Real Estate House View

United Kingdom

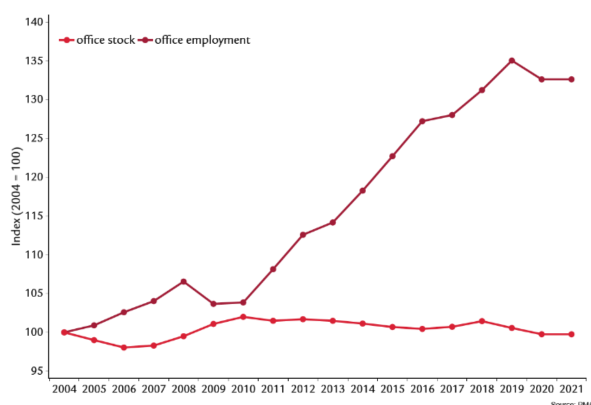
Swiss Life Asset Managers

Second half-year 2022

Key takeaways

- **UK All Property performance softens in H1:** Total returns moderated in H1 2022 to 9.6% compared to 12.9% in H2 2021 based on the MSCI UK Monthly Index. All main sectors, including retail, saw a positive return. However, performance polarisation between segments remains a pervasive theme.
- **Geopolitical events impact investment activity:** Activity during H1 2022 has been a tale of two halves. Strong momentum from last year continued into Q1 2022 but subsequent geopolitical events resulted in a more cautious investment strategy in Q2 2022, although this may present opportunities in H2 2022.
- **Logistics performance remains in top place:** As operators seek to hold higher levels of inventory as protection against supply chain disruptions, the imbalance between supply and demand continues to drive performance. Although the industrial sector has seen the highest returns over H1 2022, several factors are causing a drag and the strong pace seen last year has begun to moderate.
- **Yield gap widening between quality and secondary offices:** All-offices returned 3.4% over the first half of the year, however this figure masks significant polarisation in performance between prime, Grade A offices and weaker quality stock. A reduction in space requirements has provided the financial boost to allow occupiers to focus only on best-in-class.
- **Retail warehouses continue to skew the data:** Retail warehousing has contributed a 14.6% total return to the retail sector where all other segments recorded returns below 4.8%. As inflation continues to rise, it will be increasingly important to monitor tenant performance over the second half of the year.

Chart in focus



Since 2004, total office stock in the UK has remained broadly stable, despite a sharp and consistent increase in office-based employment. This is due to relatively low levels of development and the conversion of office space to residential. As a result, occupiers are using their space more efficiently and are considered to have less excess space than in previous downturns. This should mean the sector is more resilient than many expect, as hybrid working becomes engrained as the ‘new normal’, and also offer opportunities for rental growth in office assets that meet changing business needs and employee preferences.

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The Bank of England was one of the first central banks in Europe to start tightening monetary policy. Despite this, inflation rose seemingly unchecked until June. Consumers and wage earners, who are already having to tighten their belts, are suffering as a result. Real (i.e. price-adjusted) retail sales have been falling almost continuously since their peak in April 2021. Companies are proving surprisingly resilient. The purchasing managers' indices for industry have held up much better than on the continent, and the survey values for service providers have so far shown no signs of dampening. However, the high inflation rate will mean that the Bank of England will have to raise interest rates further in the second half of the year. The central bank itself considers the possibility that this measure will lead to a recession to be very likely.

Cautious investment activity

The strong transaction activity seen at the end of last year continued into the first quarter, with volumes reaching £15.5 bn, over double the 10-year average for Q1. Uncertainty caused by geopolitical events and rising inflation that soon unravelled subsequently impacted investment activity, which slowed to just £6.5 bn over the second quarter. Despite this, total volumes over H1 2022 are 14% above the 10-year average and, although demand may have tapered, this may present buying opportunities over the second half of the year.

