably the industrial and logistics sector
- The adjustment in real estate pricing has alleviated but not altogether removed the denominator effect for multi-asset investors. This has created redemption pressures in some real estate funds and capital raising for new funds has slowed considerably.
- Transaction activity has fallen significantly. We estimate that £8.1bn of investment property transacted in Q1 2023, down from £10.3bn in Q4 2022, and far below the £21bn that transacted in Q1 2022. Foreign investment has been relatively low, with c. 30% of volumes in Q1 attributable to cross-border purchases.
- High costs of debt have impacted market activity while lender underwriting has been more cautious. This has created challenges for borrowers looking to refinance, but existing lenders have been supportive at loan maturity for most asset types so far, albeit at slightly lower LTVs and higher margins.

Figure 2: UK quarterly investment transaction volumes (£bn)



Source: CBRE Research

02
INVESTMENT

What will happen next

- We do not anticipate any notable recovery in capital values for UK commercial real estate in 2023, especially if interest rates continue to climb, but parts of the market where rental growth prospects are stronger might fare better
- We do expect a gradual recovery in transaction activity in the second half of the year. While some investors might maintain a wait and see position, other investors will come under pressure to either release or deploy capital as the year progresses. Repricing should also make the UK more attractive relative to other national markets.
- Any recovery in either market activity or capital values is likely to be uneven, with investors exhibiting more appetite at present for residential, logistics and operational assets, but we are likely to see divergence in the fortunes of prime versus secondary quality assets across all sectors
- Debt will remain expensive compared with recent years, which will continue to pose issues for refinancing real estate loans. Yet, we anticipate that debt markets will be reasonably active, with most liquidity available for the residential, logistics and life sciences sectors. Some borrowers will need to inject more equity to facilitate refinancing, and other borrowers may need to reduce leverage levels in existing loans following recent adverse movements in values.

03

Sustainability

03

SUSTAINABILITY

What we said would happen

- Elevated energy prices would continue throughout 2023. Despite six months of energy bill support from the Government, high prices would create strong incentives to improve energy efficiency. Onsite renewable energy sources may become more attractive.
- More mandatory disclosure requirements would be introduced in the UK. They aim to prevent greenwashing and direct investment towards more sustainable practices. New requirements would include mandatory net zero transition plans.
- Despite net zero guidelines, there is a lack of transparency and verification for net zero buildings and currently no formalised certification process. As demand for net zero buildings increases and more come to market in 2023, what it means to be a net zero building would come under greater scrutiny.

03
SUSTAINABILITY

What has happened

- Since December 2022 wholesale energy prices have fallen sharply. But this is only now starting to feed through to consumer prices. The Government energy bill support for businesses was extended in April, but at a reduced level, until March 2024.
- High energy prices have likely contributed to an increased focus on efficiency and renewable energy. Q4 2022 and Q1 2023 saw the most non-domestic energy performance certificates (EPCs) of B or better issued both in real terms and as a proportion of total issuance, and solar photovoltaic deployment has grown at its fastest rate since Q1 2017, shortly after solar subsidies were cut
- UK asset managers and asset owners with more than £5bn in assets under management have been required to make TCFD disclosures at both the entity and product level. These disclosures should explain how organisations consider the climate risks and opportunities related to the real estate they manage.
- New Government plans for the UK to reach net zero by 2050 lacked widespread new measures to address energy inefficiency in existing building stock. Instead, the focus remained on pre-existing policies of transitioning to low carbon heating systems, such as heat pumps, in residential buildings as the main driver of decarbonisation.
- There was no clarification of how the Government intends to proceed with its proposed plans to increase the minimum energy efficiency standards (MEES)

Figure 3: Quarterly issuance of non-domestic EPCs of B or better (England and Wales)

Source: Department of Levelling Up, Housing and Communities

03
SUSTAINABILITY

What will happen next

- Increasing sustainability data in the valuation process will allow better interrogation of the costs and benefits of green building features. Particularly, there will be more insight into how such features can protect assets from value depreciation. Existing best practice for valuing green features will be developed further.
- The Government indicated a desire to introduce mandatory private sector net zero transition plans (for at least some companies) in 2023. However, this disclosure requirement now seems more likely to be enforced in 2024, with the Transition Plan Taskforce only due to publish its final disclosure and implementation guidance in Autumn 2023.
- Mandatory biodiversity net gain regulation for development is set to come into force across England and Wales in November 2023. Developers will need to prepare for this new requirement and understand the cost implications. Read CBRE's guide to these regulations for more information.
- As suggested by CBRE's ESG survey, occupier demand for net zero aligned buildings will continue to ramp up as net zero pledge dates approach. However, the supply of such buildings is likely to fall short of demand.
- The demand for net zero aligned assets will result in increasing scrutiny of whether net zero marketed buildings live up to their claims. The UK Net Zero Carbon Buildings Standard currently in development will aim to standardise the methodology for defining net zero buildings in the UK. The SBTi is also developing international tools and guidance for setting science-based targets for decarbonising buildings.

04

Office

04

OFFICE

What we said would happen

- Take-up in 2023 would be lower than in 2022 due to a slowdown in employment growth and weak GDP growth
- The market would polarise, with the best quality space continuing to lease and pre-lease well but poorer quality, poorly located stock will become more difficult to let
- The outward movement in yields seen at the end of 2022 would continue into 2023, with further expansion in 2023
- Towards the end of the year, pricing in the investment market would stabilise and this would enable a resumption of more normal levels of investment activity from the second half of the year

04
OFFICE

What has happened

- There has been a slowdown in leasing activity; provisional data for H1 2023 suggests that the year-on-year fall in take-up has been c.20%
- The transaction evidence from the first half of the year shows a clear preference for the highest quality buildings. For example, in H1 2023 (to date), 35% of all Central London deals were transacted at a "super-prime" level
- The market for secondary, poorly located space has remained slow in the first half of the year and is limiting overall leasing volumes
- In the investment market, most markets have seen yields increase in the first half of 2023, having already seen outward movement in the second half of 2022. Provisional data for the City of London market, for example, shows that by Q2 2023, prime yields reached 5% following two consecutive increases of 25bps in the first two quarters of the year.
- UK office investment volumes have fallen by c.70% year-on-year in H1 2023 from the heightened levels seen in the first half of 2022 according to provisional data. Office investment activity, especially at the higher end of the lot-size spectrum, have been severely constrained by the rising costs of debt, caused principally by an increase in interest rates (the five-year SONIA swap rate at the beginning of June 2023 was more than 200bps higher than it was 12 months earlier).

