UK real estate: Performance after repricing?

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Executive summary

1. We remain cautious on near-term performance at the all-property level, given persistent upward pressure on yields, but some of this pressure has reduced as inflation has decelerated. UK real estate appears closer to the end of its re-pricing journey than in other geographies.

2. We expect potentially robust performance from residential sectors and believe this will support further institutional allocations. Parts of the industrial sector and other alternatives are attractive in our view.

3. Construction frictions are expected to limit supply risk and increase the scarcity value of premium product over the medium term. Frictions may also drive opportunities for institutional forward funding.

4. We believe real estate debt offers investors attractive return potential and can play an increasingly important role in overall real asset exposure.

LGIM

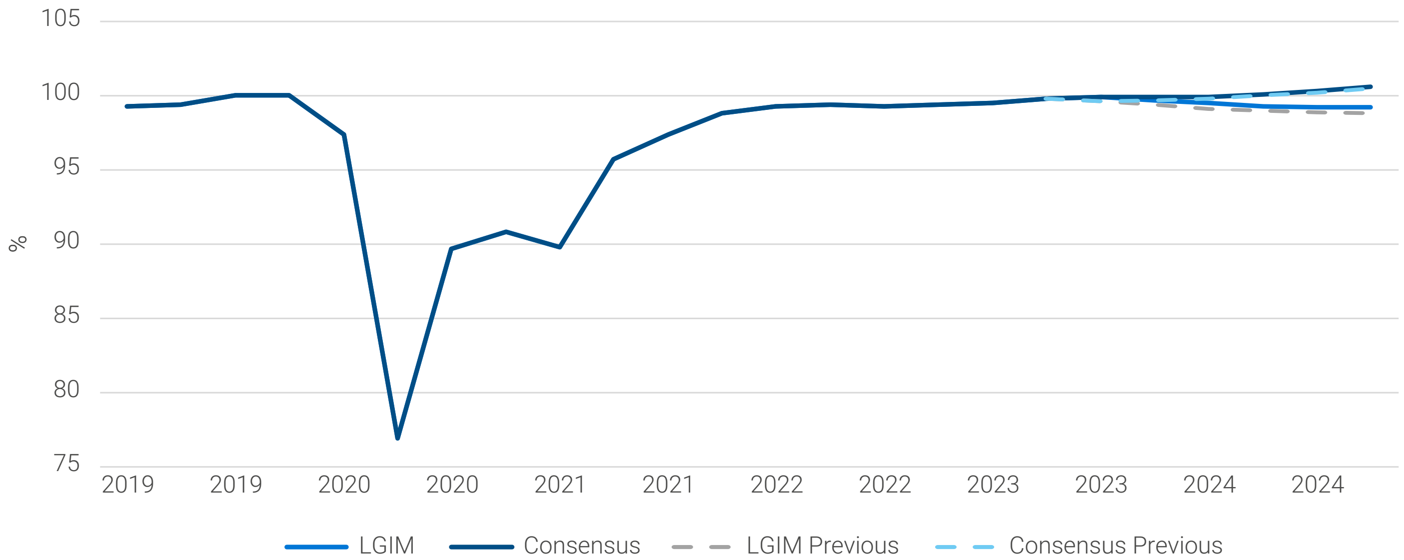
The UK economy: Reduced drag

LGIM expects both the UK and the US to enter recession before the middle of 2024. This forecast positions LGIM at the lower end of consensus, although the absolute reduction in GDP expected is modest compared to previous recessionary periods. The alternative view, reflected in consensus expectations of a 'soft landing' characterised by subdued growth, is arguably supported by recent retail sales values and consumer confidence. LGIM's more bearish view is supported by recessionary PMI data, increased unemployment, and weaknesses in higher-frequency job placement data.

