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NORD/LB Real Estate Finance

Real Estate Special Spring 2024:

UK. Real estate market showing signs of optimism.

Finanzgruppe

Contents

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Introduction

The macroeconomic market environment in the UK was marred by a number of negative factors in 2023. In an effort to tackle high inflation, the Bank of England raised its key interest rate – the Bank Rate – by 175 basis points from 3.50 % to 5.25 % in a series of five interest rate hikes in the period up to August last year. It is now official that the British economy has been in a technical recession since the end of 2023. The Office for National Statistics recently published GDP figures that continued to show negative growth of -0.3 % in the fourth quarter of 2023 (Q3 2023: -0.1 % qoq). As a result, the definition of a technical recession (when GDP is negative for two consecutive quarters) has been met. For 2023 as a whole, economic growth is likely to stand at a disappointing 0.1 %. Meanwhile, data on inflation remains cautiously optimistic and continued to point in the right direction in early 2024. At 4.0 %, however, it is still too high. Consequently, the anticipated cut in interest rates is likely to be delayed for a while yet and may not materialise until the second half of the year, at the earliest.[1] The medium- and long-term effects of Brexit on the country's economic strength constitute an additional source of uncertainty. The knock-on effects can still be felt four years after the UK left the EU.

The challenging economic conditions with high inflationary pressure and a sharp rise in interest rates were also reflected in the UK real estate investment market. Investor uncertainty was clearly noticeable. Despite a strong final quarter (£ 10.7 billion, or +2 % compared to Q4 2022), transaction volume fell by around one-third to £ 43.3 billion in 2023. UK investors accounted for 54.5 % of that transaction volume. This marked a reversal in the trend seen over the previous three years, when cross-border capital accounted for the majority of investment activity. All asset classes suffered a decline in transaction volume last year. Comprising a total investment volume of £ 10.8 billion, residential real estate was the most popular asset class. This was followed by office and industrial space in second and third place, coming in at £ 9.5 billion and £ 9.2 billion respectively, while retail space contributed £ 5.4 billion to the total investment volume. The anticipated reduction in key interest rates is likely to stimulate the leasing and investment markets appreciably in the second half of 2024. That said, interest rates will probably remain at a higher level than in the preceding decade, which is likely to make it more difficult to utilise borrowed capital for acquisitions.[2] A survey of European real estate investors conducted by CBRE found that the UK will remain the leading European destination for investment in real estate in 2024, meaning Germany has been relegated to second place for the second consecutive year.[3]

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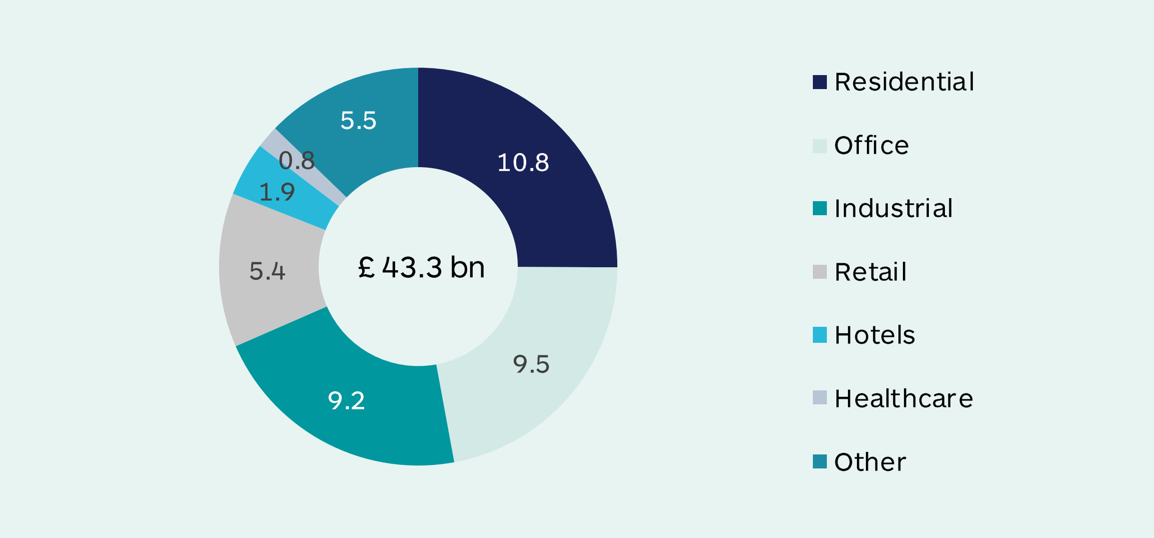
[1] NORD/LB Macro Research: News Flash: UK CPI: Die Inflation ist nicht „trendy" genug! (available in German only) 14 February 2024
[2] CBRE: UK Real Estate Investment, Q4 2023
[3] CBRE: European Investor Intentions Survey, February 2024

Investment volume in the UK by asset class in 2023 (in £ billions)



Source: CBRE, NORD/LB Sector Strategy

The individual asset classes have been impacted to varying degrees by the various crises and challenges of recent years (including the coronavirus pandemic, Brexit, the war in Ukraine and the surge in key interest rates). Sustainability is a focal point in all asset classes. Given that the UK has one of the longest-standing inventories of properties in Europe, and that further tightening of energy efficiency standards in the real estate sector is expected, the need for the energy-efficient refurbishment of both commercial and residential buildings will be accordingly high in the years ahead.[4] On the whole, the individual real estate submarkets recorded fairly robust growth:

- The **office real estate market** is facing challenges in the light of economic uncertainties and the structural reduction in the amount of space required owing to the increased number of people working from home since the COVID-19 pandemic. Demand is centred on high-quality and sustainable buildings (Grade A), which is further polarising the market. Consequently, the supply of high-quality, modern space in London's prime locations remains tight. This trend can also be seen in regional office markets across the country – a situation that is being further intensified by planning and building delays brought about by a difficult financing and cost environment.

- In spite of the uncertainties outlined above, the **retail real estate market** remains highly resilient. The slump in consumption expected for 2023 failed to materialise. Consumer spending rose by 5.1 % on the previous year, despite the fact that – adjusted for inflation – the volume of sales fell for the second year running (-2.8 %). Having fallen sharply in 2022, consumer confidence improved steadily over the course of 2023 and hit a two-year high in January 2024. Footfall is only slightly lower than its pre-crisis level. E-commerce has now returned to normal and is continuing the trend seen before the crisis. Although vacancy rates rose recently after a number of well-known retailers went out of business, prime retail areas are recording a high level of leasing transactions and positive rental growth.

[4] GTAI: Vereinigtes Königreich – Klimaneutralität bis 2050 angestrebt (available in German only), 4 September 2023

// A combination of interest rate hikes, high inflation and weak economic growth since mid-2022 has resulted in a drop in demand in the **residential real estate market**, which has gone hand in hand with a fall in house prices. Currently, however, house prices are once again showing signs of stabilising, boosted by lower mortgage interest rates and the persistent supply shortage. By contrast, rental prices on the leasing market have risen sharply over the past three years – although growth rates eased off last year.

Following a brief overview of the macroeconomic environment, this analysis of the UK real estate market will examine how the individual office, retail and residential asset classes are developing against the backdrop of current economic and geopolitical parameters and a selection of megatrends. In this context, the analysis explores the future prospects for the individual asset classes, taking into account economic uncertainties and structural particularities, as well as the risks and challenges that may need to be considered.

