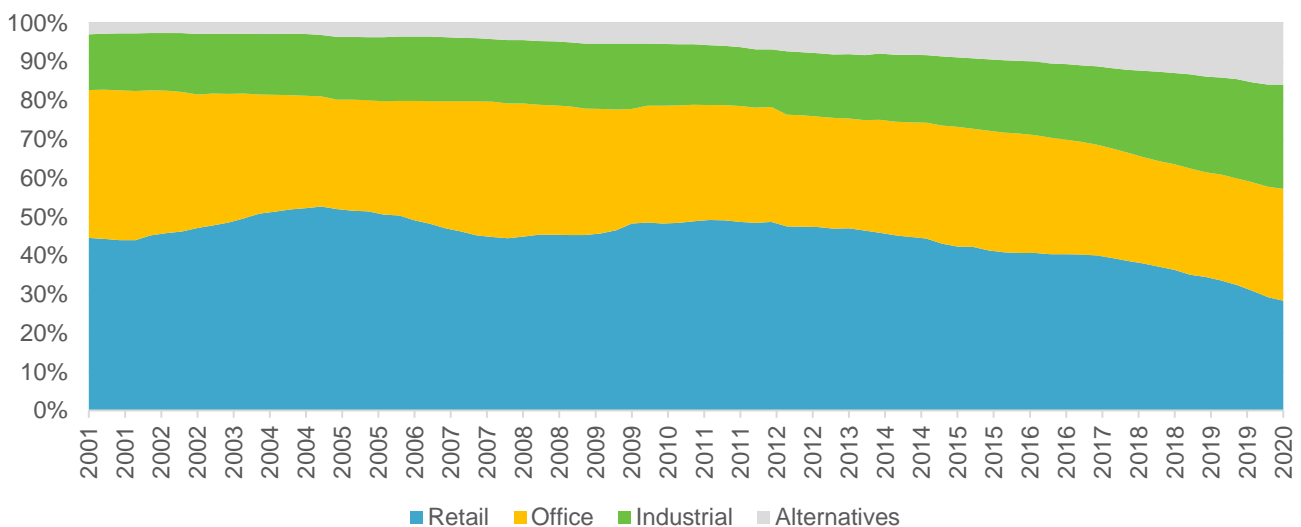


UK Property: A Changing Landscape

November 2020

The UK property market has been undergoing structural change for a number of years, attributable to changes in urbanisation, demographics and investor sentiment. As Chart 1 shows below, the makeup of the broader market (represented here by the MSCI UK Quarterly Property Index) has been changing over the last two decades.

Chart 1: Sector Composition of MSCI UK Quarterly Property Index



Source: MSCI

This article examines existing structural trends and the impact of the pandemic in either accelerating or stalling these trends, looking across each of the four sectors: retail, office, industrial and alternatives.

Retail: All Doom and Gloom?

The pandemic and lockdown have certainly exacerbated a pre-existing crisis in retail, a sector already struggling. The growing number of vacancies paired with the fact that investors are actively looking to reduce their retail exposure over the last few years has meant that capital values and the overall performance of the sector has taken a significant hit.

