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Real estate reset: The case for UK property

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Executive summary

1. After screening as expensive for several years, UK real estate valuations now appear to offer fair value on a range of metrics.
2. UK valuations also better reflect current market pricing than Europe and the US, in our view.
3. That said, sector and segment differentials remain significant and require careful navigation.
4. Continuing volatility in rates and potential geopolitical risk suggest portfolios should still tilt to income resilience rather than taking a binary 'bet' on yield compression. In our view the latter should be seen as an upside risk to expected returns, rather than a strategy.

Legal & General

In our view UK real estate pricing – and indeed valuations – have, after two years, reset to levels consistent with where rates, and other macros drivers, have settled.

Introduction

Since 2016, many asset classes, and UK real estate in particular, have been rocked by a succession of events: Brexit, Covid, spikes in inflation, and a historically aggressive policy rate hiking cycle.

At the midpoint of 2024, we feel the timing is right to look objectively at pricing and valuation to establish a clear view on the relative case for UK real estate.

Why now?

In our view UK real estate pricing – and indeed valuations – have, after two years, reset to levels consistent with where rates, and other macros drivers, have settled. Therefore, an informed view on fair value and how pricing might evolve in the medium term is warranted.

We do not, and should not, have confidence in our ability to forecast inflation, interest rates or geopolitics. Although the probability of a slow reduction in policy and market interest rates between now and the end of 2025 is reasonably high, it is not guaranteed. 'Low probability, high impact' geopolitical events may yet impact markets. Such factors can inform investment choices between resilient sectors and binary yield plays.

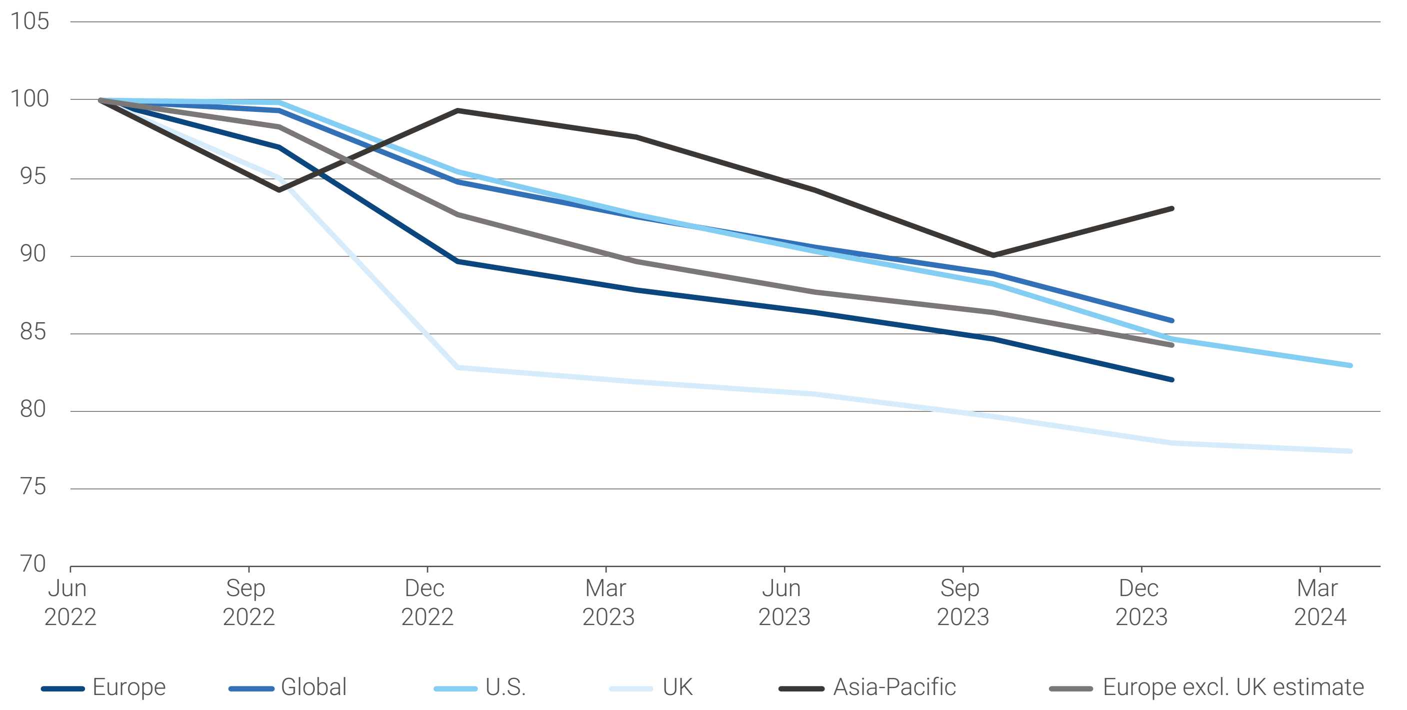
We also reflect that, internationally, gaps between transaction pricing and valuation differ, and differences vary depending on real estate sectors. Such differences matter for allocation and deployment decisions.