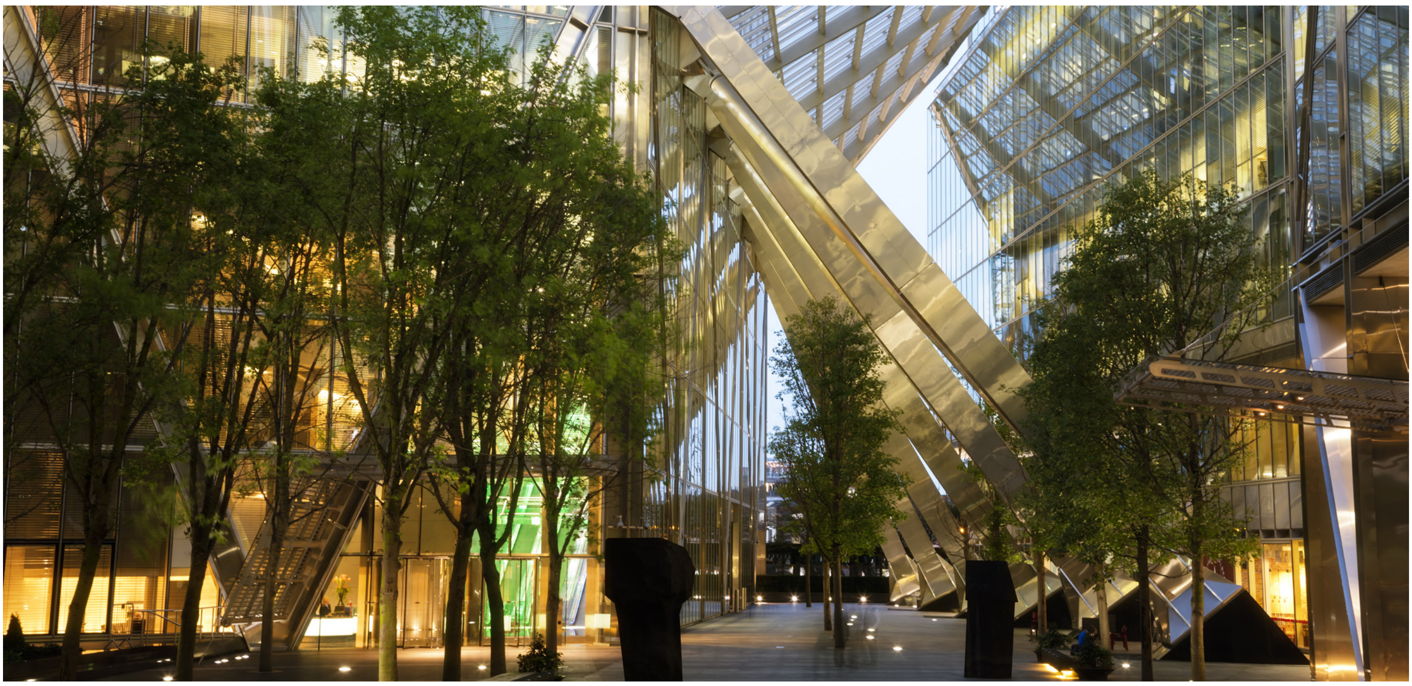
It should be noted that a softer landing scenario is not necessarily a 'goldilocks' outcome for the economy. Continued growth, albeit at low levels, may not be sufficient to bring inflation back to target and might necessitate rates staying higher for longer, ultimately choking medium-term growth. For rates to fall and allow asset prices to grow in the medium term, more economic slack is required in the near term.

The debate about rates has therefore shifted away from the terminal level of rates to the length of time rates will linger at those levels.