Macroeconomic conditions

Macroeconomic environment faced a range of different challenges in 2023
In 2020, the year when the UK left the EU and the COVID-19 pandemic struck, the country was hit by a slump in GDP of just under 10.0 % (Euroland: -6.7 %; Germany: -4.9 %). However, this was followed by a strong economic recovery in 2021, with GDP growing by 7.5 % (Euroland: +5.3 %; Germany: +2.6 %). Although Brexit caused uncertainty and a slowdown in economic growth, the overall economy initially proved to be more robust than expected. Thanks to a positive start to 2022, the UK's economic growth remained solid, with GDP growth of 4.2 % despite the impact of the war in Ukraine (Euroland: +3.5 %; Germany: +1.8%). However, the British economy was hit hard last year by multiple negative factors, such as record inflation, a sharp hike in interest rates and labour shortages. The UK is also struggling with the knock-on effects of Brexit, which are reflected in weak foreign trade. As a result, GDP is expected to grow only by +0.1 % in 2023 (Euroland: +0.5 %; Germany: -0.3 %). According to the latest figures on quarterly GDP published by the Office for National Statistics, the British economy has been in a technical recession since the end of 2023. Negative quarter-on-quarter GDP growth of -0.3 % was again reported for Q4 2023, which was even lower than the figure for Q3 2023 (-0.1 % Q/Q). Our forecasts indicate that economic growth will remain subdued in 2024, with GDP set to grow by 0.5 % (Euroland: +0.5 %; Germany: +0.0 %).[5]

Last year, the British economy was massively hit by an inflation rate that, at times, was the highest recorded by any of the major industrialised countries. The result was a considerable weakening of private consumption. The average inflation rate in 2023 was 7.3 % (Euroland: 5.4 %; Germany: 6.0 %). It is encouraging to see that inflation has been on a marked downward trend since the second half of 2023. Thanks to a significant drop in energy prices, the inflation rate fell by more than half, from 10.4 % in February to 3.9 % in November. However, it did unexpectedly rise again to 4.0 % in December before stagnating at the start of this year. Based on our forecasts, the inflation rate of 2.9 % this year is still expected to be above the target of 2.0 %, but should remain on a downward trajectory.[6] The decline in core inflation, which is calculated net of energy and food prices, is proving to be more stubborn, although the trend is pointing in the right direction in this case too. The rate fell by one percentage point to 5.1 % over

[5] NORD/LB Macro Research: Economic Adviser, 23 February 2024
[6] NORD/LB Macro Research: Economic Adviser, 26 January 2024

the course of 2023, where it remained in January 2024.[7] The labour market situation remains challenging. Brexit and the coronavirus pandemic have caused a significant decline in the labour supply in recent years, which has, in turn, resulted in substantial wage increases and pushed up inflation. In 2023, the unemployment rate rose from its lowest point of 3.7 % to 4.1 %. At the very least, this should hold back further wage increases. We expect the figure to climb further to 4.7 % by the end of 2024.[8] This development is expected to slow wage growth down further and help reduce core inflation.

Further evidence that the impact of Brexit has not yet been absorbed in full can be seen in the poor performance of the British Purchasing Managers' Index (PMI) for the manufacturing sector. Although the UK PMI Manufacturing continued to improve in February 2024 by recording a slight increase of 0.1 points to 47.1 points, it failed to break through the 50-point mark. This shows that the manufacturing industry in the UK has been stuck in a sustained crisis for 18 consecutive months. Sentiment among service providers, however, is more optimistic than in the manufacturing sector. The UK PMI Services was up 0.9 points to (rev.) 54.3 points at the start of the year and remained at this level in February – the highest it has been since June of last year. In February, the PMI Composite Output Index, which is based on data from the two indicators mentioned above, rose by 0.4 points on the previous month to reach 53.3 points. This relatively positive trend is being driven primarily by recovering consumer confidence (see retail real estate market).[9]

Preliminary figures for January 2024 indicate that sentiment in the UK construction sector improved by 2.0 points on the previous month to reach 48.8 points. While sentiment in the construction industry continues to be in a contractive range, this improvement can be regarded as a positive sign. The reasons for this improvement in sentiment are recovering supply chains and lower prices for building materials.[10]

The budget situation in the UK remains tense. In 2023, the budget deficit is expected to have widened to -5.0 % of GDP (Euroland: -3.2 %; Germany: -2.0 %),[11] although the government is endeavouring to consolidate the budget in the medium term. However, with a public debt ratio of over 100 % and significantly higher financing costs, the government's scope for investment is limited.[12]

Key economic figures (change yoy in %)

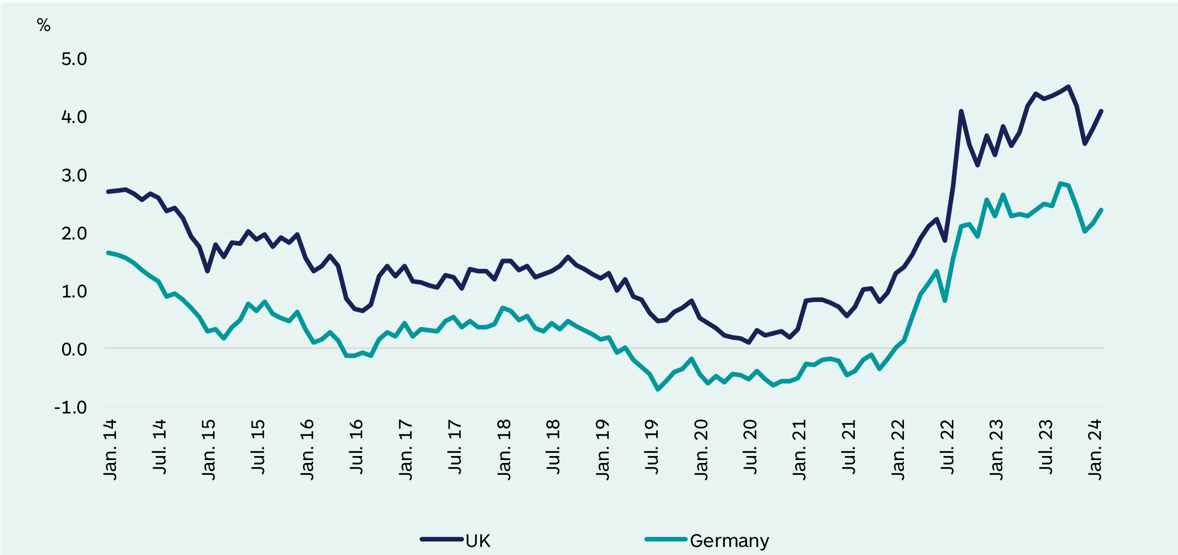
	2020	2021	2022	2023f	2024f	2025f
GDP	-9.8	7.5	4.3	0.1	0.5	1.2
Inflation (CPI)	0.9	2.6	9.1	7.3	2.9	2.2
Unemployment rate*	4.5	4.5	3.7	4.0	4.7	4.7
Budget balance**	-12.4	-8.0	-4.6	-5.0	-3.6	-3.0
Current account balance**	-3.5	-3.4	-3.2	-2.8	-2.5	-2.4

Source: Feri, Bloomberg, NORD/LB Macro Research, * in % of the labour force as per ILO concept, ** in % of GDP

[7] Office for National Statistics
[8] NORD/LB Macro Research: Economic Adviser, 26 January 2024
[9] NORD/LB Macro Research: Economic Adviser, 23 February 2024 and News Flash: UK: PMIs – Produzenten weiterhin „Pfui“ und Dienstleister „Hui“ (available in German only), 24 January 2024
[10] NORD/LB Macro Research: News Flash: UK: Construction PMI – Gewinnt Betongold wieder an Bedeutung? (available in German only), 6 February 2024
[11] NORD/LB Macro Research: Economic Adviser, 26 January 2024
[12] Office for National Statistics

Historically high inflation, one of the main factors driving monetary policy moves, prompted the Bank of England (BoE) to raise the Bank Rate for the first time in December 2021. This was followed by an additional 14 rate hikes that brought it from just over 0 % to 5.25 % in August 2023. The Bank Rate has remained at this level since then. Any further increases in the key interest rate could have slowed the UK economy down too much. Yields on UK government bonds fell sharply to around 3.5 % in December 2023 in the wake of the marked drop in inflation, before rising again to around 4.1 % at the start of the year. As a result, they continue to remain at a significantly higher yield level than government bonds in Germany and most other eurozone countries. Given the size of the national budget deficit and the current account balance, these levels are expected to remain high. Most recently, the risk premium on ten-year gilts was around 1.70 percentage points higher than German government bonds. When it comes to country ratings, the UK is rated AAu by Standard & Poor's and Aa3u by Moody's, with both agencies maintaining a stable outlook.[13]

Performance of 10-year government bond yields



Source: Macrobond, NORD/LB Sector Strategy

In 2023, the pound sterling appreciated around 3.0 % in value against the euro. The euro was slightly stronger in the wake of the BoE's decision not to raise interest rates further in late autumn, rising to £ 0.87 in October. However, it fell again at the beginning of December due to the pronounced decline in inflation, which fuelled expectations that a cycle of interest rate cuts would begin in 2024. We expect the EUR-GBP exchange rate to move sideways in 2024, with no significant upward or downward peaks.[14] Monetary policy remains the key factor. A tighter monetary policy by the BoE relative to the ECB would weigh more heavily on the British economy and the pound sterling. From the point of view of a eurozone investor looking to invest in the UK real estate market, a weaker pound would ultimately be an additional incentive to do so.

