Real Estate House View

United Kingdom

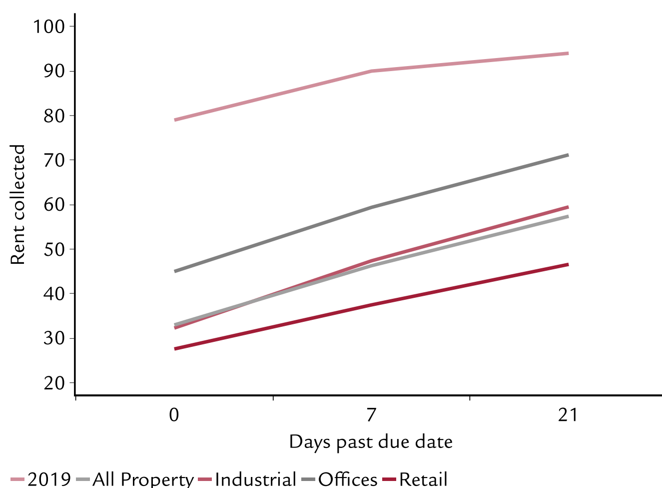
SwissLife Asset Managers

Second half-year 2020

Key takeaways

- **UK All Property returns weakened in H1**. Total return over H1 2020 equated to -3.3% compared to +0.3% over H2 2019 based on the MSCI UK quarterly index.
- **UK property remains attractive to investors**. The corona crisis has significantly impacted UK property. It has exacerbated polarisation between assets, locations and sectors that are positively and negatively aligned to structural change. UK property has characteristics which will support investor demand in a deflationary environment such as its income profile, low levels of leverage and low supply.
- **Low transaction volumes evident**. H1 investment volumes were the lowest since 2012 as COVID-19 related restrictions and the inclusion of material uncertainty clauses in valuations made real estate difficult to transact.
- **Disparities between and within sectors**. Industrials (logistics) remained the best performing UK property sector in H1 with a total return over 6 months of 0.6%, followed by offices at -0.9%. Retail registered a total return of -8.6% and we expect further future negative impacts.
- **Investment and occupational divergence**. We expect investment volumes to improve in H2 2020 but occupational weakness may persist, leading to a decoupling of investment and leasing activity.

Chart in focus:



Source: Remit Consulting

According to Remit Consulting just 33% of rents were collected on the June quarter due date. This compares to 40% in March and 90% in 2019. By 21 days past the due date collection stood at 57% compared to 60% in March and 94% in 2019. Collection rates varied by sector reflecting polarisation trends. The largest proportion of rent was collected for offices (71%), followed by industrial (60%) then retail (47%). Many occupiers, particularly those in the retail and leisure sector, have switched to monthly or turnover based rents. We expect these rental structures may become permanent market features when more normal economic and property conditions return.

In the developed world, COVID-19 has hit the United Kingdom harder than most other countries. Accordingly, the re-opening of the economy is taking place more slowly than elsewhere in Europe. We expect UK GDP to fall by -8.3% in 2020 and to not recover to pre-crisis levels before 2022. Fiscal policy measures have helped to stabilise domestic demand, most importantly thought the newly introduced "Job Retention Scheme". To boost the economy, the government will increase capital spending to 3% of GDP and loosen planning regulations to prioritise transport and housing infrastructure investment. Much of this fiscal stimulus was already planned but will be brought forward to provide a short-term economic boost. Whilst this fiscal stimulus will be beneficial, its effects will not emerge until 2021. Brexit, the UK's pre-dominant economic theme for the past four years remains unsolved and is likely to continue to weigh on business sentiment in the months ahead. A smooth transition of the UK out of the EU in December is our base case. We believe the most likely outcome is a narrow trade agreement with the details to be negotiated in the future.

Low volumes and returns

UK real estate investment volumes totalled £17.0bn in H1, the lowest level since 2012. In March, RICS directed valuers to include a material uncertainty clause in their valuations. This has since been lifted on a select few segments but most UK stock remained difficult to transact until very recently. The impact of the corona crisis and the national lockdown on the economy has been significant, having a negative impact on returns and performance. The MSCI UK Property Index (quarterly) to June recorded a total return of -3.3% over H1 2020 compared to +0.3% in H2 2019. Capital decline was driven largely by yields moving out but also moderate negative rental growth. We expect valuations to fall further for all market segments in the short-term but the gap between buyer and seller aspirations should close, supporting investment activity. Capital loss will vary significantly by asset, location and sector.

Office sector proves resilient

The office sector has proven to be relatively robust. Most occupiers switched to remote working without major adverse implications on productivity or output. Office total return was -0.9% over the six months to June 2020. Capital values declined by -2.8% driven by outwards yield shift. In the short-term occupational demand will reduce as companies reassess their future office requirements. In the medium to long-term, we believe that occupiers will take less space in aggregate but require better quality, more expensive space to facilitate collaboration, training, client interface and promote the company brand. This means office demand will evolve rather than disappear.

