

UK Real Estate View: Looking beyond COVID-19



Bill Page

Head of Real Estate
Markets Research, LGIM Real Assets



Bill has responsibility for the formation of house views and inputs into fund strategies. With 19 years' industry experience, Bill is a voting member of the real estate investment committee and actively contributes to the platform's office and industrial strategy.

Introduction

Forecasting the economy and property markets remains very challenging, but since our last update we know more about the economic damage caused by the first wave of the Covid-19 virus, the initial recovery, and how the property market has reacted. In real estate markets, uncertainty clauses have been lifted and funds are re-opening.

According to the MSCI Quarterly index, All Property values fell 6.4%¹ over the nine months to September 2020. This is better than originally feared when the pandemic first accelerated, but aggregate values have been supported by the industrial sector rather than widespread resilience.

We expect All Property returns of around 5% over the 2021-2025 horizon. Whilst we believe downside risk persists, arising from worse than expected second-round effects from heightened unemployment and corporate failures, this has been mitigated since our last update by greater confidence in the availability of effective vaccines in 2021.

The strength of the industrial sector still dominates medium term expectations; nevertheless, we acknowledge risks around the front-loading of this performance and the potential rotation into sectors perceived as offering more value. We have taken 1% p.a. from modelled office rental growth due to an expectation for structurally higher vacancy, although the sector is still expected to perform relatively well. Most retail segments are expected to

struggle, but there may be exceptions and we note increasing investor interest in retail park and retail warehouse assets.

Key messages:

- Forecast risk has reduced but remains significant.
- Rent collection figures have improved over the last six months but challenges persist, and the imposition of a second lockdown may slow progress. The relative case for property income over the medium term, assuming a return to normal collection, remains strong.
- Value reduction of 6.4% to date is less than originally feared but supported by the industrial sector. We expect values to soften in H1 2021.
- Retail segments continue to struggle but investors are more alert to value and new operating models will better reflect risk.
- Changing working patterns represent a structural risk to office performance. Forecast rental growth has been adjusted accordingly. However, we see risks as navigable.
- Our forecast of the All Property returns of 4.9% p.a. over the 2021-2025 horizon are driven by 7.3% for industrial, with offices expected to return 5.6% and retail 1.6%. Within alternative segments, BTR residential is expected to return c. 6.0%.

1. MSCI Quarterly Index, standing investments. The MSCI Monthly Index for October records -7.0% over 10 months

The information is for discussion purposes only and does not constitute advice (investment, legal, tax advice or otherwise) or a recommendation to buy or sell investments. The document presents our current views and subject to change. The content of this document should not form the basis of any investment decisions by you. Forecasts are not a reliable indicator of future performance and are based on performance scenarios in different market conditions.

Economy

We (consistently) expect global GDP to end 2021 about 3% below a pre-virus trend, assuming successful deployment of a vaccine over 2021. The UK is expected to perform worse than this global average, with GDP dropping 11% in 2020 and only partially recovering by +6% in 2021.² We expect unemployment to peak at around 7.4% compared with 4.8% in October 2020 as registered by the ONS. Economic underperformance is mostly predicated on risks around a deal with the EU following the end of the Brexit transition period. At the time of writing, this remained unresolved.

We expect real estate to lag the economic recovery as occupiers work through their occupational challenges while end users— particularly shoppers, consumers, and workers— remain reticent about returning to real estate until a vaccine is fully distributed.

Composite relative value measure



Source: CBRE, LGIM Real Assets calculations. Normalised values are expressed as standard deviations away from a long-term average (from 1972).

Values

The c. 18% gap in rent collection compared to normality has been a significant challenge for investors at a time of economic and social dislocation. Values fell by 6.4% over the three quarters to September, though MSCI monthly data show this slowing, with all property values down by only -0.5% in the three months to October 2020.

Monetary and fiscal policy has helped insulate yields, but the range within the All Property average is significant with industrial values showing only a 0.6% decline over the three quarters to September and +2.0% over the three months to October 2020. The equivalent figures for retail are -16.1% and -2.8%. We discuss some of the reasons below.

2. LGIM forecasts, November 2020

3. For June quarter day

4. MSCI Quarterly Digest December 2019-September 2020

Rent collection

Data from Remit Consulting showed that 73% of rent was collected 35 days after the September quarter day compared to 63% in June. Retail achieved 68% collection, industrial 85%, and offices 88%, while figures from Knight Frank³ shows residential achieved >95%. The sharpest improvement was seen in retail. The second lockdown is likely to affect this progress, mitigated by its time limit.

