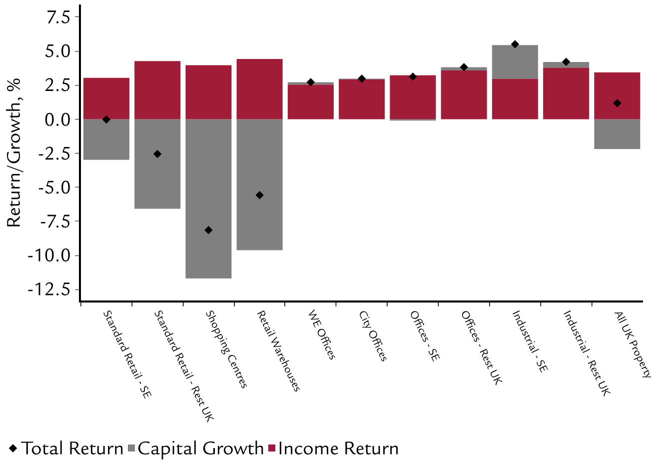
Real Estate House View
United Kingdom

First half-year 2020

Key takeaways

- **Underlying UK property fundamentals robust outside the retail sector:** pricing relative to bonds remains attractive with limited good quality supply and no over-leverage – expectation of modest economic growth predicts performance over the next five years driven primarily by income.
- **Performance of UK property moderated in 2019 as capital values fell and masks significant variation both within and between sectors:** the rolling annual MSCI total return for UK All Property slowed to 2.0% at the end of Q3 2019, compared with an annual return of 6.0% in 2018.
- **Yields have increased in all sectors:** prime pricing has been broadly stable with a marginal movement outside retail – with weaker investor appetite, pricing of secondary assets has softened.
- **Resilience of leasing volumes in office and industrial sectors:** acute shortages of good quality supply drive rental value growth in many locations.
- **Retail continues to struggle with negative total returns:** remaining role for physical retail offering convenience, value or experience – parts of the retail sector meeting these needs might overcorrect, potentially providing investment opportunities in 2020.

Chart in focus



Source: MSCI Quarterly Digest (Q3 2019)

Headline UK All Property returns mask significant polarisation both within and between sectors. At a sector level, industrial has outperformed, returning 5.0% over 2019 to the end of Q3, whilst retail returned –4.1%. Within sectors, pricing of good quality assets with secure income streams has been resilient, but values of secondary assets with income or capex risk have declined. This can even be seen in standard retail, where prime assets returned 1.6% over the first nine months of 2019, compared with secondary assets, which returned –8.6% over the same period. Stock selection and sector allocation is key at this stage in the cycle.

Brexit uncertainty has kept business investment intentions at the lowest level since the financial crisis, according to the Bank of England Agents' Survey. The UK labour market remains tight as firms are hiring instead of investing, and real wages are growing at 2% annually. Elevated wage growth should keep domestic inflationary pressures in place in 2020. After securing a majority, the conservatives have generous fiscal plans aiming to ensure annual gross domestic product (GDP) growth at around a similar pace compared to the previous year. In the short term, Brexit at the end of January 2020 and a likely front-loaded fiscal stimulus will reinvigorate corporate animal spirits. Such a temporary surge of optimism in the domestic corporate sector is supported by a gradual recovery in industrial dynamics elsewhere in Europe. Yet, uncertainties are likely to resurface as soon as UK-EU trade negotiations start later in the year.

Uncertainty slows market action

Liquidity in the UK's property investment market fell in 2019 but there is no sign of distress in the market. Instead buyers and sellers chose to sit on the sidelines, whilst they waited for political uncertainty to reduce. Alternatives and non-retail, good quality assets with long leases to strong covenants are being traded. Small investors' appetite is seen for poorer quality assets with shorter income or perceived capex risk. Overseas capital has been less active but may now increase following the UK election result. The weaker economic backdrop combined with the subdued investment market has had an impact on returns and performance moderated during 2019. In the nine months to end-Q3 2019, the MSCI quarterly index recorded an All Property total return of 1.2% compared with a 5.2% return over the equivalent period last year.

