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UK real estate review: recession, recovery, renewal

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Key takeaways

- As 2023 unfolds there remain several plausible outcomes for the performance of UK real estate. In our view, the repricing seen over 2022 positions the sector relatively favourably.
- We expect long-term resilience from residential sectors, most notably Build to Rent Residential (BtR) and Purpose-Built Student Accommodation (PBSA).
- The expected UK recession may accelerate structural change in offices and retail. Given the uncertain outlook, we believe constructing portfolios around asset quality and income risk is key.
- We expect an increase in available product to buy this year. This may provide an opportunity for those wishing to increase market exposure at more attractive pricing levels. That said, the increased supply could accelerate downward valuations, especially in secondary assets.

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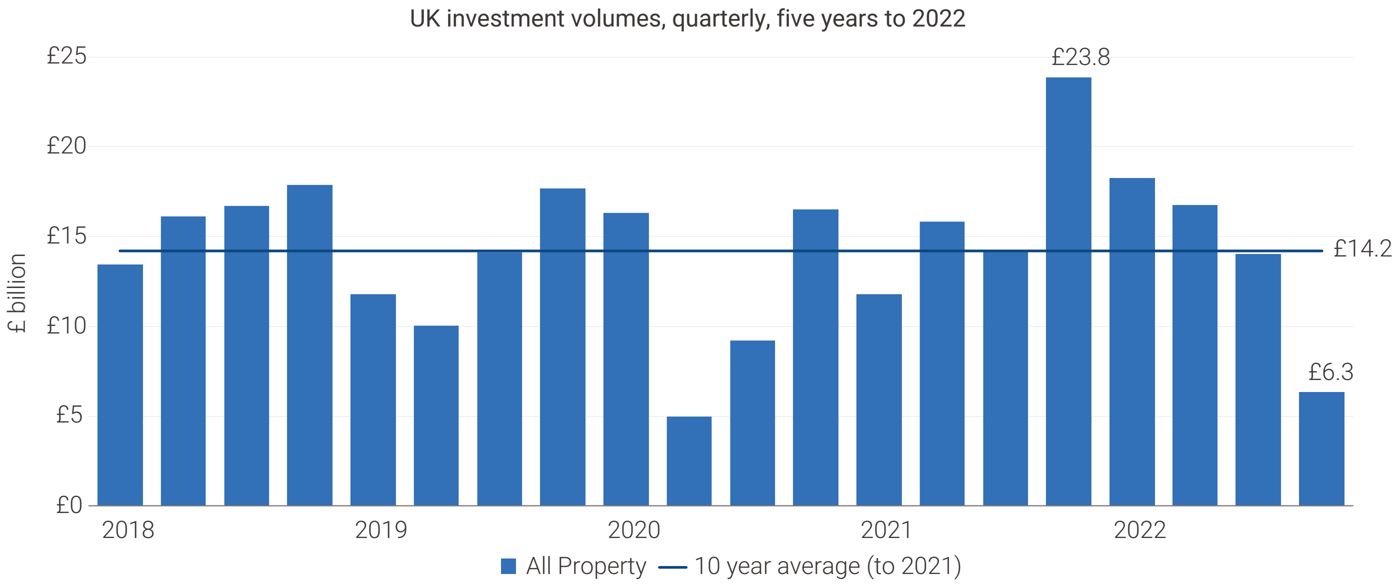
Capital market effects started the downturn

The first half of 2022 saw UK real estate values, led by industrial and parts of the retail sector, appreciate by 6.5%[1] despite a backdrop of significant inflation concerns, the invasion of Ukraine and policy rate hikes. The pricing of many other asset classes corrected[2], which made real estate look increasingly expensive on a range of measures. Investors expected a pricing correction as a rational response, which duly emerged over the summer months (-2.6% from June to August 2022)[3].

By contrast, the impact of the UK's mini-budget in late September led to a more irrational phase of repricing, in our view. Significant uncertainty drove debt costs higher, while a dislocation in market activity led to a prolonged period of pricing discovery. Values fell by a further -18% from August[4] to December bringing the total decline over H2 2022 to -20%[5].