04

OFFICE

What will happen next

- Business confidence is stronger now than at the beginning of the year as the likelihood of a 2023 recession has reduced. This will boost demand in the office occupier market. However, we still expect that aggregate leasing activity for 2023 will be lower than 2022.
- The best quality space will outperform in the second half of the year. Occupiers remain focussed on office space that helps them attract employees back to the office and helps them meet their sustainability goals, which are becoming more prevalent, especially for larger corporates.
- Flexibility is also in high demand from a significant number of large occupiers. As a result, we expect to see continued high demand for flexible office solutions across the UK for the remainder of the year.
- Key interest rates at the mid-year stage have been higher and more volatile than was expected at the start of the year. This has had the effect of increasing the costs of borrowing and is constraining investment volumes. Although we expect a greater volume of office investment volumes in the second half of the year, the full-year 2023 total will likely be lower than we had expected six months ago.

05

Industrial & Logistics

05

INDUSTRIAL & LOGISTICS

What we said would happen

- Occupier demand for logistics space would continue, albeit below recent record-breaking periods. Third-party logistics would dominate take-up as companies seek to outsource their supply chain processes.
- Rents would continue to rise as vacancy rates remain at a critically low level, although rental growth will moderate compared to the quarterly double-digit rental growth recorded in 2021 and early 2022
- Following a period of significant repricing, prime logistics yield movement would slow down in early 2023 before stabilising towards the end of the year
- Despite overall total real estate investment decreasing, fund allocations will continue to target the industrial and logistics sector due to its anticipated continued rental growth and occupational demand

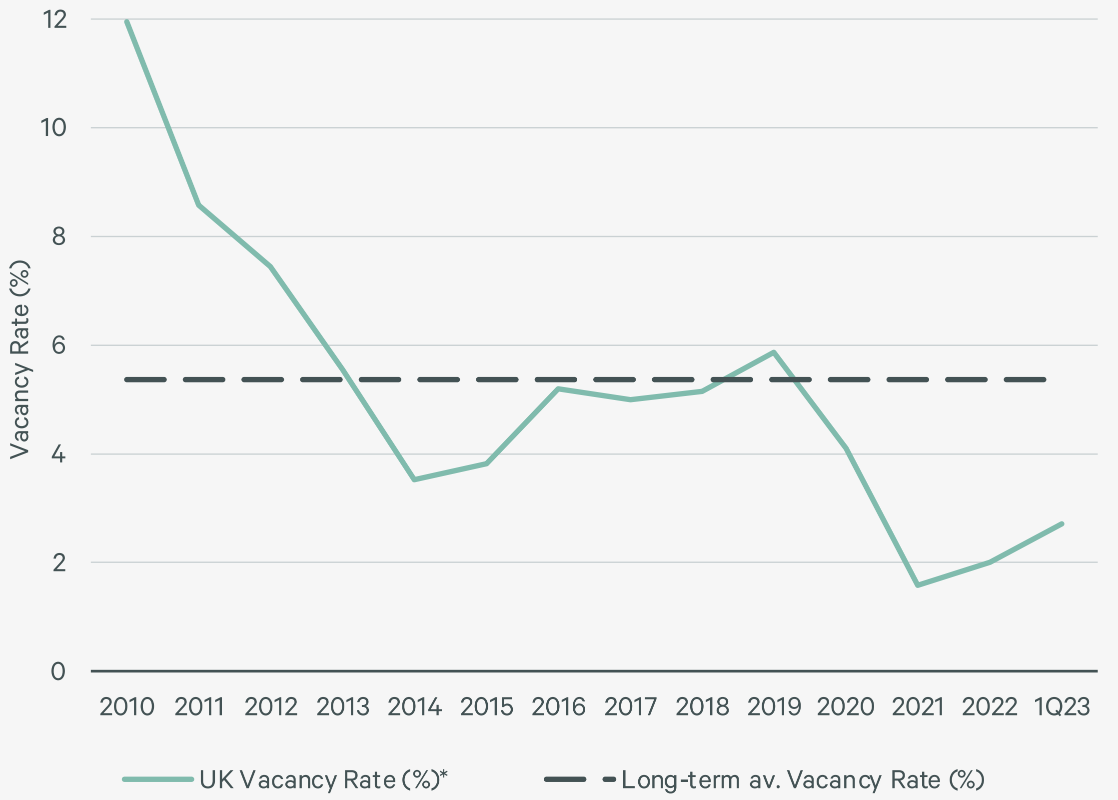
05

INDUSTRIAL & LOGISTICS

What has happened

- Take-up in Q1 was down 18% YoY as occupiers became more cautious and decision-making slowed down. Demand was dominated by third-party logistics operators, contributing to over 50% of take-up
- The vacancy rate increased to 2.71% in Q1, up from 2.00% in Q4 2022, driven by an increase in second-hand availability and speculative completions. Although up QoQ, the vacancy rate remains significantly below the long-term average due to supply being exhausted during the covid-boosted demand period.
- The development supply response has shown signs of slowing, with space under construction remaining stable and completions halving QoQ. Development financing became more challenging.
- All regions have experienced continued prime rental growth, with South East prime rents up 23% YoY to Q1; however, the quarterly rate has moderated to single digit growth between 2 to 6%
- From a valuation perspective, the equivalent prime yield has been steady at 5.25% through the early part of 2023. Economic uncertainty and a turbulent lending market has led investors to take a cautious approach, resulting in lower industrial investment volumes in line with total real estate investment.