[13] Macrobond
[14] NORD/LB Macro Research: Economic Adviser, 26 January 2024

Interest and exchange rates

	3 M	6 M	12 M
Repo rate	5.25	5.00	4.75
10Y	3.90	3.85	3.65
Spread 10Y Bund	170	175	155
EUR in GBP	0.87	0.88	0.87
GBP in USD	1.22	1.22	1.24

Source: NORD/LB Macro Research, Macrobond

When it signed the Paris Climate Accords in 2015, the UK committed to progressively reducing net greenhouse gas emissions to zero by 2050. Even though the UK has no longer been subject to EU regulations regarding sustainability since exiting the EU on 1 January 2021, many existing EU regulations have since been assimilated into UK law. An ambitious interim target of reducing greenhouse gases by 78 % compared to the base year 1990 has already been set for 2035.[15] Residential and commercial real estate is a key factor in achieving the zero-emissions target, as it is responsible for around 40 % of European energy consumption and 36 % of European greenhouse gas emissions.[16] To help improve the energy performance of private rented homes and buildings, for instance, the British government introduced the Minimum Energy Efficiency Standards (MEES) in 2018. Since 2023, the standards require buildings to achieve a minimum "E" rating (on a scale from A to G) in their energy performance certificate (EPC). Buildings that fail to meet this standard must undergo an energy-efficiency retrofit if they are to be sold or let after the transition period has expired. In addition, incremental increases to bring the rating up to EPC B are expected by 2030. The extent of the potential need for retrofitting would be huge. The United Kingdom has one of the oldest stocks of buildings in Europe. As at June 2023, it was estimated that around 88 % of residential buildings and 86 % of other commercial buildings in the UK had a rating below B.[17]

Outlook: Cuts in key interest rates expected in the second half of 2024

GDP growth	↗
Unemployment rate	↗
Inflation	↘
Private consumption	↗

While 2023 was a year marked by economic challenges for the UK, key economic indicators for 2024 contain signs for cautious optimism. A combination of easing inflation and anticipated interest rate cuts in the second half of 2024 could pave the way for an economic recovery. Falling inflation is likely to result in an increase in real income, which should, in turn, boost private consumption. It remains difficult to predict how Brexit will affect the country's economic strength and prosperity in the medium and long term. New trade regulations came into effect at the end of January (tighter import regulations on agricultural goods), which could have the effect of driving inflation up again. Moreover, uncertainty remains regarding the geopolitical situation. An escalation of the conflict in the Middle East in the form of

[15] GTAI: Vereinigtes Königreich – Klimaneutralität bis 2050 angestrebt (available in German only), 4 September 2023
[16]https://www.consilium.europa.eu/de/policies/green-deal/fit-for-55-the-eu-plan-for-a-green-transition/#:~:text=Auf%20Geb%C3%A4ude%20entfal len%2040%20%25%20des,dar%C3%BCber%20hinaus%20energieeffizienter%20zu%20machen, retrieved on 29 January 2024
[17] The UBS Sustainability and Impact Institute: Rethink, rebuild, reimagine – Laying the foundation for better buildings, 2023

further disruptions to the transport of goods via the Red Sea could also hamper the downward trend in inflation and thus keep interest rates high for longer than expected.[18] This would greatly impede economic recovery, thereby weighing on the macroeconomic environment in the real estate market.

Office real estate market

Office space faces headwinds from multiple directions
The combination of the economic downturn and structural adjustments owing to the increased number of people working from home since the outbreak of the COVID-19 pandemic are having a significant impact on the UK office space market. Against this backdrop, prime energy-efficient core office real estate in central locations has proven to be particularly resilient. In the post-COVID-19 environment, hybrid working has become a permanent feature of modern life. The average time spent working in offices has fallen noticeably since the pandemic began and now stands at 3.1 days in London, for instance.[19] This is also reflected in London's monthly passenger volumes at the main underground stations in the City and West End, which have fallen by a third (down by around 22 million passengers) compared to pre-coronavirus commuter traffic.[20] However, both businesses and employees are aware that office buildings will continue to be an integral part of modern working life in the future. Consequently, employers are gradually obliging their staff to return to the office. Even so, companies can still achieve significant cost savings and reduce inefficiency by increasing the number of hybrid workplace models. Office space is in short supply and expensive, especially in the London office market, which further incentivises companies to make efficient use of their office space. In the period from 2005 to 2022, the amount of office space available in the well-established Central London office market fell by over 30 %. As a result, there was only around 12 m² of office space available per employee working in a London office at the end of 2022. Compare this to Stuttgart, for example, where there was around 28 m² available per office employee.[21]

In addition to the conventional office, flexible workplace concepts have become significantly more important in the wake of the COVID-19 pandemic. The increasing optimisation of space, taking into account the precise weighing up of the amount and quality of space required, has boosted the flex office sector, especially in the City of London, Europe's most mature flexible office market. In the first half of 2023, this sector accounted for roughly 13 % of total office take-up in London, with the strongest demand coming from the creative industries sector.[22]

All in all, demand is trending towards smaller but high-quality office space in preferred locations. In this context, sustainability is high up on the priority list. However, the supply meeting this demand pattern is limited, with the amount of office space constructed over the past 20 years accounting for only around 38 % of total stock in Central London. By contrast, most of the existing office space in London is more than 20 years old, and the need for refurbishment is therefore quite high. The pressure to act will be further intensified by a potential further tightening of the targets laid down in the MEES (energy performance certificate with a minimum "B" rating for commercial properties; see section on macroeconomic

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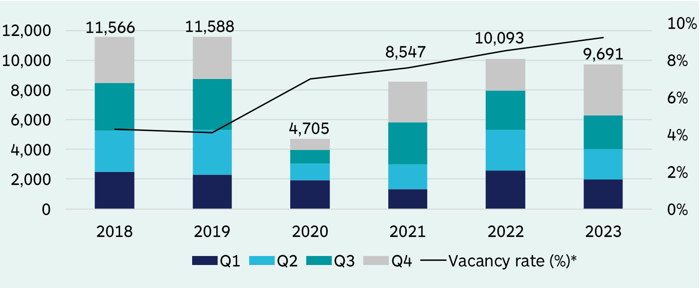
[18] NORD/LB Macro Research: News Flash: Bank of England: Eine gegen Alle (available in German only), 1 February 2024
[19] McKinsey Global Institute: Empty spaces and hybrid places, July 2023
[20] Börsen-Zeitung: Londons Büroangestellte bleiben dem Office fern, 4 October 2023
[21] Savills: European Office Outlook, August 2023
[22] Savills: Spotlight: European Flexible Offices, September 2023

conditions). This is likely to affect the lion's share of office space in London.[23] Regional markets such as Leeds and Manchester, however, are faring slightly better, with 38 % and 39 % of their buildings respectively classified as energy-efficient (with an energy performance certificate rated B or higher).[24]

Polarised demand for space in office markets

Looking at Central London, Europe's most expensive office space market, the figures for 2023 were quite robust, with take-up totalling around 9.7 million sq ft. Although market conditions were difficult, the decline on the previous year was therefore only around 4 %, and 5 % when compared to the ten-year average. The last quarter of 2023 in particular exhibited significant momentum. Take-up in Q4 2023 increased by 55 % on the previous quarter to reach around 3.4 million sq ft, thus registering the highest Q4 take-up level since 2010. In the fourth quarter of 2023 alone, a total of ten transactions comprising upwards of 50,000 sq ft were completed in London. However, it should be noted that market activity in 2023 was dominated by smaller deals overall, with 72 % of all transactions falling in the 5 to 50,000 sq ft range (2022: 68 %). In terms of industries, the banking and financial services sector, along with the other services sector, were the main contributors to the steady growth in take-up, accounting for 30 % and 25 % of total take-up respectively. Demand centred on high-quality and sustainable buildings (Grade A), which is further polarising the market. The total supply of office space in Central London fell to 23.1 million sq ft at the end of last year. Consequently, the average vacancy rate in Q4 2023 dropped quarter on quarter to 9.2 % (Q3 2023: 9.6 %). That said, the vacancy rate remained higher than in the same quarter in the previous year (Q4 2022: 8.5 %) and considerably higher than the ten-year average of 5.7 %.[25] By comparison, the average vacancy rate in Europe at the end of 2023 was slightly lower, at 8.0 %. In this case, however, the trend was higher than in the previous quarter (Q3 2023: 7.7 %).[26] Given the increase in construction and financing costs and the decline in the number of new building projects coupled with high demand, the supply of prime office space is likely to remain quite tight in the years ahead.[27]