According to higher frequency MSCI monthly data, UK real estate values are approximately -25% lower than they were in June 2022[1]. April 2024's reading showed almost zero movement in aggregate, with industrial and residential values appreciating, retail stable, and offices falling[2]. This slowdown does not guarantee the next move in values at the all-property level will be upward, but it does make a discussion of relative value timely.

Meanwhile, quarterly valuation data from MSCI clearly show how the UK correction was harder and faster than other regions.

1. Source: MSCI Monthly Digest, May 2024
2. Source: MSCI Monthly Digest, April 2024. Industrial and retail values were up 0.1% and 0.05% month on month respectively with office values down -0.5%

Capital value change since June 2022, quarterly, global regions



Source: MSCI Global Quarterly Property Index, Q1 2024. Value changes re in local currency. Note the Europe excl UK is a LGIM Real Assets calculation based on available data and reweighted. **Past performance is not a guide to the future.**

Other investors seem to agree that a change of fortunes is imminent, with the IPF consensus[3] showing expected capital growth of 0.8% this year and c. 3% p.a. between 2025 and 2028 inclusive.

At the same time, ULI[4] implies that global investors expect to see more alignment on pricing and recovering volumes as we move through 2024.

3. Source: IPF UK Real Estate Consensus Forecasts, Spring 2024
4. Source: ULI, Emerging Trends in Real Estate 2024

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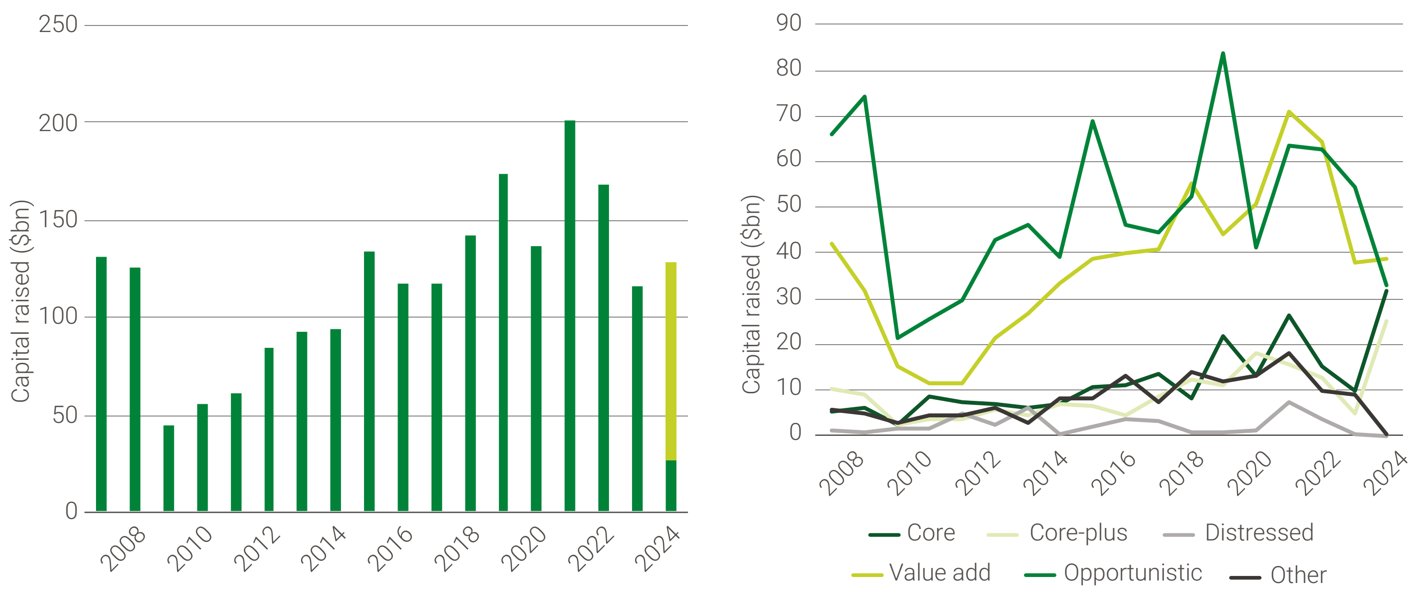
The UK REIT sector currently trades at a -9.8% discount to net asset value compared to a long-term average of -4.7%. This compares favourably to its recent trough of -38%.

