2023: the year of reckoning

Dentons UKI Real Estate market predictions 2023

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On 25 January 2023, Dentons held its annual Real Estate Market Predictions event at which our panel of experts gave us their insight into what is in store for property in 2023. Here we combine that unique insight with our own views for the year ahead.

2023 is the year of reckoning. However, that is not a negative. Certainly, there are headwinds in the market – every year has its challenges, but they always come with opportunity for the well advised. Rather, 2023 will see the culmination of several long-standing trends and issues that will drive change and push the market towards greater accountability. The environmental, social and governance (ESG) revolution is central to this and perhaps both real estate's biggest challenge and biggest opportunity. Certainly, no greenwashing is allowed.

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Our Panel

Jeremy Lawson
Chief Economist and Head
of the abrdn Research Institute

Maureen Mahr von Staszewski
Head of Pan European Office
Immobel Capital Partners

Desiree Fixler
Chair VentureESG
and ESG Advisor FCA

Andrew Davey
Head of Liability-Aware
Strategies and Affordable Housing
CBRE Investment Management

Key themes

Long-term focus

While market commentary in previous years has tended to focus on the immediate future, this year's event saw more of an emphasis on the longer term.

The market in 2023 will be a product of long-standing trends and past events such as Brexit, COVID-19, changes in consumer habits, revised working patterns, fiscal policy and an increase in regulation. However, it is also going to be influenced by expectations and aspirations that have grown over the last decade, such as real estate having to play a more active role in procuring positive environmental and societal change.

Looking ahead from an investment angle, short-term opportunities exist but there may be more of a play for those with longer-term strategies. This makes sense. If there are going to be choppier waters in 2023, then these will present bigger waves of challenge to those seeking quick realisations, but more of a ripple for those with longer-term commitments. The good news is that there are longer-term investors out there with appetite to take on the market.

However, it is not just about investment. The longer-term theme also permeates wider issues. In the pursuit of net carbon zero and the ESG agenda, organisations need to formulate credible strategies, not just for the next 12 months but for permanent structural change within the market.

Accountability

Alongside that need for structural change comes increasing accountability.

In part, this will be driven by regulation. For example, in parts of the UK in 2023, we will see greater accountability in the management of high-risk residential buildings as the provisions of the Building Safety Act 2022 come fully into force. On the investor side, overseas entities with UK property interests are now required to be transparent and record details of their registrable beneficial owners on the Register of Overseas Entities introduced by the Economic Crime (Transparency and Enforcement) Act 2022. Non-compliance is not an option.

However, accountability will also be driven voluntarily through reputation and competition. Actions need to mirror words. As one of our panellists noted, there is a need to be very clear with investors about which problem you are solving (for example, the housing shortage in a particular area) and which one you are not (for example, embedded carbon). There are plenty of stakeholders willing to challenge organisations on the claims they make.

Where there is a mismatch between claims and reality, reputations will suffer. Where there is alignment, there is credibility and a competitive edge.

ESG

ESG is more than a theme, it is an ongoing revolution within real estate and many other sectors. It is also one of the biggest opportunities.

We have already noted how poor governance and compliance can affect reputation, credibility and competitive advantage. No wonder one of our panellists suggested the need for greater investment in compliance and legal to ensure no unnecessary home goals.

2023 will be a huge year of reckoning for those guilty of the ultimate home goal of greenwashing.

Poor green credentials can have a drag effect on pricing so it is likely that more sub-standard properties will come onto the market offering opportunity to those with the right skill set to add ESG value. However, therein lies a problem – are there sufficient skill sets out there? If not, then this presents a key gap in the market. Certainly, this is something one of our panellists is trying to exploit by seeking out brown to green office opportunities.

Longer-term strong ESG credentials are likely to become more objectively measurable and this is where having the right advisers will make all the difference.

Opportunities for 2023

- **2023 sees the market in a stronger position** than at the last financial crisis. If there is a recession, then it will likely last around three quarters with growth returning in 2024. With recessions come opportunities, especially as we see overshooting prices undershoot in correction.
- **Any immediate headwinds in 2023 will not deter those with longer-term strategies** or the opportunistic investor, particularly those not weighed down by lacklustre existing portfolios.
- **2023 is a perfect time to invest in debt**. Those refinancing may struggle with lower loan to value ratios and higher costs driven by increasing interest rates, but this could trigger an uptick in market activity later in the year from which others may profit.
- **There is considerable scope for those with the vision**, resource and skill set to repurpose secondary offices. The big question is what is the vision?
- **Climate change is a pressing concern**, but it is also an opportunity for those able to exploit the energy transition. There is growing association between the greenness of a property and its robustness in the market.
- **Demographics and societal needs make senior living, build-to-rent and student accommodation attractive propositions**, but the key will be finding the right assets and the right business models in which to invest.
- **While, from a domestic perspective, 2022 was politically quite turbulent**, from a global perspective the UK is still seen as a stable and inviting place in which to invest.
- **Residential rental values are showing resilience** and are expected to remain robust, partly fuelled by any fallout from the owner-occupier market as a result of interest rate rises.
- **Retail is worth another look**. The recent market corrections in this sector are starting to make prices look attractive and there may be opportunities to repurpose, add use and/or exploit emerging occupier demands (for example, from online retailers wishing to create a physical presence).
- **Logistics is still strong**. The only caveat is whether it can successfully navigate occupational stresses.