Central London:
Changes in take-up (in 1,000 sq ft) and vacancy rates



Source: JLL, NORD/LB Sector Strategy, *Vacancy rate at the end of the year

Central London submarkets:
Changes in take-up and vacancy rates in 2023

	West End	City	East London
Take-up (in 000 sq ft)	3,209	6,046	445
Δ 2023/2022	-21%	+11%	-28%
Vacancy rate Q4 (in %)	7.4	9.1	16.3
Δ 2023/2022	+1.1%-points	+0.1%-point	+1.9%-points
Prime rent (£/sq ft)	140.00	79.50	57.50
Δ 2023/2022	+7.7%	+9.7%	+4.5%

Source: JLL, NORD/LB Sector Strategy

An analysis of London's submarkets reveals diverging market trends. West End is benefiting from a stable tenant profile and has the lowest vacancy rate of all submarkets. Following a surge in demand in recent years from the IT sector, law firms and government agencies in particular, demand for office space from the banking and financial services sector picked up again in 2023. Although the average vacancy

[23] CBRE: What does the future hold for Central London's Office supply? January 2024
[24] CBRE: How energy efficient is our city centre office stock? 31 January 2024
[25] JLL: Central London office market report, Q4 2023
[26] JLL: Europäische Büroimmobilienuhr, Q4 2023
[27] Cushman & Wakefield: Marketbeat UK Offices, Q4 2023

rate rose to 7.4 % in the fourth quarter of 2023 from 6.3 % year on year, it was down slightly on the previous quarter (Q3 2023: 8.0 %).

The submarket generating the highest take-up, namely the City, was particularly hard hit by job cuts in the financial sector caused by Brexit. The renewed uptick in demand had a positive effect in 2023. On a positive note, take-up was particularly buoyant in the fourth quarter of 2023 (highest quarterly take-up since 2010), with the result that take-up defied the market trend to increase by approximately 11.0 % year on year for the year as a whole. Year on year, the vacancy rate stayed more or less stable at 9.1 %, but has been trending downwards since summer last year (Q2 2023: 9.7 %).

Canary Wharf, an extensive office complex located in the east of London, is a prime example of the impact of hybrid working. With a vacancy rate of 16.3 % in Q4 2023, its vacancy rate is the highest by far. In all submarkets, older stock in less attractive areas is struggling with increased vacancy rates, despite high demand for modern, sustainable office space in central locations.

This pattern can also be seen in the five major regional office markets: Birmingham, Bristol, Edinburgh, Leeds and Manchester. The current challenges facing the office real estate market in these cities are comparable to those in the capital. Sustainable, as-good-as-new office space in prime locations is in very short supply and exhibits greater resilience.[28]

Performance of regional office markets in Q4 2023

	Birmingham	Bristol	Edinburgh	Leeds	Manchester
Take-up (in sq ft)	240,274	193,183	155,885	113,372	208,595
∆ Q4 2023/Q4 2022	+14%	+77%	-38%	-46%	-51%
Vacancy rate (in %)	5.6	5.0	6.7	7.3	12.3
∆ Q4 2023/Q3 2023	+0.6%-points	-1.4%-points	-1.4%-points	-5.9%-points	-1.5%-points
Prime rent/sq ft (in £)	41.50	42.50	43.00	38.00	43.50
∆ Q4 2023/Q4 2022	+3.8%	0	+7.5%	+5.6%	+8.8%

Source: CBRE, Cushman & Wakefield, NORD/LB Sector Strategy

Segmentation according to location and quality is also reflected in the development of prime rents

The high demand for modern office space in central locations coupled with the increasing shortage of available space can also be seen in the development of prime rents. Prime rents continued to climb in all three London submarkets in 2023, albeit at a different pace. The sharpest year-on-year increase in prime rents was recorded in the City (up 9.7 % to £ 79.50/sq ft), with the West End continuing to command the highest prime rent by far at £ 140.00/sq ft.[29]

In addition to location and quality, a building's sustainability rating also has a positive impact on rental growth, as quantitative studies increasingly demonstrate. Building certifications are used to identify

[28] Cushman & Wakefield: Marketbeat UK Offices, Q4 2023
[29] JLL: Central London office market report, Q4 2023

sustainable buildings, with the Building Research Establishment Assessment Method label (BREEAM) being the most common sustainability certificate used in the UK.[30] For instance, a study carried out by UBS found that the value and rent/sq ft of certified office buildings in London was an average of 17 % higher than that of non-certified buildings, even if all other criteria – such as location, age, state of repair and occupancy – were comparable.[31] Against the backdrop of the requirements under the MEES, it is becoming increasingly important to carry out refurbishments aimed at improving energy efficiency in order to avoid a reduction in value.

Slump in the investment market in 2023

In 2023, total transaction volume for office space across the UK plunged to around £ 9.5 billion, which corresponds to a decline of around 50 % on the previous year. This was predominantly due to the macroeconomic environment featuring record inflation and a sharp rise in interest rates, which led to high levels of uncertainty and differing price expectations on the part of buyers and sellers. In addition, structural adjustments owing to the increased number of people working from home prompted investors to exercise restraint, resulting in a marked decline in the volumes of office real estate transactions relative to other asset classes. On a more positive note, transaction volumes in the final quarter of 2023 increased substantially by over 73 % on the previous quarter to £ 2.6 billion.[32]

At £ 5.2 billion, Central London, the UK's largest office market by far, accounted for more than half of the country's total transaction volume in 2023, although the decline (-53 %) was even more pronounced here than at the national level. As a result, volume was at its lowest since 1999. It should also be noted in this connection that transaction momentum picked up again slightly as 2023 drew to a close. Transaction volume in the fourth quarter of 2023 increased by 60 % quarter on quarter to reach £ 1.4 billion. The proportion of foreign investors in Central London was 74 % in 2023, with Asian investors (41 %) taking first place, followed by investors from Europe (16 %) and North America (12 %).[33] The development of prime yields on the London submarkets saw a bifurcation. While they rose to 5.75 % in the City and 6.75 % in East London by the end of 2023 (both up 25 basis points on the previous quarter), they remained stable at 4.00 % in the West End.[34]

Outlook: Increased focus on high-quality, sustainable office space in central locations

Supply	→
Demand	→
Vacancy rate	→
Prime rent	↗
Investment volume	↗
Prime yield	→

2024 will be another challenging year for office space markets. Structural office space adjustments will continue, although competition for high-quality and sustainable office space in central locations ("flight to quality") will remain intense. A prime location combined with high-quality space not only enhances corporate image, but also provides a major competitive edge when it comes to attracting qualified employees, particularly within the context of the shortage of skilled workers. Even if the number of people working in offices in the UK in 2024 is set to remain at the level seen in 2023 and is not likely to pick up again until 2025, growth in the demand for office space that meets the three key criteria of preferred location, excellent facilities and

[30] Deutsche Hypo: Green Buildings – Nachhaltige Investments in Gewerbeimmobilien (available in German only), 2021
[31] The UBS Sustainability and Impact Institute: Rethink, rebuild, reimagine – Laying the foundation for better buildings, 2023
[32] CBRE: UK Real Estate Investment Volumes, Q4 2023
[33] CBRE: Figures Central London Offices, Q4 2023
[34] Cushman & Wakefield: Marketbeat UK Offices, Q4 2023

sustainability is therefore expected to be vigorous. Office space that meets these criteria will probably remain in short supply, with vacancy rates well below average. As such, market polarisation is expected to persist. This trend in demand can also be seen in the high pre-letting rate of 37 % for office space expected to be finished across the UK this year. All British office real estate markets are expected to see continued moderate increases in prime rents (an average of +3 % in 2024 following a strong rental year in 2023). The investment market is expected to stabilise once the cycle of interest rate hikes comes to an end, especially in the second half of 2024. Transaction volume is likely to be slightly higher than in 2023, but still well below the ten-year average of £ 22 billion. Upward pressure on yields is expected to level off over the course of the year, with a moderate decline not expected until the end of 2024.[35]

Overall, an office building's microlocation, quality and sustainability are now more important than ever in an increasingly polarised market. Core properties in prime locations that meet sustainability criteria are proving to be particularly resilient and should continue to perform well, even in the face of economic and structural uncertainties. From a macroeconomic point of view, headwinds should ease somewhat in light of declining inflation and the possibility of gradual interest rate cuts, which would mean a number of developments returning to profitability this year and necessary property refurbishments being initiated.