Global data from Preqin[5] shows how real estate fundraising was affected by the macro picture in recent years. But more interesting, we think, is the deviation in fundraising by style. Two years ago, there was a surge in fundraising activity for value-add styles. We would interpret this as fund managers requiring greater risk to deliver investors the return over the risk-free rate they require.

More recently, value-add strategies have decelerated from their cyclical highs, replaced by an increase in core and core+ strategies. We think this shows managers are more comfortable with current property pricing and see less need to take additional risk.

Global real estate fund raising, overall and by risk style, 2007 - 2024 (estimates)



Source: Preqin, Data as at 31 March 2024. The light green bar is an estimate of fundraising over the remaining three quarters in 2024, based on average trends over the last three years. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

5. Source: Preqin Quarterly Updates, May 2024

Does UK real estate offer fair value?

The UK REIT sector currently trades at a -9.8% discount to net asset value compared to a long-term average of -4.7%. This compares favourably to its recent trough of -38%[6]. Asset valuations (the NAV) have fallen to close the gap with investor perceptions of pricing, which may have stabilised. Such high-frequency signals were hugely important in gauging valuation risks to direct UK real estate as markets evolved over summer 2022; and they should not be ignored as sentiment improves.

Furthermore, strategies that combine direct real estate and indirect and more liquid REIT options have been shown to outperform[7]. We think the recent performance seen in REITs is indicative of an ability to capture growth before direct property valuations do.

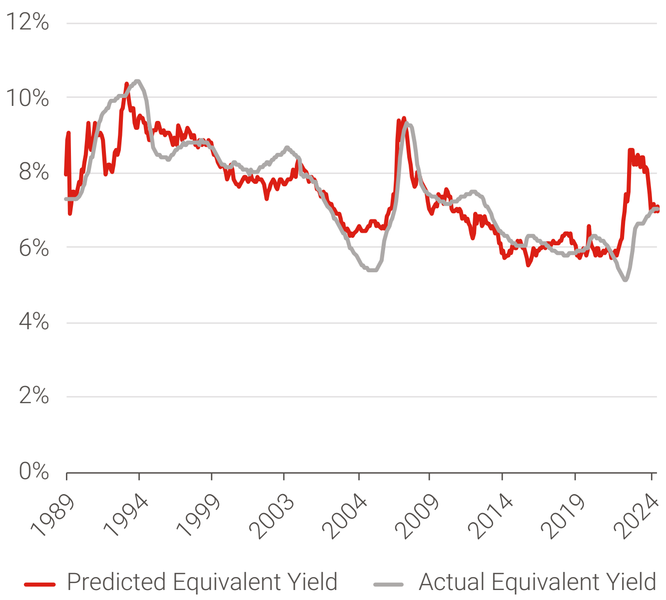
UK REITS discount to net asset value

Source: Bloomberg, LGIM Real Assets, May 2024. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

