UK Real Estate View - The emergence from lockdown

LGIM Real Assets, September 2020

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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.

Key takeaways

- Covid-19 and the resultant economic impacts represent a genuinely unprecedented set of circumstances in which to forecast real estate equity returns. Confidence in forecasting against a single scenario is low and there is a wide selection of plausible outcomes
- High-frequency economic indicators are currently suggestive of an upside "v-shape" recovery globally. However, identified risks make a slower recovery possible: persistent unemployment and what happens after the cessation of furlough; corporate delinquency; future virus waves and lockdown policy; and the timing and effectiveness of vaccines and treatments. The UK faces the additional complication with the ending of its transition period with the EU in December 2020, which has the potential to slow the pace of recovery
- Capital value declines, as measured by the MSCI Quarterly Digest, have registered -5.4% over the first half of 2020. Industrial was relatively stable at -1.5% while retail values have declined by -11.1%
- Notwithstanding the heightened forecasting risk, indicative forecasts through to the end of 2024, excluding the first half of 2020, suggest returns of around 5% p.a. under an upside scenario or around 3% p.a. should the path to recovery be slower
- The relationship between occupiers and investors will change, as will the way consumers use real estate. Being able to respond to these changing needs will help to ensure continued strong long-term performance

Global Economic Scenarios

These scenarios are not mutually exclusive and LGIM guide a median between scenario 1 and 2 leaving global output 3% behind trend by the end of 2021.

Scenario 1

This scenario has a 45% probability from a UK context and describes Covid-19 being managed without any major additional restrictions, with social distancing continuing through to the end of 2020 before a vaccine is available during the first half of 2021. The economy and society would return to relative normality by the end of 2021.

Scenario 2

This can be described as some recovery but with some long-lasting scarring, it is given a 50% probability for the UK. This is characterised by increasing numbers of infections and renewed restrictions, a heightened level of bankruptcy and permanent redundancies. It would mean the equivalent of 2-3 years of lost economic output.

Scenario 3

This describes a persistent slump and is given a 5% probability. This is characterised by a second wave of infection, more significant periods of lockdown and a double dip recession. It would also mean that there would be no effective vaccine, nor would herd immunity be achieved.

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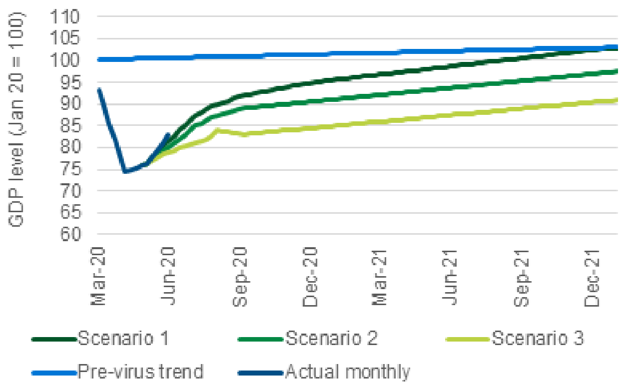
GDP scenarios and growth tracker



Estimated or forecasted information/data presented are not a promise nor guarantee of future events and are subject to change.

Source: UK Economic Scenarios, LGIM

Economic Environment

Like many global economies, much of the concern for the UK relates to the path of unemployment. As of July, around 36% of the labour force was receiving employment protection[1]. However, furlough is expected to end in October and there is concern about what this will mean for unemployment subsequently. Surveys suggest that up to 25% of furloughed staff are at risk of losing their jobs[2]. LGIM economists expect unemployment to peak at around 10%; this would be higher than after the global financial crisis.

Real estate markets

A useful indicator is to consider the relative value of real estate income, under normal collection conditions, versus other asset classes as well as real estate's own history. Our analysis into the relative value of real estate income shows that it still offers significant value on several measures. Real estate's risk premium has grown as gilt yields continued to erode while the yield offered by real estate increased. Furthermore, as rental and capital value performance deviates from trend, there is a potentially positive trend reversion which can make income seem better value. Additionally, given the recovery in equity pricing since March, real estate income compares favourably to dividend yields. Consensus forecasts for many of these measures suggests that real estate income may seem even better value by year end.