Figure 3: UK logistics vacancy rate



Source: CBRE Research *Vacancy Rate shown is as of end Q4 of each given year, apart from 2023 where the Q1 vacancy rate is shown

05
INDUSTRIAL & LOGISTICS

What will happen next

- Occupational market fundamentals will remain robust, with demand continuing to be derived from a wide range of occupiers and particularly from third-party logistics. We expect that take-up levels will stabilise slightly above pre-pandemic levels, sitting above the long-term average.
- Some regions will experience a growth in the vacancy rate as supply of new speculative space reaches completion. However, occupiers' appetite for grade A facilities, especially those that offer sustainability features and operational cost saving, should contribute to relatively quick absorption.
- Rental growth will continue across all regions, albeit at the more moderated rate recorded over the last few quarters, with South East prime rents anticipated to increase by 4.7% in 2023 as a whole
- Continued emphasis will be placed on the need for alternative decentralised energy solutions, along with the provision of ultra-rapid EV chargers to service growing EV distribution fleets
- With positive fundamentals evident in the occupational market and a reduced risk of recession, we expect to see an increase in investment activity after summer. There is still substantial capital targeting the sector, with smaller lot sizes particularly in demand.

> "This increase in the national vacancy rate is good news for the occupier world. However, with supply almost completely exhausted during the recent extraordinary demand period, the vacancy rate is still very low and we will continue to see fierce competition for the best available facilities and sites."

Jonathan Priestley
Head of UK Industrial & Logistics Occupier Services, CBRE

06

Retail

06
RETAIL

What we said would happen

- Consumer confidence had fallen to near record lows, and as such UK retail sales were expected to decrease in the year ahead. However, there would be fewer business casualties than during the pandemic, as many occupiers have already undertaken portfolio restructuring in the last couple of years. Modest expansion was anticipated for well positioned occupiers, resulting in vacancy rates remaining stable.
- Given yields were comparatively higher than other sectors, retail would be better protected against the increasing cost of debt and yield movements would be less significant. The attractive pricing of shopping centres was expected to continue to fuel their recovery. Meanwhile, with the average tenant mix well-suited to the current economic environment, investor interest in retail parks would be maintained.