Retail real estate market

General conditions are stabilising

The easing of the pressure on the European retail markets that had been anticipated as the COVID-19 pandemic receded largely failed to materialise owing to the war in Ukraine, which resulted in other crises. The rise in energy prices, inflation and supply bottlenecks continue to be a source of uncertainty for retailers, consumers and the economy. Nonetheless, the British retail industry successfully weathered the crisis in 2022, benefitting from the easing of coronavirus-related restrictions and the gradual return of tourists. Footfall in city centres is also gradually returning to pre-crisis levels. In 2022, nominal retail sales were up by around 5.2 % on the previous year (EU 27: +6.5 %).[36] In 2023, Europeans' purchasing power (analysis of 42 countries) also increased by 5.8 % in nominal terms (average purchasing power per capita: € 17,688). However, in real terms, consumers have less money at their disposal than previously due to high inflation. With purchasing power per capita of € 26,081, the UK is ranked tenth among European countries, directly behind Germany (€ 26,271). This means that it has a very high purchasing power that is roughly 47 % higher than the European average (purchasing power index per inhabitant: 147.4 %).[37]

The anticipated slump in consumer spending in the UK in 2023 due to a variety of macroeconomic factors failed to materialise. Consumer spending in the UK last year (excluding motor fuels) was up by 5.1 % on the previous year. This meant that it was 3.5 % higher than the ten-year average, corresponding to the second-highest increase since 2001. When adjusted for inflation, however, sales volume (excluding motor fuels) in 2023 fell for the second year in a row. At -2.8 %, though, the decline was lower than in 2022 (-3.9 %). As a result, sales volume has returned to 2018 levels and is consequently lower than pre-crisis

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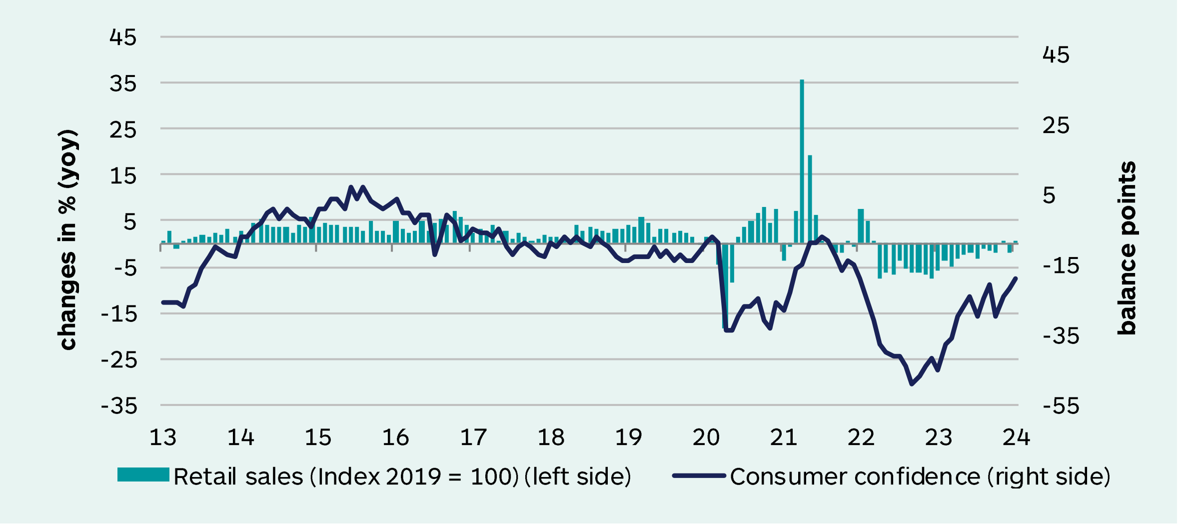
[35] Cushman & Wakefield: Marketbeat UK Offices, Q4 2023
[36] GfK: Einzelhandel Europa 2022 und 2023, 2023
[37] GfK: Die Kaufkraft der Europäer steigt 2023 auf 17.688 Euro (available in German only), press release dated 25 October 2023

levels in 2019.[38] Consumer confidence was at a two-year high in January 2024. The index climbed from -22 in December to -19 in January – its highest level since January 2022. The survey conducted by GfK found that households' expectations with regard to their personal finances improved in January. Although the cost-of-living crisis is still affecting many households in the UK, consumers appear to find encouragement in the positive news that inflation is declining. This is resulting in a gradual improvement in the general conditions in the retail sector.

Footfall increased in December 2023 compared to the same month in the previous year. However, it was still 10.9 % lower than the pre-crisis level recorded at the end of 2019.[39] It is expected to remain stable this year. Online shopping is now continuing the trend seen before the crisis. As in other European markets, e-commerce in the UK grew at a very brisk pace during the coronavirus crisis (online share of total retail sales in 2019 19.2 %; 2020: 28.1 % and 2021: 30.7 %). In 2022 and 2023, however, British consumers resumed shopping at local retailers, in line with the trend in Europe's more mature e-commerce markets (online share: 26.6 % in both 2022 and 2023).[40] In January 2024, e-commerce accounted for 24.8 % of nominal, seasonally adjusted retail sales. This corresponds to an increase of 1.0 % compared to the same month last year (previous month: -4.1 %). The British e-commerce market is set to continue expanding in the future. However, growth is likely to be significantly lower than in markets in southern and eastern Europe, where market penetration is significantly lower.[41] Annual e-commerce growth rates in Europe will average 14 % between 2021 and 2025. At 7%, the UK, Europe's largest e-commerce market, is projected to have the lowest annual growth rate.[42]

Retail sales* and consumer confidence



Source: Office for National Statistics, Macrobond, NORD/LB Sector Strategy
*seasonally adjusted sales volumes (excluding motor fuels)

Retail leasing market resilient despite stress factors

Although the retail leasing market continues to be affected by a challenging macroeconomic environment, it is nevertheless proving to be quite resilient. The gradual improvement in consumer

[38] Office for National Statistics
[39] ibid.
[40] Office for National Statistics
[41] https://www.knightfrank.com/research/article/2023-09-27-european-industrial-property-market-update-q3-2023, retrieved on 7 December 2023
[42] Savills: European Retail Spotlight. Fair pricing in 2023, December 2022

confidence, which is able to withstand inflationary pressure, and stabilising retail sales highlight the sector's resilience. Vacancy rates have risen recently by 30 bps to reach 11.7 % as a result of several well-known retailers going out of business, thus bringing them back up to the level recorded in Q1 2022. However, the performance of the individual sub-segments varies. In the retail parks segment, the vacancy rate fell thanks to a more diverse tenant base. As this segment closely tracks consumer trends, it is also expected to perform well in 2024. While the average vacancy rate in the shopping centre segment is expected to remain high, prime properties are displaying a significantly better performance and higher occupancy rates. Premium real estate is facing competitive pressure and may see rents increasing. In response to growing popularity, a number of tenants have increased the size of their units in order to provide customers with a premium shopping experience – a trend that is set to continue as the year goes on. As the market environment for retailers is forecast to remain challenging this year, vacancy rates are expected to continue to rise at a moderate pace.[43]

Although this asset class has undergone major rationalisation in recent years, retailers are taking advantage of new rental levels and high vacancy rates to negotiate favourable terms and secure prime retail space in new locations. As such, prime retail locations continue to see strong enquiry levels and significant leasing activity. On the whole, a certain amount of optimism is gradually returning, which is reflected in growing competitive pressure and positive rental growth. This is particularly true for prime locations, where supply remains narrow. The asset management strategies adopted in recent years have had the effect of reducing vacancy rates and limiting availability. Nationally, rents remained largely stable in Q4 2023. However, a number of submarkets registered a year-on-year increase in rents, with best-in-class locations achieving double-digit rental growth. Minor corrections and adjustments could be seen in the shopping centre segment during 2023. In 2024, however, this sub-segment will likely see a return of rental growth, albeit at moderate levels (see table).[44]

Well positioned retailers are now beginning to re-align themselves. In this context, they are focusing on an in-store shopping experience and looking for locations that facilitate omnichannel integration and micro-fulfilment (last-mile delivery or pick-up by the customer). Meeting sustainability targets is also becoming a priority. This year, an increase in new entrants from international markets is expected, as is the leasing of shop premises by what were previously online-only brands, which should increase competitive pressure even further. New tenants are expected from the med-tech, sportswear and premium fashion brand segments.[45]

Rents and yields in individual submarkets (Q4 2023)

Submarket	£ PSF Zone a year	Prime yield (%)
London (City)	240	4.25
London (West End - Bond Street)	2,000	3.00
London (West End - Oxford Street)	450	3.75
Manchester High Street	225	6.75
Birmingham High Street	185	7.00
Leeds High Street	130	7.00
Bristol High Street	85	7.00
Cardiff High Street	135	7.00

Source: Cushman & Wakefield, NORD/LB Sector Strategy

Rental development by segment (Q4 2023)

Indicators	Value	Δ yoy	Outlook
High Street	+1.3 %	↗	↗
Retail Warehouse	+3.1 %	↗	→
Shopping Centre	-1.2 %	↘	↗

Source: Cushman & Wakefield, NORD/LB Sector Strategy

[43] CBRE: Real Estate Market Outlook UK 2024, December 2023
[44] Cushman & Wakefield: Marketbeat UK: Retail & Leisure, Q4 2023
[45] ibid.

