Intelligent Investment

Market Outlook 2023

REPORT

UK
REAL ESTATE

CBRE RESEARCH

Introduction

Although 2022 started positively, with a growing economy and strengthening labour market, geopolitical events soon took over. The Russian invasion of Ukraine pushed up energy and other commodity prices, adding more pressure to the already inflationary backdrop. Political events also dominated the domestic landscape, in a year with three prime ministers, four chancellors and six fiscal events.

We enter 2023 under the spectre of a moderate recession, with high inflation and rising interest rates putting downward pressure on growth. As a result, the environment will be more challenging for property, with higher debt costs, and we expect, lower investment volumes. Still, it should be a short lived and a moderate recession, with the green shoots of recovery evident towards the end of the year. Real estate investment markets will emerge from a period of uncertainty, pricing should stabilise, and activity should return. However, conditions will remain challenging for the deployment of equity and debt capital and will require investors to adapt.

For all assets we expect a continued flight to quality, and real estate that does not match investor and occupiers' environmental goals will be increasingly marginalised.

Read on to find out more.

Contents

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Economic Outlook

The economy is weakening as we go into 2023, and we expect a moderate recession throughout the year. The economic backdrop presents both challenges and opportunities for real estate.

Key Takeaways

01

The economic downturn evident in the latter half of 2022 will continue into the new year, and we expect a moderate recession in 2023. This has in part been driven by the inflationary backdrop and the policies in place to bring inflation back to its target level.

02

Throughout 2023, we expect unemployment to rise from its current historically low level. In tandem, job vacancies will decrease. Wage growth will not be able to keep up with inflation until late 2023, eroding consumer purchasing power.

03

Inflation in the UK has reached levels last seen in the 1980s. This has been driven by a post-COVID surge in consumer demand and global supply chain issues, as well as rising energy and other commodity prices, due to the war in Ukraine. We expect inflation to peak at the start of 2023, and then slowly reduce. This reflects a reconfiguration of supply chains, falls in commodity prices, and weaker consumer demand.

04

During 2023, the Bank of England will continue to raise interest rates, which are likely to peak at around 4.5%. As inflation begins to cool, rates will begin to decrease, declining gradually to a 'new normal' of around 2% from 2026 onwards.

05

Long-term interest rates will peak at 3.9% in early 2023, and slowly reduce to 3% by the end of 2025. This decline partly reflects the movement expect for base rates, as well as by lower public spending and higher taxes, as outlined in the 2022 Autumn Statement. It will also follow the trajectory we expect in global long-term rates.

Recession and recovery in 2023

After a strong post-COVID rebound, the UK economy is now more challenging. Output has started to decline, inflation remains elevated, and the labour market is showing signs of weakening. We expect a moderate recession throughout 2023, with GDP falling by 0.9%. In 2024 the economy will recover, growing by 1.7%.

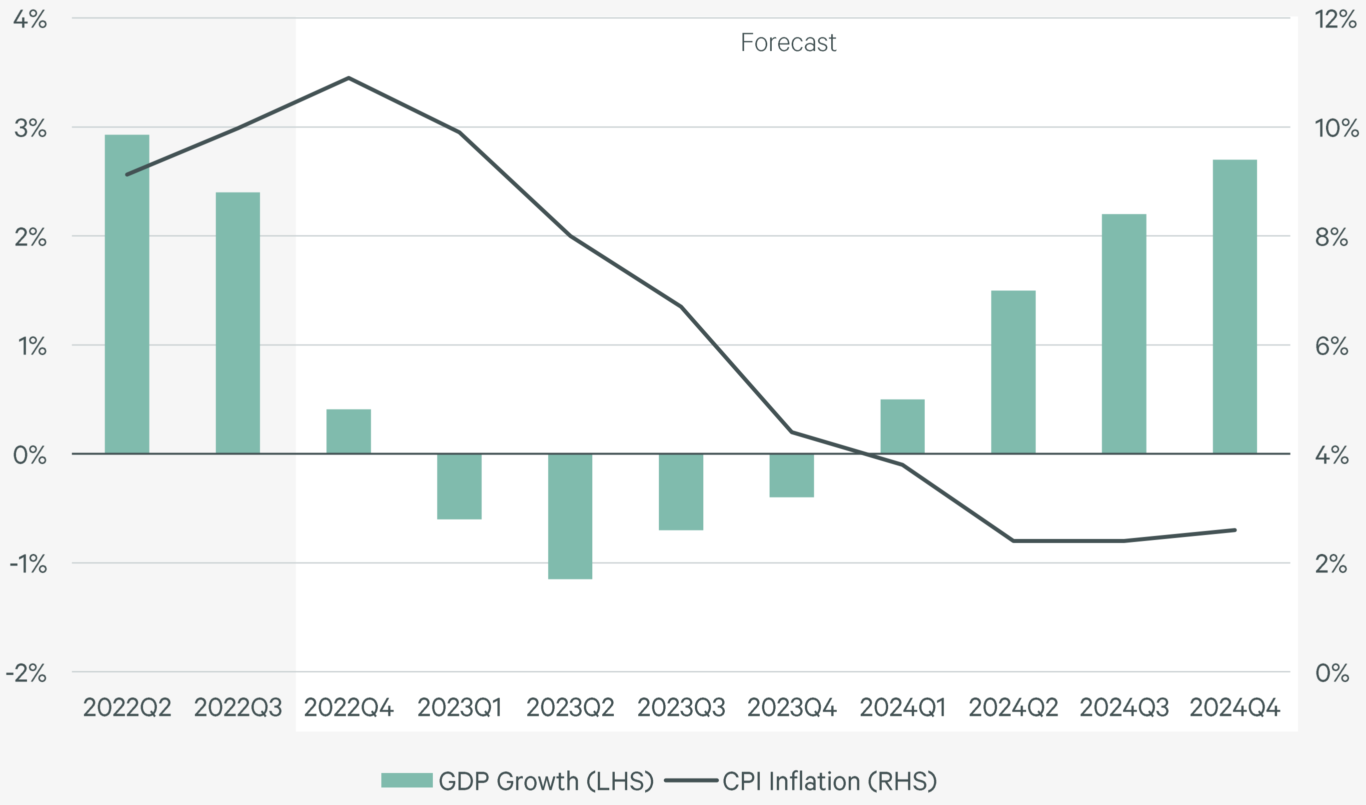
The key economic challenge is inflation, which has been at double digits for most of the second half of 2022, and hitting levels not seen since the 1980s. To contain inflation, the Bank of England has increased interest rates, with the base rate up 270bp since the start of 2022.

Faced with spiralling prices and higher interest rates on loans, businesses and consumers are limiting spending. Consumer confidence has been hit, and retail sales will continue to decline until inflation moderates and consumers restore their purchasing power. Businesses will have to cut costs to preserve margins in a high-inflation environment. This will lead to some job losses and higher unemployment in the first half of 2023.

However, we expect that economic growth will return by early 2024. We project inflation to peak at the end of 2022, or early 2023. It will then come down gradually, due to lower wholesale import prices and higher interest rates, as well as cooling domestic demand. The economy appears sufficiently healthy to avoid long-term scarring, such as reduced business investment, high long-run unemployment, and permanent decline in key sectors.

As inflation reduces and the Bank decreases interest rates, consumers' incomes will restore their purchasing power. Spending will increase, ushering growth in output in early 2024, with strong recovery underway by the second half of 2024.

Figure 1: Falling inflation and fiscal support will help GDP recovery by Q4 2023



Source: ONS via Macrobond, CBRE Research

> “The recovery will set in as inflation falls, and the drag on real incomes eases.”
>
> Neil Blake, Chief Economist
> CBRE

INFLATION ROSE SHARPLY IN 2022

CPI inflation rose by 11.1% in the year to October, up from 10.1% in September. Core inflation, which strips away volatile food and fuel prices, has remained broadly flat at around 6% throughout 2022, suggesting domestic inflationary pressures are not the decisive factor behind the spike to double-digit inflation.

Inflation has been rising relentlessly over the past 18 months and is at its highest for 40 years. Inflation has been driven by a post-COVID surge in demand, which could not be met due to supply bottlenecks. Russia’s war in Ukraine has exacerbated supply shortages, pushing energy, food, and other commodity prices even higher. Policy choices, such as China’s zero-COVID policy, are slowing down the recovery of supply chains, and raising the costs of imported durable goods. In the UK, inflation has been exacerbated by a weak pound, which has made imports more expensive to the UK consumer.

High inflation has not been just a UK phenomenon. It has affected most countries in the world, with developing countries experiencing higher inflation, on average. October CPI inflation in the Euro Area and the USA, was 10.7% and 7.7% respectively. Despite structural differences, high energy and durable goods prices, alongside broader global supply chain disruptions, are the common underlying cause. In the UK, the Euro Area and the US, very low unemployment has contributed to a tight labour market, further pushing inflation upwards.

WHY WILL INFLATION REDUCE IN 2023?

We expect the underlying drivers of current inflation to be resolved slowly during 2023. After a year in which their levels were dictated by geopolitical events, commodity prices have begun to fall. A sharp global growth slowdown is weighing on commodity prices. The World Bank projects that energy prices will fall by 11% in 2023, agricultural prices by 5%, and metal prices by 15%, compared to their 2022 averages. It usually takes some time for these price movements to be passed on to consumers, but we believe this transition will be eased by the Energy Price Cap.

However, there are risks that supply chain disruption might persist. Russia’s war in Ukraine creates geopolitical risk that threatens to put upward pressure on energy and food prices, if the conflict escalates and current arrangements on food passage are not renewed. Meanwhile, the possibility of wage inflation will wane, as businesses and consumers are squeezed by higher costs. Signs of softening in the labour market, and increased business insolvencies, suggest that the risk of a wage-price spiral is currently low.

On balance, our view is that CPI inflation will peak at around 11% in Q4 2022 and then moderate to around 4.4% by Q4 2023. This forecast is subject to geopolitical and supply chain normalisation, as well as the avoidance of policy errors from both fiscal and monetary authorities.

60%

The drop in Dutch gas price are now below their August 2022 peak. However, they are still over seven times higher than at the end of 2021

11%

Inflation will peak in Q4 2022

4.4%

Expected rate of inflation in Q4 2023

Interest rates approaching their peak

The Bank of England has reacted to the steep rise in inflation by tightening interest rates; rates have increased by 270bp over 2022. In addition, the Bank has had to blunt the fallout from the September mini-budget, which caused a spike in market interest rates, by buying bonds to stabilise markets.

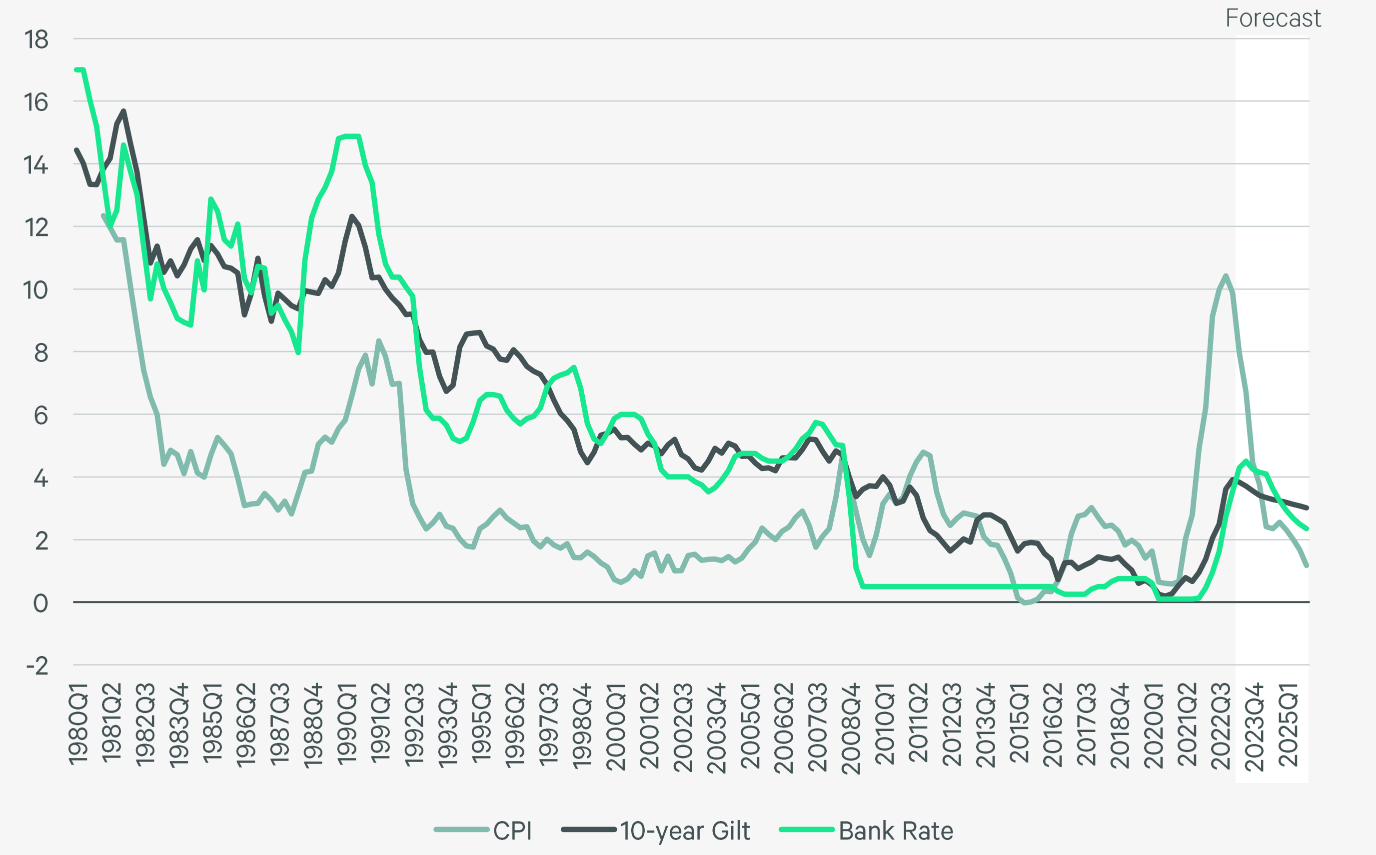
The Bank is likely to tighten further, reaching a peak of 4.5% in Q3 2023. While market expectations of the peak rate have been volatile, the alignment of fiscal and monetary policy that comes with the 2022 Autumn Statement, would make it possible for a lower peak Bank Rate to bring down inflation.

Long-term interest rates have closely followed the Bank Rate, but will peak in early 2023. We expect that ten-year Government gilts will peak at 3.9% in Q1 2023, and then decline to 3.5% by Q4 2023. After this, the yield will continue along a gradual decline path, reaching 3% by Q4 2025.

Once inflation comes under control, and interest rates start to fall, yields will shift downwards too, opening up new opportunities for investors and occupiers. The return to growth in Q1 2024 will boost occupier demand for office, retail, and industrial space. Our models show that for every 1% point increase in GDP, total returns increase by 0.7%.

The risks to this forecast are both external and internal to the UK. A prolonged war in Ukraine might slow the downward adjustment of energy, food, and other commodity prices, keeping consumer prices higher for longer. Internally, the Bank of England might overtighten, causing a more painful landing than is necessary to bring down inflation. Substantial future cuts to Government spending may also adversely impact output, but the lower spending and higher taxes of the 2022 Autumn Statement are in line with our forecast.

Figure 2: UK CPI inflation and interest rates



Source: Oxford Economics, Macrobond, CBRE Research

What are the implications for property returns as inflation and interest rates come down, and the economy starts growing again?

CBRE

INFLATION AND RISING INTEREST RATES HAVE BROUGHT ABOUT AN INCREASE IN PROPERTY YIELDS. WHAT'S NEXT?

01 The ongoing yield shift has hit values and returns for past investors. As the cost of capital, closely related to the interest rates of central banks and therefore to inflation, have risen, valuations have changed.

