Alternatives Research
Real Estate

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Marketing Material*

U.K. REAL ESTATE STRATEGIC OUTLOOK

First Quarter

IN A NUTSHELL

- Entering 2021, there are certainly reasons for optimism. Nevertheless, the short term is still fraught with challenges.
- Residential and logistics continue to be best placed to outperform, and although we are more cautious towards offices in general, our outlook for the Central London prime office market remains positive.
- We anticipate that the U.K. retail sector will endure yet further losses over the coming years.

Entering 2021, there are certainly reasons for optimism. The uncertainty of a No Deal Brexit has finally been laid to rest and a national Covid-19 vaccine rollout is well underway. Nevertheless, the short term is still fraught with challenges and the path to recovery is not expected to be a simple one. Residential and logistics continue to be best placed to outperform and our outlook for the Central London prime office market remains positive. That being said, we are now more cautious towards the office sector in general and we anticipate further divergence between prime and secondary stock. We anticipate that the U.K. retail sector will endure yet further losses over the coming years.

Short-term challenges remain

Last year proved a challenging year for U.K. real estate, with the market severely impacted by the Covid-19 pandemic alongside ongoing Brexit uncertainty. According to the MSCI monthly index, average commercial property values fell by 6.3% over the year – led by double digit declines in retail and hotel values. Only the industrial sector recorded growth over 2020, at 3.6%.[1]

In the short term, as Covid-19 remains an immediate threat, headwinds to U.K. real estate persist. With the country entering a third national lockdown in January this year, suppressed occupier and investment activity is likely to continue over the first half of 2021, particularly impacting the office and retail sectors.

While the hit to employment has not yet been as severe as expected, government support schemes will begin to wind down later this year and a weakening of the labour market is anticipated. Given the close correlation between office rents and employment, we expect to see further pressure on prime rents this year, although the decline is forecast to be less severe than in 2020.

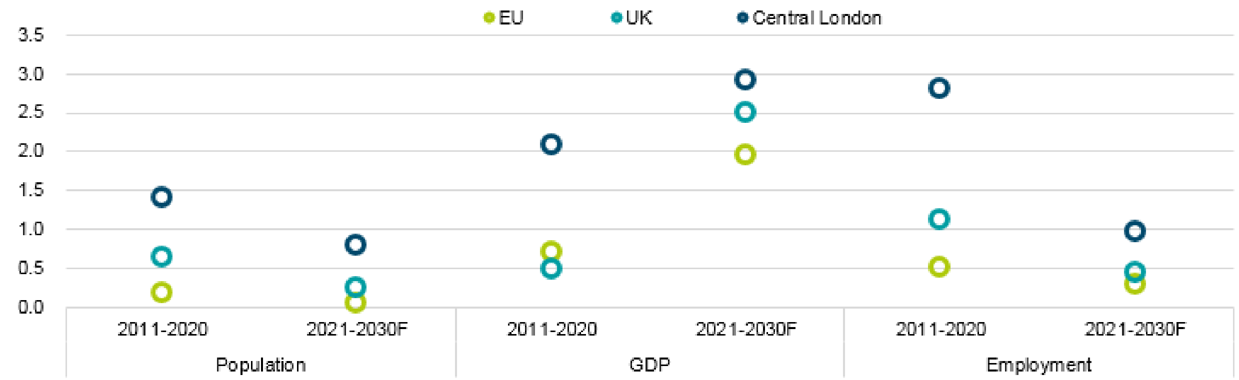
[1] MSCI, January 2021

Longer-term growth and recovery

Beyond these short-term risks, the picture for U.K. real estate is more positive. Most importantly, a Covid-19 vaccination programme is now well underway across the country and as the year progresses we expect a rebound in economic activity. Occupier demand should then begin to recover, and coupled with a relatively modest development pipeline, we expect to see fairly strong levels of prime rent growth across all sectors – excluding retail – from 2022 onwards.

On a relative basis, longer-term growth fundamentals are also encouraging. The economy is expected to grow faster than the E.U. average over the coming decade, with London in particular a considerable outperformer. In addition, regardless of the anticipated reduction in E.U immigration post-Brexit, the national population is still expected to grow.[2]

Macroeconomic Outlook (% P.A)



Source: DWS, Oxford Economics, January 2021. F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

With regard to the investment market, we anticipate that international investors will increasingly target U.K. real estate as the year progresses. After four years of political uncertainty, the U.K. and E.U. reached a post-Brexit trade agreement on 24th December 2020, removing the threat of a No Deal Brexit that has undoubtedly held back the U.K. real estate market since the referendum in 2016. With yields remaining fairly stagnant in recent years, prime U.K. real estate now offers a considerable premium over both government bonds and other European real estate markets. For example, the London City office market has seen prime yields track the Core Europe average for much of the past fifteen years, but today a 75 basis point premium has opened up.[3] In addition, with 10-year Gilt yields close to zero, the yield spread on a City of London office is around 400 basis points, a record high, and more than double the historical average.[4]

As such, while there is undoubtedly still some level of Brexit uncertainty, particularly regarding financial services, we anticipate that the attractive pricing of U.K. real estate in relative terms will attract investors and subsequently push up prices.