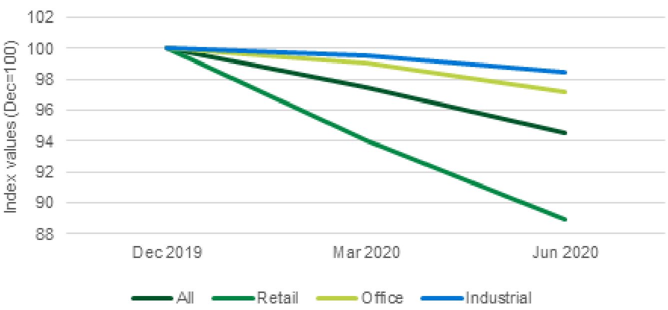
Part of this narrative, however, relates to real estate yields moving out and, indeed, valuation yields have increased 25 bps over the first half of the year to 5.8%, according to the MSCI Quarterly Digest. Our proprietary pricing models currently show that real estate values are broadly appropriate.

[1] Source: HMRC, [2] Source: MarketFinance Ltd

This is based on two indicators. The first is a yield model which uses credit spreads and gilt yields to judge an appropriate real estate yield. Following government stimulus this measure is suggesting an unrealistically small change to property yields. An alternative measure is to look at a basket of REITs and adjust for leverage and outliers which shows an outcome much closer to the -5.4% reduction in values this year.

Within this All Property average, however, there continues to be a wide range of performance. The MSCI Quarterly Digest shows industrial assets have shown a minimal -1.5% capital value decline in the first half of the year, office assets have seen -2.8%, while retail assets have seen value declines of -11.1% which follows value drift which began in 2017. This detail is important as it emphasises long-standing structural shifts in real estate before Covid-19, and that the virus has accelerated these rather than caused them; in particular the risks associated with retail and the relative resilience of industrial.

Capital value movements over 2020



Source: MSCI Quarterly Digest

This retail risk has been illustrated by an increasing number of retail Company Voluntary Arrangements (CVAs) and insolvencies. Over the six months to the end of June, 2,630 retail stores were impacted by administrations or CVAs, which would annualise to the worst year since the GFC[3]. This additional pressure from Covid-19 contributed to the insolvency of Intu during the second quarter although we would emphasise that the company was facing significant headwinds before this crisis.

Statistics from Remit Consulting show that 63% of rent was collected 35 days after the June 2020 quarter end, around 10% lower than the previous quarter. A constructive dialogue with occupiers remains of paramount importance. Although many businesses reliant on discretionary spend require support, LGIM Real Assets has been closely involved in lobbying government to clarify messaging around the potential gap between ability and willingness to pay. Whilst we recognise the uncertainty on this question, we take the view that expectations upon occupiers to honour commitments will revert to pre-Covid norms in the coming months.

[3] Source: Centre for Retail Research

Leasing volumes for the office sector were very low over the second quarter, which was unsurprising given elevated economic uncertainty as well as an inability to view properties physically. However, the industrial sector continued to perform well and, in the market for larger units of space, Q2 2020 was a record quarter for take-up, according to CBRE. This was partly driven by issues related to Covid-19: NHS requirements and short-term deals to manage supply chains as e-commerce volumes jumped, for instance, but there were also several large deals from pure-play retailers such as Amazon on longer term commitments.

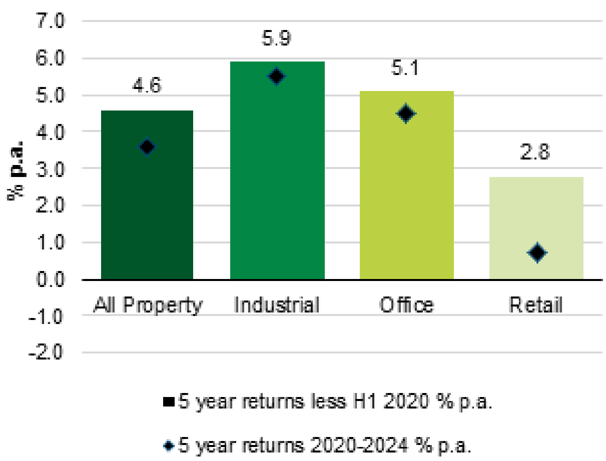
Investment volumes over the second quarter of £4.3 billion represented a record low, according to figures from Property Data. Market commentators have emphasised the fall, however given the extreme circumstances it seems remarkable that £4.3 billion still transacted. Investment transactions have now allowed for market uncertainty clauses to be lifted for many sectors, including long income, industrial, and most parts of the office sector. The lifting of these restrictions should help open ended funds reopen in the second half of the year.