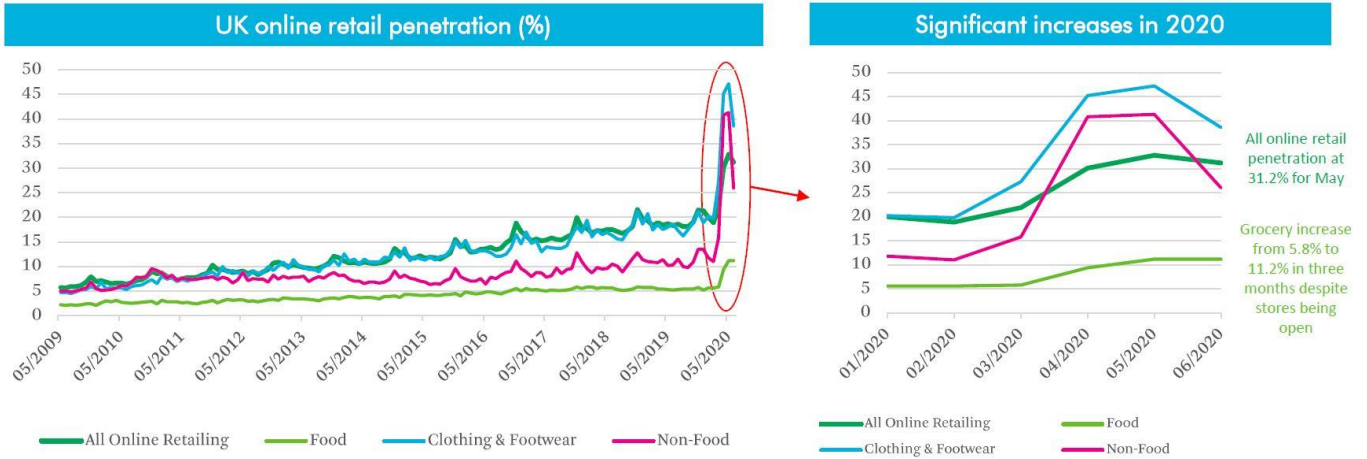
Uncertainty around retailer performance and rising vacancies across the country will likely add downward pressure to rents, a picture worsened by the macro elements: should unemployment increase considerably or there is prolonged uncertainty, consumer spending will be hit, which will mean further pain for the retail sector in general.

However, essential retail, such as supermarkets, has fared much better and is generally well valued by investors for being typically long-term, inflation-linked leases.

Industrials: Logistics and the Rise of Ecommerce

There has long been a rise in online shopping to the detriment of bricks and mortar retail. With the national lockdown affecting non-essential shops, this caused a massive spike in ecommerce activity as spending shifted online. Online ecommerce penetration jumped from 19% to 32% from February 2020 to May 2020 with a slight decrease since. Chart 2 below breaks this out by sector:

Chart 2: The Growth of E-Commerce in the UK



Source: CBRE and the Office for National Statistics

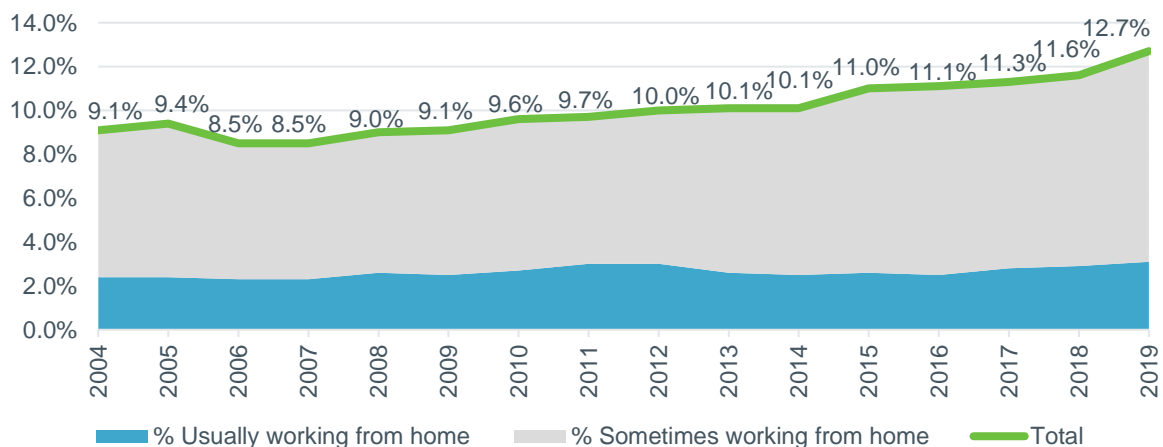
Logistics, a sub-sector of industrials, has been a popular allocation for investors for some time. In fact, the second quarter of 2020 saw a record take-up for UK logistics property, mainly driven by ecommerce-related functions, and this sector has proven resilient in terms of rent collections during the pandemic. This is a spike in activity previously fuelled by tenants seeking to secure both larger warehouse spaces and smaller, “last-mile” facilities close to city centres.