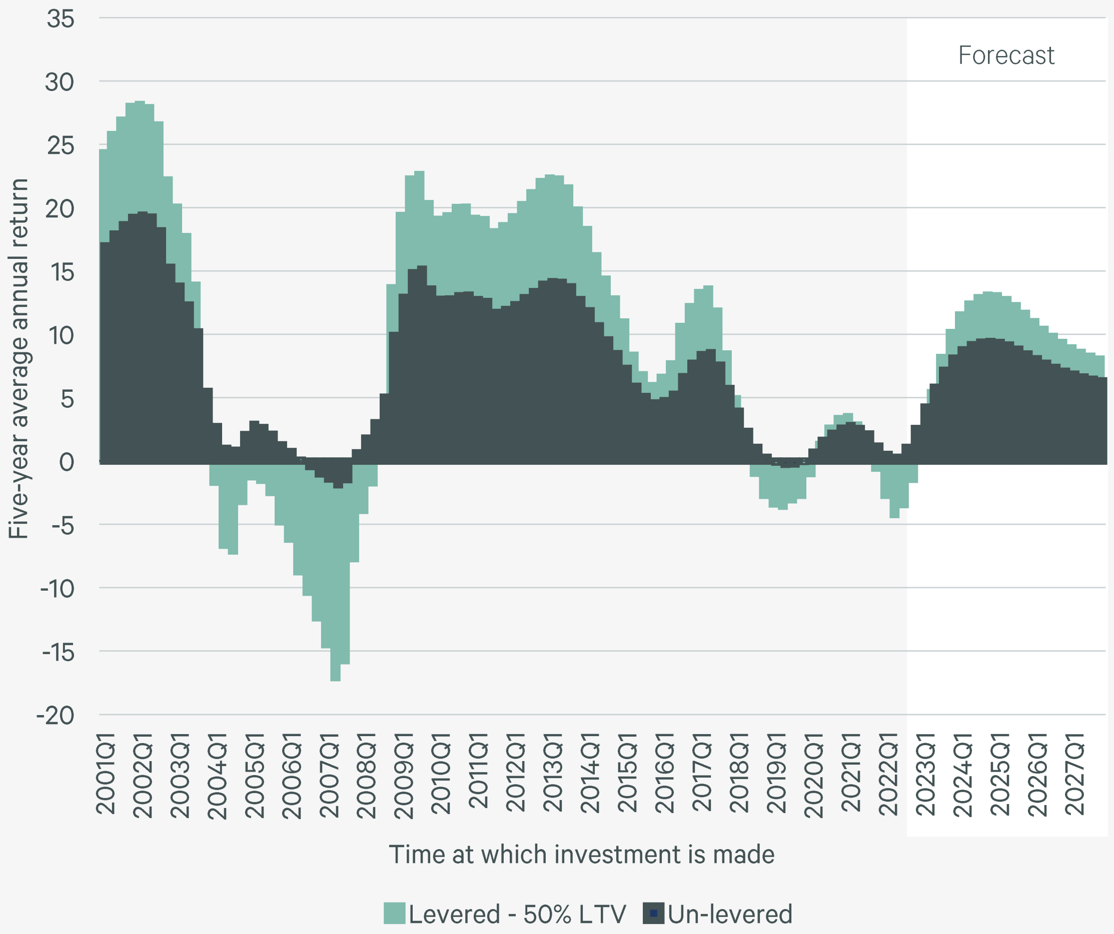
02 However, if we are right about inflation peaking in Q1 2023, and then reducing throughout 2023, prospects are rapidly improving for new investment in the UK property market.

03 As interest rates and debt come down, we see the possibility of 13% returns over five years for levered investment made around end 2024, even with a low LTV financing.

04 The time to reach peak returns depends on how quickly yields correct after inflation and interest rates fall, as well as on when the interest rate loosening begins.

Generally, periods of high inflation have been associated with lower real returns, and low inflation with higher real returns. As inflation abates and growth returns, the opportunities for attractive return on investment will follow closely.

Figure 3: UK all property total returns for a 5-year investment (illustrative)*



Source: CBRE Research

*Returns are pre-tax and are based on the CBRE macroeconomic House View.

02

Investment

Real estate investment markets will emerge from a period of uncertainty. Pricing should stabilise and activity should return, but conditions will remain challenging for the deployment of equity and debt capital and will require investors to adapt.

Key Takeaways

01 Real estate prices should stabilise in 2023. It is hard to predict where real estate yields will settle, but we do not anticipate that they will rise to the same extent as government bond yields. This suggests that the spread over gilt yields going forward will be tighter than in the last decade.

02 Income returns, rather than capital growth, is likely to drive commercial real estate returns in the year ahead. This means more focus on asset management, and on the financial performance of occupiers, as key factors that affect income and occupancy at the asset level.

03 The performance of other asset classes will affect capital flows to real estate, and multi-asset investors may enter 2023 relatively underweight in bonds and overweight in other assets (including real estate), as a consequence of how yields moved in 2022.

04 We forecast transaction volumes to fall in 2023, but the UK benefits from a diverse and internationalised investor base. Constraints impacting some investors means opportunities for others, and private capital awaiting deployment, could be one of the beneficiaries.

05 The debt market should 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, will pose challenges for investors that need to refinance next year.

Pricing adjusts to a new economic environment

Real estate investment performance was affected by economic uncertainty and rising interest rates at the end of 2022. The brunt of the impact was borne by capital values, with income left to prop up total returns as the year ended. The impact was felt most in the industrial sector, where positive rental growth could not offset rises in yields, and values fell sharply.

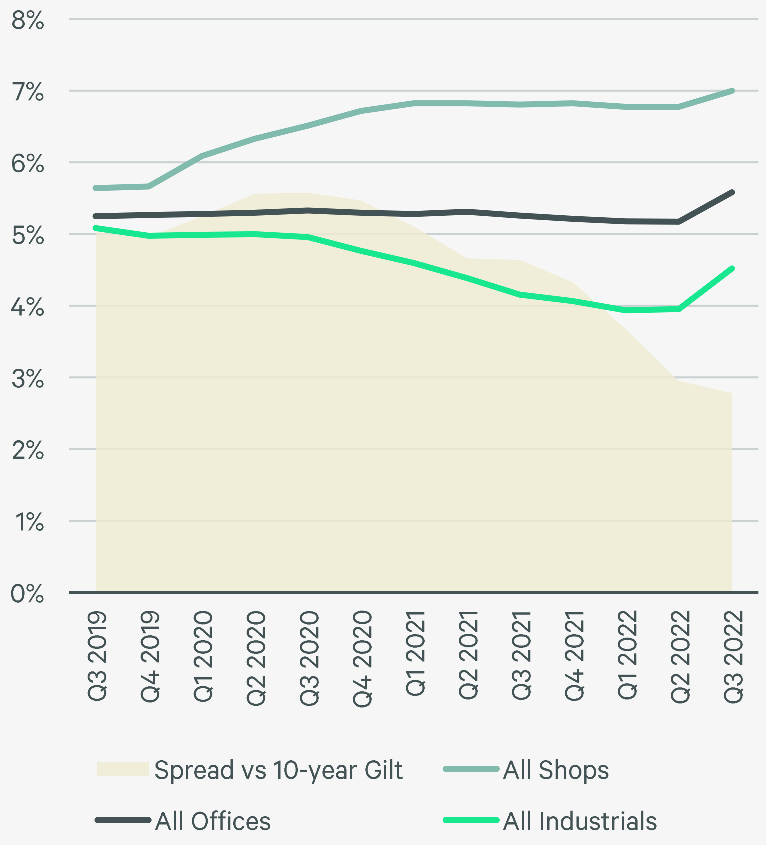
WHERE NEXT FOR YIELDS?

A key issue is whether, and for how long, real estate yields will continue to rise, or whether 2022 marks the worst of any upward rerating of yields and, consequently, downward rerating of real estate values. If interest rate rises bring inflation under control relatively quickly, and confidence returns to investment markets, values should stabilise, but it is hard to predict exactly where real estate yields will settle.

One factor that often attracts comment is the spread between commercial real estate yields, and those of UK Government bonds. At an all-property level, the spread has narrowed considerably as gilt yields have risen, but this spread was abnormally high in a historical context because of the effects of quantitative easing implemented after the Global Financial Crisis.

We do not anticipate that real estate yields will rise to the same extent as Government bond yields have done, which implies that a narrower spread over gilt yields will prevail in future. However, yields in specific sectors, and for individual assets, will be sensitive to perceptions of risk and prospects for cash flow growth going forwards.

Figure 4: Trends in prime yields, 2019-2022



Source: CBRE Prime Rent & Yield Monitor

WHERE WILL RETURNS COME FROM?

While we expect that real estate yields will stabilise in 2023, rental growth will be impacted by the weaker economic outlook, so capital growth is unlikely to drive returns as a result. Therefore, performance must be driven by income return, placing the focus on asset management to deliver such return.

Asset management has risen in prominence as the UK market has transitioned to shorter leases, and as lease events and tenant financial performance have come into sharper focus. But the ability to maintain income return will also depend on how occupiers ride out challenging economic conditions in the months ahead.

BETTER TIMES AHEAD?

Once real estate yields have stabilised, better rental growth prospects in the medium-term should facilitate underwriting of new investments and expenditure plans for existing assets in the portfolio. Expenditure will be especially necessary to mitigate transition risks for assets where preparations for tighter future energy efficiency standards are yet to commence.

The performance of the listed sector in 2023 will also be of interest. As the share prices of UK REITs in 2022 fell some time in advance of the change in the private property market, investors will be watching for signs in listed property prices that indicate improving views of the prospects for UK real estate.

Investment and lending strategies adapt

ACTIVITY TO DROP BUT NOT DRY UP

There is no doubt that economic and political uncertainty weighed on investment activity during 2022. While activity was strong in the first half of the year, volumes tailed off as investors grappled with the implications of lower growth, higher inflation, and higher interest rates for prospective returns from all asset classes.

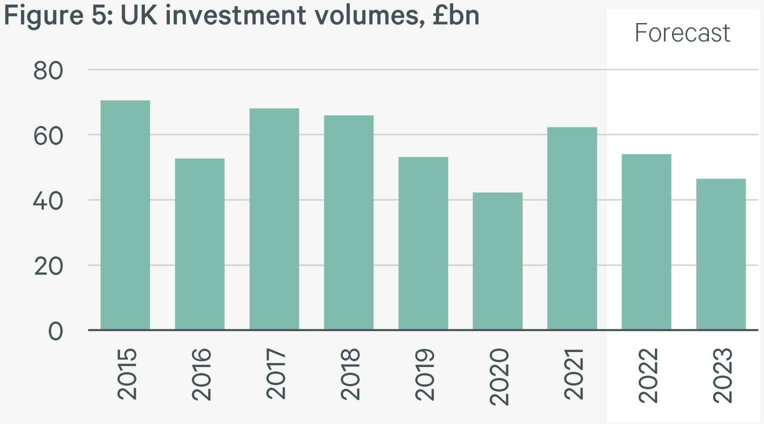
Rising gilt yields means that institutional portfolios are likely to be underweight in bonds relative to other assets, such as real estate, and this could act as a brake on investment. However, while we forecast volumes to drop somewhat in 2023, the UK real estate market benefits from a diverse investor base.

SOURCES OF CAPITAL IN 2023

Domestic investment has accounted for less than 50% of total transaction volumes in recent years, with Asia, Europe and North America all supplying significant amounts of equity capital. The lower value of the pound relative to other currencies, especially the US dollar, may stimulate further inbound investment, despite slow growth domestically.

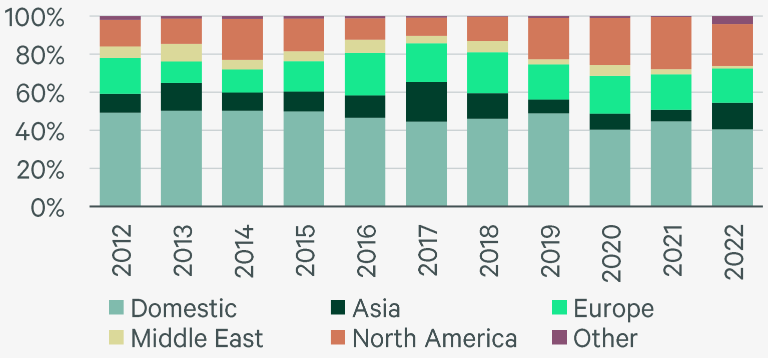
There has also been capital raised globally for private real estate funds that is still waiting to be deployed, especially for value-add and opportunistic strategies. The realignment of real estate prices at the end of 2022 means that 2023 may provide opportunities for this capital to enter the UK market.

Figure 5: UK investment volumes, £bn



Source: CBRE Research

Figure 6: Source of inbound capital, % of total invested



Source: CBRE Research, Real Capital Analytics

DEBT MARKETS REMAIN RESILIENT

The end of 2022 has been a challenging time for commercial real estate lenders and borrowers. Yet the debt market is better placed to weather a downturn in comparison with 2007-2009. The overall amount of debt relative to equity in the market, and the LTV ratios applied to new loans, have been lower.

As interest rates have risen and capital values have fallen, the relationships between interest and income, and between loan amount and asset value, have come under scrutiny. LTV ratios for new loans have reduced further to maintain adequate interest cover for lenders, and the total cost of debt has risen significantly.

CHALLENGES IN THE YEAR AHEAD

Borrowers that need to refinance in 2023 will face challenges if recent falls in value have eliminated gains made in the post-COVID recovery. Refinancing at a lower value and a lower LTV will require borrowers to inject more equity, or find further funding, if they are to retain assets. While we do not anticipate significant levels of lender enforcement, we do think that there will be a reasonable volume of lender-encouraged sale processes in cases where fresh equity is not available, to reduce leverage levels in existing loans.

Debt markets remain liquid, supported by the emergence of debt funds as key players in the UK lending landscape. Capital remains available for deployment in debt strategies, and higher interest rates will mean improved returns, if borrowers remain able to service loans in a higher rate environment.

03

Sustainability

Failure to act on sustainability will have immediate and tangible impacts in 2023. Mandatory disclosure requirements and high energy prices will incentivise urgent action from both investors and occupiers. Improving data will provide greater insight into how sustainability is affecting value, allowing better informed decisions on the issue.

Key Takeaways

01 More mandatory disclosure requirements will be introduced in the UK. They will aim to prevent greenwashing and direct investment towards more sustainable practices. New requirements include mandatory net zero transition plans.

02 The changed energy price environment is set to continue throughout 2023. Despite six months of energy bill support from the Government, high prices will create strong incentives to improve energy efficiency. Sustained high gas prices will make onsite renewable energy sources more attractive.

03 A better understanding of the value of sustainability features will be established, as sustainability data is increasingly integrated into asset valuations. This will allow increasingly accurate measurement of how green features can protect against value depreciation and insulate assets from transition risks.

04 Greater scrutiny of net zero buildings will occur as demand increases and more come to market in 2023. Despite net zero guidelines, there is a lack of transparency and verification for net zero assets and currently no formalised certification process.

05 There will be a renewed focus on physical climate risk after the record temperatures and wildfires of 2022. Forecasting, adapting to and insuring against physical risk, will become increasingly important for both investors and occupiers.

The need to act on sustainability will become more urgent

In 2023, the focus on sustainability issues will intensify. The forces of disclosure regulation, and high energy prices, will accelerate sustainability action across the UK real estate industry.

THE CHANGED ENERGY PRICE ENVIRONMENT

High energy costs will incentivise energy efficiency, regardless of disclosure or other regulation. Buildings with greater energy efficiency or using onsite renewables, will be insulated from the worst of the price shock.

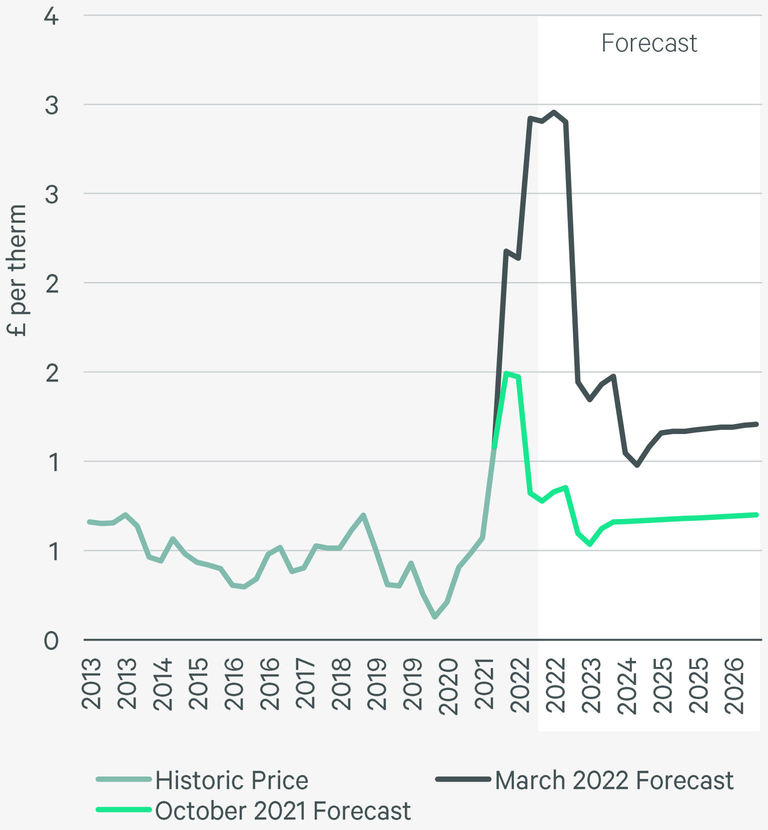
Occupiers that may not have prioritised sustainability in the past will demand improved energy efficiency to keep bills down as prices remain high.

