Real Estate House View
United Kingdom

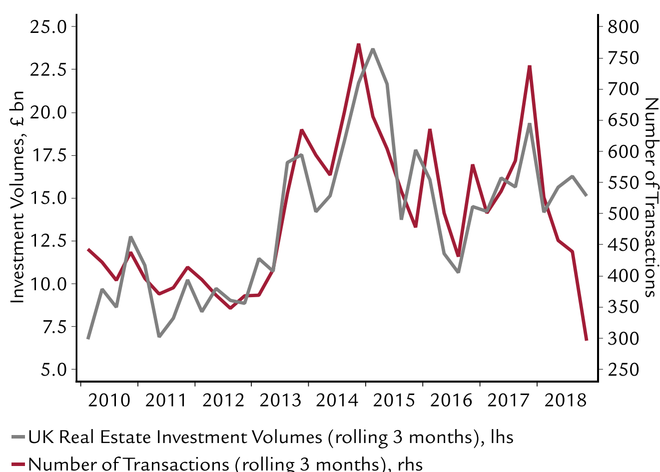
SwissLife Asset Managers

First half-year 2019

Key takeaways

- UK real estate returned 2.2% in the second half of 2018 and 6.0% on an annual basis, according to the MSCI All Property quarterly index. Capital growth of 1.4% was achieved over the year, largely due to yield compression, although this was supported by 0.5% rental value growth.
- The level of yield compression accommodated by the market is indicative of ongoing investor appetite for UK real estate. Buyers are being selective and a lack of quality stock is leading to competitive bidding for such properties when they are brought to market.
- Polarisation both between and within sectors continues to characterise the UK real estate market. Careful stock selection is therefore critical for investors.
- Logistics is maintaining its outperformance and is the strongest returning sector with an annual return of 16.4% in 2018. By contrast, the retail sector returned -0.5%. Annual retail returns have fallen from 4.5% over the last six months as rents and yields have softened.
- Offices returned 6.2% over the year, with capital growth supported by both rental value growth and continued yield compression. Across the sector, total returns ranged from 8.0% in the Rest of UK offices segment to 4.6% in London West End.

Chart in focus:



Source: PropertyArchive (January 2019)

UK real estate remains a popular investment asset class, reflecting its steady returns and high income component. Investor demand has continued to exceed supply and there is a lack of investable stock on the market. As a result, market liquidity has reduced significantly. 2018 saw approximately GBP 61bn transacted, only 6% down on the 2017 total, but the average deal size grew every quarter to reach GBP 51m in Q4 2018. This was the largest average deal size recorded since 2003 when the data series begins. Where good quality stock is available, the market remains highly competitive but buyers are discerning and interest is much thinner for compromised assets.

GDP rose by 0.6% in the third quarter, the fastest pace in seven quarters. Strong private consumption in July, boosted by good weather, will not be repeated in the foreseeable future. Consequently, this decent performance masks the slowing underlying momentum. This is reflected in the Office for National Statistics figures, which indicate that GDP growth stagnated in August and September. Furthermore, business investments contributed negatively to growth for the third consecutive quarter. Incoming data for the fourth quarter suggests that dynamics have slowed even further. Retail sales fell for a second straight month, while purchasing managers' indices hint at slower momentum in manufacturing, construction and the service sectors alike. We believe that a "blind Brexit" is the most likely scenario when the UK exits the EU in March 2019, but the risk of a "no deal" scenario remains considerable.

Extended market cycle forecast

UK real estate returns moderated in 2018 as the rates of yield compression and rental growth reduce. Over the year, All Property UK returned 6.0%, based on the MSCI quarterly index. Capital growth of 1.4% was driven predominantly by pricing movements. Headline numbers mask polarisation both between and within sectors, reflecting the underlying occupier market. Consequently, understanding local market dynamics and occupational need when selecting stock is critical. Over the next year, we anticipate an extended market cycle where performance is driven by income and pricing is maintained by capital seeking yield in a low-interest-rate, low-growth environment. At present, there is little that suggests an imminent downturn: relative pricing looks attractive; debt levels are low; and the development pipeline is moderating. That said, there are a number of downside risks and a significant external trigger could result in a sharp decline in sentiment. At present, this trigger looks most likely to be political rather than structural.