Longer term, an analysis of property yields compared with their own history and the yields offered by other asset classes implies property offered greater relative value at the end of September than it has for over 25 years assuming, of course, that normality returns to rent collection. This was only partly driven by the outward movement in property yields (25bps over the year to date);⁴ the main contribution was the compression of yields in other asset classes.

Our forecasts of the MSCI annual digest (which contains more retail and less industrial than the quarterly index) are for an annual value reduction of c. 9% for 2020 and total returns of -5.7%.

Retail

The retail sector remains challenged with values 16.1% lower over the first three quarters of the year, with shopping centres worst affected at -23.0%. Supermarkets remain resilient with values unchanged. LGIM Real Assets has launched its Flexible Partnership Model which illustrates of how investors can respond to the new retail landscape by embracing turnover leases in ready to occupy ("white boxed") formats to access and enable new concepts, while still allowing for more traditional operators and leasing models.

Qualitative survey evidence suggests that required returns⁵ for shopping centres (the only segment measured on this basis) are now lower than valuation yields, implying the sector might offer fair value. Investors remain reluctant to deploy capital, however - indeed, our forecasts for shopping centres show expected returns of -1.7% p.a. with rents drifting and depreciation increasing over the horizon, suggesting this “fair value” for the sector overall would only be assumed by the most optimistic investors. However, investment volumes have increased elsewhere: PropertyData records £488m of retail warehousing deals in Q3, up from £142m in Q2.⁶ We do, therefore, see tentative signs of capital returning and expect this to increase over 2021.

We expect retail returns of 1.6% over the horizon led by supermarkets at 4.0%, with retail units returning 0.8%, retail parks 3.4%, and retail warehouses 3.5%.

Offices

Office values have fallen 3.6% over the three quarters to September 2020, with London values 3.1% lower. This compares to -6.4% for All Property. There doesn't – yet – appear to be any evidence in property values of additional risks concerning long lasting home working, although in the REIT market office majors have underperformed.⁷ Our views are explored in more detail in a separate paper; in short, we do expect additional structural risk caused by a shift in working patterns resulting from COVID -19, but we view these risks as navigable. We do not subscribe to the view of offices being “the next retail”; employer and employee views and strategies will be nuanced and mitigated by changes to density and medium-term jobs growth while void risk will be moderated by less new stock being created. However, the risks are notable and sufficient to reduce occupier stock, structurally increase supply and, therefore, reduce potential rental growth.

In our forecasts this has led us to reduce the pace of rental growth implied by modelling by -1% p.a. to c. 2.0% p.a., with total returns for the sector of 5.6% ranging between 6.3% in regional CBDs, 5.7% for London, and 4.9% for the South East.

Strategically, we see wider deviation around this average performance, with the risks to office buildings with poor to average specifications, inflexible layouts, and poor occupier engagement and management being significantly higher. This amplifies the resilience offered by well-managed, better specified (especially in terms of air quality), well designed, and collaborative offices.

Industrial

The industrial sector has been relatively strong with values only -0.6% lower over the first three quarters of this year, with the MSCI monthly showing growth of 2.0% over the three months to October. Leasing markets, particularly for larger units, have seen record levels of activity fuelled (although not exclusively) by, pure-play online retailers. Investors' preference is to remain structurally overweight to the sector,⁸ comforted by an expectation of a structural increase in ecommerce penetration as a result of the pandemic. This implies additional alpha to fuel performance and justify lower yields.

We forecast returns of 7.3% p.a., ranging between 7.7% in London multilet estates and 7.5% for urban logistics, to 6.9% for estates over the rest of the UK. There are risks to this expectation: the extent to which growth is front-loaded is important, even to the extent of boosting 2020 performance at the expense of the forecasting horizon; as values continue to increase and set new records, there is a risk that investors seek value elsewhere, thereby reducing market-derived yield compression.

Alternatives

We expect BTR residential rental growth to rebound both in London and the rest of the UK next year. However, expectations for the pace of recovery have eased, owing to a slower recovery in the wider economy and household income than previously suggested. Nevertheless, the fundamental demand and supply imbalance in the housing market will support long-term growth while economic uncertainty, which is likely to dissuade households from making big ticket purchases, will provide additional support. We see this having a larger impact in London where the cost of ownership is significantly higher.