6. Source: Bloomberg, LGIM Real Assets calculations, May 2024
7. Source: See, for instance, "Blending Public and Private Real Estate Allocations for Defined Contribution Pension Funds: A U.K. Case Study", Journal of Real Estate Portfolio Management, Vol. 20, No. 3, 2014

LGIM Real Assets has several proprietary models it can use to gauge fair value and we cover two here. The first is a yield model which represents where valuation yields should be in accordance with their historic relationship to rates, corporate credit, lending activity and rental growth expectations. It creates an expected yield and compares this to actual valuation yields. This model showed a gap of 200 bps immediately after 2022's LDI crisis, implying significant value risk for directly held assets. These risks came to pass and, following outward yield movement and some amelioration in rate inputs, the yield model is now at parity with valuation yields for the first time in almost three years.

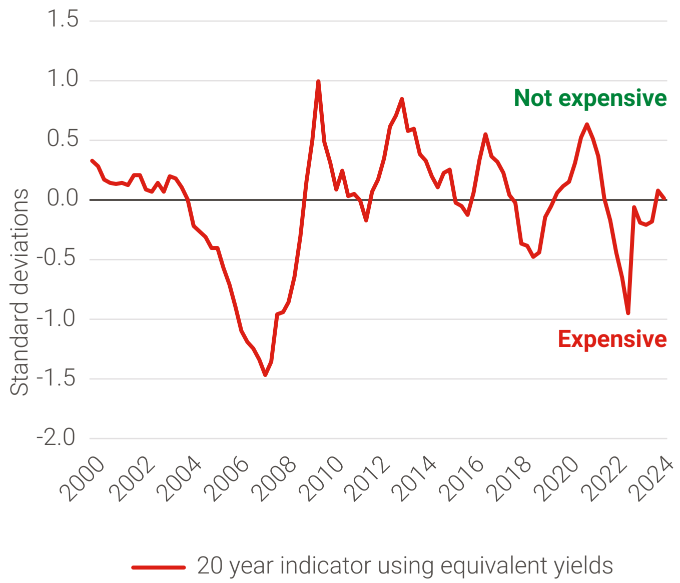
LGIM Real Assets yield model



Source: LGIM Real Assets, May 2024. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Secondly, LGIM Real Asset's relative value indicator also looks at MSCI yields and compares them to their own history and to other asset classes such as equities and corporate bonds. This indicator has screened 'expensive' since 2019, but – like the yield model – has recently moved into neutral territory.

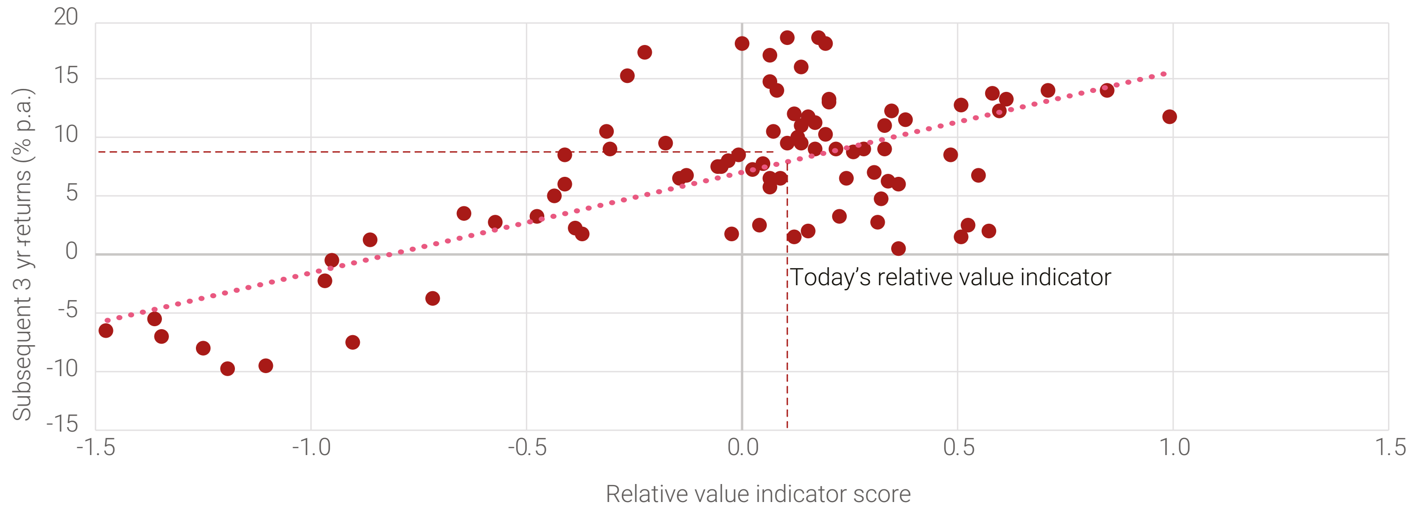
LGIM Real Assets relative value indicator