Figure 7 shows that gas prices are expected to stay elevated long after Government support with energy bills, which could end in April 2023. Acting sooner rather than later to increase building efficiency will create lasting benefits for occupiers in the form of reduced bills.

WHAT DOES A NET ZERO BUILDING LOOK LIKE?

The emergence of more net zero buildings on the market in 2023 will spark discussion about defining and verifying net zero status, both at the asset and portfolio level. Questions around 'net zero ready', how to accurately measure embodied carbon, the formalisation and transparency of carbon offsets, and whether net zero should be certified, will come to the fore. Attention will be especially focused if disclosure requirements result in more capital being funnelled towards net zero buildings.

Figure 7: Historic and forecast UK gas prices



Source: OBR Forecast, 2022

MORE SUSTAINABILITY DISCLOSURE REQUIREMENTS

Disclosure aims to prevent greenwashing and direct capital towards more sustainable practices. In 2023, the market will begin to see how large companies and financial institutions plan to use real estate to reduce climate-related risks and reach net zero by 2050. The effect of such disclosures on investment will start to emerge. Upcoming requirements include:

- TCFD – Mandatory for the largest UK-registered companies and financial institutions. The first annual reports incorporating mandatory TCFD disclosure are due in spring 2023
- Net zero transition plans – Planned mandatory disclosure for all UK financial institutions and listed companies in 2023. The exact date is currently unknown
- SFDR Regulatory Technical Standards - Extension of existing SFDR disclosure applying to financial market participants based in the EU, or marketing their products in the EU. New mandatory reporting templates will be introduced in January 2023. Unless marketing their products in the EU, UK companies will not have to disclose under this framework. However, it will affect EU investor attitudes towards UK real estate

VALUING SUSTAINABILITY

Increasing sustainability data in the valuation process will allow better interrogation of the costs and benefits of green building features. Particularly, insights into how such features can protect assets from value depreciation. Whether this leads to a rush to install green features remains to be seen. Whatever the outcome, landlords and investors will be better equipped to make informed decisions on the issue.

04

Offices

Office-based employment will fall in 2023 and this will constrain leasing activity across the UK, but the outlook for the best quality space remains positive. Increasing interest rates has caused pricing uncertainty, and this will create a more challenging environment for the investment market in the first half of the year.

Key Takeaways

01

Falling office-based employment and a recessionary environment will constrain growth in the office leasing market. Take-up of office space in the UK will be lower in 2023 than it was in 2022.

02

A large proportion of the office space under construction or undergoing refurbishment due for completion in 2023, has already been pre-let. Continued strong demand for the best quality space will cause demand for development or refurbishment to remain high, despite overall levels of demand falling.

03

Poorer quality, or poorly located office space, will underperform in 2023. Buildings that do not match the environmental goals of large occupiers will be the most difficult to let and are likely to experience long void periods.

04

Having already seen outward movement in 2022, it is expected that yields will expand further during the first half of 2023 in most UK office markets.

05

Pricing will stabilise during 2023 and this should stimulate more investment activity. Office investment volumes are expected to be 20% down year-on-year in 2023, with the majority of transactions focused in the second half of the year.

Cyclical slowdown in aggregate leasing activity

FOLLOWING A LARGE INCREASE IN 2022, OFFICE-BASED EMPLOYMENT WILL FALL IN 2023

A slowdown in the UK economy will adversely impact demand for office space. Office based employment in the UK tracked by CBRE is expected to fall by c.1% in 2023. The fall in office jobs will impact all markets, however the forecast decline is more muted in Central London than other markets.

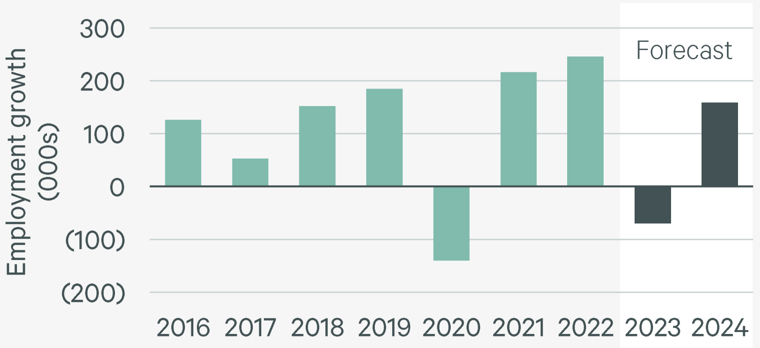
As a result of falling employment numbers, take-up across the UK office markets in 2023 is expected to see a decline of 7%, relative to the 2022 levels, marginally lower than trend levels.

A STRONG PIPELINE OF SPACE WILL BE WELL RECEIVED BY THE MARKET

We are tracking 10.9m sq ft of office development or refurbishment space under construction with an earliest possible completion date during 2023 across the UK office markets. This would represent an increase from the estimated full-year 2022 total of 7.9m sq ft. However, delays to completions are expected and could significantly reduce the total.

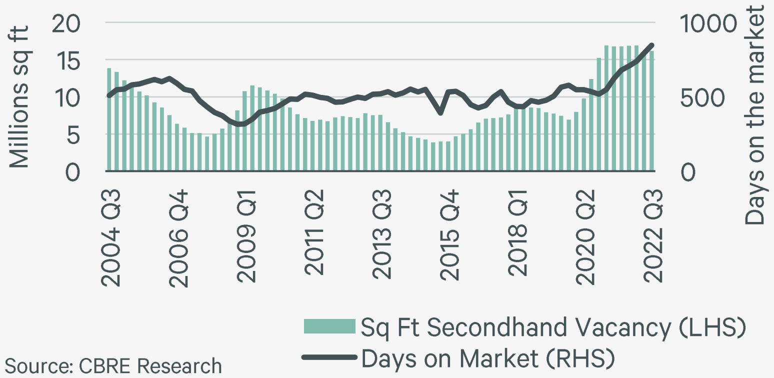
Although take-up is expected to be below-trend in 2023, demand for the best quality space will remain robust. Of the space under construction and due for completion in 2023, 35% has already been pre-let, and the anticipated high levels of demand for development space will deplete the pipeline further as the year progresses.

Figure 8: UK office-based employment growth forecasts



Source: CBRE Research/ONS. Covers big six office markets plus Central London and South East

Figure 9: Central London secondhand vacancy, time on market, size-weighted average



Source: CBRE Research

Demand for development space will continue to be driven by large occupiers' desire to acquire the very best space to reward returning office workers, and to fulfil sustainability goals within efficient modern buildings.

SECONDHAND SPACE WILL UNDERPERFORM IN 2023

The slowdown in leasing activity will be most notably felt in the secondhand office market, especially if the space is poorly located, or of poor quality. Average void periods for secondhand space will increase in 2023. For example, it is likely that second-hand void periods will reach 1,000 days in Central London by the end of the year (Q3 2022 average void period for second-hand space was 850 days).

2023 will see a drop in investment volumes

PRIME YIELDS HAVE INCREASED WITH RISING INTEREST RATES

Most UK office markets have seen outward movement in prime yields so far in 2022, ranging from +15-50 bps. At the end of Q3 2022, prime office yields stood at 3.5% in London's West End (core markets of Mayfair & St James's), following outward movement (+25 bps) during Q3 2022. The UK prime yield remained higher than its equivalent in several key European markets, such as Paris (3.15%), Berlin (2.90%), and Madrid (3.25%).

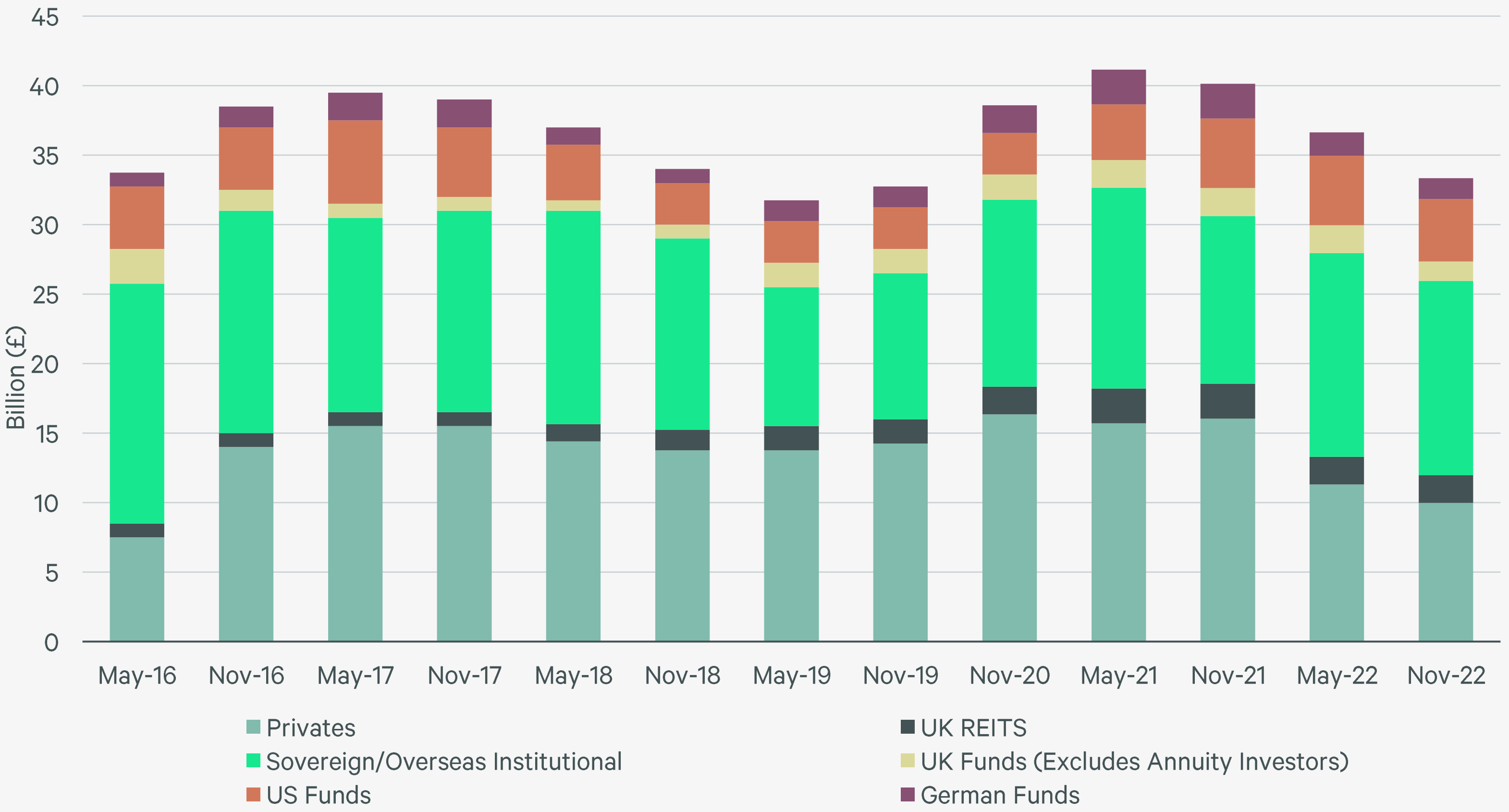
Outward yield movement of up to 100 bps in some UK office markets is forecast for the final quarter of 2022. The Mayfair & St James's prime yield is expected to end the year at 3.75% (+25 bps quarter-on-quarter). Yields are expected to increase in 2023, with prime yield compression resuming across UK office markets from 2024-2027. Overall, prime yields are expected to move out from their end of 2022 levels in most UK office markets.

MARKET UNCERTAINTY COULD LIMIT INVESTMENT VOLUMES

Equity targeting London offices has fallen below trend levels to £33bn, down £3bn from the level recorded in H1 2022. Despite having the capital available, not all investors will transact in the current market – we estimate approximately 30% of equity interested in London would transact in current market conditions.

Forecasts indicate a 20% fall in investment volumes in 2023 to £16.2bn, of which £10.5bn is expected in the Central London market. Volumes are likely to be more constrained in H1 2023, with a recovery expected in the second half of the year.

Figure 10: Equity targeting London (£Bn)



Source: CBRE Research

05

Industrial & Logistics

The UK logistics market will experience continued occupational demand above long-term averages, with third-party logistics distributors leading take-up, as organisations seek more flexibility in their supply chains. Vacancy rates will remain critically low, as build-to-suit development grows, and rising cost of finance and higher exit yields create a challenging environment for speculative development. Following a period of sustained repricing, logistics yields will stabilise. Industrial and logistics assets will remain attractive to investors with continued rental growth expected.

Key Takeaways

01

Demand from occupiers will continue, with take-up volumes remaining above the 10-year average, albeit below recent record-breaking periods. 3PLs will lead take-up at a sector level, as companies seek greater flexibility and look to outsource their supply chain processes.

02

Vacancy rate to remain at a critically low level, with lack of available units hindering take-up levels. Rising cost of finance, increasing construction costs and higher exit yields will create a challenging environment for development.

03

Rental growth will continue, driven by the demand and supply imbalance. The growth rate will moderate compared to the quarterly double-digit rental growth levels experienced through 2021 and early 2022.

04

Automation and advancement of electrical transportation will increase demand for power. A lack of sufficient power will become a deal breaker for occupiers when assessing potential buildings and sites.

05

Following a period of sustained repricing, logistics yields will stabilise, potentially sooner than other sectors. The logistics sector will reinforce its position as a major contributor to total real estate investment and will remain an attractive asset class.

Lack of new supply could squeeze take-up levels

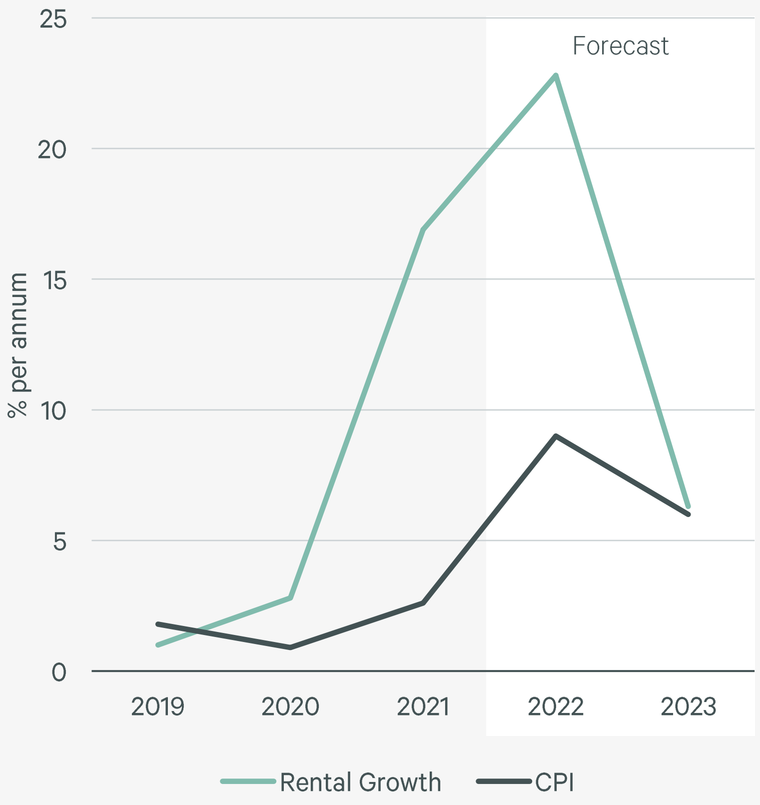
OCCUPIER DEMAND TO CONTINUE WITH 3PLS TO DOMINATE

Following a record-breaking period, take-up levels have started to moderate, but occupier demand will likely continue through 2023 and remain above the 10-year average. Big box logistics space under offer at the end of Q3 totalled 16.8m sq ft (up 27% YoY), indicating that appetite from occupiers for warehouse and manufacturing space is still strong, despite caution over the impact of the cost of living on consumers, and a slowdown in retail spend.