For purpose-built student accommodation (PBSA), the key risk was around student numbers, given the effects of the pandemic. That risk has subsided as overall student numbers surprised to the upside for the 2020/21 academic year. This was particularly so for stronger institutions, following the Government's decision to award students their predicted grades. The segment should be supported by underlying demand fundamentals: domestic participation rates in higher education have grown through the crisis and, coupled with forecast growth in the number of 18-year-olds in the UK and the typically counter-cyclical nature of university enrolment, this is likely to drive demand.

We expect the care home sector to be exposed to COVID-specific risks to occupier demand, investor appetite, and management expense, which will limit returns.

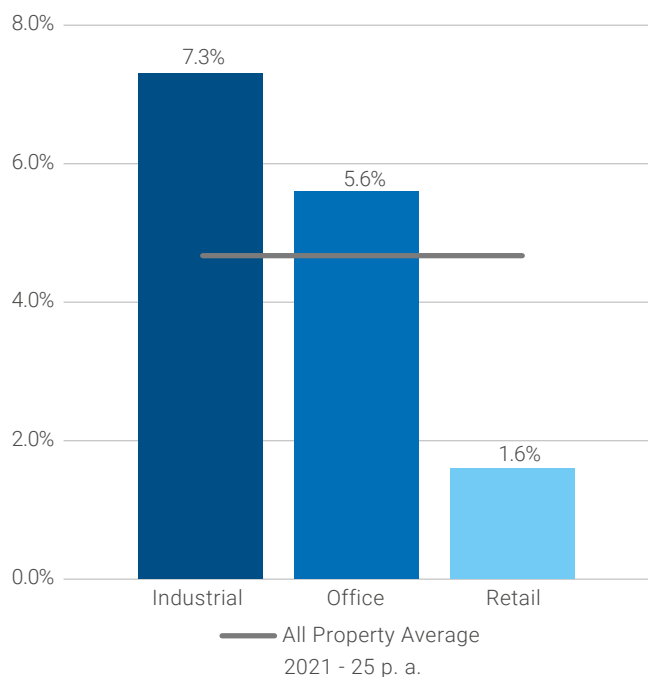
5. PMA Survey of Investor Preference, October 2020, compared with MSCI Quarterly Equivalent Yields, Q3 2020

6. Some, but not all, will be investors targeting change of use

7. A weighted average of Great Portland Estates and Derwent London shows a de-levered valuation decline of 14.3% between the February peak and early November, versus -1% for the wider REIT market excluding Intu, Hammerson and Big Yellow. This includes the rally in early November following the announcement of successful vaccine trials

8. As evidenced by the PMA survey

Total return forecasts, 2021-2025 (% p.a.)



Investment

UK commercial property investment volumes increased by 90% versus Q2 but the year to date total of £29.2 billion was still 18% behind the equivalent point of last year. Volumes remain constrained by economic and sector uncertainty and the inability of investors to travel to and view properties. According to the PMA SIP, investors remain “risk off” regarding property as a whole,⁹ but within this, average positive investment intentions were recorded for London offices, industrial, residential, student accommodation, and hotels. Negative intentions were recorded for most parts of the retail market, south east offices, business parks, and leisure.

Uncertainty clauses have been lifted allowing most institutional funds to reopen.

The case for property income, illustrated by the relative income analysis discussed earlier, implies that investor sentiment toward property will strengthen but practical restrictions on the ability to transact and continued uncertainty about how occupiers will interact with property suggests volumes are likely to remain low at the start of 2021.

Forecasts and implications

We expect a reasonable forecast at the All Property level for the 2021-2025 horizon of 4.9% p.a. but the differentiation between segments and sectors has increased relative to previous forecasts.

9. PMA Survey of Investor Preference, Net Balance of Investor intentions

Outperform

Urban Logistics	RUK multilet industrial
London multilet industrial	Trade Parks
Distribution Warehouses	Regional CBD office
SE multilet industrial	BTR London

Neutral

City Offices	South East Offices
BTR Non-London	Office Parks
West End offices	Supermarkets
Student Accommodation	Leisure

Underperform

Retail Parks	Non-London Unit Shops
Retail Warehouses	Shopping Centres
Care Homes	
London unit shops	

We do not depart from consensus in terms of sector order, but there are points of difference in the treatment of income returns, adjustments made to office demand and a more cautious view on retail over the horizon.

Our forecasts do suggest a recovery from 2021, with the capital value declines forecast for 2021 more likely to be front-loaded. This should improve the case for new property vehicles, which in practice may not be able to deploy until Q2 2021. Existing investors, however, are still facing a period of capital value declines.