Source: LGIM Real Assets, May 2024. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Both models evidence our view that UK real estate offers fair value – although we would emphasise that they do not suggest the sector is cheap, only that it is no longer expensive. We would also caveat this by pointing out it is the office sector that has done most of the recent work in increasing the all property yield. Nevertheless, such signals have historically correlated well with subsequent returns, as shown in the graph on the next page.

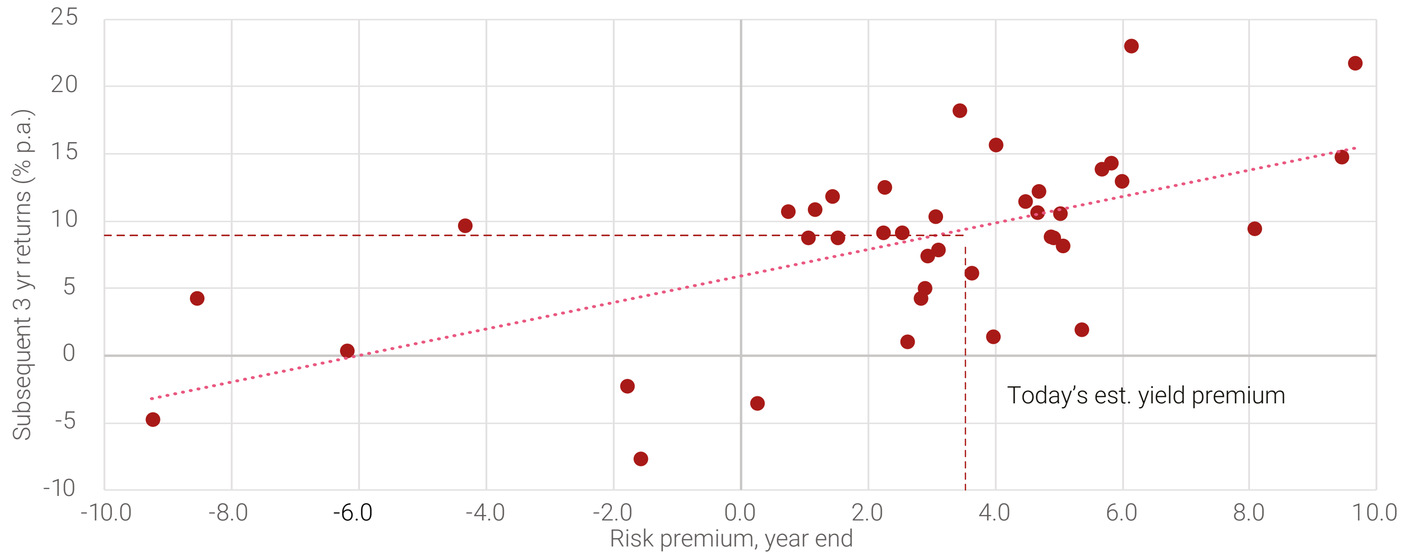
LGIM's relative value indicator and subsequent returns for UK all-property (three-year annualised)



Source: LGIM Real Assets, MSCI Quarterly Digest, Q1 2024. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Analysis of the risk premium offered by UK real estate (calculated by current yields plus growth expectations less depreciation and gilt yields) currently shows a risk premium of 3.2%, compared to an average since 1981 of 2.6%. There is a notable range between sectors on this measure, but the current all-property average is associated with subsequent returns in the region of 9-10% p.a., consistent with the analysis above.