LGIM GDP expectations versus consensus



Source: LGIM, as at September 2023.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

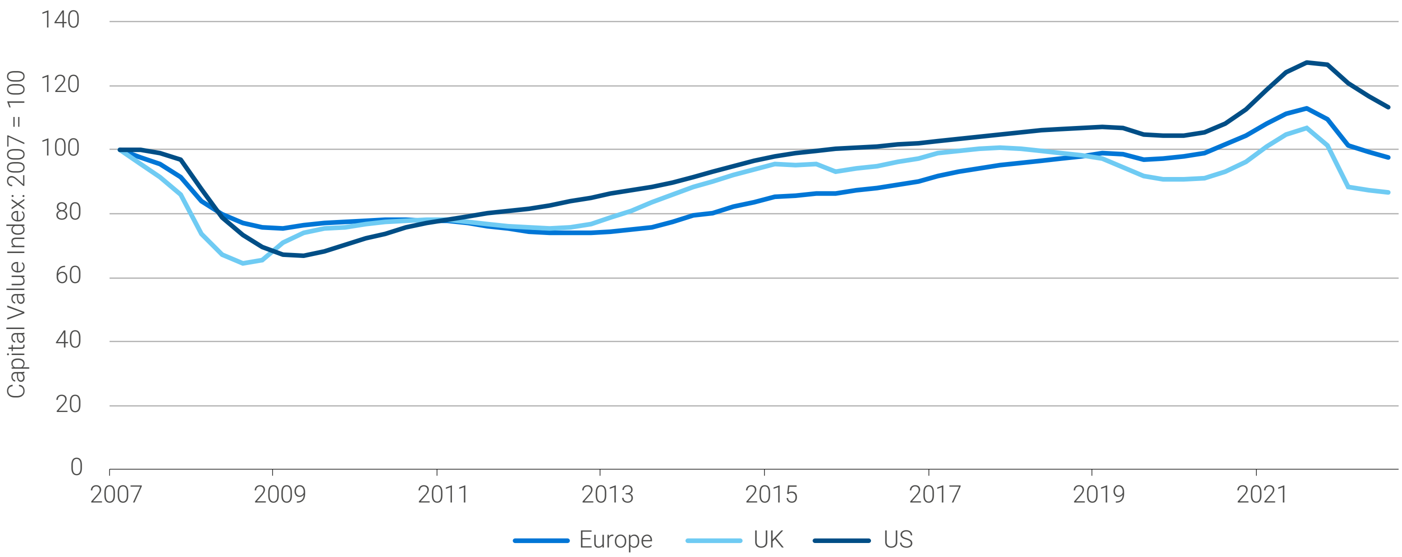


Property pricing

Some economic indicators have remained robust in tandem with persistently elevated inflation, and markets have priced in a higher-for-longer interest rate environment. The five-year SONIA swap rate had risen to 4.8% at the start of September, having been 3.8% in Q1, while the 10-year UK gilt yield rose 90 basis points from 3.5% to settle at 4.4%[1]. A squeezed risk premium for UK real estate, combined with our expectation for real-term rental declines at an all-property level, means we anticipate continued upward pressure on yields in the near term. However, some of this pressure has lessened relative to highs over the last 12 months and suggests a slightly lower peak in yields than forecasts made six months ago.

Transaction volumes remained weak over Q2, with £3.7 billion traded versus the five-year quarterly average of £13.6 billion[2], reflecting a disconnect in expectations between buyers and sellers, as well as expensive debt. However, we note that investor sentiment towards UK real estate, as measured by surveys from PMA and Preqin[3], was net positive at the end of H1, suggesting capital continues to target UK real estate – at least more so than this time last year – but it may remain on the sidelines until fair value is perceived. We anticipate more motivated sellers will emerge over the next 12 months in response to refinancing pressures and an increasing number of defined benefit pension schemes disposing of riskier assets. This should support price discovery and potentially present attractive acquisition opportunities, particularly for all-equity purchasers, in our view.

MSCI Real Estate Valuations



Source: MSCI, as at September 2023.
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.

The repricing of UK real estate has been ahead of Europe and the US, albeit with both regions catching up over 2023[4]. From the valuation peak in mid-2022, the UK has seen a decline of -19% as of the end of Q2 2023, versus -14% in Europe and -11% in the US. Values continued to decline over the summer, with the MSCI monthly reading for August showing a -22% decline from last year's peak. We believe that we have seen the greater share of the correction. The expected disposal of assets by leveraged investors unable or unwilling to refinance and the strategic disposals by DB investors are in our view likely to create some potential opportunities to create attractive entry positions.