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Standing stock will be more in demand than forward funding in BTR, student accommodation and hotel sectors. Significant retail investment activity building on momentum from improved letting take up and greater price certainty. Operational real estate will be attractive in current economic cycle.

Andrew Muckian,
Ireland Real Estate Partner,
Dentons

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We will see a big increase in secondary markets in real estate in terms of LPs selling out of funds.

Maureen Mahr von Staszewski,
Head of Pan European Office,
Immobel Capital Partners

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My sense is that we'll see some opportunistic buying in the first half of the year, particularly by those who are not dependant on third party finance. Given the volume of capital waiting to be deployed, there could well be a stampede in the second half of the year if we are at or close to the bottom of the cycle and pricing has stabilised (as is expected). I would expect beds, logistics and prime office to be the most popular asset classes.

Brian Hutcheson,
Scotland Real Estate Partner,
Dentons

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This is a long game, and the outlook for long term returns is much better than the outlook, for short term returns – If you don't need to time the market and making decisions that aren't primarily about what happens in 2023, but instead, what the world look like in 2030, or beyond.

Jeremy Lawson,
Chief Economist and Head of the abrdn Research Institute

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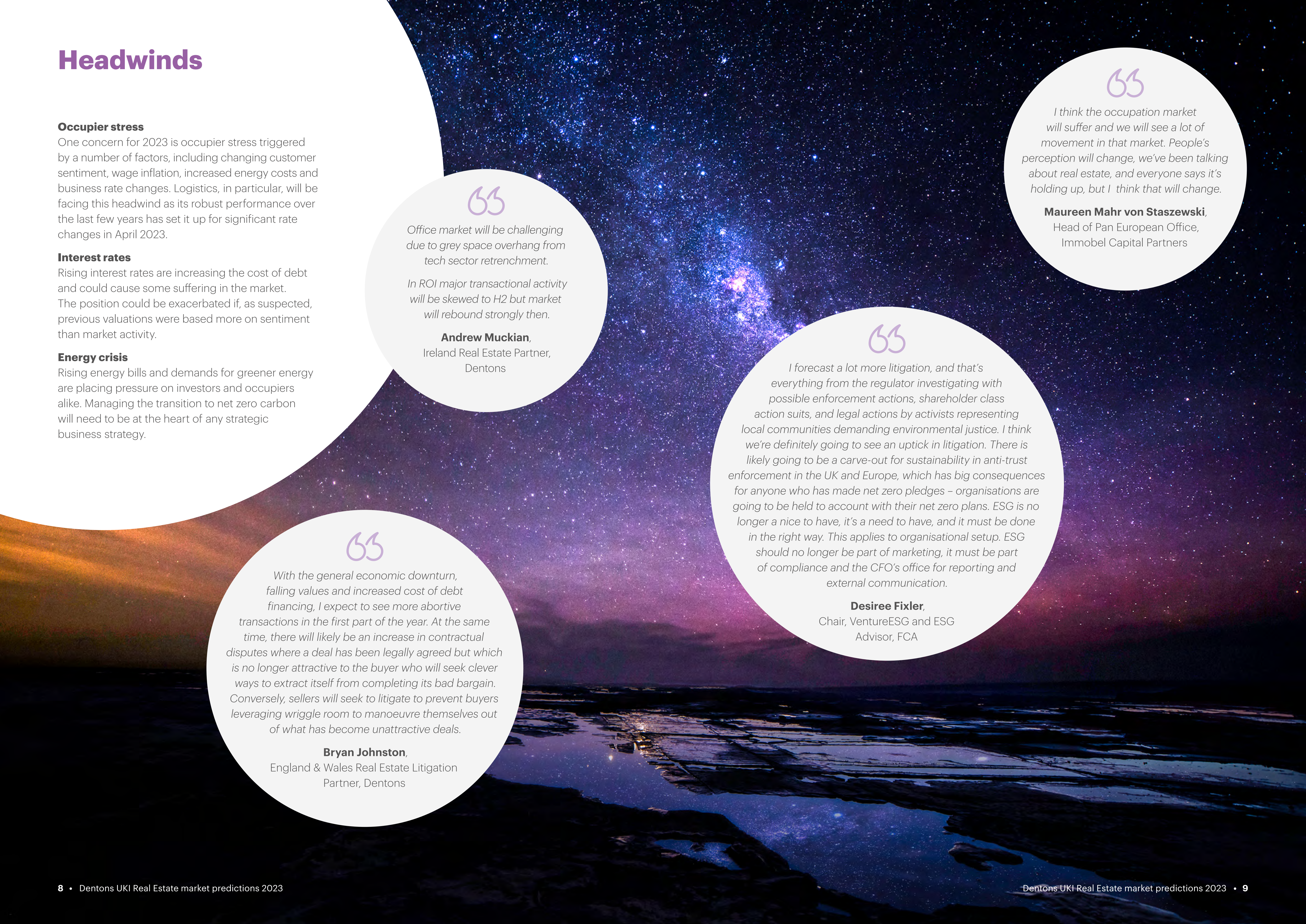
My predictions are commercial capital values down 10%; resi for sale values of c.10%; and rented broadly robust. Maybe a slight correction. I think the supply and demand dynamic will protect investors and in terms of rental growth, we're seeing in Lewisham, for instance, it's been 17% last year. So, it's crazy how quickly flats are being let.