Demand is being driven by an increasingly diverse range of occupiers with third-party logistics distributers leading the way at a sector level, a trend which is being observed across Continental Europe and the US. We anticipate this trend to continue as organisations seek greater flexibility and increasingly look to outsource their supply chain processes. This is likely to be accelerated as companies continue to be subjected to further energy price uncertainty in respect of both power and fuel, fluctuations in retail demand, and wider economic risks.

Whilst occupiers' prioritisation for buildings in traditionally prime locations will persist, we expect to see growth in take-up for buildings in 'off prime' or secondary locations. This will be driven by lack of availability of buildings in prime locations that meet occupiers' required specifications, in addition to the affordability of rents in these areas. We also expect to see an increase in the numbers of occupiers looking to be located adjacent to major rail hubs, benefitting from potential savings in transportation costs, whilst reducing their carbon footprint.

Figure 11: UK annualised rental growth, CPI and forecast



Source: CBRE Research and ONS (rental growth is the weighted average, calculated by rentable space)

NEW, GRADE A UNITS WILL BE QUICKLY ABSORBED

Despite a record amount of space under construction, the UK logistics occupational market continues to be very tight, with new grade A stock being quickly absorbed by occupiers. This is translating to critically low national vacancy rates; sub 2% for the last five quarters. At current take-up levels, there are only two months of ready-to-occupy space available, and we anticipate that the supply response through 2023 will continue to be insufficient to satisfy demand. Any new stock will be attractive to occupiers, with the acute lack of supply potentially restricting take-up levels, despite demand persisting.

We have also seen a resurgence of occupiers turning to build-to-suit developments due to the lack of available speculative units, weakening developer risk-appetite, and increasingly bespoke occupier requirements. We anticipate this trend will continue with a growth of build-to-suit development next year.

With rising 'all in' cost of debt finance, increasing construction costs, and higher exit yields, we expect that some speculative developments may become unviable, further impacting supply.

RENTAL GROWTH TO MODERATE

As supply will remain constricted, we will see continued rental growth across all regions, most pertinent in the Midlands and North of England. Rental growth is likely to be lower than the double-digit quarterly rental growth experienced in recent quarters but will be significantly above growth levels seen prior to the pandemic.

POWER PROVISION IS BECOMING INCREASINGLY CRITICAL

Whilst the cost of power is of concern to occupiers, it is the availability of and access to that power that is becoming increasingly challenging. Without sufficient power operating from a particular building or site it may become too onerous. The supply of energy to sites via the National Grid is finite, and providing additional power through new connections and sub-stations is expensive and a protracted process.

Demand from occupiers often includes an element of 'future-proofing' for their business, particularly with the growth of automation and the advancement of electrical transportation. The challenge occupiers will face is obtaining that power to meet technological advances, whilst doing so in a sustainable way. Developers are alive to the issues, with many new schemes offering solar ready provisions and power saving initiatives, a trend we will continue to see through next year and beyond.

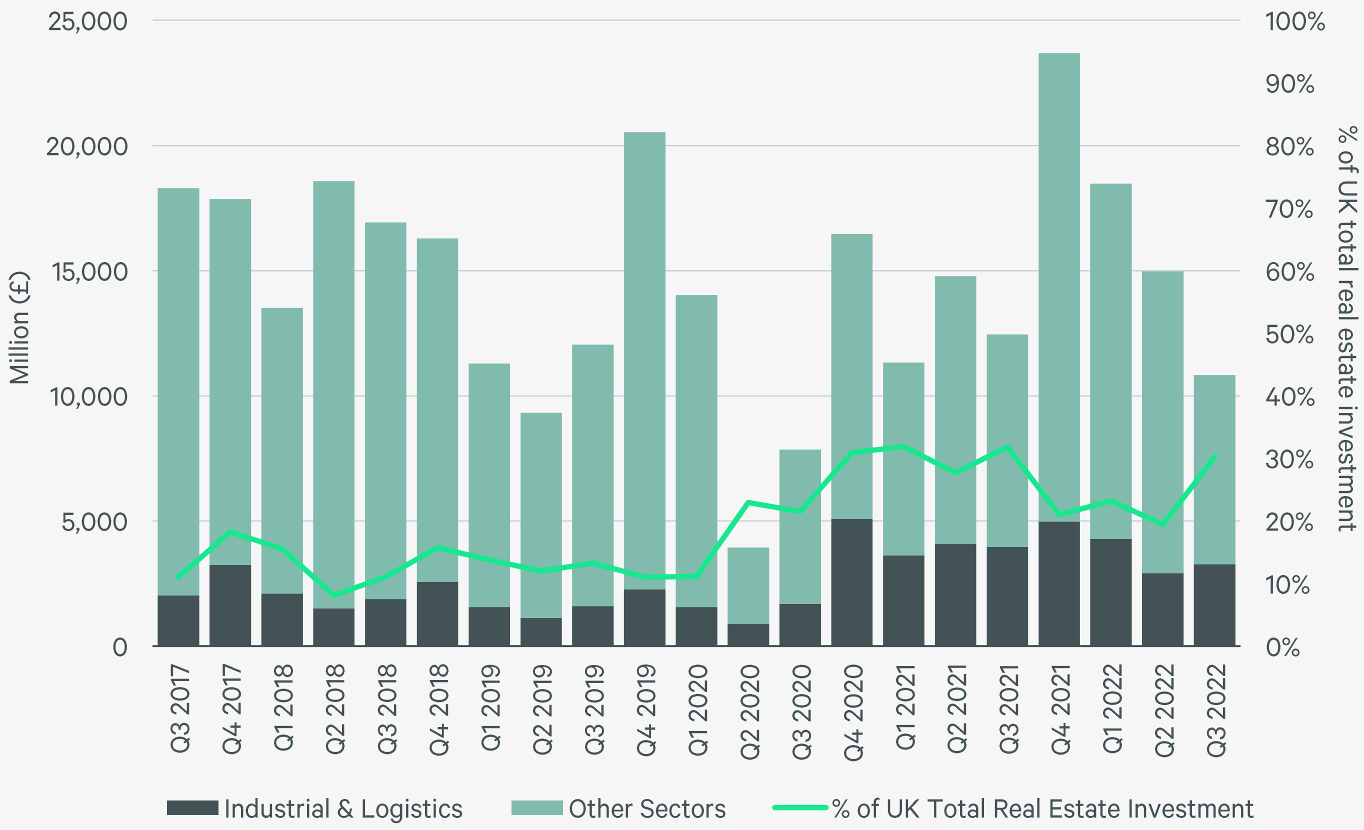
I&L STILL CONTRIBUTING MAJOR SHARE OF REAL ESTATE INVESTMENT

The industrial and logistics investment market this year has been characterised by a period of repricing, with prime yields quickly moving out up to 100 bps by Q3, from the historic lows seen in Q1. By the end of 2022, prime yields will have moved out as much as 150 bps from the beginning of the year.

Repricing thus far has been most substantial in the logistics sector, outpacing other real estate sectors. We anticipate that the bulk of repricing of prime logistics assets will have happened this year, with early 2023 seeing a slowdown in prime yield movement before stabilising towards the end of the year.

Despite total real estate investment decreasing, the apportionment of investment for industrial and logistics has remained resilient, contributing 30% in Q3. Fund allocations are still targeting the industrial and logistics sector, which will continue to be attractive for investors due to anticipated continued rental growth.

Figure 12: UK real estate investment by I&L and other sectors (LHS), and I&L % of total investment (RHS)



Source: CBRE Research ('other sectors' include office, retail, residential, healthcare, hotel, and other)

06

Retail

Retail will not be immune to the wider economic headwinds in 2023. Cost saving initiatives are already underway for many occupiers, with the store at the heart of this exercise. Modest expansion is anticipated for well positioned occupiers, and the volume of business casualties is expected to be less severe than during the pandemic. When compared to other sectors, UK retail is expected to be less effected by repricing.

Key Takeaways

01 Given the current economic backdrop and near record lows of consumer confidence, it is anticipated that UK retail sales will decrease next year. Discretionary items and leisure activities will come under the greatest pressure.

02 Since the pandemic, online penetrations have declined faster than expected, demonstrating that consumers still value physical retail. This metric appears to have reached a new norm, for the time being.

03 Occupier profit margins will be under increasing strain as inflation continues to bite. With logistic costs continuing to soar, many occupiers will seek to direct consumers back into stores to increase efficiencies.

04 Modest expansion is anticipated in 2023, for well positioned occupiers in the best locations. Vacancy rates will remain stable, with many having already undertaken portfolio restructuring in the last couple of years.

05 Going into 2023, UK retail yields are comparatively higher than other sectors. For that reason, retail will be better protected against current debt costs, and the impact of yield movements will be less significant than other sectors.

Retail

SALES HAVE BEEN ON A STEADY DECLINE

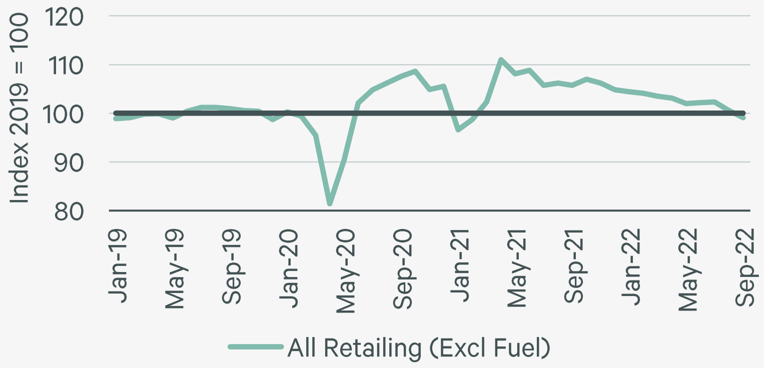
Consumer confidence is at near historic lows – below the levels reported during the Global Financial Crisis, and the height of the pandemic. In September 2022, the UK retail sales volume index dipped below 2019 levels for the first time since the pandemic. This follows a gradual decline from the peak in April 2021, when restrictions were lifted. Given the current economic backdrop, we expect sales will continue to decrease in 2023. Discretionary products, such as household goods and clothing, are currently the most challenged, and as consumers prioritise their spending, this trend is expected to continue in the year ahead.

LEISURE SPEND WILL BE PRESSED IN THE YEAR AHEAD

Aside from discretionary products when considering where money will be saved, CBRE's Global Live-Work-Shop Survey found that UK consumers will first cut back on dining out and leisure activities. While the experience sector remains key to long-term leasing plans, to increase resilience in the short-term, asset managers could consider offering flexible leases to occupiers that are relatively more insulated from economic downturn.

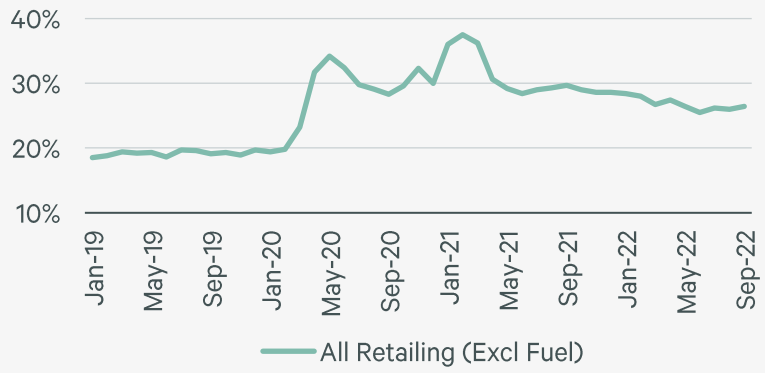
As consumers go out less, at-home entertainment products are expected to perform well in the year ahead, with many seeking to make memories and socialise, but in a more cost-effective way.

Figure 13: UK retail sales volumes (Index 2019 = 100)



Source: ONS, CBRE Research

Figure 14: UK online penetration



Source: ONS, CBRE Research

ONLINE PENETRATIONS REACH NEW NORM – FOR NOW

Online penetrations have come down faster than expected, clearly demonstrating that consumers still value physical retail. Since the start of 2022, penetrations have been on a steady downward trajectory and are now fluctuating at around 26%. Looking ahead to 2023, we expect online penetrations will remain stable, perhaps even falling slightly. According to CBRE's Global Live-Work-Shop Survey, 71% of UK consumers prefer to shop for essential items in-store. As consumer budgets are tightened, essential products will account for a greater share of overall spend, pushing average penetrations down further.

THE STORE WILL BECOME EVEN MORE IMPORTANT

Occupier profit margins will be under increasing strain in the year ahead as inflation continues to bite. One opportunity to save on costs is to rely more heavily on the store portfolio. As logistic costs continue to soar, occupiers are directing consumers back to stores to increase efficiencies. A number of major occupiers are now charging shoppers who return items bought online, with the cost taken from their refund. However, items bought online can still be returned for free in stores. CBRE's Global Live-Work-Shop Survey demonstrates that this initiative is supported by consumers, with 49% of UK respondents preferring to return their orders in-store (a further 30% remain undecided).

MODEST OCCUPIER EXPANSION, BUT VACANCY RATES TO REMAIN STABLE

Modest store expansion is anticipated for well positioned occupiers, in the best locations in 2023. Moreover, following the recent good news from the Autumn Statement on rates revaluation and the abolition of downwards transitional relief, coupled with many occupiers having already undertaken portfolio restructuring in the last few years, we expect there will be less business casualties than during the pandemic. As such, vacancy rates will remain unwavering, and rents will remain stable in prime locations.

RETAIL LESS AFFECTED BY REPRICING THAN OTHER SECTORS

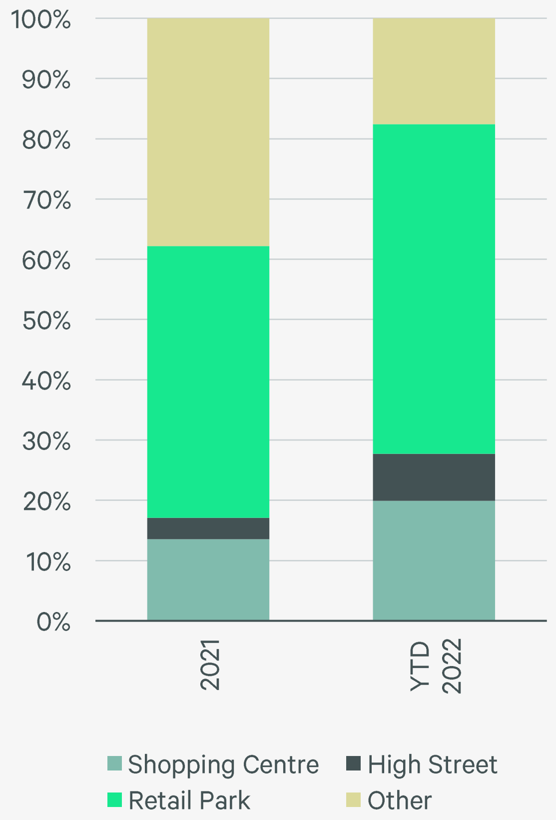
Going into 2023, UK retail yields are comparatively higher than other sectors. Accordingly, we anticipate retail will be better protected against the current costs of debt, and the impact of yield movements will be less significant than other sectors. Year-to-date (YTD) shopping centre yields are stable and remain above shops and retail warehouses, both of which only experienced a small uptick in Q3 2022.

Given the current relativities between the retail sub-sector yields and the bounce back of their performance since the pandemic, we expect the shopping centre come back will continue in 2023. In 2021, the sub-sector accounted for 14% of all retail investment, YTD 2022, it now accounts for 20%. The momentum of retail warehouses might slow slightly in the year ahead, now accounting for 55% of all retail investment YTD 2022. However, given the current economic environment, and their focus on grocery and discounter occupiers, we expect maintained investor interest in this sub-sector.

Figure 15: UK prime retail yields

Source: CBRE Research

Figure 16: UK retail investment profile



Source: CBRE Research

07

Residential

The residential market will face challenges in 2023. This will curb activity and result in moderate price falls in the mainstream housing market. Investment into the sector will remain robust, but pricing will adjust to reflect some yield expansion. However, this will be partly mitigated by strong rent growth.

Key Takeaways

01

As home buyers are faced with a more challenging backdrop in 2023, activity in the housing market will reduce. Even so, while we expect sales to fall below their long-run average, the market will avoid a 'cliff-edge' fall in activity.

02

In line with the wider economic slowdown, we expect prices to fall moderately in 2023 and 2024. But stricter mortgage regulations (since 2014) will somewhat insulate the housing market against large scale distressed sales. The absence of such a 'supply shock' should prevent a significant fall in prices.