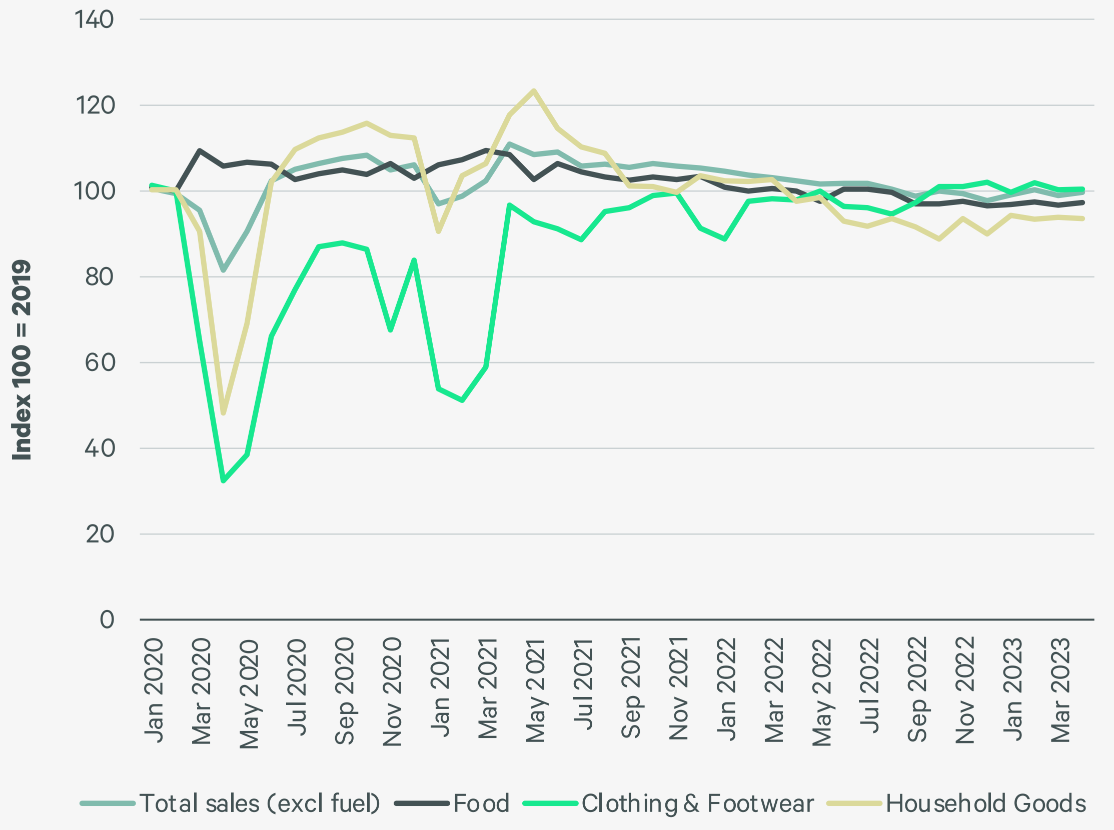
06
RETAIL

What has happened

- Consumer confidence has steadily improved since the beginning of the year and is now at its highest point since the war in Ukraine. Although this has not translated to improvements to Springboard's all-retail average footfall, this metric remains relatively stable at 12% below 2019 levels for the first 20 weeks of the year. While retail parks continue to see the strongest footfall performance – on average -2.7% vs 2019* – in our experience, super regional shopping centres remain popular amongst consumers, with footfall performance well ahead of the all-retail average.
- Sales surprised on the upside, with the ONS reporting volumes remaining somewhere between 1–2% below 2019 levels. However, as with footfall, we note a polarisation of performance, with smaller convenience and larger regional schemes demonstrating the most resilience. In line with expectations, the share of sales occurring in-store has remained stable. Recognising the value of the physical store, in the first half of 2023 we have seen several former online-only brands secure their first retail unit and even certain brands return to the high street.
- However, not all retail has been immune from the wider economic headwinds, with several administrations announced. Positively, the brands affected are not typically large space users as has been the case in the past. Moreover, as anticipated this has not been to the same level seen during the pandemic and so vacancy rates have remained stable.
- Following the modest outward movement seen in Q4 2022, yields have remained stable for high streets and shopping centres. Meanwhile, retail park yields have already begun to compress, reflecting investor interest in the sub-sector. However, uncertain macroeconomic conditions have thus far dampened investment activity for 2023, with volumes traded in Q1 down 38% year-on-year.

*Source: Springboard

Figure 4: UK retail sales chained volume index (seasonally adjusted)



Source: ONS

06

RETAIL

What will happen next

- By the end of 2023, lower inflation will have fed through to household bills, meaning real incomes will have started to gradually recover. Improvements to consumer purchasing power are expected to translate to an increase in retail sales. The golden quarter could be seen as an opportunity for consumers to treat themselves after a challenging year. Online penetration is set to see mild growth, but with a focus on profit margins, occupiers will continue to encourage consumers to utilise their physical store network.
- Well positioned occupiers will continue to seek expansion opportunities in the right locations, with competitive tension and rental growth delivered in prime assets. However, more administrations are expected, with certain occupiers unable to withstand rising prices and cuts to consumer spending. Despite this, overall vacancy rates will remain stable, with opportunities for compression in prime locations.
- While the Bank of England will continue to increase interest rates in the short-term, we anticipate it will reach its peak rate in late 2023. A clearer macroeconomic environment will translate to improved investor confidence in the market. Retail parks are set to remain the most popular retail sub-sector, given their strong occupancy fundamentals and relatively small lot sizes. Meanwhile, interest in shopping centres is expected to regain momentum in the second half of the year.

07

Residential

07

RESIDENTIAL

What we said would happen

- Sales activity would fall below its long-run average, but the market would avoid a 'cliff-edge' fall in activity. In line with the wider economic slowdown, prices would fall moderately in 2023. But stricter mortgage regulations (since 2014) would insulate the housing market against large scale distressed sales and, as such, a significant fall in prices.
- Rental growth would continue to be strong in 2023, driven by an acute supply and demand imbalance. Wider inflation would also push up rents, particularly for renters with inflation-linked tenancy agreements.
- Investment appetite for Build-to-Rent (BTR) and co-living would remain strong. However, pricing would adjust to reflect the higher interest rate environment. The challenging sales market would present opportunities for single family BTR investors. However, high build cost inflation would continue to hamper forward-funding viability in early 2023.