1. Bloomberg as at September 2023
2. RCA, September 2023
3. PMA Survey Of Investor Confidence, Summer 2023; Preqin investor intentions survey
4. MSCI data as at September 2023

Construction costs: Reducing supply risks and creating new opportunities

The consensus among cost consultants is that after historic highs in tender price inflation (TPI) in 2022 (8.6% YoY according to RICS BICS[5]), the rate of TPI inflation is likely to fall, but remain elevated. Growth of around 5% is expected over 2023, before falling to an annual average of c.3.0%. This compares to an expected increase in commercial real estate capital values of 0.8% a year[6], implying a lasting impact on development viability, all else being equal.

Recent peaks in TPI were driven by materials inflation, which rocketed after COVID and again following Russia's invasion of Ukraine. Average material price inflation peaked at 27% YoY in June 2022[7], with many critical materials inflating much more. Much of this impact was absorbed by contractors reducing margins to keep the contract prices experienced by investors more manageable.

Although average materials prices have fallen -4% over the 12 months to July 2023[8], they remain 42% higher than before COVID and prices for some critical components for commercial property remain stubbornly high. Cement prices, for instance, are 7% higher than they were 12 months ago.

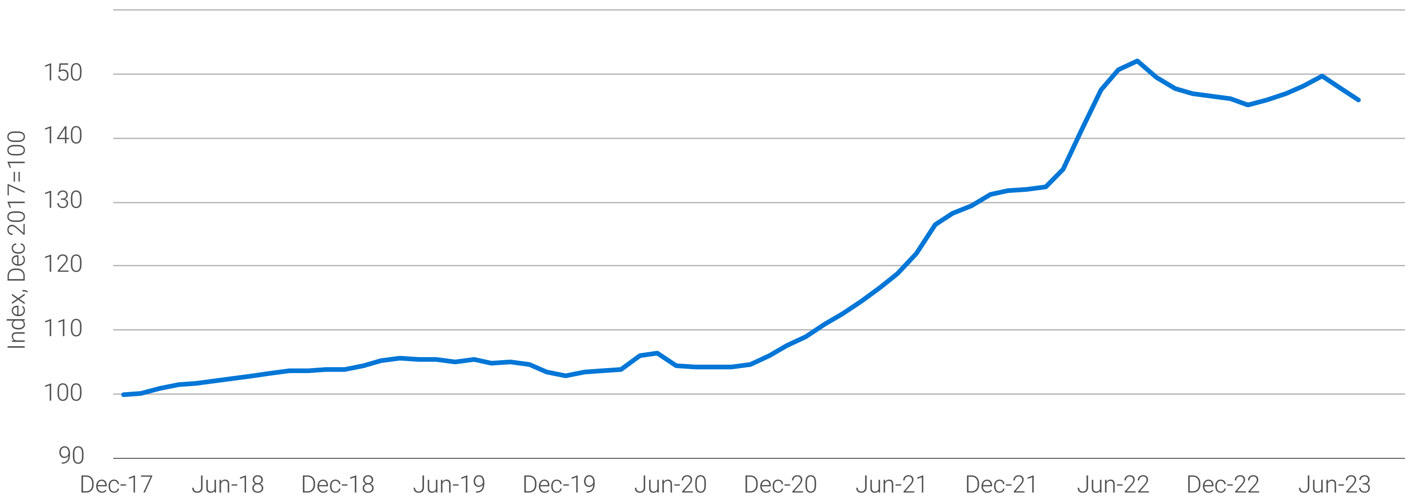
However, this may also impact the market positively by:

1. Reducing supply risk over the 2025-2027 period that otherwise may drag on growth.

2. Increasing the scarcity value of any new development, especially where high specification and exemplary sustainability credentials are offered.