Risk Premium and subsequent returns for UK all-property (three-year annualised)



Source: LGIM Real Assets, MSCI Quarterly Digest, May 2024. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Evolution of the risk-free rate

At the time of writing, financial markets were pricing in two policy rate cuts in the UK over the remainder of 2024 and three by May 2025. Our expectations are very similar. Market interest rates have adjusted to this slower anticipated pace of easing, with 10-year gilts hovering around 4.2% and expected to reach 3.4% by year end 2025[8]. As mentioned above, analysts should be humble in both their own predictions and in reading too much into volatile financial market signals.

But we can consider scenarios with relevance to the relative pricing of real estate assets:

1. Rates fall, as implied by markets

2. Rates fall faster than markets imply

3. Rates stay at current levels over the near term

4. Rates increase

8. Source: Bloomberg as at May 2024

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We think that real estate yields, as evidenced by the above metrics, have broadly adjusted to today's market interest rates.

Therefore, scenario 1 would allow for modest yield compression as well as being consistent with a reasonable economic backdrop supporting rental growth.

Scenario 2, a faster reduction in rates, may all else being equal technically allow for a reduction in real estate yields, but could come at a recessionary cost with weaker occupation markets.

Should rates stay at current levels – scenario 3 – then our assumption that real estate values have already broadly adjusted would suggest future returns are almost entirely driven by income returns and rental growth.

Finally, an increase in rates – scenario 4 – would remove much of the potential for yield compression, all else being equal, but may also be consistent with stronger growth which could benefit higher beta sectors such as retail, as well as mitigating office risk via additional jobs growth.

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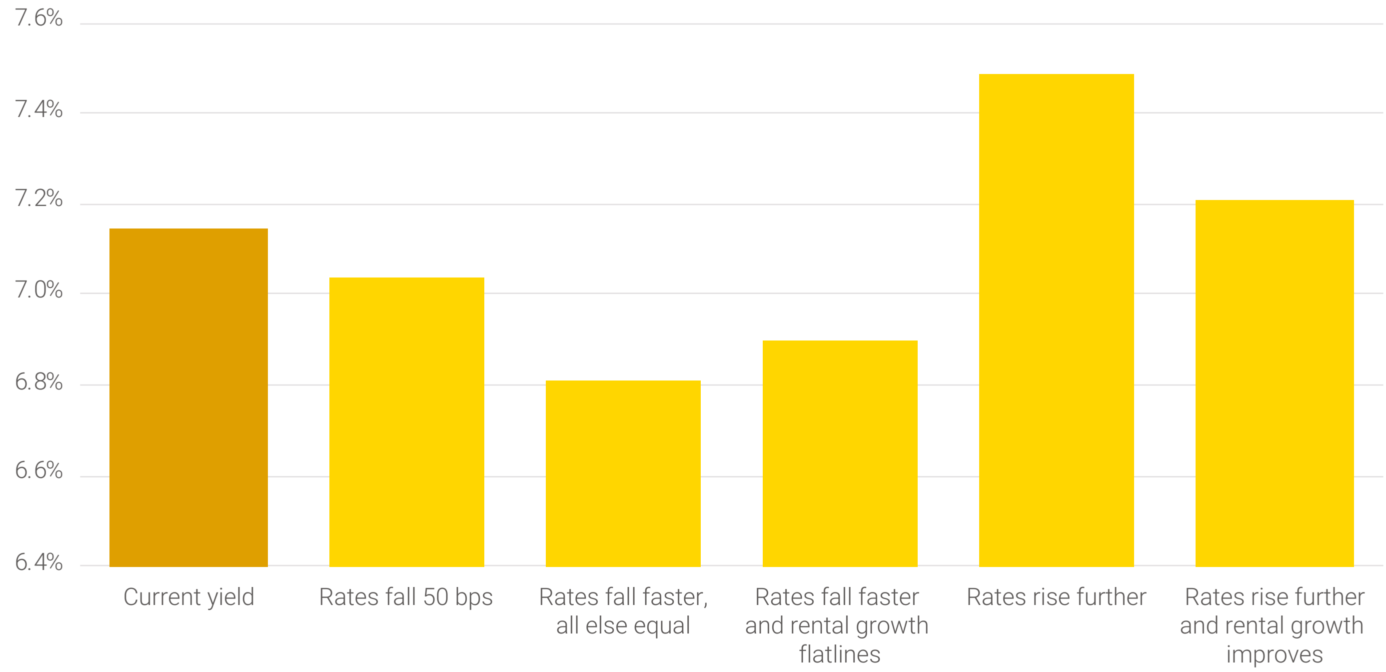
Illustrative property equivalent yield in 2025 under various scenarios