Select regional offices offer value

Annual total office returns in 2018 were 6.2%. Capital growth of 2.1% was supported by 0.8% rental growth and 2.0% from yield hardening. West End offices recorded the lowest total returns in this sector (4.6%) as capital values grew by a relatively modest 1.3%. In contrast, the City returned 6.9% with capital growth of 3.1%. This reflects sizeable demand from overseas buyers for prime City stock, which has exerted downwards pressure on yields. Outside London, performance was boosted by a higher income return but capital values have also edged upwards, delivering annual returns of 6.5% and 8.0% in the SE and Rest of UK. Select regional markets are attracting occupiers on account of their affordability, access to talent and liveability. Where this is combined with a suppressed development pipeline, these markets still offer value.

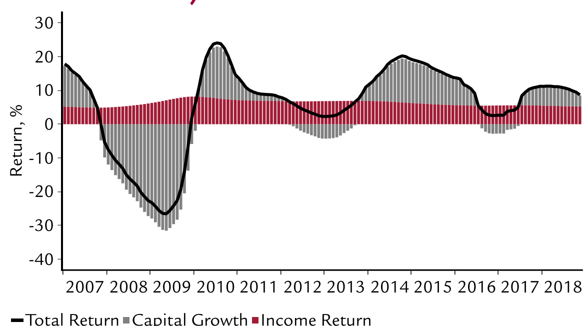
Logistics performance endures

Logistics property continues to outperform. The sector recorded an annual return of 16.4%. While this rate of return has slowed over the last six months, it still represents a clear margin over the All Property average. Capital values have increased 11.4% over the year with 7.3% from yield compression and 4.6% from rental value growth. The South East segment achieved the highest annual return, delivering 18.5%. Given the level of yield compression which has already been realised, the scope for further hardening of the scale witnessed recently is limited. However, the acute supply-demand imbalance and structural demand drivers offer good prospects for rental growth in the short and medium term.

Negative retail sentiment prevails

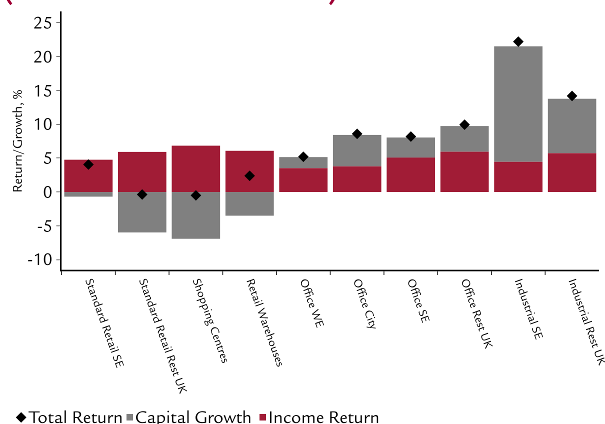
A raft of retailer failures in recent months is feeding through to investor sentiment and retail yields are moving out in response. The occupational market remains weak and limited demand is driving rental declines. Retail recorded a negative return of -0.5% in 2018, a marked slowdown from the 6.9% recorded in 2017. Capital values declined 5.3% as rents fell 2.2% and yields softened. Rents have fallen across all retail segments, but standard retail – Rest of UK has been the worst performer on account of the secondary nature of much of this stock. Whilst further weakness is expected, and given the ongoing significant cyclical and structural challenges facing the sector, there are pockets of resilience where retailers offer convenience, value and experience. These types of retailer tend to occupy modern, efficient portfolios.

Chart 1: All Property Performance (12-mth rolling to November 2018)



Source: MSCI Global Digest Monthly (November 2018)

Chart 2: Composition of total returns by segment (12-mth to November 2018)



Source: MSCI Monthly Index (November 2018)

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