Logistics and residential set to outperform

Like much of the rest of Europe, and in a continuation of the trends witnessed over 2020, we anticipate logistics and residential to be the top performing sectors within the U.K.

Last year proved to be a record year for U.K. logistics take-up, driven by the ongoing shift to online sales. Although big box logistics rents in corridor locations remained largely stable over the year, we saw further strong prime rent growth in urban logistics locations. Looking forward, we continue to favour these urban locations – within a city's inner ring road –

[2] Sources: DWS, Oxford Economics, January 2021
[3] PMA, December 2020
[4] Macrobond, PMA, December 2020

which benefit from access to a large volume of online spend and are often supported by particularly constrained levels of supply.

The residential private rented sector (PRS) was the other outperformer of 2020. The rapidly institutionalising sector is increasingly considered a key investment strategy for core real estate investors, given its counter-cyclical characteristics. Indeed, rising unemployment and mortgage restrictions have limited owner occupancy and demand for PRS has continued to strengthen. The limited supply picture, alongside a positive outlook for medium-to-longer-term disposable income growth should drive strong future rental appreciation, particularly in London (Zones 2-6), the capital's surrounding commuter locations, and major regional cities.

Prime Rent Forecast, 2021-25F (% P.A.)

Source: DWS, December 2021. F = Forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

We are generally more cautious on the office sector. Prime rents were not impacted as severely as was expected over 2020, but take-up plummeted across U.K. markets. Going forward, we expect that the acceleration of remote working could dampen office demand over the longer term and London has been identified as one of the European cities most exposed to increased levels of working from home, due to the city's long commute times and expensive office rents.

Nevertheless, although our long-term rent growth outlook is now somewhat weaker than prior to the pandemic, over the five-year forecast, we still see London as a strong outperformer. In addition, as fundamentals improve we expect that international capital will drive yields lower, resulting in returns well in excess of the European average.

Finally, we anticipate further divergence between prime and secondary office stock. ESG will increasingly be at the forefront of both occupier and investment decisions and 'Next Generation' office buildings are expected to outperform as occupiers increasingly seek quality over quantity.

Research & Strategy—Alternatives

OFFICE LOCATIONS:

Chicago
222 South Riverside Plaza
34th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
Winchester House
1 Great Winchester Street
London EC2N 2DB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
20th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000

TEAM:

Global

Kevin White, CFA
Co-Head of Real Estate Research & Strategy
kevin.white@dws.com

Simon Wallace
Co-Head of Real Estate Research & Strategy
simon.wallace@dws.com

Gianluca Minella
Head of Infrastructure Research
gianluca.minella@dws.com

Americas

Brooks Wells
Head of Research, Americas
brooks.wells@dws.com

Liliana Diaconu, CFA
Office Research
liliana.diaconu@dws.com

Ross Adams
Industrial Research
ross.adams@dws.com

Ryan DeFeo
Property Market Research
ryan-c.defeo@dws.com

Ana Leon
Retail Research
ana.leon@dws.com

Joseph Pecora, CFA
Apartment Research
joseph.pecora@dws.com

Europe

Tom Francis
Property Market Research
tom.francis@dws.com

Siena Golan
Property Market Research
siena.golan@dws.com

Rosie Hunt
Property Market Research
rosie.hunt@dws.com

Martin Lippmann
Property Market Research
martin.lippmann@dws.com

Florian van-Kann
Property Market Research
florian.van-kann@dws.com

Aizhan Meldebek
Infrastructure Research
aizhan.meldebek@dws.com

Asia Pacific

Koichiro Obu
Head of Research & Strategy, Asia Pacific
koichiro-a.obu@dws.com

Natasha Lee
Property Market Research
natasha-j.lee@dws.com

Seng-Hong Teng
Property Market Research
seng-hong.teng@dws.com

Hyunwoo Kim
Property Market Research
hyunwoo.kim@dws.com

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- Adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;
- Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established;
- Changes in the relative popularity of property types and locations;
- Risks and operating problems arising out of the presence of certain construction materials; and
- Currency / exchange rate risks where the investments are denominated in a currency other than the investor's home currency.

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