Activity focused on prime offices

Performance in the office sector has been steady during H1 2022, returning 1.7% in Q2 compared to 1.5% in Q1. Across all segments, rental values inched up 0.3%, but pricing changes have resulted in a larger spread in capital value growth, with the strongest growth seen in the West End and weakest in the regions, recording 2.7% and 0.0%, respectively. Although yield movements have been modest overall, significant polarisation is being experienced as demand focuses almost exclusively on prime, grade A stock. As a result, the yield gap has widened and will continue to do so as occupier demand targets best-in-class space and will pay premium rents to secure this. In Greater London and the Southeast, grade A rents were 53% above Grade B and C rents, which is being echoed across other markets particularly outside of London where commuters seek well-connected assets to avoid rising fuel costs.

Industrials outperform

The industrial market continues to outperform, albeit at a slower pace. Industrials returned 13.9% over H1 2022, reflecting a slowdown since last year. Several factors have, unsurprisingly, caused a drag on performance including the rise in fuel, with costs now reaching a 30+ year high, and continued disruptions across the supply chain. Nevertheless, capital values are up 11.9% over H1 due to a combination of continued inward yield shift and rental growth. Rental growth has been relatively consistent across the sector, with values increasing 6.3%, and is forecast to continue as rising construction costs subdue the development pipeline.

Retail warehouses outperform

MSCI all-retail has performed well over H1 2022, with returns reaching 10.1% and capital values increasing by 6.8%. Performance continues to be skewed by retail warehousing, which outperforms all other segments, returning 14.6% and experiencing capital value growth of 11.3%, driven by continued yield compression over the period. Rental growth has been poor overall at 0.3%, with all segments other than retail warehousing experiencing negative growth. The current fall in real incomes has forced households into cautious spending behaviour. Coupled with rising energy, manufacturing, and staff costs, the outlook for retail operators looks challenging. Budget and food-based operators are likely to be most defensive, as well as luxury retailers who target an affluent consumer base.

Recovery likely to slow in 2022

The uncertain economic outlook will have undoubtedly affected investor confidence, which combined with a higher interest rate environment may put upward pressure on yields. Nevertheless, opportunities for rental growth are still apparent, particularly in prime, well-connected locations with strong market fundamentals. The supply-demand imbalance remains favourable for living sectors, with the PRS segment anticipated to prove relatively resilient and continue to deliver impressive income returns.

Chart 1: All Property returns (Q2 2022)

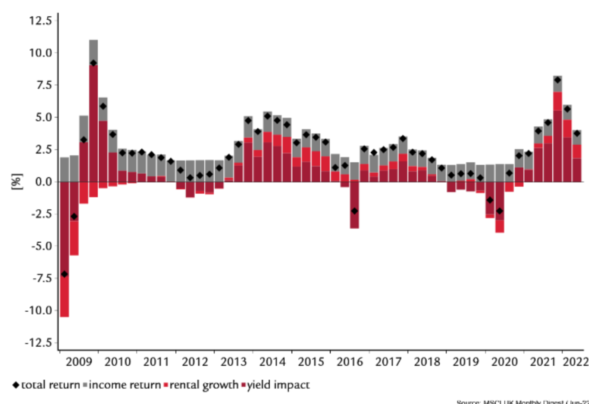
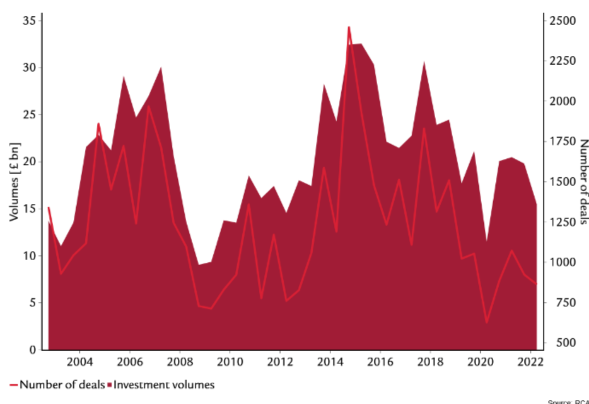


Chart 2: UK property investment volumes (to Q2 2022)



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