03

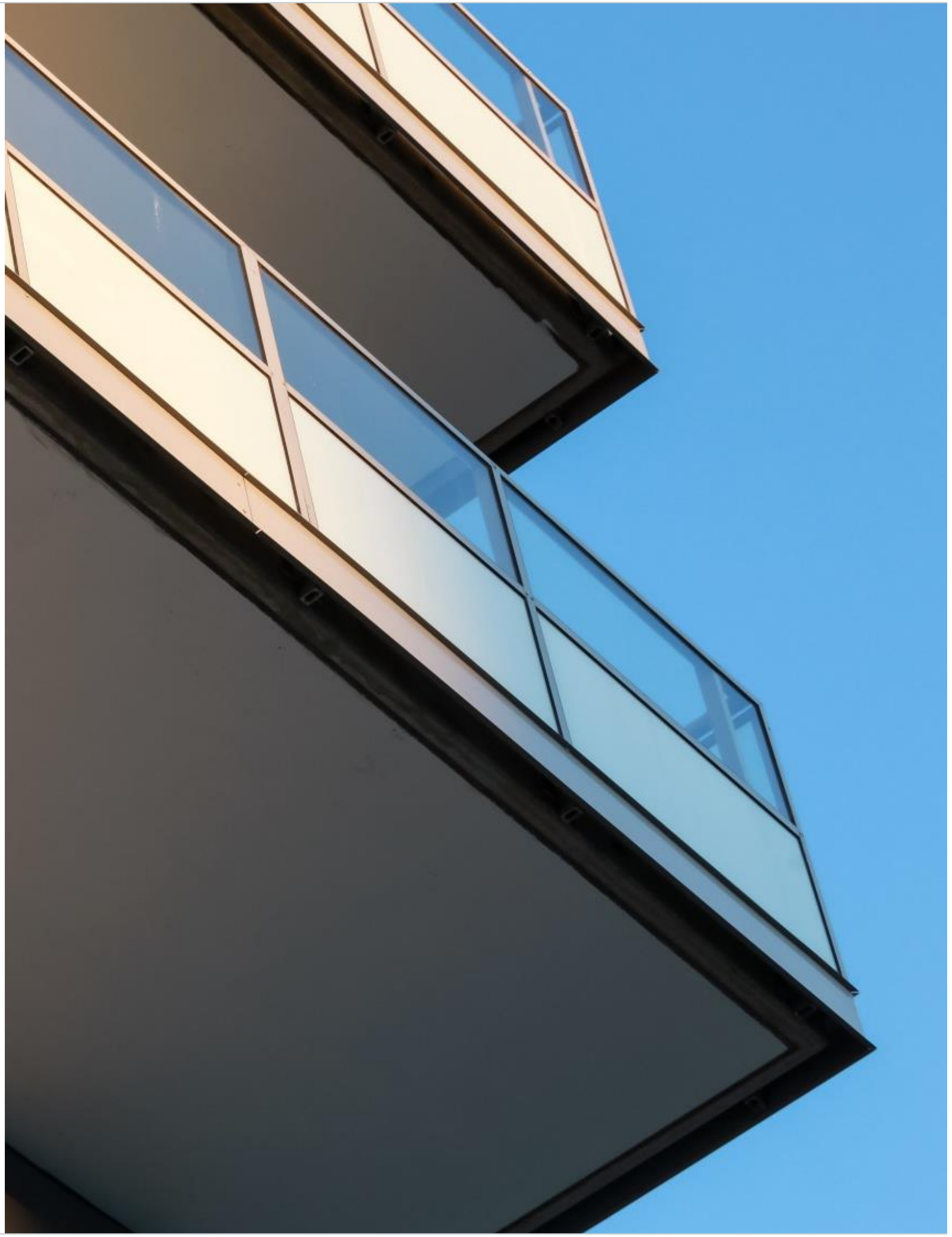
In contrast, the rental sector will remain extremely strong. The challenges faced in the sales market will boost the already strong occupier demand for Build-to-Rent (BTR) and Co-Living.

04

Driven by an acute supply and demand imbalance, rent growth will continue to be strong in 2023. Wider inflation may also push up rents, particularly for renters with inflation-linked tenancy agreements. However, operators have a duty to their tenants and will need to be extremely sensitive of the increased cost of living.

05

Investment appetite for Build-to-Rent and Co-Living will remain strong. However, pricing will adjust to reflect the higher interest rate environment, albeit this will be partly mitigated by strong rent growth. The challenging sales market will present opportunities for single-family Build-to-Rent investors. However, high build cost inflation will continue to hamper forward-funding viability in early 2023.



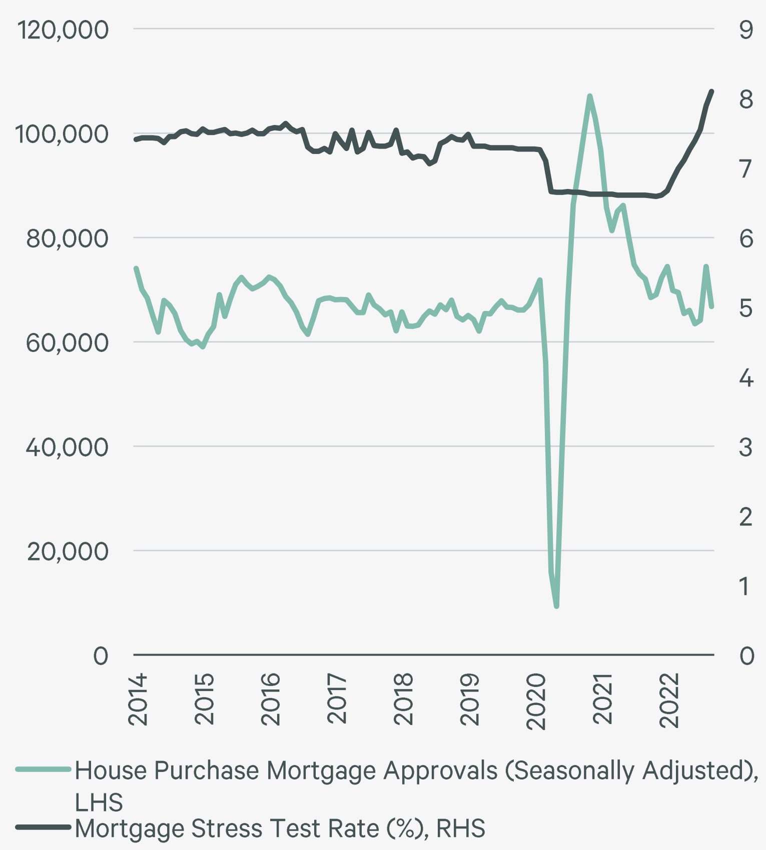
Housing market momentum to slow

The housing market will undoubtedly be turbulent in 2023 as borrowers, who already face a significant increase in their cost of living, will find it more difficult and more expensive to get a mortgage. Mortgage rates increased steeply in the second half of 2022, and will continue to rise in 2023, in line with further base rate rises from the Bank of England. Moreover, the number of mortgage products dropped sharply following the mini-budget on 23 September 2022. Although this has since recovered, the number of fixed rate mortgages available is still 30% below the pre-budget level.

Favourable changes to Stamp Duty thresholds will be in place until 2025, meaning buyers will save some money on their upfront costs. Although, this measure will not dramatically incentivise activity, and any savings will be quickly eroded by higher borrowing costs.

As a result of the more challenging environment, we expect a smaller potential buyer pool in 2023. This may be compounded by the end of Help to Buy scheme that, on average, has facilitated the sale of 40,000 homes a year since its inception in 2013. Although not everyone using the scheme necessarily needed to, we identified that it's absence could result in a fall of 25,000 new home sales per year going forward.

Figure 17: Mortgage stress test And approvals



Source: UK Finance, Bank of England

Taking all the factors together, we expect sales volumes to fall below their long-term average. Still, the economic backdrop is far more favourable than during the Global Financial Crisis, during which time home sales still averaged around 730,000 p.a.

The housing market should be somewhat protected against the higher interest rate environment, due to the stricter mortgage regulation brought in after the Global Financial Crisis, which required borrowers to be 'stress tested' at interest rates of around 7%. Although the regulatory requirement has been scrapped by the Bank of England, individual lenders are still enforcing their own stress testing.

These tighter regulations mean that existing owners should still be able to meet their mortgage repayments, and pressure will ease once inflation comes under control. Lenders will also offer flexibility to make repossession an absolute last resort. As such, the level of distressed sales should be minimised, so there won't be a 'supply shock' to the market. This should keep a floor under prices.

That said, the broader economic outlook creates the conditions for a moderate fall in house prices. By historic standards however, this recession is forecast to be relatively moderate. The current forecast for the unemployment rate is also much lower relative to previous recessions. On balance, we forecast that UK house prices could fall by 3% in 2023, and a further 1% in 2024. We then forecast a strong bounce-back as the economy recovers and lower inflation allows interest rates to be brought back down.

The rental sector will remain resilient against the recession

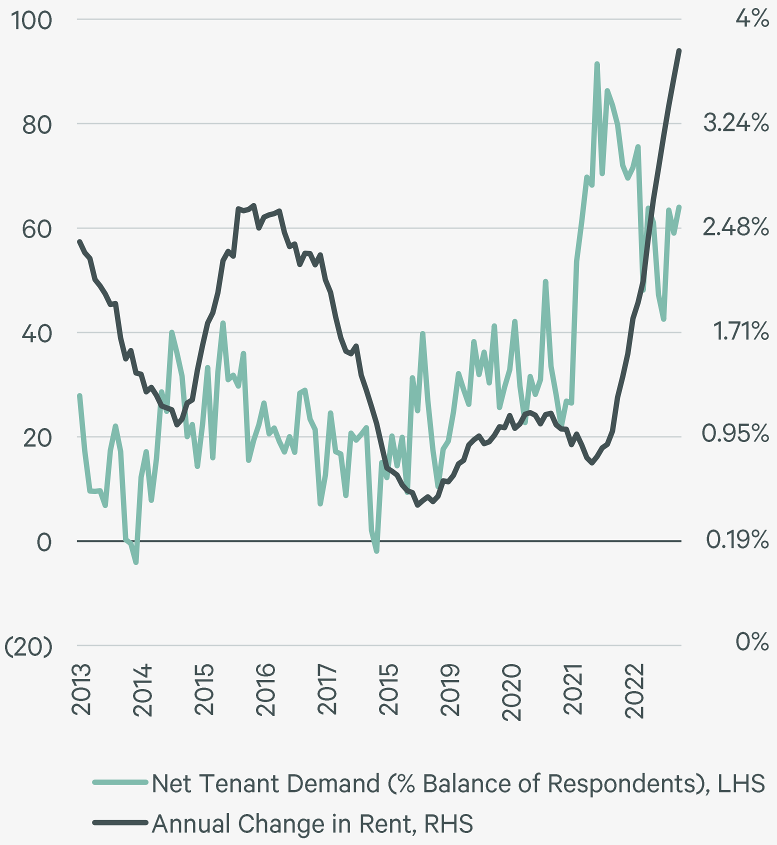
BUILD-TO-RENT SECTOR TO REMAIN FIRM, BUT PRICING WILL ADJUST

The difficulties faced in the sales market will support continued growth in the rental market. For example, with no Help to Buy scheme and higher borrowing costs, many potential first-time buyers will remain in the rented sector. This will sustain what is already, an extremely high-level of tenant demand.

In 2022, high demand significantly outweighed supply, resulting in record levels of rent inflation. This is also partly due to headline inflation being passed through to tenants. Both of which will continue, and we forecast strong rental growth of 4% in 2023, rising to 5% in 2024. These are whole of market forecasts, and the Build-to-Rent sector has the potential to outperform this. That said, operators have a duty to their tenants and will need to be extremely sensitive of the increased cost of living.

In terms of the investment market, demand for Build-to-Rent across both the multifamily and single-family sector, will remain strong. However, yields are likely to expand given the broader interest rate backdrop, albeit this will be limited to an extent by strong rental growth. The more challenging sales market will present further investment opportunities, particularly in the single-family space where housebuilders look to de-risk schemes. Still, until build cost inflation falls and stabilises, the viability of forward funding transactions will remain challenging.

Figure 18: Net tenant demand and change in rent



Source: RICS, ONS

CO-LIVING MOMENTUM TO CONTINUE

Co-Living will continue to gain traction in 2023. More schemes are now complete and operational, which is providing evidence to underpin investment appraisals. Moreover, reflecting the general trend of extremely high tenant demand, completed Co-Living schemes have leased up quickly and are recording high occupancy rates. This is providing further comfort to existing investors and those looking to enter the market.

In our recent report, we highlighted how policy H16 of the London Plan has helped to formalise the Co-Living tenure within the capital. The outcome of the space standards consultation as part of this policy is also due in Q1 2023. This should provide further clarity for the sector from a planning perspective. Given high build cost inflation and onerous S106 payments, the repositioning of existing assets (such as hotels and hostels) to Co-Living will remain an attractive feature of the sector in 2023.

08

Purpose-Built Student Accommodation (PBSA)

Student numbers are at an all-time high. This is driving strong demand for PBSA, which continues to outpace the supply of available beds. As a result, rental growth prospects for the sector are extremely strong.

Key Takeaways

01

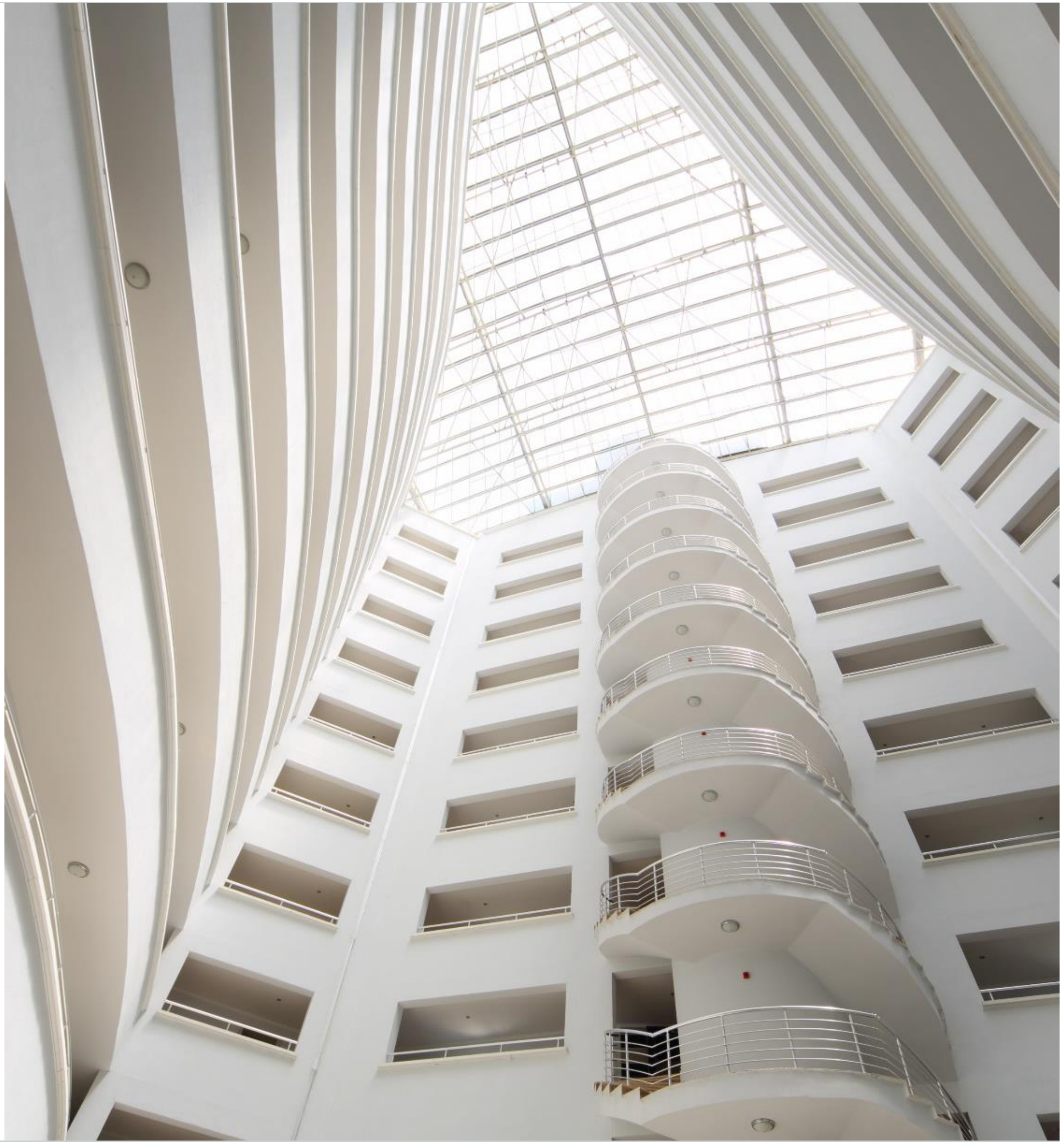
At a macro level, the underlying fundamentals of the PBSA sector have never been in better shape.