Source: LGIM Real Assets, May 2024, based on MSCI Monthly Data as at April 2024 and calculated through LGIM's yield model. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

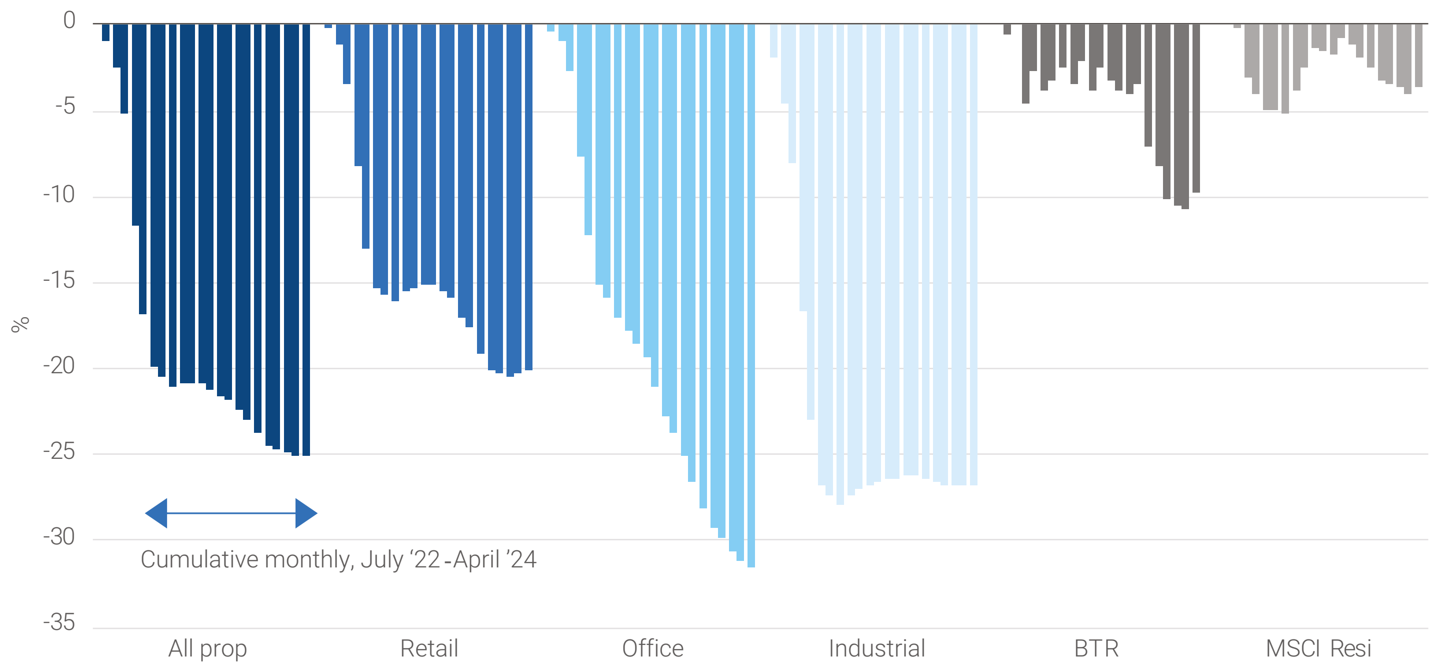
In summary, there are various potential rates scenarios with only one of those considered – increased rates without any rental growth benefit –significantly detrimental to real estate performance based off today's valuation yields.