Resilience in office leasing

Offices returned 3.1% over the first three quarters of 2019. Capital values have been stable as rental growth of 1.0% counterbalanced marginal yield increases. Regional offices outperformed due to their higher income return and slightly stronger rental growth. Occupier demand has held up well in London this year, with activity running at around 14% ahead of the ten-year average. Available supply has fallen, and many occupiers look at the development pipeline for good quality space. As a result, pre-letting activity has increased and the volume of speculative space under construction has fallen to its lowest level since 2015. Outside London, leasing volumes are around long-term average levels in regional cities but slightly below in the south east market. Many regional cities have benefited from the expansion of flex office operators who have taken significant volumes of space this year. Supply conditions remain tight across most regional markets. The development pipeline is limited outside Manchester, Birmingham and Glasgow. The sustained shortages of supply should support rental growth even if with a slight cooling in occupational demand.

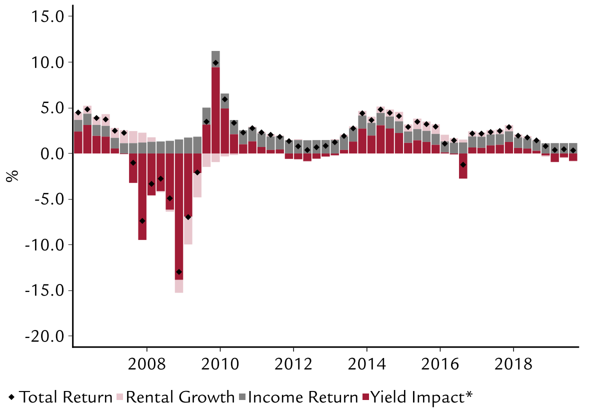
Industrial moderates

Industrial remains the strongest performing traditional sector in the UK returning just over 5.0% in 2019 (to the end of Q3). Capital values grew 1.7% supported by rental increases of 2.2%. Occupational demand remains robust, but supply has edged up, causing rental value growth to slow. Further growth is anticipated but is likely to be at lower levels compared to previous years. Weaker rental growth expectations may impact pricing, but the sector is expected to continue to outperform. Overall supply remains low with variation across the market; the average vacancy rate is 6.7% falling to less than 2.0% in London (Savills). This will drive increasing polarisation in the sector. Industrial will continue to benefit from structural change and will need to respond to increasing consumer demand for shorter delivery times. As a result, demand for urban logistics can be expected to remain particularly strong.

Negative retail returns in 2019

The retail sector continues to suffer from the ongoing shift towards online, which is driving an increasing number of store closures, oversupply and a lack of tenant demand. Retail values fell 7.7% over the first nine months of 2019 due to rental declines (–2.9%) and pricing movements. Values have fallen across the sector, but this has been most acute in shopping centres (–11.7%) and retail warehouses (–9.6%). Further declines are anticipated but, during 2020, we expect some opportunities in selected parts of the retail sector – particularly retail warehouses with a strong convenience and/or value offering – as the market is rebased.

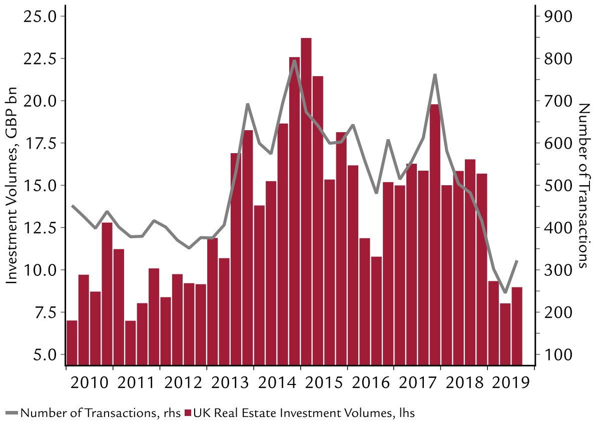
Chart 1: Quarterly UK All Property performance



Source: MSCI UK Quarterly Digest Reference Tables (Q3 2019)

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

Chart 2: UK property investment volumes (to Q3 2019)



Source: PMA / Property Archive (October 2019)

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