Investment volumes – a significant reduction in activity in Q4 2022

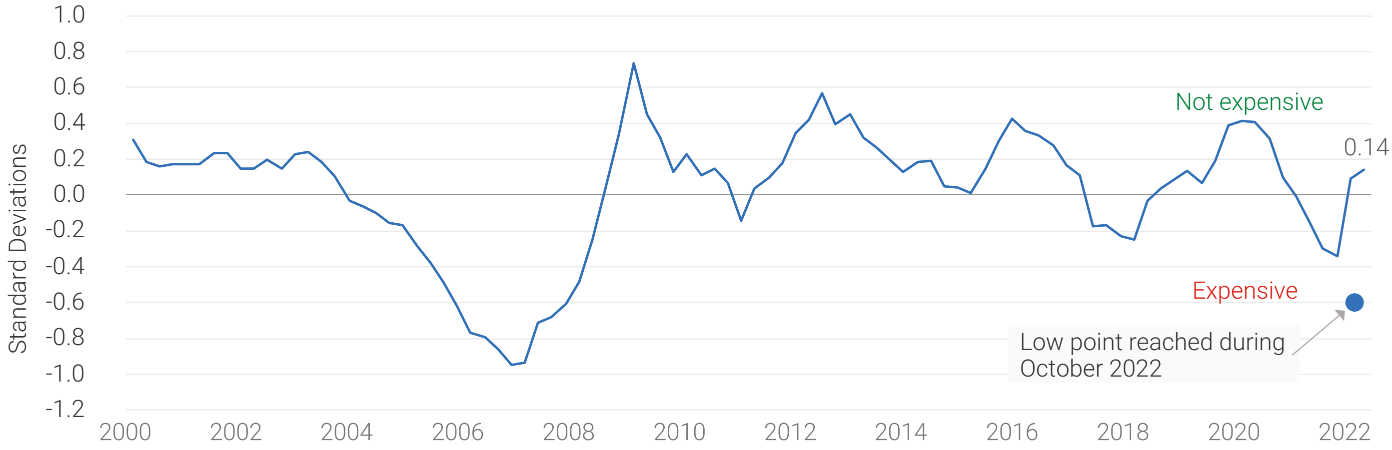


Source: PropertyData, LGIM Real Assets, February 2023.

This correction in real estate values – together with lower gilt yields and swap rates and a strong equities market sending dividend yields lower – led to a return to relative value, according to some indicators. This is illustrated in the graph at the top of the next page. While we would emphasise that the volatility of inputs into the model means we are not wholly convinced this represents a true inflection point, the change in relative property values since the third quarter of 2022 is noteworthy.

1. Source: MSCI Quarterly Digest, Q4 2022, February 2023.
2. Source: The MSCI World Equity Index fell -19.5% period covered, Jan – Jun 2022.
3. Source: MSCI Monthly Digest, January 2023.
4. Source: MSCI Monthly Digest, January 2023.
Note declines on the Quarterly Digest were less.
5. Source: MSCI Monthly Digest, January 2023.

LGIM RA's relative value indicator – returned to positive territory in February



Source: Bloomberg, Macrobond, LGIM RA Research. Data as at 07 February 2023. **Past performance is not a guide to the future. The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.**

2023 outlook

For those adopting a more optimistic outlook for 2023, we believe several downside risks remain. Geopolitical tensions and macroeconomic risks have not gone away, but more parochial to real estate are the impacts from an expected increase in investment stock. The liability driven investment (LDI) crisis of late 2022 may lead to more investment supply this year as many defined benefit funds approach a fully funded position earlier than expected, requiring less illiquid assets, such as real estate. Meanwhile, some leveraged investors, struggling with higher repayment costs, may need to dispose of assets. Similarly, higher corporate debt costs for larger investors may encourage asset sales.