Investment market: Retail parks remain popular, demand for other sub-segments on the rise
Reflecting the weak economic backdrop, transaction volume in the UK retail investment market was also down approximately 30 % year on year to £ 4.76 billion in 2023. [46] Compared to other asset classes, prices for retail properties remained relatively stable and attractive. Rents and capital values in the retail sector appear to have bottomed out and are in a phase of stabilisation. Last year, the total return for retail properties increased by 2.7 %, putting it in second place behind industrial properties (+6.4 %) and therefore well ahead of the office sector (-6.7 %). Although capital values continued to decline by 4.2 % in 2023 (December 2023: -1 %), rental values rose by 1.1 % (+0.2 % in December).[47] The retail investment market has become increasingly diversified over the past year – a trend that is likely to continue in 2024. While retail parks accounted for around one-third of investment volumes (as was the case in the previous year) and are likely to retain their status as one of the most sought-after sub-segments going forward thanks to solid fundamentals, other sub-sectors have also become more popular. Accounting for 26 % of total transaction volumes, the grocery segment saw significant growth thanks to its high resilience in the face of high inflation and weak economic growth. The shopping centre segment also reported a noticeable increase in transaction activity on the previous year (31 % share). While secondary properties continue to attract opportunistic investors and local players in particular, the core segment is also picking up speed. Market polarisation in favour of high-quality assets is likely to persist.[48] Prime yields have largely stabilised. In the high street segment, prime yields are the lowest in London's Bond Street (3.00 %) and Oxford Street (3.75 %). They are around 7.00 % in major cities such as Manchester and Birmingham.[49] Prime yields of 8.00 % are reported for prime shopping centres and 6.25 % for the retail park segment.[50]

Outlook: Positive signs on the increase

Demand (stationary retail)	→
Prime rent	↗
Vacancy rate	↗
Investment volumes	↗
Prime yield	↘

The outlook for 2024 remains muted. Since interest rates are likely to remain high in the first half of the year, consumer confidence will remain subdued. Consumer spending by private households is likely to increase only moderately for the time being, given the higher interest rates on follow-up financing. A strong recovery is not expected until the second half of 2024, at the earliest.[51] Nevertheless, demand in the bricks-and-mortar retail sector is likely to remain stable. E-commerce has returned to its pre-pandemic trend (2015-2019). A further moderate increase in the share of e-commerce to 28 % is expected by the end of 2024. Retailers will continue to incentivise shoppers to visit bricks-and-mortar stores so as to maximise their profits. In the future, an increasing number of brand manufacturers are also expected to impose fees for online returns. Moreover, tenants will expand their range of in-person services in order to set themselves apart from online retailers.[52] Some retailers will expand, but the focus will be on prime locations. Given that the market environment continues to be challenging, vacancy rates are expected to see a modest increase. In prime locations, however, the supply of space is expected to narrow further. Rents are likely to increase further in the high street segment. In the retail park segment, rents are expected to remain

[46] CBRE: Real Estate Market Outlook UK 2024, December 2023
[47] CBRE: Capital values fall again in December, resulting in total returns of 1.7% for 2023, 10 January 2024
[48] CBRE: Real Estate Market Outlook UK 2024, December 2023
[49] Cushman & Wakefield: Marketbeat UK: Retail & Leisure, Q4 2023
[50] Knight Frank: Prime Yield Guide, January 2024
[51] CBRE: Real Estate Market Outlook UK 2024, December 2023
[52] ibid.

stable following a sharp rise in Q4 2023. Following a phase of rent adjustments, the shopping centre segment is now also expected to see rental growth.

Given the anticipated cut in interest rates and stabilisation of the economy, a marked increase in investment volume is expected in the investment market between now and 2025. In addition to prime locations, established investors will focus on segments like grocery that are able to cope with inflationary pressure and a weaker economy.[53] In light of the uptick in demand in the investment market, prime yields in all sub-segments are set to fall slightly over the course of 2024.[54]

Residential real estate market

House prices are stabilising – declining mortgage rates are stimulating demand
The rise in interest rates, high inflation and weak economic growth have led to a decline in demand and falling house prices in the British residential real estate market since mid-2022. The decline in affordability and a lack of buyer confidence in the market environment have triggered a noticeable decline in activity in the residential real estate market. However, according to mortgage lender Nationwide, house prices have begun to stabilise in recent months. In January 2024, house prices rose by 0.7 % on the previous month. The year-on-year decline was a mere 0.2 % (December: -1.8 % yoy). It also constitutes the most positive rate of change since January 2023. As a result, current house prices are still roughly 3.6 % lower than the all-time high registered in late summer 2022. The recent robust trend in house prices is being fuelled by the decline in mortgage interest rates. Mortgages with a five-year fixed interest rate have been below the 4 % mark since Q4 2023. Lenders are keen to stay competitive amid an environment of subdued market activity and have cut their interest rates in anticipation of the Bank of England cutting the base rate earlier than expected.[55] Demand for residential real estate has increased slightly in line with falling mortgage interest rates. According to an RICS survey, the number of real estate surveyors reporting an increase in new buyer enquiries rose in January 2024 (net balance of +7 % compared to -3 % in December).[56] This points to a gradual recovery in demand in the residential real estate market. While still relatively modest in a longer-term context, the latest figure is the most positive since February 2022. The number of loan approvals also increased slightly in December. However, it remains roughly 22 % below the pre-crisis level.[57] It will be some time before we see improvements in the market environment reflected in rising transaction figures. At 85,820, the number of transactions in December 2023 was down by approximately 16 % on the average for December in the period from 2017 to 2019.[58] However, a further decline in mortgage interest rates will probably help boost transaction numbers.

An analysis of house prices at the regional level based on quarterly data indicates that developments in the individual regions of the UK varied greatly. While East Anglia in the south of England saw house prices fall by 5.2 % in Q4 2023 compared to the same quarter in the previous year, Northern Ireland and Scotland became the only regions to record growth (+4.5 % and +0.5 % respectively). London, by far the

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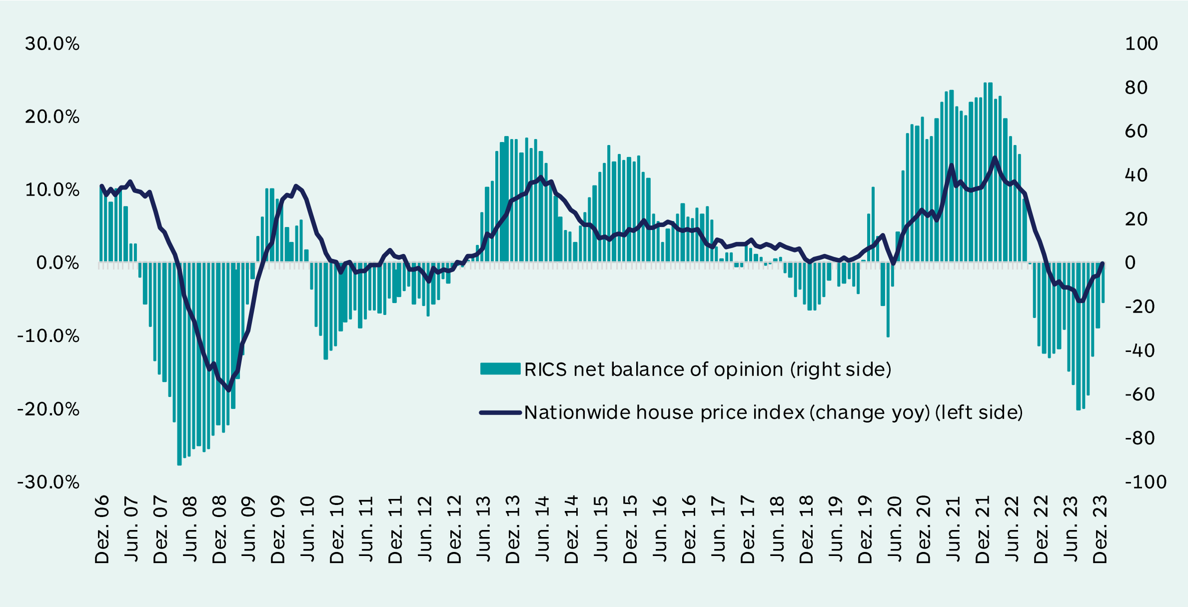
[53] Cushman & Wakefield: Marketbeat UK: Retail & Leisure, Q4 2023
[54] Knight Frank: Retail Investment Update – H2 2023
[55] Savills: UK Housing Market Update, January 2024
[56] RICS: UK Residential Market Update, January 2024
[57] Savills: UK Housing Market Update, February 2024
[58] ibid.