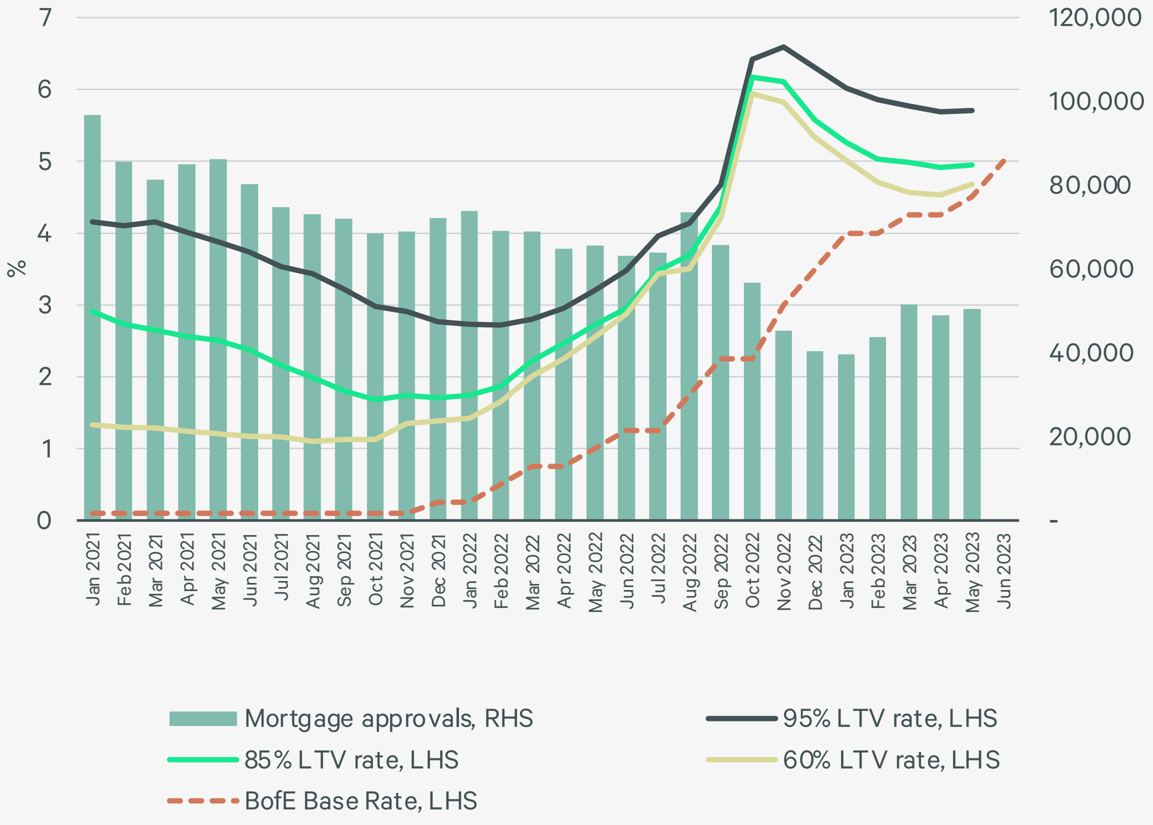
07

RESIDENTIAL

What has happened

- Transaction activity at the start of 2023 has been slow as households continue to navigate a new higher-interest rate environment and an ongoing cost of living crisis. Mortgage approvals are running at around a third lower than in the same period of 2022.
- Although the Bank of England base rate has risen this year, mortgage rates have seen a gradual decrease. This reflects unusually high mortgage rates at the end of 2022 as a legacy from the mini-budget. The average rate on an 85% LTV two-year fixed mortgage has fallen from 5.57% in December 2022, to 4.95% in May 2023. However, the recent rise in the Bank of England base rate has resulted in a further spike in mortgage rates.
- House prices have decreased by 1.4% across the UK, and by 0.4% in London since the end of 2022, according to the ONS. A correction in values had been overdue following a post-pandemic surge in prices, but the average UK house price is still £55,900 higher than pre-pandemic.
- UK rents have increased by 2.1% since the end of 2022, and by 2.2% in London. Annual growth figures are at their highest ever levels since the ONS index started in 2006. This has been driven by a shortage of supply and continued high demand.
- BTR investment totalled £1.9bn in H1 2023, 21% below than the same period last year. The Single-Family Housing (SFH) sector saw record volumes of investment of £460m in H1 2023. Yields across the sector have trended stable.
- Development activity in London dropped to its lowest level since 2013. The sum of new applications, permissions and construction starts in Q1 2023 is 39% below the 2022 quarterly average, and 69% below the peak of 2015, according to Molior. In Prime Central London (PCL), the figure is 33% below the quarterly average of 2022 and 86% below the peak of 2016.

Figure 6: Mortgage approvals, mortgage rates and BofE base rate



Source: Bank of England

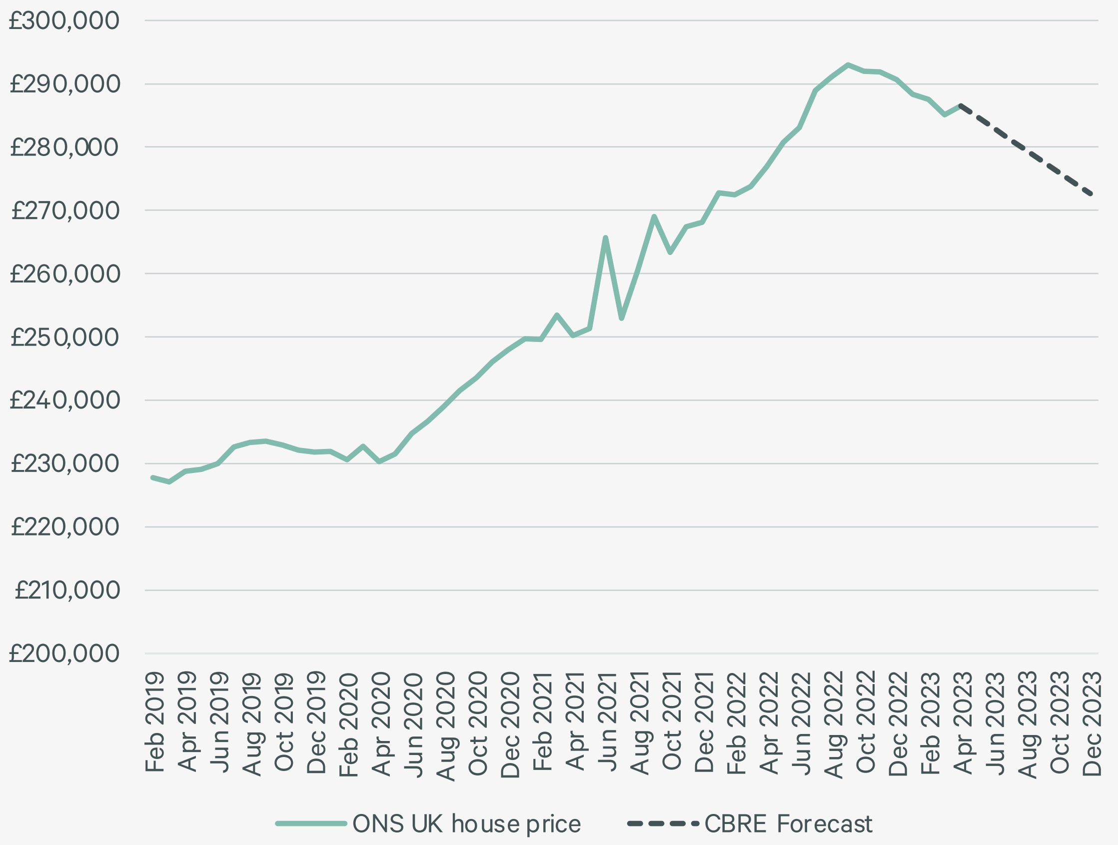
07

RESIDENTIAL

What will happen next

- The number of new sales instructions recorded by the RICS monthly residential survey has been gradually increasing. While this will help support transactions, the comparative shortfall in buyer enquiries points to further house price falls. We forecast prices to fall in the region of 6% in 2023. Assuming the economic backdrop continues to improve, and inflation continues to trend lower, we would expect sales volumes to continue to gradually recover.
- The rental market will continue to see demand significantly outstrip supply. Increasing mortgage costs for potential first-time buyers who are currently renting, a strong labour market and high inflation will fuel rental demand. The recent Renters Reform Bill adds protection to tenants' rights but taking away power from landlords may have negative impacts on rental supply. We forecast that rental values will increase by 4.7% across the UK in 2023.
- We are seeing liquidity from lenders and an appetite to sponsor residential investment assets. As a result, we expect the positive momentum in the BTR investment volumes to continue for the remainder of the year. There is currently over £2bn worth of deals currently under offer and new opportunities ready to be launched to the market. However, investors remain cautious and investment activity will ultimately depend on the economic backdrop continuing to improve in the second half of the year.
- In the development market, a slowdown of planning activity points to a continued undersupply of housing. Developers will continue to face challenges in the rest of 2023, with interest rates remaining high, new planning regulations surrounding second stairwells and a slow sales market post-Help-to-Buy.