Offices: Working Hard or Hardly Working?


The trend of flexible, or remote working, and for more flexible co-working spaces had already begun to grow in favour in the UK. With lockdown forcing the vast majority of office workers to work from home, this trend has become the “norm”, and indicates a shift in demand.

Pre-pandemic, employees who were working from home at least part of the time were a relatively small proportion of the workforce but had been growing as demonstrated in Chart 3.

Chart 3: The Rise in Home Working



Source: Federated Hermes and Morgan Stanley Research



A survey by Morgan Stanley has indicated a significant acceleration of this trend with all demographics and sectors indicating a preference to work from home more frequently in the future. In addition, nearly three-quarters of an Institute of Directors' survey respondents indicated that they would encourage staff to increase working from home post-pandemic. This change of demand is set to change the dynamics of office sector, but we may not see the impact for a few years as companies are unlikely to break current leases and will make any changes at lease renewal stage.

Alternatives: Mixed Fortunes

Alternatives is a catch-all sector for assets outside of the main three sectors: retail, office and industrials. Within alternatives, hotels and residential (typically purpose-built rental accommodation rather than individual houses and flats) are the most established sectors but there has been a more recent emergence of student accommodation and healthcare underpinned by similar fundamentals: changes in demographics, a rise in middle-class incomes and urbanisation.

Residential property has, by far, proven itself to be the most resilient sector during the crisis and this is no real surprise as it is expected that the population will continue paying for its housing costs whenever possible. Student accommodation has also proven more resilient than expected with initial data showing lower than expected vacancy rates as universities have taken on more domestic students.

Other sectors within alternatives have had a much more mixed picture with UK hospitality suffering especially in areas dependent on business travel. Within the healthcare sector, the sector has suffered general reputational damage due to its handling of the pandemic in care homes and the outlook remains to be seen.

So, What Next? Looking Further Afield

The UK is now officially in a recession. While we have seen some recovery in GDP, there are differing views, even within the Bank of England, as to how protracted the recovery will be amid assertions that some sectors may not fully recover.

With capital values likely to continue to face downward pressure well into 2021, total return expectations among those property investors brave enough to make forecasts over the next 3-5 years have low single digit returns for UK commercial property. Income returns should mitigate the declining capital values but we do not believe we have yet reached the bottom of the current property cycle.

In time, we expect core property allocations among investors to look markedly different to current allocations. There are potential parts of the property market investors may look to target to mitigate against the current risks to UK commercial property.

The UK Private Rental Sector is a nascent sector but rapidly growing, supported by a chronic shortage of supply caused by under-development and an increase in the population. People are renting for longer as it takes a lot longer to save a deposit to buy a house. This is a demand trend we expect to continue, which will further support this sector going forward.

According to LaSalle Investment Management, the UK real estate market in 2018 was only around 6% of global institutionally owned real estate. While the UK has always been attractive for foreign capital as it is a relatively liquid market backed by a strong legal framework, a global allocation to property can provide diversification from the enhanced opportunity set. While there is no doubt that real estate markets outside of the UK are undergoing similar trends, particularly in retail, a focus on resilient sectors internationally could be of benefit to investors with a property allocation.

Finally, ESG is now firmly on the agenda in major real estate markets as investors look to manage climate change risks especially. Asset managers predict that it will become almost impossible to sell buildings that

aren't climate friendly, requiring further investment to bring them up to standard. Highly efficient buildings can mean higher levels of operational performance, lower emissions and lower cost of capital.

Summary

The UK commercial property market is changing, both due to structural change already underway pre-pandemic, but also due to the decline of the current property cycle. Brexit will also bring further short-term uncertainty. But the question remains as to what a Balanced Core property allocation will look like over the longer-term?

We expect balanced funds to transition to a more defensive allocation focusing on longer leases and high-quality tenants, moving away from retail to focus more on industrials and resilient alternatives, including residential. Investors may also wish to consider allocating capital beyond the UK property market to diversify exposure and help mitigate declining returns over the short and medium-term.



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