02

Overall, the sector continues to be undersupplied but this is highly nuanced. An in-depth understanding of the submarket dynamics is critical.

03

High inflation and rising interest rates will continue to impact the investment market. But this will be offset by the strong return prospects which will drive continued investment into the PBSA sector.



Fundamentals have never been better

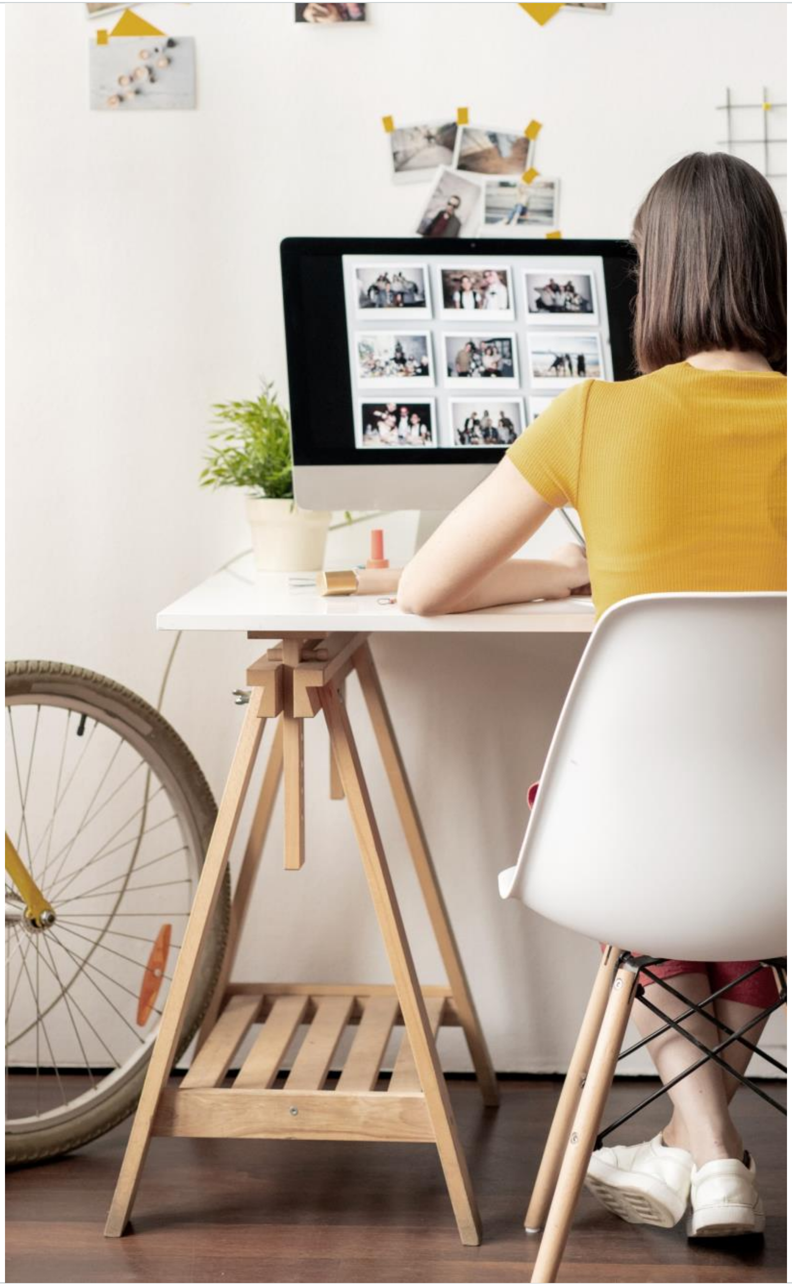
DEMAND WILL REMAIN EXTREMELY STRONG

PBSA demand will remain strong in 2023 as the UK's student population continues to grow. This is underpinned by broad demographic trends, with the population of 18-year-olds forecast to continue rising and increasing participation rates. Historically, recessions have resulted in additional demand for higher education. International student numbers will also continue to grow, building on a record volume in 2022. This will be further driven by the weakening pound, making studying in the UK more attractive. This growth will also offset the fall in students from the European Union, albeit on average, these have only comprised 7% of the UK's higher education population.

In addition, because of increased taxation and further regulation, the supply of Houses in Multiple Occupation for students is falling, which will boost demand for purpose-built accommodation.

SUPPLY WILL CONTINUE TO SLOW

Overall, the development of new PBSA is slowing due to a combination of factors, and this will carry forward into 2023. For example, rising build costs present viability challenges, and the planning system remains a significant barrier to delivery. Rising operational costs will also continue to hinder new development, but positively this should be a more short-term challenge as inflation starts to recede in 2023.



There is, however, an emerging opportunity to reposition legacy PBSA where a new build is unviable. This, and the conversion of office to student accommodation, is likely to increase. Still, any new supply will be concentrated in fewer areas that meet key criteria.

On balance, the growth in demand will continue to significantly outpace the supply. And in certain locations, where the demand and supply imbalance is particularly acute, universities will not be able to guarantee accommodation.

FUNDAMENTALS AND STRONG RETURN PROSPECTS WILL DRIVE INVESTMENT

Occupancy for the 2022/23 academic year is at record levels, and the same is expected for 2023/24. This will create a highly competitive environment and translate into strong rental growth across the sector. This should also give investors comfort that net income growth can be sustained throughout a tumultuous period.

A surge of new entrants will come forward, including overseas investors, attracted by the discount offered by a weaker pound. This, however, will be set against a backdrop of unwilling sellers, which will create competitive tension in the investment market.

Overall, the underlying fundamentals and the prospect of high total returns led by strong rental growth, will continue to drive PBSA investment in 2023.

09

Affordable Housing

The Affordable Housing sector will be resilient in the face of economic pressures. Due to the inflation linked nature of the revenue stream and the strong ESG credentials, private capital will continue to target the sector in 2023.

Key Takeaways

01 Housing associations are resilient, so the sector will remain robust as an asset class over the next year. Arguably, the need for affordable housing increases during an economic downturn.

02 The number of For-Profit Registered Providers (FPRPs) will continue to expand, which will drive investment in the sector. This will also be driven by the strong ESG credentials of affordable housing.

03 It is anticipated that there will be an increase in mergers between Not-For-Profit Registered Providers (RPs). There have been many mergers over the last few years, and this is predicted to continue throughout 2023.

04 The Government's 7% rent cap will mean the sector needs to act in a more effective and cost-efficient manner, but this could have an impact on values.

05 There will be an increase in joint ventures and partnerships between local authorities, housing associations and investors. As we see more investment from private capital, organisations will explore more creative ways of investing in the affordable housing sector.

RPs will remain resilient

INCREASING INTEREST IN AFFORDABLE HOUSING

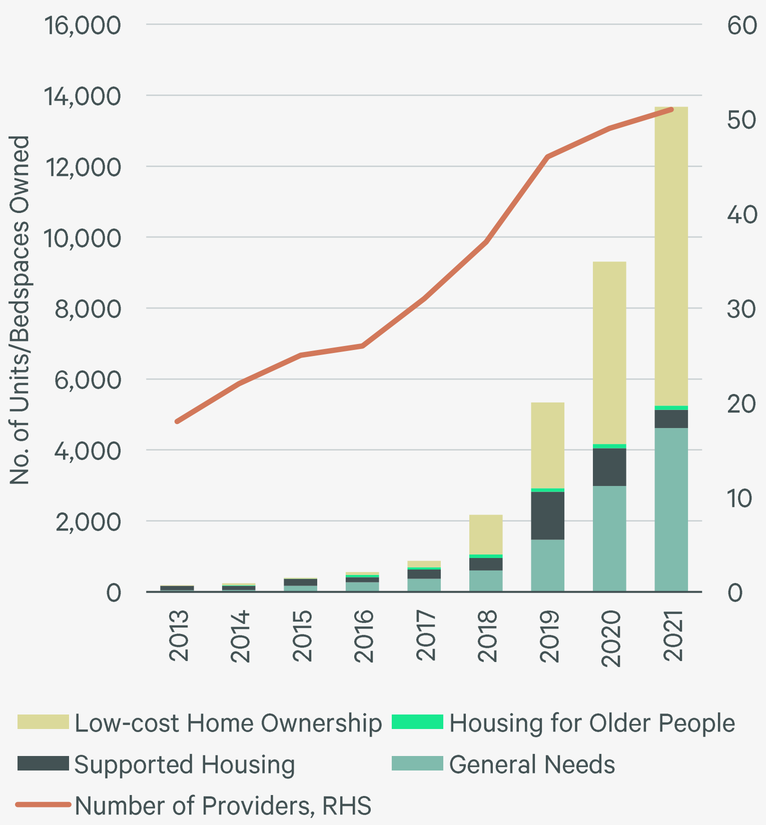
There is a great deal of uncertainty currently facing the affordable housing sector. The wider economic environment is challenging, and the political environment has been in a state of flux, which will have a potential impact on policy. The 2022 Autumn Statement also confirmed that rent rises would be capped at 7% from April next year. This will at least help to reassure investors looking to deploy capital in 2023. However, from a tenant point of view, this level of rent inflation could lead to an increase in arrears. This may lead to voids and bad debts, which could translate into a value adjustment in 2023.

Regardless of any short-term rent caps, the CPI and RPI linked nature of the sector will still attract interest in 2023, particularly from private capital.

We are anticipating yields to move out over the course of 2023. However, affordable housing has some unique characteristics which means it may fare better in a downturn relative to other real estate sectors. These include:

- Inflation linked revenue stream
- Low voids and bad debts
- Inelastic demand
- Counter-cyclical demand
- Robust ESG credentials

Figure 19: For-Profit Registered Providers, England



Source: Regulator of Social Housing (RHS)

ADDITIONAL MERGERS

The rent reductions of the Welfare Reform and Work Act 2016 has driven many mergers between Not-For-Profit RPs over the last few years. We predict that this will continue throughout 2023.

RPs are broadly resilient, but a continued consolidation will help further strengthen smaller and less agile RPs. These new organisations can pool resources and are ultimately better equipped to weather the financial and operational impact resulting from an economic downturn.

We forecast that 2023 will see smaller scale mergers. This will be driven by RPs with less than 1,000 properties looking for increased financial stability that comes with being part of a larger group. This could also lead to further stock rationalisation in 2023.

SHARED OWNERSHIP FACES CHALLENGES

Currently, there is no rent cap and/or Government intervention proposed for this tenure. However, the National Housing Federation has discussed potentially matching the general needs rent cap of 7% for the sector. Market risk is spread across both rent and house price inflation, and although RPI linked rent growth will be strong, falling house prices could soften yields across the sector.

In addition, only a limited number of lenders offer shared ownership mortgages. This, combined with higher mortgage rates, will be a challenge for prospective buyers in 2023 and curtail demand.

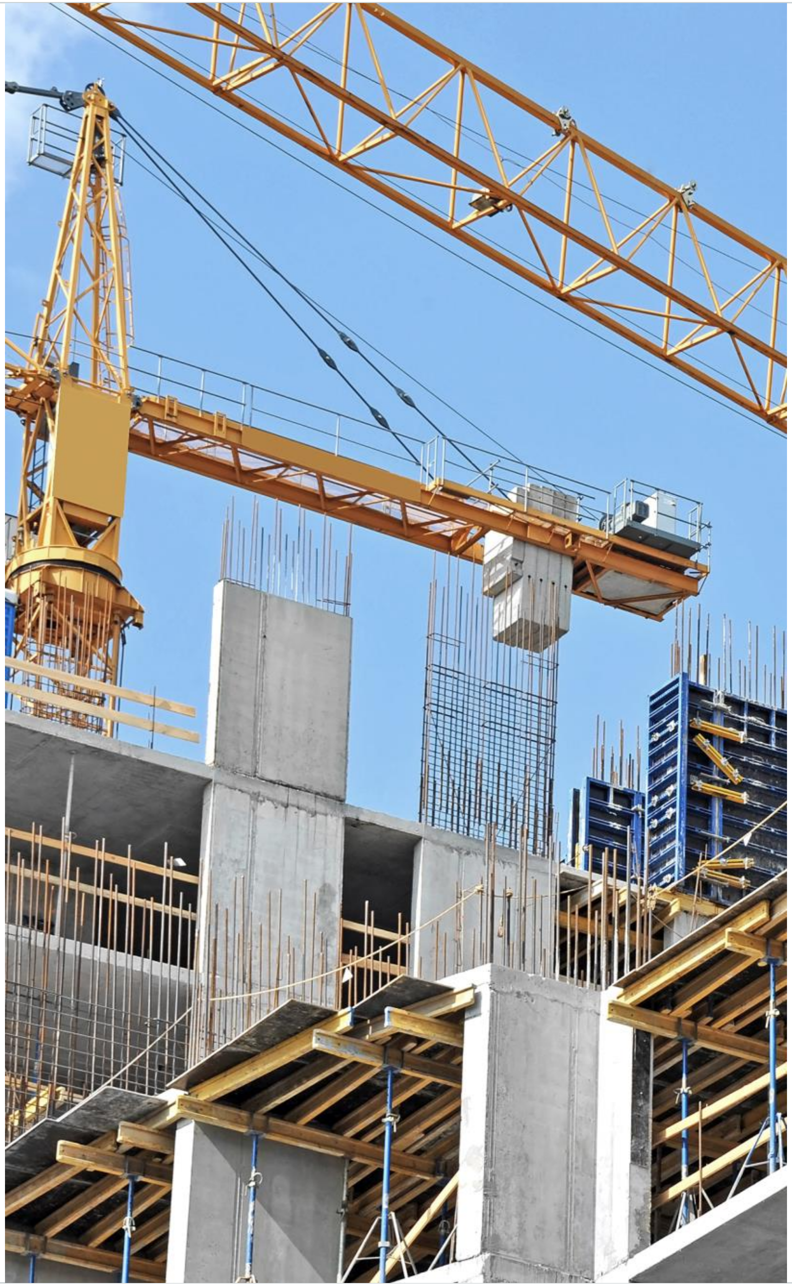
PRIVATE CAPITAL AND INSTITUTIONAL INTEREST IN THE SECTOR WILL REMAIN STRONG

The affordable sector continues to appeal to private capital, which is attracted by the demand and supply imbalance, indexed linked rents, and strong ESG credentials. Given the illiquidity of the sector, partnerships between housing associations and private capital are likely to increase.

Despite the financial uncertainty in 2022, and the recently announced rent cap, institutional interest in the sector remains strong. This will continue to grow in 2023, given the underlying need and demand for affordable housing.

The continued growth of FPRPs means that, according to the Regulator of Social Housing (RSH), there are some sixty applications registered for FPRPs, waiting to be completed. These providers, combined with additional new entrants, will add a significant number of new affordable homes to the UK market in 2023 and beyond.

Significant building cost inflation will impact the financial viability of new schemes, resulting in a slowdown in building activity and supply. In addition, a continued focus on fire safety is an issue for traditional RPs with significant amounts of legacy stock, but this is also impacting on some RPs' appetite for acquisition. Finally, we expect a slow start to the new year, with the bulk of acquisition activity expected in H2 2023.



STRONG ESG CREDENTIALS WILL DRIVE INVESTMENT

The strong ESG credentials of the affordable housing sector remain attractive to investors.

According to figures from Big Society Capital, social impact investment in the UK has grown nearly tenfold over ten years, from £830m in 2011, to £7.9bn in 2021. It states that around £1.6bn of investment was committed across approximately 1,300 investments in 2021. Social and affordable housing funds continue to account for the largest segment of the total market at £3.8bn.

However, we predict that in 2023 there will be a trade-off between ESG targets and the rent cap, which is expected to cost RPs £1.3bn next year.

RPs represent a good, socially responsible investment. As such, more RPs will publish their own ESG reports to help investors understand their credentials, and ultimately, attract further investment.