most expensive region (average house price: £ 515,132), underwent a similar year-on-year decline (-2.4 %) in Q4 2023 as the UK as a whole (-2.3 %, average house price: £ 259,157).[59]

The RICS House Price Balance is a useful leading indicator of changes in the UK residential real estate market. Having recovered from its most recent low in August 2023 (-67) to reach -18 in January 2024,[60] the number of respondents reporting falling house prices has decreased significantly, yet remain slightly in the majority.

Changes in UK house prices in the period up to January 2024



Source: Nationwide, Macrobond, NORD/LB Sector Strategy

According to projections by Knight Frank[61], house prices are likely to rise by 3.0 % in 2024, given the anticipated reduction in the base rate (see table). Owing to the backlog demand in the residential housing market, positive single-digit growth rates are also expected in the years leading up to 2028. In Greater London, house prices are expected to grow by 2 % in 2024, which is somewhat lower than the national average. This is due to high price levels, which reduce affordability. A slight decline in house prices is still expected in the market for prime rural properties this year, as the market already peaked during the pandemic (urban exodus). London's prime markets are initially expected to make only slight gains this year, since they are exposed to greater risks due to the upcoming general election. Although we are not currently aware of any government measures that are likely to result in major concerns for investors (such as the introduction of rent controls or a wealth tax), there are nevertheless measures that could dampen demand for prime properties, such as the discussion about increasing the 2 % Stamp Duty Land Tax for overseas buyers.[62] As a result, foreign investors in particular are often adopting a wait-and-see approach in the run-up to general elections.[63] That said, growth in Central London is likely to pick up again from next year on, seeing as how prices there are still 17 % lower than the last time they peaked in mid-2015.[64]

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[59] Nationwide
[60] RICS: UK Residential Market Update, January 2024
[61] Knight Frank: UK House Price Forecasts, January 2024
[62] ibid.
[63] CBRE: The general election 2024: Analysing the influence on real estate, January 2024.
[64] Knight Frank: UK House Price Forecasts, January 2024

House price forecasts (in %)

	UK	Greater London	Prime Central London	Prime Outer London	Prime Country
2024	3.0	2.0	1.0	2.0	-2.0
2025	3.0	2.0	3.0	2.5	3.0
2026	4.0	3.0	5.0	3.0	4.0
2027	5.0	4.0	4.0	3.0	4.0
2028	4.0	4.0	4.0	4.0	4.0
5 Year Cumulative	**20.5**	**15.9**	**18.1**	**15.4**	**13.5**

Source: Knight Frank, NORD/LB Sector Strategy

Rent forecasts (in %)

	UK	Greater London	Prime Central London	Prime Outer London
2024	5.0	5.5	5.5	4.5
2025	3.5	3.5	3.5	3.0
2026	3.0	3.0	3.5	3.0
2027	2.5	2.5	3.0	3.0
2028	2.5	2.5	3.0	3.0
5 Year Cumulative	**17.6**	**18.2**	**19.9**	**17.6**

Source: Knight Frank, NORD/LB Sector Strategy

Insufficient construction activity in the UK is expected to boost a rapid stabilisation or growth in house prices. The construction of residential real estate is faced with a variety of challenges. As a result of increased construction and financing costs, high capacity utilisation, the limited availability of land for development and stricter regulations, construction activity – at around 150,000 new builds per year – is well below the political target of 300,000 new builds per year. This year, the number of new builds is likely to remain at approximately 150,000 and will only increase slightly starting from 2025 (to 170,000 new builds). Consequently, the current shortfall in supply is expected to grow to 720,000 homes between 2023 and 2028.[65]

Robust but slower rental growth

Excess demand in the private rental market in the UK has pushed up rents for new lets by around one-third over the past three years. This is mainly due to the recovery of the economy and international tourism following the easing of coronavirus-related restrictions in mid-2021, solid growth in employment, record immigration figures and higher mortgage interest rates since autumn 2022, which have made home ownership more expensive.[66] Having grown by over 10 % for two consecutive years, average rents for new lets most recently rose at a slightly slower rate of 8.3 % in 2023. Tenants now pay an average of £ 1,220 per month, ranging from £ 695 in the north-east of the country to £ 2,119 in London.[67] According to the Office for National Statistics (ONS) Index of Private Housing Rental Prices, which also takes rental growth on current leases as well as new leases into account, rents rose by 6.2 % last year, the highest increase since records began in January 2016.[68]

A differentiated analysis of the development of rents on new lets in individual UK regions reveals that Scotland recorded the highest rental growth in 2023 (+11.6 % yoy). This is due in particular to the introduction of a 3 % cap on existing rents in February 2023, which led to a significant rise in the rents for new lets. The strongest drop in rental growth was recorded in London, where the increase fell from 15.9 % a year ago to 6.4 % currently. These declines indicate that rents are reaching an affordability ceiling as a result of the rising cost of living.[69]

[65] JLL: UK Residential Forecasts 2024-2028
[66] Zoopla: Rental Market Report, December 2023
[67] Zoopla: Average rent in the UK: February 2024, 12 February 2024
[68] https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/indexofprivatehousingrentalprices/december2023, retrieved on 22 January 2024
[69] Zoopla: Average rent in the UK: February 2024, 12 February 2024

Investment market: strong growth in build-to-rent housing construction
Residential properties[70] were the largest asset class in the UK real estate market in 2023. A total of £ 10.8 billion was invested in this segment last year (down 12 % on 2022). Investments in residential properties therefore proved to be more resilient than the real estate investment market as a whole, which saw transaction volumes declining by over 30 %. The largest sub-segment in the UK residential real estate market is build-to-rent, accounting for an investment volume of £4.6 billion. This corresponds to an increase of 19 % on the previous year and also constitutes the highest investment volume since 2014.[71] As a result, build-to-rent has withstood the challenging macroeconomic environment, which has been associated with increased financing, construction and labour costs, thus hampering the opportunities for project development. Consequently, many investors have been forced to review their investment strategies carefully in the short term in order to align them with altered market dynamics. Growth in investment volumes has remained resilient thanks to build-to-rent's comparative attractiveness. The segment benefited from a persistent supply/demand imbalance and high levels of rental growth. Due to its solid fundamentals, the market will remain attractive for investors in the future. While the rise in construction costs is tapering off, the construction industry continues to be challenged by the high cost of labour and the shortage of skilled workers.[72] A strong closing quarter in 2023 (investment volume of £2.0 billion or +50 % yoy) suggests that confidence is slowly returning to the build-to-rent segment thanks to a stable interest rate environment, which ensures a higher degree of planning security. This strong momentum is expected to continue into the first quarter of 2024. Prime yields ranged between 4.15 and 4.50 % in Q4 2023, corresponding to an increase of 50 to 90 basis points on the second quarter of 2022. [73]