Figure 7: UK house prices



Source: CBRE Research, ONS

08

Student Accommodation

08

STUDENT ACCOMMODATION

What we said would happen

- The development of Purpose-Built Student Accommodation (PBSA) would continue to slow due to barriers such as rising construction costs, and difficult planning conditions. Rising operational costs (inflation) would continue to hinder the development of new PBSA schemes.
- Demand for PBSA would continue to significantly outpace supply with severe shortages in certain locations. Occupational demand would reach unprecedented levels, which would translate into strong rental growth across the sector.
- Low supply and strong demand were expected to drive investors and new entrants into the market

08
STUDENT ACCOMMODATION

What has happened

- Demand for higher education (and therefore PBSA) has increased, with over two million full-time students in the UK, up by approximately 30% compared with ten years ago
- End of cycle data from UCAS shows that after a period of hyper-recruitment following the pandemic, higher tariff universities have started to cut back on the number of students they are accepting. In turn, lower and medium tariff universities have increased acceptances, benefitting from the reductions at higher tariff institutions.
- Strong rental growth has been observed, driven by supply and demand dynamics. Empiric Student Property has reported rental growth in excess of 6% for the 2023/24 academic year and Unite Students has reported rental growth of 6-7%. Rental growth has also been driven by increases in operating costs, which have been predominantly driven by fluctuations in utility prices. The war in Europe has been discussed as the cause for the widespread increases in utility prices, with some PBSA operators reporting rises of up to 300%, with an average of 73%.
- Investment activity in 2023 has so far been subdued (£544m transacted between January and May 2023, compared to £2.6bn within the same period in 2022) due to a mismatch between investor and vendor aspirations. Although investor demand remains strong, there is a lack of good quality opportunities being brought to market. Given the unexpected rise in inflation in February, wider global banking volatility and further rise in the UK base rate, there has been hesitation in investment.

08

STUDENT ACCOMMODATION

What will happen next

- UCAS published its 'Journey to a Million' in Q1 2023, projecting that by 2030 there could be one million undergraduate applications per year, compared to the current figure of 750,000, due to improvements in both international student mobility and domestic trends. Applicant data for the upcoming 2023/24 academic year at the midpoint in the cycle shows it to be the third highest on record in the last 10 years.
- PBSA markets are expected to continue seeing a supply and demand imbalance while the student population continues to grow. Housing pressures will become more acute as PBSA development does not keep pace with demand.
- Onerous planning policies and ageing university-operated PBSA stock will further fuel the supply and demand imbalance
- We expect rental tension to continue with schemes selling out much earlier than in previous cycles further driving rental performance. Unite Students announced 83% of the rooms were booked for the 2023/24 academic year as at December 2022 – up from 67% for the 2022/23 academic year at the same time in the previous year.
- Investor sentiment is likely to pick up, with the excitement of the strong rental growth for 2023/24 increasing demand as well as increased clarity around utilities and inflation

09

Affordable Housing

09

AFFORDABLE HOUSING

What we said would happen

- Housing associations were resilient, so the sector would remain robust as an asset class. Arguably, the need for affordable housing (AH) would increase as it tends to during an economic downturn.
- The number of For-Profit Registered Providers (FPRPs) would continue to expand, which would drive investment in the sector. This would also be driven by the strong ESG credentials of AH.
- There would be an increase in mergers between Not-For-Profit Registered Providers (RPs). There have been many mergers over the last few years, and this was predicted to continue throughout 2023.
- The Government's rent cap would mean the sector needs to act in a more effective and cost-efficient manner, which could have an impact on values
- There would be an increase in joint ventures and partnerships between local authorities, housing associations and investors. As we saw more investment from private capital, organisations would explore more creative ways of investing in the affordable housing sector.

09

AFFORDABLE HOUSING

What has happened

- Despite continued demand for affordable housing, there are considerable challenges to viability and delivery because of market volatility, inflation and the ongoing requirements regarding decarbonisation and building/fire safety. It has therefore been a relatively quiet start to the year with fewer transactions taking place than originally envisaged.
- While there remains a great deal of interest from institutional investors, only a small number of parties are currently willing to transact, and we are in a period of "pricing discovery" and yields have softened
- The stock rationalisation market is active with a number of portfolios either currently in the market or about to be launched. This reflects a need to improve operational efficiencies due to inflation and the impact of the rent cap on rental income.
- Mortgage rate rises have dampened some providers' appetite for shared ownership (SO) - particularly apartments - given that the cost of SO mortgages is typically higher
- New Government policy has increased investor caution, with funders and RPs carefully considering rental cap impacts against the responsibilities to maintain and bring up to standard legacy stock
- Both the Greater London Authority (GLA) and Homes England have been reassessing previously agreed tariff rates with their strategic partners, in light of the continued viability constraints on delivering new stock. The deployment of grant funding will be essential to the continued delivery of new affordable housing.
- Mergers remain popular; the proposed merger between Sovereign and Network Homes will create a new 82,000 home provider. Silva Homes recently announced that they are in talks with Abri, which would create a 45,000 home provider. In February, the 11,000 home Swan officially become a subsidiary of 105,000 home provider Sanctuary. In April, Peabody and Catalyst completed the final stage of their merger, creating one of the country's largest housing associations with over 104,000 homes.