10

Hotels

On the operational front, hotel demand will remain strong and will hopefully enjoy the first full Covid-free year since 2019. The dynamics around high-end leisure remains favourable in both the short and long term, and the economy segment will hold its gains from the re-bound post-COVID. Corporate travel may face budgetary pressures in the face of wider economic weakness, but demand for small corporate MICE (Meetings, Incentives, Conferences and Exhibitions) business appears to be growing. As the debt market stabilises, the operating fundamentals will attract investors to step in, with growing investment volumes during the year.

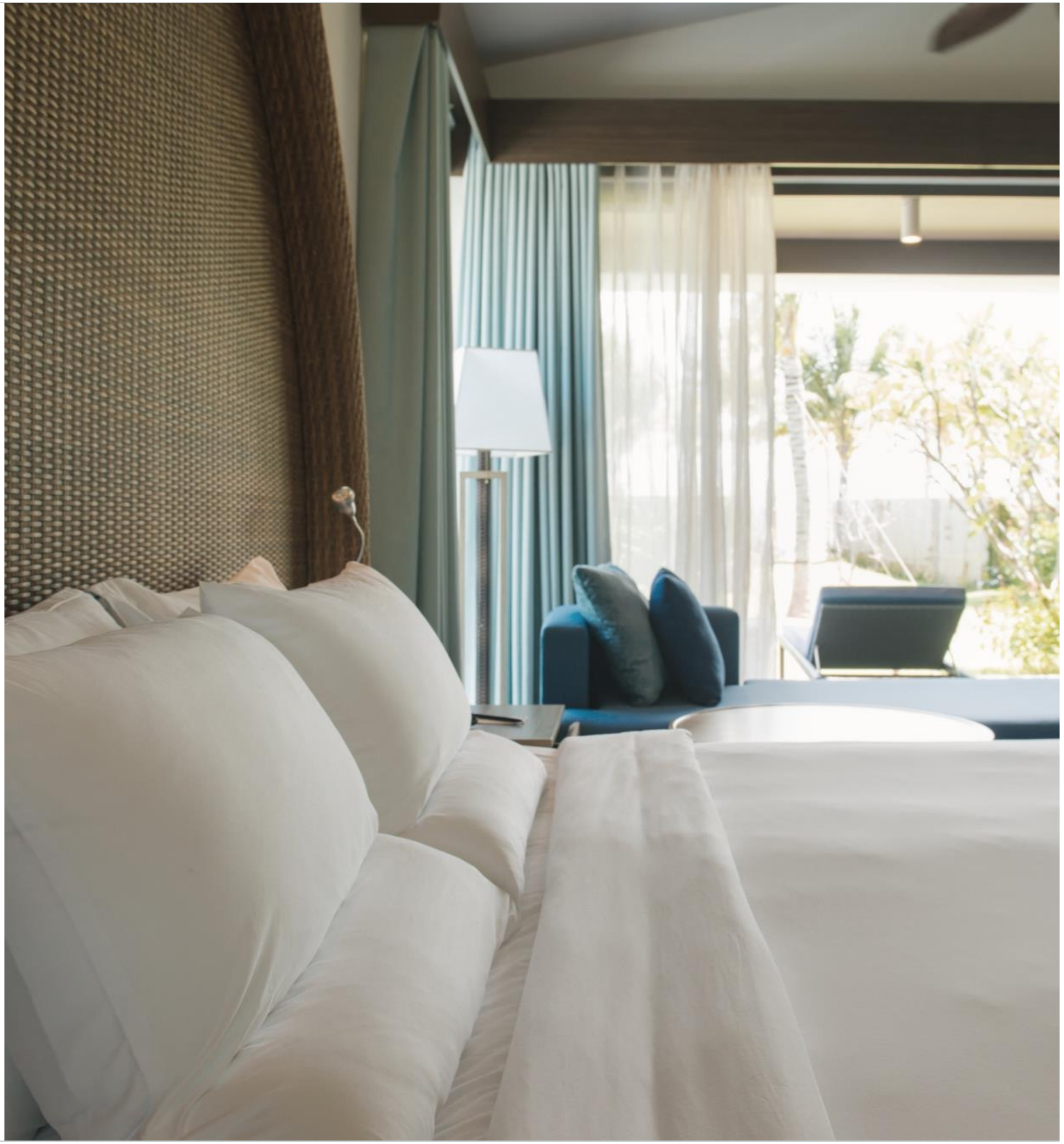
Key Takeaways

01 The rebound of the sector post-COVID has been more rapid than anyone predicted. The early rebounders (economy and luxury leisure) are expected to hold performance levels close to 2022 and continue to grow in later 2023. For those in the 'squeezed middle', it will be imperative to know how a property's positioning is suited to the shifting market environment.

02 A focus on operations management will be key in the context of inflation that affects supplies, wages and utilities. On the revenue side, the sector's historical ability to outpace inflation cannot be taken for granted, but its ability to reprice daily is still a key aspect for the sector while inflation remains high.

03 Demand for larger events may remain muted, but the smaller MICE market appears to have growing demand. Corporates are holding smaller team meetings, but demand for in-person events appears strong – something that is expected to continue nationwide.

04 The rapid slowdown in investment activity, caused by the interest rate volatility, is expected to reverse as both inflation and interest rate movements stabilise. Providing investors with the landscape to invest in a sector where long-term demand fundamentals appear strong.



2023: A multi-speed market that requires operating know-how

Coming off the back of the worst industry crisis in history caused by the pandemic, the UK hotel sector staged a remarkable recovery during 2022. The sector has, historically, been affected by slowdowns in GDP growth. In the current version, we expect that the slowdown's impact will be felt differently across different segments. Previously, people have tended not to stop travelling entirely, though they may travel more selectively.

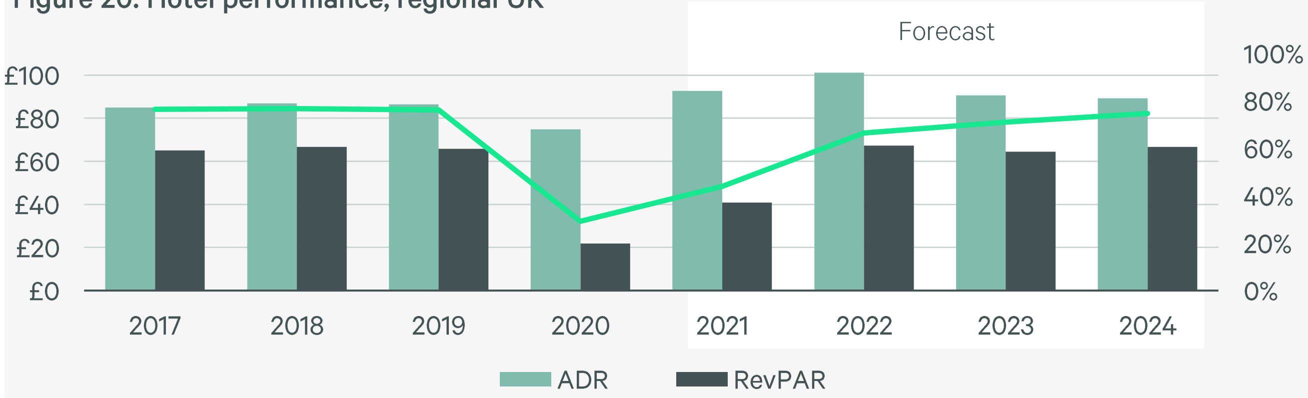
Two groups that we expect to do better are the luxury/leisure segment, poised to continue to do well as its demographic will be less vulnerable to the issues flowing from any recession. Alongside the economy/budget segment, which was the first segment to capture rebounding demand when travellers ventured out tentatively post-COVID – we see this segment as well placed to keep holding that demand. These segments also benefit from either an ability to reprice strongly to offset inflationary costs (in the case of luxury), or minimise the effect of cost inflation due to lower nominal levels of inputs (budget). Investors will see the benefits of these attributes.

In contrast, full-service hotels that face competitive pressure on rates while requiring full input costs will come most under pressure, and it is here where dislocation may create opportunities for change that attract a more active investment strategy.

Large conference and group events remain a challenging arena for the sector, due to the impact of the pandemic, and as this segment tends to track the overall economy. However, the focus for businesses to get people together has been building, and operators are reporting strong in-bound inquiries for smaller MICE business. Investors will look for operators with sales teams that are equipped to capture this demand.

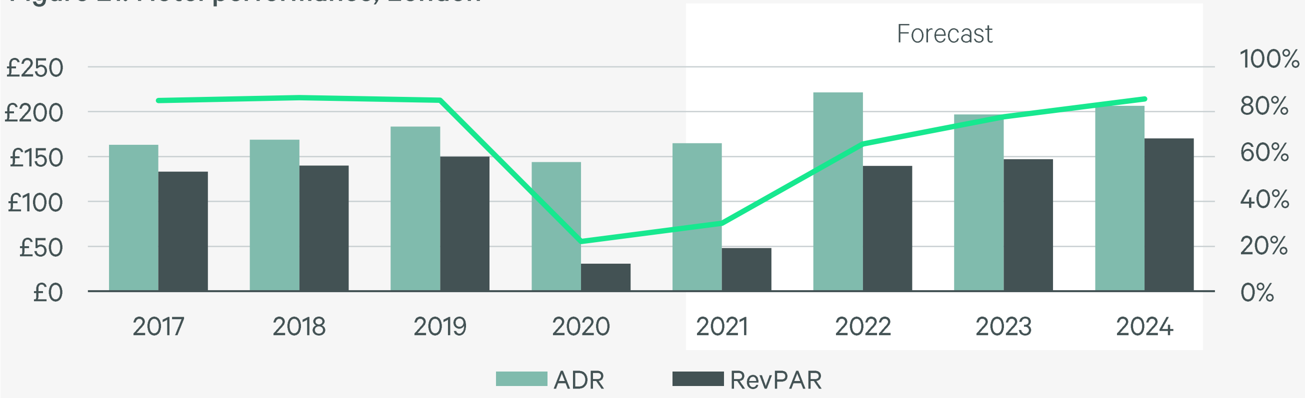
Affected dramatically from mid-year by the volatility in base rates, 2022 will have been one of the quietest investment years on record in the UK. As this volatility abates, investors surveying the landscape will see opportunities both in terms strong underlying fundamentals and more challenged segments that are ripe for repositioning.

Figure 20: Hotel performance, regional UK



Source: HotStats & CBRE Forecasts

Figure 21: Hotel performance, London



Source: HotStats & CBRE Forecasts

11

Healthcare

Healthcare investment activity is 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.

Key Takeaways

01

Investor interest in healthcare property remains strong and transactional activity continues, albeit at a slower pace. As across the wider real estate market, there is some downward pressure on pricing due to wider economic factors, although less so than in other sectors.

02

UK healthcare investment activity is likely to remain robust in 2023, with investors attracted by strong occupier demand, the opportunity to deliver on ESG strategies, long leases and index-linked reviews.

03

Understanding the operational position of healthcare opportunities is critical to investment approach, and being able to analyse performance at a local asset level is vital.

04

The current lending environment is creating opportunities for property investors that can work with operating businesses to create flexible, long term funding partnerships. We expect this to be an area of increased activity in 2023, particularly where refinancing has become more challenging.

Investors drawn to strong occupier demand and attractive lease terms

PRIVATE ACUTE HOSPITALS

Private hospital providers have seen significant growth in both private pay and NHS activity in 2022, as a response to increasing NHS waiting times, and improved private/public sector integration because of the COVID pandemic. It is likely that this trend will continue in 2023, with more than seven million people waiting for NHS treatment, as of August 2022.

We anticipate that the next round of investment activity will be characterised by larger scale strategic recapitalisations.

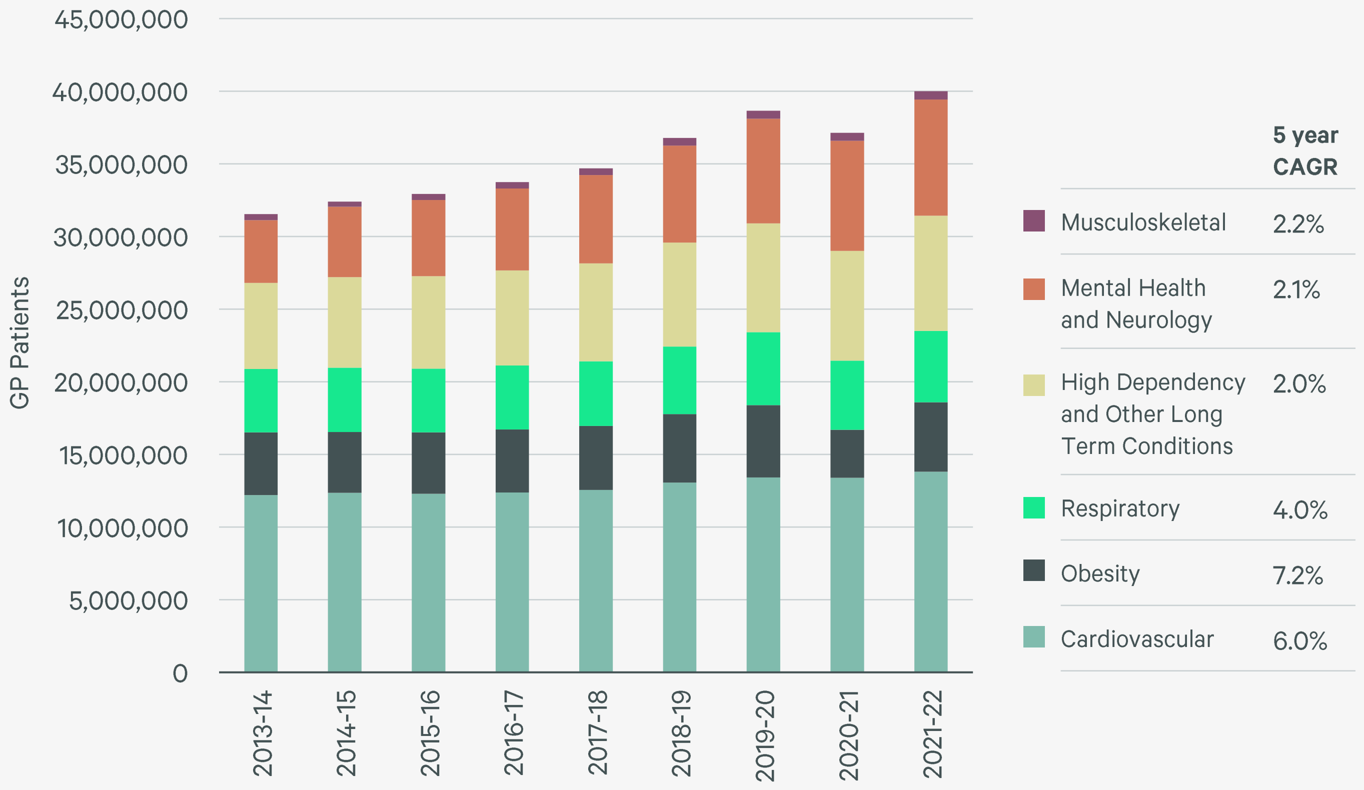
As the trend from inpatient to outpatient activity in the sector evolves, we expect to see an increasing number of smaller local development fundings for elective day surgery facilities. This will create further opportunities for the emerging post-acute rehabilitation market.

PRIMARY CARE

The COVID pandemic has highlighted the importance of primary care to social infrastructure. As NHS waiting lists reach record levels, primary care will become an important part of delivering healthcare services. Over the last decade primary care rents have decreased in real terms, and construction costs have risen. We expect to see upwards pressure on primary care rents in 2023 to enable and encourage third party development to meet increasing demand, and deliver on NHS ESG strategies.

Investment activity slowed following the mini-budget, but we believe volumes will return in the first half of 2023, with investors attracted to stable NHS income streams in a time of economic uncertainty.

Figure 22: Condition prevalence rates, England



Source: NHS Digital QOF Framework

ELDERLY CARE

Rising operational costs compounded by staffing shortages remain a challenge for elderly care providers. Despite this, many operators with a private pay focus have been able to pass on inflationary costs through fee rate increases of over 10%.

Most operators that we work with have seen occupancy recover to pre-COVID levels in 2021, and it is expected that occupancy will fully recover by the end of 2023.

Although real estate investment slowed at the end of 2022, we have seen more overseas investors consider opportunities in the UK elderly market. This will likely translate into a return in volumes in the first half of 2023. An understanding of operational performance at an asset level will be critical for these investors.

Anchor's acquisition of Halcyon has evidenced the demand for OpCo investment in the elderly care space. We expect this demand to gain momentum in 2023.

RETIREMENT LIVING

Investor demand is focused on the nascent rental model, given similarities to the BTR sector. We are also seeing growth in consumer demand for a rental product, but supply will lead this trend.