The UK economy also remains difficult to predict, and more specifically the likely path of gilt yields. Inflation may be more persistent than first thought, which may result in higher gilt yields for longer. Alternatively, but also plausible, a low-productivity, low-growth environment with inflation tamed sooner may be associated with lower gilt yields. Predicting yields based on an average of two opposing views is risky, and we would advocate a scenario-based approach.

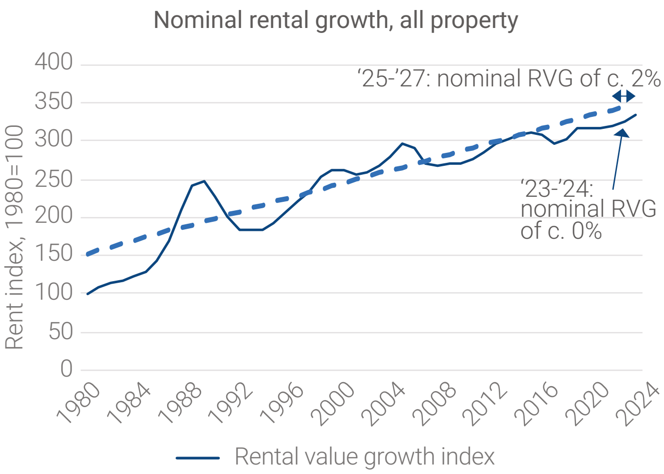
Property yields are heavily influenced by gilt yields, of course, but our modelling also shows a notable effect from real terms rental growth, swap rates and credit spreads. The belief that that these factors improve in investors' favour over the medium term, while gilt yields remain relatively high, drives an expectation of yield compression after 2023, but we are cautious on anchoring on any single path.

6. Source: 20.8% versus 10.7% 10 years ago according to the MSCI Annual Digest (2021).

Potential risks for rental growth in the near term

As the UK is likely to enter recession this year there are growing risks around a deterioration in rental markets and an associated decline in values. For real estate, recessions are associated with more void and default risk and lower rental growth. We have therefore reduced our forecast for rental growth in the near term, as outlined in the graph below. However, continued growth from the industrial sector, albeit at a much slower rate, and the positive impact from alternative sectors which now comprise a much larger proportion of the MSCI sample[6] mitigate downside risk, in our view.

Downside risk but near-term support from industrial and residential sectors



Source: MSCI Annual Index, LGIM RA Research as at January 2023. **Past performance is not a guide to the future. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Structural and cyclical sector risks

We think the recession may accelerate the impact of structural changes within the office sector. Extra nervousness about headcount, growth and size requirement may lead to a more rapid downsizing from occupiers. Previous corrections in office rental values were often preceded by a boom. This will not be the case this time round. We expect a deviation from nominal trend growth of 10% or more. This is a forecast of the MSCI sample, though, and we strongly believe there will be increased polarisation within the office sector based on asset quality, location, and management acumen.

We also see risks of a cyclical downturn impacting retail and leisure. In retail, we believe there will be continued structural adjustments and therefore hold a below-consensus position, although we see pockets of resilience. In leisure, we believe the sector will outperform from 2023 onwards, where higher yields and income return will likely favour well-located leisure assets.

For industrial property we see increased cyclical risk in the near term, particularly affecting occupation costs. Occupiers face higher fuel, wage, transportation tax (e.g.ULEZ)[7], and business rate pressures this year, but we expect performance will be supported over the medium term by consistent tailwinds of portfolio adjustments to e-commerce, onshoring and limited supply risk specifically for multi-let estates. We therefore expect continued rental growth, albeit at a much slower pace than recent averages.

Residential sectors

Within the broader universe of alternative sectors, we believe prospects for both BtR and PBSA remain strong. Over 2022 rental growth was expected to be 6.3% and 4.5%, respectively, compared with 3.9% for the 'all property' index, and we expect this momentum to continue into 2023 with forecasts of 5.6% and 5.0%, respectively[8]. Both segments share similar characteristics of low supply risk and supportive long-term demand fundamentals.