Record logistics take up

Industrial (logistics) registered a total return of +0.6% in H1. Moderate rental value growth was achieved in both industrial segments, but this was outweighed by outwards yield movement. The sector has proven resilient due to higher online spending and supply chain renationalisation. Q2 logistics take-up was the highest on record according to CBRE. Elevated levels of take-up are expected to endure in order to service e-commerce demand and given the rising need to store more stock domestically.

Retail under pressure

Retail returned -8.6% over H1. Forced shop closures and social distancing have been particularly challenging for this sector. Rental growth on the quarter was -4.7% and equivalent yields moved out by 54 basis points. Shopping centres absorbed the most severe impacts. More retail pain is expected but there will be pockets of resilience like supermarkets, affordable value retail warehousing and localised retail facilities which have traded strongly during the pandemic and are likely to be used more by shoppers in the future.

Enduring real estate appeal

Despite recent capital loss, real estate will to remain attractive for its income. A deflationary environment is expected to persist with little immediate prospect of interest rate rises. The sector has deleveraged since the GFC. Leading into the crisis there was an acute shortage of quality stock and a constrained development pipeline in most major markets which will limit availability. Occupational weakness may persist leading to a decoupling of investment and leasing activity.

Chart 1: All Property Return (to Q2 2020)

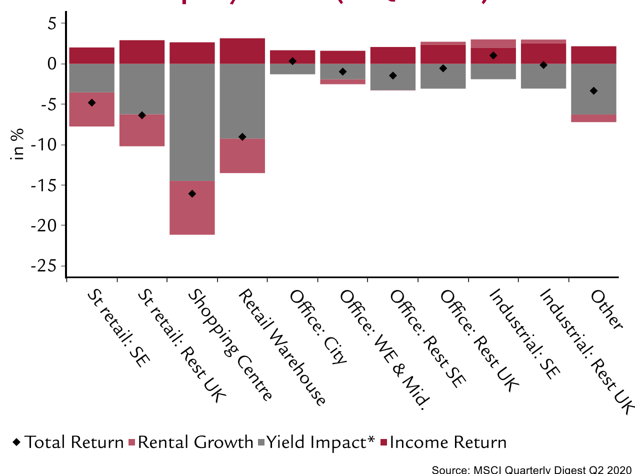
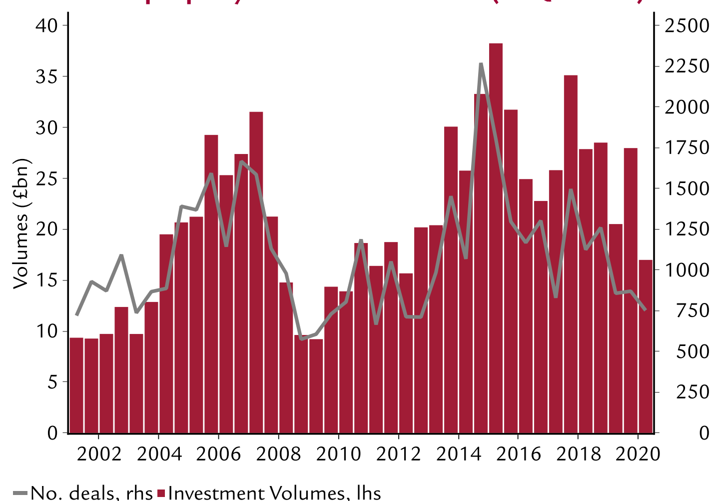


Chart 2: UK property investment volumes (to Q2 2020)



Source: RCA

*Yield impact measures the impact of pricing movements on capital values

Authors

Mayfair Capital

Tom Duncan
Research, Strategy and Risk
tduncan@mayfaircapital.co.uk

Fintan English
Research, Strategy and Risk
fenglish@mayfaircapital.co.uk

Swiss Life Asset Managers

Francesca Boucard
Senior Economist Real Estate
francesca.boucard@swisslife.ch

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch

Do you have any questions or would you like to subscribe to this publication?
Please send an email to: info@swisslife-am.com.
For more information visit our website at: www.swisslife-am.com/research

Released and approved by the Economics Department, Swiss Life Asset Management Ltd, Zurich
Swiss Life Asset Managers may have acted upon or used research recommendations before they were published. The contents of this document are based upon sources of information believed to be reliable but no guarantee is given as to their accuracy or completeness. This document includes forward-looking statements, which are based on our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements.
France: This publication is distributed in France by Swiss Life Asset Managers France, 153 rue Saint Honoré, F-75001Paris to its clients and prospects. **Germany:** This publication is distributed in Germany by Corpus Sireo Real Estate GmbH, Aachener Strasse 186, D-50931 Köln and Swiss Life Asset Managers Luxemburg, Niederlassung Deutschland, Hochstrasse 53, D-60313 Frankfurt am Main and Zeppelinstrasse 1, D-85748 Garching b. München and BEOS AG, Kurfürstendamm 188, D-10707 Berlin. **UK:** This publication is distributed by Mayfair Capital Investment Management Ltd., 55 Wells Street, London W1T 3PT. **Switzerland:** This publication is distributed by Swiss Life Asset Management Ltd., General Guisan Quai 40, CH-8022 Zurich.