Andrew Davey,
Headof Liability Aware Strategies and Affordable Housing, CBRE Investment Management



Headwinds

Occupier stress
One concern for 2023 is occupier stress triggered by a number of factors, including changing customer sentiment, wage inflation, increased energy costs and business rate changes. Logistics, in particular, will be facing this headwind as its robust performance over the last few years has set it up for significant rate changes in April 2023.

Interest rates
Rising interest rates are increasing the cost of debt and could cause some suffering in the market. The position could be exacerbated if, as suspected, previous valuations were based more on sentiment than market activity.

Energy crisis
Rising energy bills and demands for greener energy are placing pressure on investors and occupiers alike. Managing the transition to net zero carbon will need to be at the heart of any strategic business strategy.

Office market will be challenging due to grey space overhang from tech sector retrenchment.

In ROI major transactional activity will be skewed to H2 but market will rebound strongly then.

Andrew Muckian,
Ireland Real Estate Partner, Dentons

With the general economic downturn, falling values and increased cost of debt financing, I expect to see more abortive transactions in the first part of the year. At the same time, there will likely be an increase in contractual disputes where a deal has been legally agreed but which is no longer attractive to the buyer who will seek clever ways to extract itself from completing its bad bargain. Conversely, sellers will seek to litigate to prevent buyers leveraging wriggle room to manoeuvre themselves out of what has become unattractive deals.

Bryan Johnston,
England & Wales Real Estate Litigation Partner, Dentons

I think the occupation market will suffer and we will see a lot of movement in that market. People's perception will change, we've been talking about real estate, and everyone says it's holding up, but I think that will change.

Maureen Mahr von Staszewski,
Head of Pan European Office, Immobel Capital Partners

I forecast a lot more litigation, and that's everything from the regulator investigating with possible enforcement actions, shareholder class action suits, and legal actions by activists representing local communities demanding environmental justice. I think we're definitely going to see an uptick in litigation. There is likely going to be a carve-out for sustainability in anti-trust enforcement in the UK and Europe, which has big consequences for anyone who has made net zero pledges – organisations are going to be held to account with their net zero plans. ESG is no longer a nice to have, it's a need to have, and it must be done in the right way. This applies to organisational setup. ESG should no longer be part of marketing, it must be part of compliance and the CFO's office for reporting and external communication.

Desiree Fixler,
Chair, VentureESG and ESG Advisor, FCA

Hear more about what is in store from different perspectives and different sectors

Where would you invest £100m in 2023?

I think that government bonds will be the best performing asset of 2023, and where I would put my money.

Jeremy Lawson,
Chief Economist and Head of the abrdn Research Institute

And, as far as investment is concerned, I would say that financial institutions should be investing in compliance and legal right now.

Desiree Fixler,
Chair, VentureESG and ESG Advisor, FCA

Food retail, data centres/ life sciences, healthcare and commercial to resi repurpose opportunities.

Andrew Muckian,
Ireland Real Estate Partner, Dentons

Life science and logistics, we're in a place where distribution of goods and services is critical, not just in the UK but on a global basis.

Rob Thompson,
England and Wales Real Estate Partner, Dentons

If I had £100m to invest, I would invest in offices in prime locations – assets that are in need of work.

Maureen Mahr von Staszewski,
Head of Pan European Office, Immobel Capital Partners

I'd split this between prime office, BTR/ student development and secondary industrial.

Brian Hutcheson,
Scotland Real Estate Partner, Dentons

If I had £100m to invest, I would spread risk both geographically and cross-sector. For 2023 in the UK, whilst demand has softened, prime logistics and warehousing looks reasonably attractive for the latter part of the year due to a lack of supply arising from an upturn in demand once the economy recovers. This should be a good longer-term investment. Prime central office space that has wow factor and ticks all the environmental and sustainability boxes would be a good investment. Whilst hybrid working is rightly here to stay, there is increasing momentum to balance this with more collaborative in-person working. Space that make a commute worthwhile will be very much in demand.

Bryan Johnston,
England & Wales Real Estate Litigation Partner, Dentons

Hypothetically if the deal flow was there, I would invest in debt, however, if I can't have my highly hypothetical situation, I'll just be picking winning sectors that have strong demographics and acknowledging I might lose maybe 50 dibs on a downturn but investing for the long term.

Andrew Davey,
Head of Liability Aware Strategies and Affordable Housing, CBRE Investment Management

ABOUT DENTONS

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