Returns, however, are expected to slow as this rapid growth in rental values decelerates. It is important to emphasise that this marginal deterioration in relative performance does not change our views on the merits of these segments over the long term. Segments providing assets which are vital for their occupants, where supply risks are manageable, and where there is conviction on a long-term demand underpin, we believe, are positioned well for both long-term performance and near-term resilience. In an environment of persistent macro uncertainty such characteristics fulfil an important part of portfolio construction.

Real estate forecasts 2023-2027

The assumptions behind our central forecast for property yields are improving real terms rental growth after 2023, normalisation of credit spreads, and relative stability of gilt yields and swap rates. These allow for yield compression but to a level well above the June 2022 lows. We expect further outward movement in 2023. We re-emphasise that the above describes one potential path and there remains uncertainty around these key inputs, in particular where gilt yields may stabilise.

Nevertheless, this path suggests a reduction in values of around 30-35% (including the 20% seen in the second half of 2022). We do expect a subsequent recovery, but values are not expected to return to the highs of mid-2022. Over the full five years return expectations of 5.5-6% p.a. are marginally above consensus but shift from below consensus in the downturn phase to above consensus during the recovery.

Risks to this view are a mixture of real estate specific factors and broader macroeconomic ones. As mentioned above, more investment supply could depress values further, with the 'backlog' taking more time to clear. The UK economy could also be 'low-growth, high-inflation' for longer than currently expected.

7. Source: London's extended Ultra Low Emission Zone.
8. Source: Source: LGIM Real Assets, January 2023.

Strategic implications

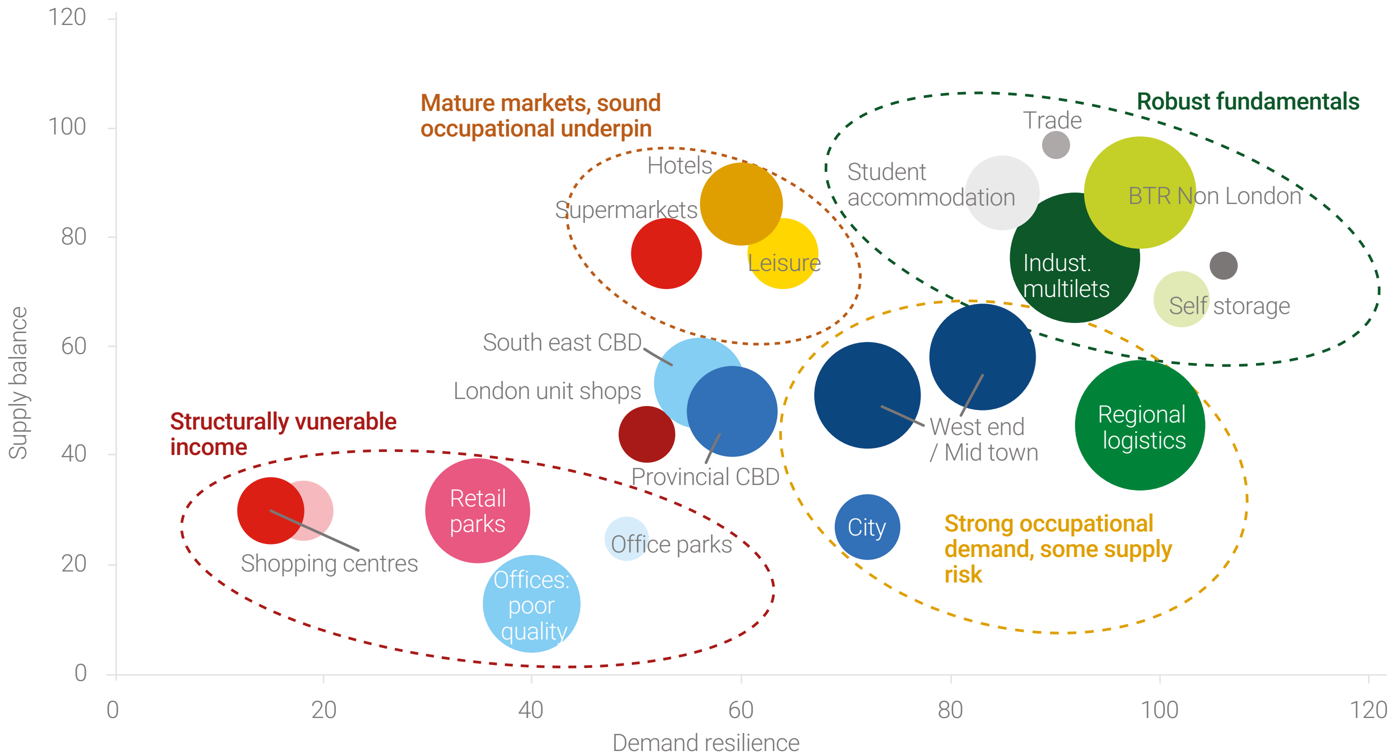
Our forecasts are based on the MSCI annual sample. This contains a range of property ages, qualities and different approaches to management and occupier engagement. Implicit is a growing deviation around averages. This is particularly true of offices but will apply to all sectors, in our view.