Forecasts

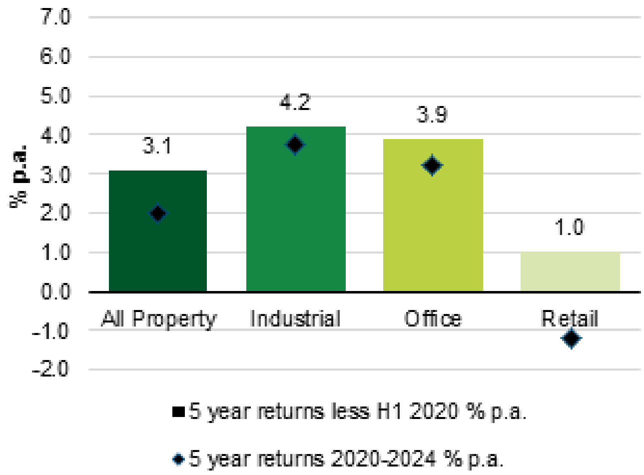
These are our thoughts on connecting the economic scenarios described above into scenarios for real estate total returns. Under the upside "v- shape" recovery, we would expect all property values to start to recover during 2021. Values would - relatively quickly - return to pre-virus levels, although of course there would still be structural issues to navigate in the retail sector. This scenario is associated with capital value declines of 5-10% in totality and an average annual total return performance in the order 5% p.a. over the 2020 H2-2024 horizon.

Under scenario two, best described by a "tick -shape" recovery, recovery would be slower and dragged by a higher rate of unemployment and insolvency. Value declines of -15% to -20% would be expected, with average annual total returns, removing the first half of 2020, of around 3%.

Economic scenario 1



Economic scenario 2



Source: Graph: LGIM Real Assets
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Winners and losers

We would expect the industrial sector to lead offices and be followed by retail, with segments of the alternative market also performing well, in particular Build-to-Rent (BTR) residential. The broad segment order would be similar under both scenarios.

Industrial market

Within the industrial market, the current performance of logistics suggests good performance over the near term, particularly from urban logistics. However, we note this is a consensus view and there is a need to be creative in unlocking opportunities. Multi-let industrials have surprised to the upside in terms of leasing requirements and rent collection, but in the near term we would expect performance to be slightly behind the logistics segment due to greater perceived covenant risk and shorter income streams.

Office

Our view on the office market is that predicted employment growth over five years and a likelihood of longer-term decreases in spatial density will mitigate the effects of lower utilisation, while an expected reduction in development may mean the impact to medium term void risk is marginal. We would expect short-term decline in rental and capital values but, towards the end of the horizon, and supported by a lack of new development, we would expect performance to accelerate.

Retail

Within retail, supermarkets are currently outperforming the All Property average and are expected to outperform in the near term. However, it is increasingly important to consider stock and location specific factors in appraising individual investments. Elsewhere, we continue to expect further value declines meaning all retail segments underperform over the five years.

Alternative sectors

Within alternatives, we still view BTR residential favourably due to structural support and even an expectation that families will turn to renting while uncertainty around purchasing homes is elevated. There continues to be a compelling case for self-storage and, although there are clear short-term risks, we expect well located student accommodation assets to perform well over the medium term.

Leisure and Hotels

The sectors where relative performance is believed to be most exposed to the differences between scenario one and scenario two are leisure and hotels. These sectors have been highly exposed to lockdown and an upside scenario concerning the virus and the economy would be expected to lead to a rapid resumption of trading.

Opportunity out of adversity

Covid-19 has created a clear challenge to the pace of returns but has also created an opportunity to reshape elements of how we deliver long-term investment performance in collaboration with occupiers and thereby position to deliver better than average risk adjusted performance.

ESG factors have become amplified as real estate's role in the functioning of society was elevated. This is expected to endure. Many investors, LGIM included, are accelerating their response to net zero carbon targets and are developing and refurbishing properties now which meet such goals ahead of time. Success will depend on relationships with occupiers on sustainability in-use, and the crisis has improved principal to principal dialogue.

This dialogue has been particularly important in the retail space and LGIM Real Assets has launched a new commercial leasing framework for retail and leisure occupiers ("flexible partnerships model"), with an initial focus on turnover rent options.

Occupiers are also expected to increasingly challenge investors on the impact real estate can have on health outcomes. Wellbeing strategies centred on Indoor Environmental Quality (IEQ) are expected to become much more important.

Contact us

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