3. Increasing opportunities for forward funders to enable the viability of development and regeneration in the relative absence of bank funding, whether for structural reasons (banks' concerns over real estate risk) or more cyclical factors (uneconomic terms[9]).

Construction Building Materials Price Index, December 2017=100



Source: Department for Business & Trade, September 2023.
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5. Royal Institute of Chartered Surveyors BCIS forecast, as quoted by CAST July 2023
6. IPF Real Estate Consensus Forecasts, September 2023
7. Monthly Bulletin of Building Materials and Components - August 2023, Department for Business & Trade
8. Monthly Bulletin of Building Materials and Components - August 2023, Department for Business & Trade
9.Bayes estimated that, at the end of 2022, average margins for speculative development were 481 bps compared to 270 bps for prime offices, for instance

Strategic sectors

We expect substantial differentiation by sector. Sectors within residential and industrial look well placed, for instance, for instance, with strong rental growth prospects, supported by robust fundamentals and with a weight of capital targeting a comparatively limited pool of assets. In contrast, we expect the greatest risk around values to be felt in the retail and office sectors, where we anticipate cyclical pressures on occupiers to be magnified by ongoing structural challenges, particularly affecting average to poor-quality buildings and locations.

We think the office sector may reprice to fair value, with yields offering compensation for new risks as well as older ones – such as management costs, shorter leases, and refurbishment requirements – that arguably were not adequately compensated for before. We will explore this in more detail in a forthcoming paper.

Living sectors

We see the living sectors as being relatively resilient and expect alternative sectors to outperform their traditional counterparts over 2023. The relative countercyclicality of residential sectors supports the case for greater allocation to these sectors in our view.

Both the Build to Rent (BTR) and Purpose-Built Student Accommodation (PBSA) sectors have been somewhat more insulated from the significant outward movements in yields recorded across other commercial sectors. A key driver of this has been the strength of occupational demand. Supply shortages in both the BTR and PBSA sectors may worsen as construction activity weakens and difficult planning regulations curb new permissions. UK wages are growing at 7.8%[10]; we would expect this to continue to support strong rental growth through to year-end. The relationship between wages and rents is clear and illustrated by affordability ratios remaining relatively static over the long term.

We expect a modest further softening of yields, given that risk premiums at present look low relative to historical levels, but investor interest remains high. Given limited transactable assets in the sector, and the likelihood of rental growth compensating for some outward yield movement, it is plausible that investor interest will limit outward yield movement.

We note that living sectors in the US have seen notably higher movements in yields. In contrast to the UK, the US market has been characterised by slowing and falling rents through 2023. In our view, that reflects the fact that the US is more mature and liquid, with supply far more elastic.