A vital consideration of asset quality is sustainability. This impacts forecasts in three ways. Firstly, the expenditure requirement, which is a drag on returns, has risen and becomes more urgent ahead of MEES regulation. Secondly, evidence of rental premia, lower yields and better exit liquidity for certified property continues to improve[9]. Although empirical evidence is still dominated by research on London offices, the logic that this is universal is sound. Thirdly, investor nervousness around the interventions required to drive sustainability may encourage the release of secondary product onto the market. This may further depress pricing for non-sustainable assets.

Small areas within larger sectors may offer greater resilience over the long term

We expect long-term resilience from certain segments, as illustrated in the below chart. These have common features of a demand underpin, supportive long-term supply risk and offering a product occupiers need. These characteristics can be found in small parts of larger sectors. We favour the BtR and PBSA sectors, as described above, but also favour high-quality offices in the strongest markets, urban logistics, self-storage and urban multi-let industrial, supermarkets, hotels and good quality leisure assets.

Real estate resilience matrix



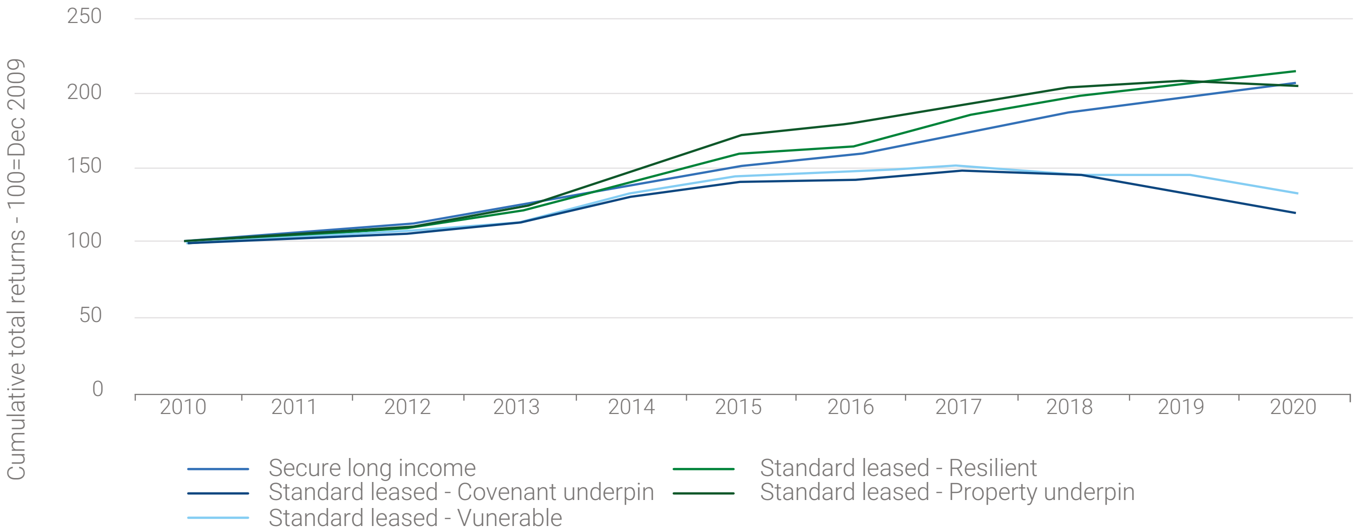
Source: MSCI, CoStar, Local Data Company, PMA, Unite, Grainger, Savills, English Housing Survey, HESA, ONS, LGIM RA Research as at Q4 2022.