Development activity in London and the South East has been strong and we expect this to continue in 2023. However, wider economic factors and residential market trends will impact activity.

SPECIALIST CARE HOMES

Infrastructure funds are drawn to the Government-backed income in this sector. There is, however, a question around whether strong historic fee growth will be maintained in 2023, given increasing scrutiny on local authority commissioning.

Cost inflation and staffing has been a challenge for all operational sectors, and we will see continued M&A activity within the specialist care market as groups with efficiencies of scale expand. This market consolidation will be led by smaller platforms, since the top groups are more constrained by competition law.

Services that require specialist real estate, like neurorehabilitation, have attracted capital from property investors. This was demonstrated by the Octopus Real Estate acquisition of six Inspire NeuroCare assets in May 2022. The neurorehabilitation market is fragmented, and we believe there is a significant opportunity for both M&A and real estate investment in this space.

SEN schools represent another key growth market, with parents increasingly demanding specialist care, specialist education and specialist facilities for their children.

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Leisure & Pubs

Operators across the sub-markets are at various stages of recovery and confidence is growing. There is a wall of capital targeting the sector, with a surplus of demand over supply for operational platforms. Visibility of the recovery, and understanding of future performance, will continue to be the key predictor of investment appetite and pricing in each sub sector. Investors able to assess recovery ahead of the curve can benefit from both trading upside and pricing improvements.

Key Takeaways

01

As the sector still holds high attractive inflation protection, urban leisure investment yields should start to stabilise. The delta between prime and secondary assets will increase, with yields anticipated to stabilise by the end of Q1 2023. Yields are unlikely to recover to 2019 levels until the debt markets fully recover.

02

The leisure sector is carrying very high debt levels, whilst finance costs have increased. Cost inflation and pressure on consumer spending will further squeeze operators. We expect operators to review debt positions, and some will take additional debt, or equity, to bridge gaps in their balance sheet.

03

Operational, debt and macroeconomic pressures will see the leisure sector look to access cash locked up in assets. Operators will look to sale and leasebacks, or ground rent transactions, to raise capital without losing sites.

04

Recessionary impact on consumer spend will challenge operators' profitability. Nevertheless, historically leisure has fared well during recessions.

Tight consumer spending will challenge operators' profitability

We expect the impacts of macroeconomic turmoil to be a dominant factor in 2023 with:

- Pressure on sales, driven by lower consumer spending
- Increased operating costs
- Higher debt costs caused by rising interest rates
- Many operators already carrying increased debt burden from COVID

HEALTH CLUBS

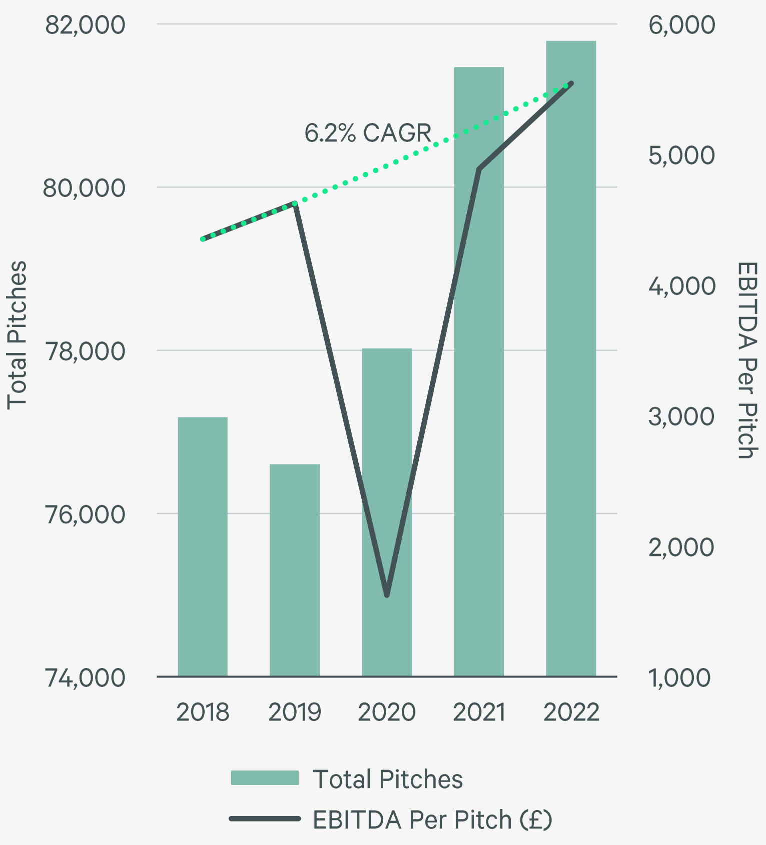
During the Global Financial Crisis gym membership was rated the third commodity, after holidays and mobile phones, that people were least likely to curtail spending on. Racquets clubs have exceeded their pre-COVID membership levels and are known to be the most resilient to recessionary pressures. The mid-market sector will see further consolidation, as these look for selective site acquisitions from their weaker rivals, which will continue into 2023.

CINEMA

Cinema refinancing will continue as operators are still trading below 2019 levels and as such some corporate restructuring will also occur. The impact on attendances means some existing sites are now overrented for current admission numbers. This should ease in 2023 as audience numbers continue to rise on the back of a strong film slate – but it may not be until 2024 when the sector has fully recovered.

Smaller operators such as Everyman, Curzons, The Light and Tivoli will continue to expand, albeit selectively and principally into urban areas with regional operators continuing to expand.

Figure 23: Major holiday park operators



Source: CBRE Forecasts

HOLIDAY PARKS

The strong performance of the UK holiday park market continued for much of 2022. The sector is well placed for 2023, as it was in the immediate aftermath of the Global Financial Crisis. The wider issues around overheads in other hospitality sectors will create pressure on the ability to retain profit margins. Operators have noted that the ability to drive ADR and AWF growth, as they did in 2021, will be problematic due to the wider economic situation. We forecast foreign travel to ease; however, and therefore, the domestic holiday market will be one of the most resilient sectors. Holiday home sales are also expected to ease in 2023 as more operators look towards fleet and hire units ahead of a busy summer.

PUBS

As costs across the board rise for beer, food, labour and energy, coupled with COVID loan repayments and meeting lending covenants, many operators are no longer looking at getting back to 2019 profits in 2023. This has significant implications for cashflow, and, in some cases, the viability of businesses, and we anticipate more agitated corporate action.

We have already started to see a slight weakening in investment yields, but strong covenants and great locations still count for much and should protect the value of some standing investments. This may even be a route that freehold operators might look to in the months ahead.

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Data Centres

Capacity offered by providers in London has been in great demand and 2023 is not expected to be any different in that regard. Cloud service providers need data centres to underpin their efforts.

Key Takeaways

01

Despite weaker macroeconomic conditions, demand for data centre space will remain near all-time highs as the largest cloud service providers look to expand their presence in London.

02

Mergers and acquisitions are 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 will be created as a result.

03

Data centre providers are likelier to cancel newer ventures, such as edge data centres, or plans to expand into smaller locales where returns are less certain.

04

Sustainability-related regulation is 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 also be mandated.

Continued strong demand for data centres

DEMAND FOR CAPACITY TO REMAIN NEAR ALL-TIME HIGH

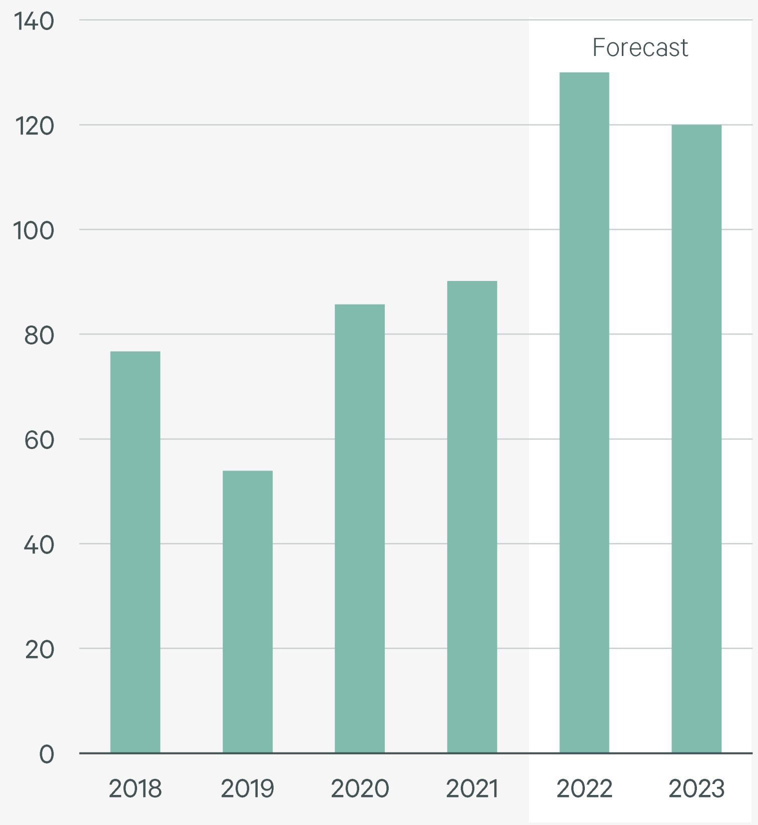
The cost of data centre capacity has soared over the past year, yet demand is expected to remain near its peak in 2023. Microsoft, Google, and Amazon Web Services, collectively referred to as hyperscalers, need the additional data centre capacity to support their plans to offer digital services despite the weaker macroeconomic conditions in the UK. Furthermore, any concerns that the appetite for capacity may be waning in London or abroad, are unfounded in CBRE's view. We forecast 120MW of take-up in 2023, just below the all-time high (130MW) we believe the market will reach in 2022.

SUSTAINABILITY-SPECIFIC REGULATION TO BE INTRODUCED

As the data centre industry has grown, the environmental impact of its facilities have become a topic of greater concern. The industry has developed a higher profile as the importance and level of services, and the pressure its placed on the electricity grids in multiple markets, has grown. The Greater London Authority recently rejected power applications by housing authorities in three West London boroughs citing data centre demand.

To address those concerns, operators have made commitments to achieve net zero carbon across their estates, and deploy clean energy strategies. We don't think the measures will be perceived as sufficient. As such, data centre specific regulations are likelier to be introduced in 2023. As a result, designated areas for data centre development could be implemented in the future. Similarly, district heat reuse and limits on power consumption may be mandated.

Figure 24: London data centre take-up (MW), 2018-2023F



Source: CBRE Research

SOME PROVIDERS TO SCALE BACK EXPANSION PLANS

Plans to build in some of the smallest markets in Europe may be put on hold or cancelled altogether in the new year by some providers. Uncertain returns in the short-term means plans to enter some new markets will be scrutinised further, if not cancelled altogether, given worsening economic conditions. The development of edge facilities, an emerging class of data centres, run a similarly higher risk of cancellation given the expense involved and largely unproven business case behind edge-focused providers.

SPATE OF DATA CENTRE PROVIDER CONSOLIDATION EXPECTED

We expect a consolidation of data centre providers in the new year, as larger cash-rich players will take the economic downturn as an opportunity to subsume weaker competitors.

Data centres are seen as an attractive investment class given the defensive nature of revenue streams and robust associated capital values. However, the risk of tenant flight in a recession or economic downturn is somewhat higher which could lead to the sale of weaker, more inefficient providers, to stronger competitors.

CBRE expects several significant platform opportunities to arise in 2023. The providers likeliest to be on the block will represent significant expansion potential for acquisitors, have power secured and a strong management team in place. It is likely we will witness more activity in smaller, second-tier European markets.

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Life Sciences

The sector continues to expand, in part driven by companies seeking to de-risk supply chains following the experience over COVID. The golden triangle remains a particular focus, with a majority of funding allocated to these areas. Still, its reach is broadening into other regional locations.

Key Takeaways

01

The life sciences sector will continue its growth trajectory, and employment is also expected to grow at double the rate of wider employment, as outlined in CBRE's Trends That Transcend The US Life Sciences report. The current demand/supply imbalance of available lab space is likely to continue into 2023, particularly in the Golden Triangle of Cambridge, London, and Oxford. Laboratory rents are therefore expected to increase in these locations.

02

The Golden Triangle remains the focus of life sciences activity from both an employment and funding point of view; 80% of all venture capital is directed to these three cities. However, other locations are also attracting investment including Stevenage, Manchester, Edinburgh, and Birmingham. The Government's proposals to promote investment in low growth university towns, as announced in the Autumn Statement, could help other aspiring hubs.

03

The Government has ambitions to make the UK a "Science Superpower" by 2030 and the sector will benefit from continued Government R&D funding as part of a package to deliver this. There is also a review of EU regulations to identify if changes are needed to help boost the sector's overall competitiveness on a regional and global scale.

The Life Sciences sector continues to evolve

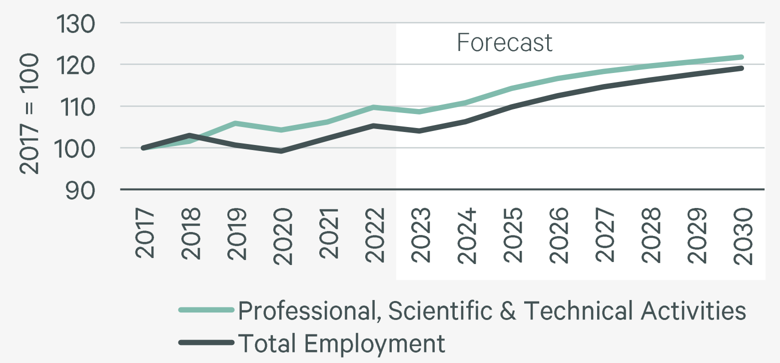
The UK has made big advancements in the life science sector, with the amount of Venture Capital investment more than doubling and a 20% increase in the number of firms over the past five years. The demand for lab space to house the growing start-ups and mid size companies has been growing as a result.

Incubators provide affordable space for start-up companies to grow, and are often founded or linked to academia. In the UK, these are expanding and we are now also witnessing a healthy blend of other incubator types emerging, including private/public JVs and more recently real estate investor backed facilities.

Even prior to the pandemic, there were concerns around supply chain resilience and the over-reliance on overseas markets for the manufacturing of many drugs. Recent supply chain issues have exposed the UK; currently only 25% of our medicines are produced at home. With the current trend moving away from global supply chains to more regionalised and localised operations, the UK should benefit from onshoring, reshoring and nearshoring movements. With its highly skilled workforce, the UK remains well placed to attract Advanced Therapies Manufacturing, for vaccines and Cell and Gene Therapies.

The Government has ambitions to make the UK a "Science Superpower" by 2030. Despite the current economic climate, the sector will benefit from continued Government R&D funding as part of a package to deliver this. There is also a review of EU regulations to identify if changes are needed to help boost the sector's overall competitiveness both regionally and globally.

Figure 25: Employment growth



Source: ONS, Oxford Economics

EMPLOYMENT WILL CONTINUE TO GROW

There are around 268,000 people employed in the life sciences industry. And over the last 5 years, participation has grown by c10%. This is double the rate of growth of total employment. We expect this trend to continue, and forecasts suggest employment in the Life Science sector will increase by around 8% between now and 2027. This compares with total employment growth of about 3.5%.

Still employment levels and growth are not uniform across the UK, with the established clusters in Cambridge, London and Oxford having the biggest concentration of scientists and entrepreneurs.

This mirrors the Venture Capital distribution trend, where over 80% of funding is allocated to the Golden triangle. These cities now have about 10.2 mill sq ft of space in the 5 year delivery pipeline, but until that starts to deliver, a demand/supply imbalance of lab space will continue,. Other life sciences hubs, existing and emerging, like Stevenage, Manchester, Edinburgh and Birmingham are attracting VC investment, which is feeding through to employment prospects.

ENERGY COSTS AT THE FOREFRONT

Labs are intensive energy users and the National Renewable Energy Laboratory estimates the annual energy costs in a lab can be between £6-£14 per sq ft. So, even prior to the current energy crisis, occupiers were increasingly demanding energy efficient labs. But the recent focus on costs has amplified this trend, as Harvard University shows, an energy efficient lab can reduce costs by 70%. Energy use is also increasing due to the intensification of technology adoption including lasers, robotics and image analysis. The supporting infrastructure is also energy intensive, for example, a single fume ventilation hood can consume as much energy as up to three homes per year. The push towards net zero carbon further increases the appetite for energy efficient accommodation.

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