10. ONS, September 2023

Affordable housing

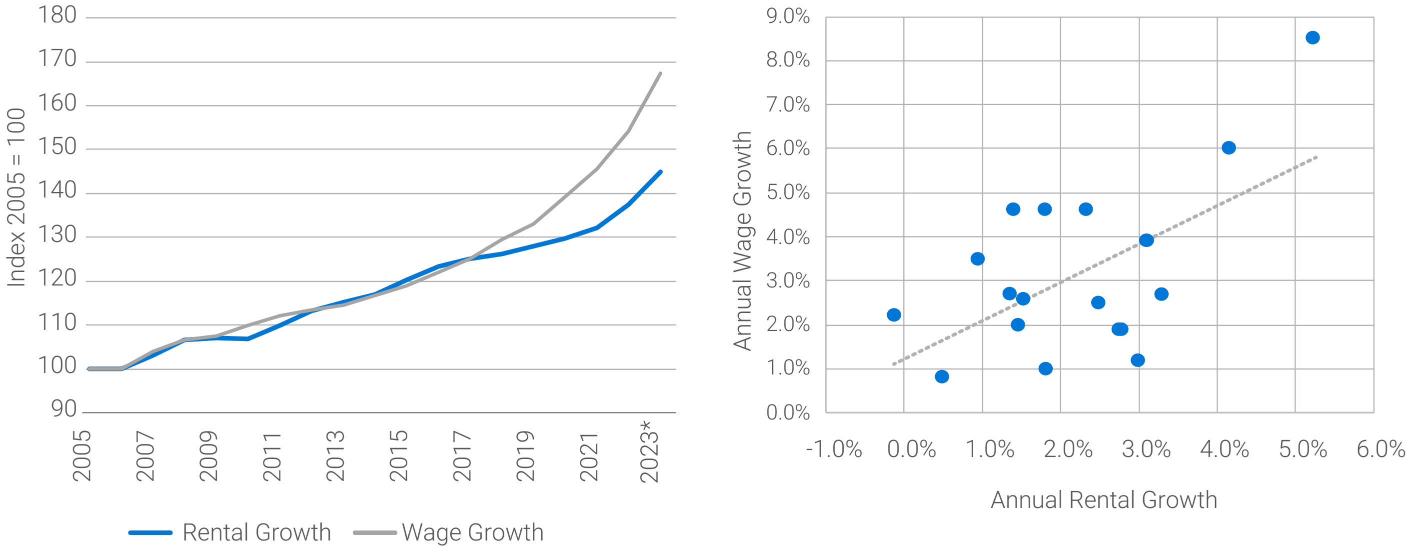
Affordable housing is still a nascent sector for institutional investors, but we see exposure growing. The explicitly inflation-linked performance and ability to drive clear social impact provides investors with a platform to be both purposeful and profitable within an increased allocation to alternative sectors.

The sector benefits from similar structural demand and supply tailwinds to those seen in the other residential sectors, albeit within a different regulatory environment. Supply tightness is likely to be further exacerbated over the medium term as housing associations, the key conduit for new supply, face a more constrained future – higher interest rates are likely to further weaken their output, given high debt levels in the sector, weaker government funding, and the requirement for significant refurbishment of dated housing stock.

We expect long-term performance to be similar to that seen in the BTR sector, but with less upside given the capped rental growth. Regulation is an issue that can create uncertainty in the short-term progression of rents, but there is a long-term underpin in the need to create an economic basis in which to provide below-market rental housing.

Affordable housing should be inherently less risky than other residential segments: income is in theory more secure as they are part-funded by the state, the occupier base is relatively more needs-based, and demand pressures are more acute.

Relationship between wages and rental growth, BTR



Source: ONS, LGIM Real Assets, as at September 2023.
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Industrial segments

In early 2022, industrial yields of 4.0% compared with an All-Property average of 4.9% and provoked questions about the sustainability of pricing, even as rental growth was powering forward at 12% yoy[11]. The rapidity of outward yield movement in Q3 and Q4 2022 reduced values by -26.1% in total and allowed for the return of perceptions of value; the sector was once again positioned favourably.

Although cyclical risks remain in focus, in particular the impacts from higher debt costs faced by SMEs and the reaction from the trade park sector from slower housing transactions, we continue to have conviction in the long-term structural support to occupier demand from the repositioning of portfolios to ecommerce, onshoring, and, longer-term, a fundamental need for more housing and infrastructure in the UK.

We are particularly positive toward urban logistics, which we would define as distribution facilities between 25,000 and 75,000 sq. ft. within or near urban areas offering the latest specification for rapid movement of goods in (electric) vans. Over recent years this has evolved from a description of a process to a defined asset type; we think the UK market is fundamentally undersupplied.

Separately, although there are cyclical risks from a slower housing market, we advise increased exposures to self-storage as the UK remains fundamentally undersupplied, especially in newer and fit-for-purpose 'fourth generation' stock. We are favourable to operational exposures rather than traditional leases where upsides can be shared, and downsides mitigated by good management.