The second-largest sub-segment in the UK residential real estate market is purpose-built student accommodation (PBSA). This sub-segment accounted for £ 2.7 billion, representing just two-thirds of the previous year's transaction volume, which included a number of large portfolio transactions. Prime yields remained broadly stable last year following a slight increase at the end of 2022. This was boosted by strong rental growth. Prime yields also remained largely unchanged in Q4 2023, with only Central London registering an increase to 4.25 %. Capital values were under pressure in this context due to higher gilt yields. Demand in this sub-segment continues to outstrip supply. Only 10,000 beds were added to the market in 2023. Supply is becoming increasingly constrained by stricter regulations with regard to building safety and energy efficiency standards. On the plus side, the market absorbed the majority of the projects much faster than in previous letting cycles, and record rental growth was achieved. [74]

Outlook: Reversal in house price trend expected soon

Household demand	↗
Supply/ construction activity	→
Prices	↗
Rents	↗
Investment volumes	↗
Prime yield	→

The UK residential real estate market has a favourable fundamental development potential. In addition to an anticipated slight increase in the population by 2040, which will further increase domestic demand for housing, the housing market is also expected to benefit from a recovery in the economy in the years to come. We are now seeing more and more signs of optimism now that the challenging market environment – which was associated with rising interest rates, high inflation and weak economic growth – has been resulting

[70] Based on CBRE's definition, this segment comprises all transactions in the residential sector as a whole, including build-to-rent, purpose-built student accommodation (PBSA), co-living, affordable housing, building land development and private investments.
[71] CBRE: UK Residential Investment, Q4 2023
[72] Savills: UK Build to Rent Market Update Q4 2023, 31 January 2024
[73] CBRE: UK Residential Investment, Q4 2023
[74] ibid.

in value corrections in the housing market since mid-2022. Declining mortgage interest rates have recently helped to stabilise house prices. Even if the possibility of further minimal value corrections cannot be ruled out in the short term, a vibrant upturn in demand for residential real estate is expected in the second half of 2024, if not before, which should bring about a reversal in house prices. House prices are expected to edge up slightly this year. Positive single-digit growth is also expected in the years leading up to 2028 owing to backlog demand in the residential housing market. Insufficient levels of construction activity, which will widen the existing supply gap in the years ahead, is expected to boost a rapid stabilisation or growth in house prices.

Excess demand in the private rental market caused rents to rise sharply again last year. The increase in rents is expected to taper off significantly in 2024. Demand will soften in the face of slower wage growth, deteriorating affordability and a slight improvement in the supply of rental accommodation. Forecasts indicate that rents will increase by 5 % across the country owing to the persistent supply shortage.[75] A further slowdown in rental price growth is also expected in 2025 and beyond, as more attractive mortgage interest rates will shift demand away from the rental market and back to the owner-occupier market, thereby ensuring a better supply/demand balance.[76]

Confidence in the investment market is gradually beginning to pick up again and, together with the expected turnaround in interest rates, should help to revive transaction activity. Both build-to-rent and student housing will remain attractive options for investors due to excess demand. In 2024, the latter segment will benefit above all from the anticipated high occupancy rate and further rental growth in 2024/2025.[77] Prime yields are set to rise marginally in some cases over the coming months. But, given the anticipated turnaround in interest rates and further rental growth, they are likely to stabilise as the year goes on.[78]

Conclusion and outlook

Demographic development	↗
GDP growth	↗
Inflation	↘
Unemployment rate	↗
Private consumption	↗
Demand for office real estate	→
Demand of stationary retail	→
Demand for residential real estate	↗

The outlook for the development of the economy and real estate markets in the UK shows signs of optimism. While macroeconomic headwinds continue to abound, we expect a slightly more favourable economic environment in 2024. The main source of hope is declining inflation. Expectations are high that the Bank of England will decide to make its first base rate cut in the second half of 2024. That said, further inflationary danger brought about by potential geopolitical risks should not be overlooked. If the current tensions in the Red Sea escalate, supply chains in the UK – as well as the rest of Europe – could be severely impacted.

The UK real estate investment market has been dominated by a challenging market environment over the past 18 months, which pushed investment volumes down by around a third in 2023. However, opportunities for investment are expected to pick up this year. While capital growth is expected to remain

[75] Knight Frank: UK House Price Forecasts, January 2024
[76] JLL: UK Residential Forecasts 2024-2028
[77] CBRE: UK Residential Investment, Q4 2023
[78] CBRE: Real Estate Market Outlook 2024, December 2024

subdued, rental income especially will help to improve investors' returns. In addition, the declining inflation rate will presumably increase the probability of positive real returns from real estate investments. 2024 is expected to see a rebound in transaction activity, particularly from the second half of the year, in conjunction with the anticipated reduction in key interest rates. In this context, the previous year's result should be exceeded. However, it will be some time before the levels seen prior to the downturn can be reached again. While transaction figures are likely to recover more quickly, volume will probably take longer to pick up, given the fact that investments are being made at lower prices amid the current trough.[79]

According to a survey of European real estate investors carried out by CBRE, the UK will continue to be the leading destination for real estate investments in 2024. London remains the undisputed number-one city in Europe for both foreign and local investors in real estate.[80] The annual report by PwC and ULI also ranks London ahead of Paris and Madrid as one of the three most promising cities in terms of real estate investment and development potential.[81]

The performance of the individual asset classes will probably continue to vary. While residential real estate is set to benefit from growth in rents and high levels of investor demand in the short term, office and retail space is likely to undergo further polarisation in the direction of high-quality assets. The following asset-specific developments are also worth highlighting:

// Since the onset of the COVID-19 pandemic, the **office real estate market** has been undergoing structural change as the workplace environment becomes increasingly digitalised. Hybridisation and flexibilisation are the main trends in workplace models. Working from home is now the norm. Nevertheless, offices remain essential to foster communication and innovation. The trend towards higher-quality space has also become firmly established in UK office space markets. The polarisation in demand between modern and energy-efficient space in central locations and older properties in decentralised locations is likely to persist in 2024. This segmentation will continue to be reflected in differing vacancy trends and higher prime rents. In parallel to flexible and hybrid workplace strategies, demand trends will also be increasingly driven by sustainability criteria imposed on tenants, owners and investors.

// Meanwhile, the market environment in the **retail real estate market** is gradually beginning to stabilise. Consumer confidence is set to improve incrementally in 2024. Adjusted for inflation, sales volumes are expected to return to positive territory for the first time in two years.[82] While the vacancy rate is expected to continue to edge up slightly for the time being, the supply of space in prime locations especially is set to narrow further. Rents and capital values appear to have bottomed out and are now in a phase of stabilisation. Rents are expected to rise, especially in the high street segment and for shopping centres. In addition to prime locations, investors will be on the lookout for retail parks and other sub-segments such as the crisis-proof grocery sector.

// A light at the end of the tunnel is emerging in the **residential real estate market**. Declining mortgage interest rates helped to stabilise house prices at the end of 2023. Even if the possibility of further value corrections cannot be ruled out in the short term, a vibrant upturn in demand for residential real estate is expected in the second half of 2024, if not before, which should bring about a reversal in

[79] CBRE: UK Real estate Market Outlook 2024.
[80] CBRE: European Investor Intentions Survey, February 2024
[81] PwC und Urban Land Institute: Emerging Trends in Real Estate®: Europe 2024, November 2023
[82] Knight Frank: Retail Investment Update, H2 2023

house prices. The residential real estate market has a favourable fundamental development potential. Rents should continue to increase significantly, albeit at a slower rate than in the previous year. In the medium term, more attractive mortgage interest rates will shift demand away from the rental market and back to the owner-occupier market, thereby ensuring a better supply/demand balance.

Looking at the overall picture, there are increasing signs of optimism in the UK real estate market. That said, the current geopolitical and macroeconomic environment remains volatile. Tougher financing conditions, weak economic growth and increasing pressure relating to ESG will continue to pose challenges for both users and investors. As a result, it remains very important strategically to monitor the market environment on an ongoing basis. However, we believe that the real estate market will continue to recover as the year goes on, buoyed by the anticipated stabilisation of the economy. The prospects and opportunities for real estate investments in the UK have improved on the previous year. In this context, one of the main factors influencing this development will be the anticipated interest rate trend. Cyclical factors, as well as structural changes, will influence how the real estate market performs. Energy, artificial intelligence (AI) and sustainability will continue to be the focus of all asset classes and will inform rental and investment decisions. The current market environment is likely to offer very good entry-level opportunities, especially for anti-cyclical investors. In this regard, the investors who stand to benefit the most are those who also take sustainable and digital transformation into account and thus develop properties that are both highly marketable and retain their value.[83]

[83] PwC und Urban Land Institute: Emerging Trends in Real Estate®: Europe 2024, November 2023

Appendix

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