As resilience from stronger covenants on longer income streams in more resilient geographies and better buildings is accentuated, so too is the risk associated with poorer stock. Holding assets where shoppers, consumers, residents, or office workers would prefer not to visit, or are at best indifferent to - whether through geography or specification - has become structurally riskier.

Asset management initiatives to de-risk such properties, where a sale is unviable, will be critical in navigating the short term and, increasingly, occupier engagement is a central part of that strategy. We also identify environmental resilience also a major driver of value protection and liquidity into the medium term.

Contact us

For further information about LGIM Real Assets, please visit www.lgim.com/realassets or email contactrealassets@lgim.com



Important Information and Disclaimer

The information contained in this document (the 'Information') has been prepared by LGIM Real Assets (Operator) Limited and/or their affiliates ('Legal & General', 'we' or 'us'). Such Information is the property and/or confidential information of Legal & General and may not be disclosed by you to any other person without the prior written consent of Legal & General.

Confidentiality and Limitations:

Unless otherwise agreed by L&G in writing, the Information in this document (a) is for information purposes only and we are not soliciting any action based on it, and (b) is not a recommendation to buy or sell securities or pursue a particular investment strategy; and (c) is not investment, legal, regulatory or tax advice. Any trading or investment decisions taken by you should be based on your own analysis and judgment (and/or that of your professional advisors) and not in reliance on us or the Information. To the fullest extent permitted by law, we exclude all representations, warranties, conditions, undertakings and all other terms of any kind, implied by statute or common law, with respect to the Information including (without limitation) any representations as to the quality, suitability, accuracy or completeness of the Information.

Credit rating data, valuations and other specific forms of data:

No Information (including ratings, credit-related analyses and data, valuations, models, software or other applications or output therefrom) or any part thereof may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of L&G. By receiving this Information you understand and acknowledge that any ratings provided to you are private and are not intended for public disclosure or distribution by subscription. The Information is strictly confidential and shall not be used for any unlawful or unauthorised purposes.

Credit-related and other analyses, including ratings, and statements in the Information are statements of opinion as of the date they are expressed and not statements of fact. L&G's opinions, analyses and the provision of ratings data do not constitute a recommendation to purchase, hold or sell any securities or to make any investment decisions, and do not address the suitability of any security or entity. In the context of supplying credit rating information, L&G does not act as a fiduciary or an investment advisor to the recipient or any third party. While L&G has obtained information from sources it believes to be reliable, L&G does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

Risks, liability and "forward looking" data:

Any projections, estimates or forecasts included in the Information (a) shall not constitute a guarantee of future events, (b) may not consider or reflect all possible future events or conditions relevant to you (for example, market disruption events); and (c) may be based on assumptions or simplifications that may not be relevant to you.

No representation regarding the suitability of instruments and/or strategies for a particular investor is made in this document and you should refrain from entering into any investment unless you fully understand all the risks involved and you have independently determined that the investment is suitable for you. If you are in doubt as to any aspect of this material, you should consult with your professional advisor(s), as appropriate. Where relevant, the risks associated with each fund or investment strategy are set out in the relevant product documentation (such as a prospectus or investment management agreement) and these should be read and understood before making any investment decisions.

The Information is provided 'as is' and 'as available'. To the fullest extent permitted by law, neither L&G, its affiliates nor its third party licensors accept any liability to you or any other recipient of the Information for any loss, damage or cost arising from, or in connection with, any use or reliance on the Information or any errors or omissions contained therein. Without limiting the generality of the foregoing, neither L&G, its affiliates nor its third party licensors accept liability for any indirect, special or consequential loss howsoever caused and on any theory of liability, whether in contract or tort (including negligence) or otherwise, even if it has been advised of the possibility of such loss.

Third Party Data:

Where this document contains third party data ('Third Party Data'), we cannot guarantee the accuracy, completeness or reliability of such Third Party Data and accept no responsibility or liability whatsoever in respect of such Third Party Data.

Publication, Amendments and Updates:

L&G reserves the right to update this document and/or the Information at any time and without notice.

Although the Information contained in this document is believed to be correct as at the time of printing or publication, no assurance can be given to you that this document is complete or accurate in light of information that may become available after its publication. The Information may not take into account any relevant events, facts or conditions that have occurred after the publication or printing of this document.

Telephone Recording:

As required under applicable laws L&G will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time)) and will be provided to you upon request.

LGIM Real Assets (Operator) Limited (Company No. 05522016) is authorised and regulated by the Financial Conduct Authority (Firm Reference Number 447041) and has its registered office at One Coleman Street, London, EC2R 5AA.