Data centres have been beneficiaries of several structural tailwinds in recent years (the outsourcing of corporate IT systems and exponential rise of social media, for instance) and the rise of AI appears likely to drive further demand growth, albeit with different specification requirements[12]. Data centres can offer higher yields than traditional industrials and rental growth prospects may potentially be stronger, given likely trends in demand. Depreciation costs and liquidity are less clear, however. In locations where there is comfort in power provision – and the prospects of greening that power long term – we expect investor demand to increase, further supporting outperformance potential.

Hospitality

The hospitality sector has experienced a turbulent few years, with the pandemic forcing the closure of many businesses over 2020 and 2021. Evidence over the past 12-18 months indicates that the pandemic has not provoked a structural shift in consumers' leisure behaviours, with most sub-sectors reporting trade back to or above pre-pandemic levels.

The cost-of-living crisis provoked questions as to whether this recovery could be sustained. Yet data from Barclaycard have showcased continued healthy demand, with monthly debit and credit card spending on the sector growing by 15.9% for the year to June 2023, comfortably ahead of all non-essential spending at 4.7%[13]. Meanwhile, hotel RevPAR in the UK continues to track at 20% above 2019 levels.

These dynamics are consistent with the recession that followed the global financial crisis: in unfavourable economic times, consumers tend to cut back on higher value, delayable purchases (such as new furniture, white goods and electronics), instead prioritising more affordable, shared experiences. While headwinds remain for consumers, we expect leisure demand to continue to outperform the broader discretionary goods sector. We have greater concerns regarding the impact of cost increases, in particular rising debt and labour costs, on operators' bottom lines. However, we expect these risks to be mostly mitigated by a dynamic and growing occupier base, particularly among 'competitive socialising' operators.

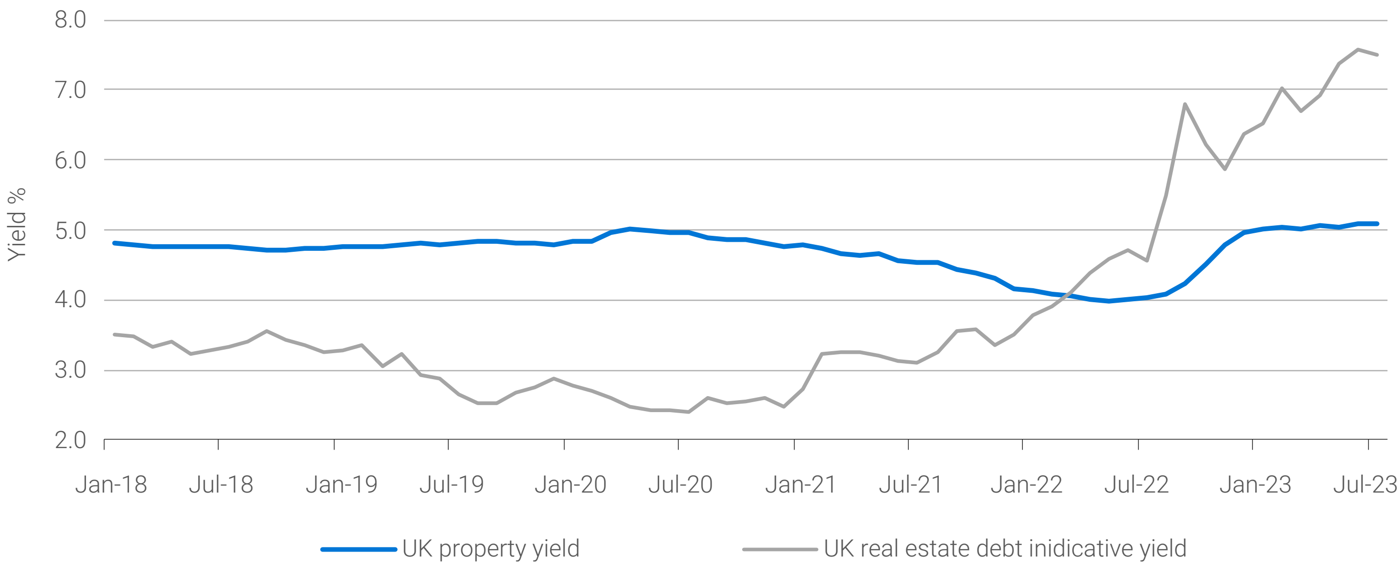
In the near term, we anticipate that the hospitality sector will not be immune from the broader pressure on valuations affecting UK real estate. But it benefits from positive structural demand drivers, reduced new supply risk and elevated yields, which we expect to support outperformance potential over the medium to longer term. We believe a lack of capital currently targeting the sectors could present attractive acquisition opportunities over the coming 12 months.