09

AFFORDABLE HOUSING

What will happen next

- Investor confidence will continue to gradually improve, which will lead to a pickup in transactional activity. But the level of recovery will depend on the inflation and interest rate trajectory.
- We estimate that c.£10bn of capital is targeting the AH sector and we anticipate equity funded investors will need to start deploying capital towards the end of the year/ early 2024
- Price volatility, inflation and contractor insolvencies will continue to impact the sector's ability to deliver new build housing stock. The rent cap means rental income cannot keep pace with price rises, and so many providers will need to focus on maintaining existing stock rather than developing. Stock rationalisation will therefore continue to be an active sector of the market.
- The Chartered Institute of Housing (CIH) recently reported that 44% of Local Authorities are reducing their housing capital programmes and a quarter plan to halt development programmes altogether
- Constraints on providers' ability to develop, coupled with the increased cost of finance and balance sheet pressures, mean that traditional providers will increasingly seek alternative funding sources including partnering with private capital, to de-risk their development pipelines and meet delivery targets
- A key consideration for investors is the discussions around the Building Safety Act and the requirement for a secondary means of escape. Currently, a dual means of escape is only required at 30m, but this is subject to ongoing consultation. Both the CIH and National Fire Chiefs Council have backed the recommendation for all buildings over 18m to have a secondary means of escape. There will be an associated impact on viability and timescales to deliver the existing pipeline, as even consented schemes will require amending.

10

Hotels

10

HOTELS

What we said would happen

- Hotel demand would continue to grow, albeit at a slower rate, with high spending leisure replaced by volume based corporate and Meetings, Incentives, Conferences, and Exhibitions (MICE) sectors
- Despite the various economic and financial headwinds, we expected the pricing gap between buyers and sellers to close, resulting in increased deal flow in the second half of 2023
- The recruitment and retention of hotel staff would be a material threat to the sector, with the potential to negatively impact service levels and hotel profitability. Hotel profitability would also be affected by inflation pressure, in particular from rising energy prices and food costs.

10
HOTELS

What has happened

- While there is strong interest from both buyers and sellers to transact, there is still a pricing gap, and consequently transaction volumes continue to be subdued
- The economic and operational headwinds are continuing to impact the operational performance of hotels. On a positive note, strong average daily rates and continued occupancy recovery are enabling hotels to offset some inflationary costs impacting GDP.
- In relation to the investment market, a number of high-quality assets have sold since the beginning of the year in strong urban locations, particularly London, with typical buyers being long-term owners who are acquiring for both financial and strategic reasons

10
HOTELS

What will happen next

- We expect high spending leisure demand, especially in regional city centres, to be replaced by high volume, lower spending corporate and MICE segments, resulting in reduced average rates but higher occupancies
- We expect occupancy to continue to grow, albeit at a much slower rate, with volume being provided by increasing corporate activity. As occupancy grows, we expect average room rates to drop marginally.
- The pressure on household income may result in a reduction in leisure spend, but this will likely be offset by corporate and group demand

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Leisure

11
LEISURE

What we said would happen

- Urban leisure investment yields would start to stabilise, reflecting the sector's high attractive inflation protection. The delta between prime and secondary assets would increase, with yields anticipated to stabilise by the end of Q1 2023. Yields would be unlikely to recover to 2019 levels until the debt markets fully recover
- Cost inflation and pressure on consumer spending would squeeze operators, some would take additional debt, or equity, to bridge gaps in their balance sheet
- Operational, debt and macroeconomic pressures would see operators look to sale and leasebacks, or ground rent transactions to raise capital without losing sites

11
LEISURE

What has happened

- Yields across health clubs have drifted due to price corrections in H1 2023, but interest around prime stock continues to drive yield deltas. Pub investment yields have continued to weaken in secondary areas (anticipating a slowdown) and potential sellers of operating assets are not yet accepting the 'distressed' pricing offers.
- Quality assets, in a good location with secure sustainable income, are holding up value and liquidity. Banks have given extensions to lending profiles, but this will not last indefinitely and some more radical measures may be needed
- Sales are more subdued due to lack of stock as landlords look to hold, collect the income and manage whilst there is a disparity between book values and market values
- The anticipated agitated corporate action we expected due to higher operating and financing costs has not yet emerged

11
LEISURE

What will happen next

- Corporate activity is expected to improve when debt markets stabilise and the outlook for gyms remains healthy. Operational performance is expected to recover in H2 2023 and into 2024.
- Recovery across the leisure sector will occur later in H2 as profitability is forecast to improve and yields stabilise as buyers see the value within the sector
- Corporate activity is expected to improve when debt markets stabilise

12

Healthcare

12

HEALTHCARE

What we said would happen

- Healthcare investment activity was expected to remain robust in 2023, with investors attracted to strong occupier demand, long lease terms, index-linked reviews and the ability to deliver on ESG strategies
- The current lending environment would create opportunities for property investors that can work with operating businesses to create flexible, long term funding partnerships. We expected this to be an area of increased activity in 2023, particularly where refinancing has become more challenging.
- Despite challenges that remain in the capital markets, there is strong investor demand for healthcare assets over the longer term, as a result of the sector's robust, needs-driven demand and the ability to make a positive social impact

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HEALTHCARE

What has happened

- There has been evidence of operating company (OpCo) transactions in the UK, which is a clear link to the European model where many operators have limited exposure to real estate
- Care homes are seeing strong occupancy levels, but also an inflationary hedge as cost rises have been absorbed by customers, protecting margins and enabling providers to continue investing in staff pay, training and assets
- Investor and consumer demand has remained strong for retirement living, particularly for the emerging rental product. However, constrained supply and the lack of mature operators means there have been limited investment opportunities.
- Regarding elderly and specialist care, operational performance continues to improve with increases in both private and local authority fees. Furthermore, staffing costs are stabilising with operators focussing on reducing agency usage.