9. Source: See JLL Sustainability and Value, January 2023 or Knight Frank, The Sustainability Series, September 2021.

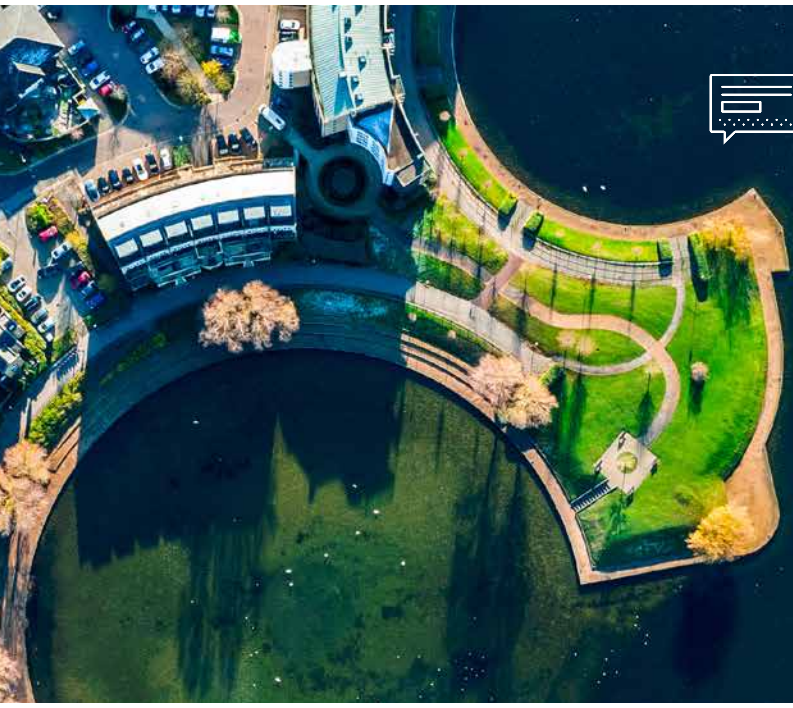
A feature of recent months has been a more rapid and severe repricing of lower-yielding and higher-quality assets compared with the rest of the market. This seems at odds with our view of outperformance from such property segments but is explicable based on higher interest rate sensitivity, better evidence of pricing, and yield impact.

In the near term we would expect buildings with longer income streams and strong covenants to outperform relative to higher-beta areas of the market. This is another way of delineating portfolios demonstrated in the below chart and based on LGIM RA assets.

Macro uncertainty means income and risk styles are key



Source: LGIM Real Assets as at Q4 2022. **Past performance is not a guide to the future. The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.**



Summary

There are many areas where conviction is difficult, such as where gilt yields will settle, the duration of inflation and recession, and of course geopolitical risk. However, there are areas where our conviction is strong or growing. Over the long term, resilient sectors and styles, the importance of asset quality and sustainability, and resultant polarisation are key themes. In the short term, more investment product may come onto the market this year while rental values will be under pressure, in our view. Navigating this will be difficult, but investors have been helped by a significant correction in pricing over 2022. Prices in a number of sectors benefiting from strong long-term growth prospects have fallen significantly, providing, we believe, an opportunity to access relatively well positioned real estate at significantly lower prices than has been the case in the past.

Contact us

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

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Key risks

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