11. MSCI UK Quarterly Digest, September 2022. Quoted data refers to Q2 2022
12. JLL (September 2023 EMEA Data centres report) note, for instance, that GPU chips are needed rather than the traditional CPU chips used in current data centre design
13. These chips require liquid cooling rather than air cooling to keep temperatures below the thermal limit Barclaycard data, September 2023

Real estate debt

The biggest challenge facing real estate sponsors, in our view, is the cost of financing: it has soared since the beginning 2022. With little appetite to take back the assets, lenders have been patient in general, working with borrowers to find solutions. We have also seen a lot of borrowers injecting capital to maintain loan-to-value (LTV) or sourcing mezzanine debt.

UK debt yields and property yields



Source: MSCI, Bayes Business School, as at July 2013. We have proxied real estate debt yield using average senior lending yield on prime office assets.
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For new loans, financing is still available, but lenders are defensive. LTVs are down to 50-55% (typically from 60%) and individual lenders' appetites have trended downwards. Most of the real estate debt activity this year has been refinancing, given low acquisition transition volumes. Appetites for development financing are also more constrained, given the rise in construction costs and weak macroeconomic environment.

Residential and logistics have been most successful at attracting financing, alongside alternative sectors, such as life sciences and self-storage. At the other end of the spectrum, lenders are extremely cautious on office assets, although relatively more comfortable with high-quality, environmentally-friendly offices in attractive locations with strong tenants.

Banks have retrenched and are more focused on asset management and existing borrowers. This could present a window for alternative lenders. We believe insurers and debt funds are actively (and carefully) deploying capital and can benefit from greater pricing power, higher yields, and lower leverage. Since insurers typically focus on investment-grade risk assets, debt funds may be the only solution for the most challenged assets, with a potentially hefty coupon.

UK real estate: Nearing the end of its repricing journey?

Although we remain cautious on aggregate real estate performance in the near term, in line with broader economic concerns, the pricing adjustment seen to date, coupled with positive growth expectations for specific sectors and strategies are suggestive of higher absolute returns than over the last two years.

We think the UK is further along in this journey than other regions. Portfolios that actively position to resilient sectors in the near term and growth sectors in the medium term are, of course, expected to offer robust performance potential and scope for significant deviation from benchmark averages. This includes long-income styles which, after the re-pricing seen at the end of last year, could be viewed as an adjacent strategy to real estate debt in providing highly stable cashflows with a robust underpin.

As the above analysis explains, we believe that overweight positions to BTR, PBSA, specific parts of industrial, and emerging sectors like data centres could be beneficial. More tactically, we think high-quality and well-managed offices, leisure parks, and specific parts of retail like supermarkets and fairly priced retail parks could present good opportunities once yields stabilise.

Although debt markets may yet provoke further direct pricing pressure as leveraged investors dispose of assets because of sharp swings in repayment costs, the prospects for debt returns creates a real estate opportunity set away from direct ownership. There are also compelling opportunities for lending from non-bank lenders, in our view.

As we move toward 2024, we think real estate equity is nearing the end of its repricing journey and is positioned well for growth, while real estate debt has the potential to offer compelling risk-adjusted returns. Meanwhile, we believe the maturity of real estate loans made over the five years to 2022 will increasingly influence market function and price discovery.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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