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HEALTHCARE

What will happen next

- We expect to see upward pressure on primary care rents, which will enable and encourage third party developers to meet increasing demand and deliver on NHS ESG strategies
- Across private acute hospitals, in terms of investment, there will likely be some larger scale recapitalisations in the second half of 2023
- There are several retirement living platforms currently seeking funding partners and are marketing a ground-breaking long-income opportunity in this space. This will provide proof of concept and pricing for retirement living over the next six months.
- There will be selective demand for high-quality real estate with strong ESG credentials. We will also see a focus on value-add opportunities in secondary markets as investors become more creative in their strategies and seek higher returns.
- We expect to see continued demand for care home OpCos throughout 2023 due to the ability to access EBITDA income at day one, compared to the longer-term returns from turnkeys or developments

13

Data Centres

13
DATA CENTRES

What we said would happen

- Despite weaker macroeconomic conditions, demand for data centre space would remain near all-time highs as the largest cloud service providers look to expand their presence in London
- Mergers and acquisitions were likely to feature prominently on the data centre landscape, as providers need to expand to meet the needs of their largest customers and the cost to do so has soared. New combinations would be created as a result.
- Data centre providers were likelier to cancel newer ventures, such as edge data centres, or plans to expand into smaller locales where returns were less certain
- Sustainability-related regulation was likelier to be introduced in the UK to ensure data centre providers don't develop facilities in certain areas of London. Limits on power consumption and district heat reuse may have also be mandated.

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DATA CENTRES

What has happened

- It's been a slow start to the year for London's data centre market, Europe's largest by far. For example, there were 17MW of take-up in Q1 and no new supply was delivered.
- There were few deals signed with hyperscalers in Q1. Deals with hyperscalers are taking longer to sign given the economic uncertainty in Europe. Sales cycles are often longer than in the past as operators have a list of compliance and sustainability requirements that must be met before deals can be completed.
- Further complicating matters are the lack of power and a lack of appropriate land to build data centres on for hyperscalers; these factors have made expansion efforts increasingly difficult in London
- Nevertheless, CBRE has seen continued strong interest in London from hyperscalers this year. The world's largest technology companies want to expand their presence in the market to ensure demand for their services can be met in future.

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DATA CENTRES

What will happen next

- Despite the noted resource constraints in London, the pace of development hasn't slowed down much in the capital. Data centre providers are set to deliver an estimated 98MW this year, the second-highest amount of supply added in any given year.
- Data centre providers are adding supply to the market in response to continued strong demand from hyperscalers. To that end, there are new facilities and expansions that are expected in the second half of this year.
- By the end 2023, we expect the London market to have surpassed the 1GW mark in terms of operational capacity; it will be the first European market to do so
- In global terms, London is the second-largest colocation data centre market behind only the Northern Virginia region of the US
- There was a record-high of 132MW of capacity added last year. However, the forecasted supply in 2023 does represent a year-over-year decline from the record-high 132MW of capacity added in 2022.

14

Life Sciences

14

LIFE SCIENCES

What we said would happen

- The life sciences sector was expected to sustain its growth trajectory, with employment growing at twice the rate of wider employment
- The supply and demand imbalance of available lab space would likely to continue into 2023, particularly in the Golden Triangle of Cambridge, London and Oxford. Consequently, Laboratory rents were therefore expected to continue to increase in these locations.
- The Golden Triangle would remain the primary focus of life sciences activity, both in terms of employment opportunities and funding
- The Government had ambitions to make the UK a "Science Superpower" by 2030 and the sector would benefit from continued Government R&D funding as part of a package to deliver this
- Other life sciences hubs, such as Stevenage, Manchester, Edinburgh, and Birmingham, were expected to emerge as prominent centres of activity in the sector, alongside existing hubs
- Energy costs would remain a significant concern as the industry strives towards achieving net-zero carbon emissions, further driving the demand for energy-efficient facilities

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LIFE SCIENCES

What has happened

- Rents have continued to rise due to the ongoing supply and demand imbalance, as occupiers' options for lab space is extremely limited
- Employment in the sector has continued to grow
- There has been a number of overseas biotech companies opening research and development facilities in the UK, drawn by the strength of UK science, particularly in advanced therapies. The Moderna Innovation and Technology Centre (MITC) is set to be constructed at the Harwell campus in Oxford. BioNTech has outlined its investment plans in the UK, intending to establish a research and development (R&D) hub in Cambridge and a regional HQ in London.
- The UK Government Spring Budget outlined a number of initiatives to support the "Science Superpower" ambition, calling out the development of commercial lab space as a key growth enabler. Addressing the R&D tax incentives for SMEs was particularly welcome for the sector as well as a regulatory overhaul.
- By contrast, The UK Government's voluntary medicines pricing agreement has caused industry backlash with some companies citing the spiralling costs of big pharma operating in the UK vs other countries
- With emerging ecosystems, Manchester is seeing significant investment, with the allocation of £127.6 million to support the relocation of UK Biobank to a purpose-built facility at Bruntwood SciTech's Manchester Science Park. Kadans along with McLaren Properties, Property Alliance Group, Moda and Pioneer have also committed to the Manchester ecosystem by announcing a 230,000 sq ft campus on Upper Brook Street.
- The venture capital landscape continues to present challenges globally, with start-ups having to work hard to secure funding, particularly with later stage rounds

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LIFE SCIENCES

What will happen next

- Rental prices are anticipated to continue to rise over the next 12 months, due to limited stock availability in the market. Approximately 1m sq ft of new lab space is expected to be introduced by the end of 2023; however, this will not meet the current demand.
- In the long-term, the life sciences market in the UK is projected to add around 22m sq ft of lab space by the end of the decade. As more commercial lab space becomes available, rental prices will stabilise.
- Venture capital funding will continue to drive growth, but will be at more normalised levels vs the peak of 2021
- To capitalise on the potential of the life sciences sector, the UK Government need to address industry concerns around the increasing costs of doing business in the UK vs other countries. In addition, they need to continue to streamline the regulatory landscape and make UK more attractive for large scale, pivotal clinical trials.

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