Sector differences

The graphs below show the cumulative value change on the MSCI monthly index by main sector, with an LGIM Real Assets estimate for BTR (build-to-rent residential) where most of the recent deterioration was a direct result of the scrapping of multiple dwelling relief in this year's budget). Yields are commensurately different, with the expansion in office yields compared to other sectors historically aggressive.

Compared to an all-property valuation fall of -25% since June 2022, retail values have fallen -20%, industrial 27%[9] and offices 32% with the residential sample within MSCI down around 4% and a BTR sample around -10%[10].

Capital value change (cumulative), peak to today, main MSCI sectors



Source: MSCI Monthly Digest, April 2024, LGIM Real Assets calculations[11]. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

9. Source: -28% at their lowest (Feb 2023) but -27% at the end of April 2024
10. Source: MSCI Monthly Digest, April 2024
11. Source: BTR is our estimate of market build-to-rent residential capital value changes which were affected by the announcement of the cessation of Multiple Dwellings Tax relief in the 2024 Spring Budget.

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Retail

Since values peaked in 2015, they have fallen in 23 of the last 33 quarters, bottoming at -40% below 2015 peaks (including events since 2022). Rental values are almost -20% lower. This repositioning has led to the sector rising up the ranks in many forecasts thanks to its strong income returns (6.0%[12]) and growth potential, given its more affordable rental base. We remain more cautious than consensus, seeing continued risk to the consumer in the near term, but do recognise opportunities at the asset level where yields and rents have repriced and where local demographics support long-term growth. We feel the most compelling opportunities are in the supermarket and retail park segments.

Leisure

Leisure now offers an income return of 6.7% from an equivalent yield of 7.8%. The sector experienced a very difficult Covid and, although we perceive consumer expenditure shifting toward experiences from discretionary purchasers as a long-term trend, the cost-of-living crisis has also brought challenges. Going forward, as these risks subside, income growth on top of generous yields positions the sector well.

Industrial

More extensive views can be found in this paper, but in short, we see industrial as a repriced sector offering consistent growth potential for the long term, albeit with notable segment differences which require careful navigation. We prefer urban logistics and multi-let industrials over, say, regional logistics, given different supply and demand risks – although we think all industrial segments could outperform the all-property average over our forecasting horizon.

Residential

As with industrial, multiple segments with different drivers offer a diversification of income styles within one sector. We see most growth potential from BtR and selective purpose-built student accommodation (PBSA), with inflation-linked income streams and the clear social value upside offered by affordable housing. Despite lower yields on average, we see the income growth potential as significant, potentially supporting outperforming total returns both over our five-year horizon and on a long-term fundamental basis.

Offices

We offered more detailed thoughts in this series of blogs, but in short we see MSCI valuations (reflecting an average of qualities) as near to fair value, given historic repricing, but with higher quality offices much closer to this threshold than lower quality offices, which in our view still do not adequately compensate investors for known risks. Although there could be some compelling income streams on offer at generous yields, we still think it unlikely that institutional investors will pivot towards the sector while structural growth remains more convictional in sectors like residential and industrial.

Other alternatives

We explain our approach to global megatrends in this paper and this lens informs our long-term positioning in various sectors within real estate and beyond. One field which straddles categories is digital infrastructure, in particular data centres, where clear demand coincides with a lack of appropriate built infrastructure.

Income styles: long income versus operational

Yields available from long income investments with inflation linkage corrected sharply in 2022 and remain generous relative to recent history. This could allow institutional investors access to secure income streams at higher yields than corporate equivalents.

At the other end of the risk spectrum, we are seeing more operational styles in traditional segments like retail and offices joining self-storage, hotels, student accommodation and residential. Given the risks of inflation eroding operational income, caution on asset and operator selection remains paramount here, but where successful it can offer performance in real terms and access to niche parts of the real estate market.

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12. Source: MSCI Quarterly Digest, Q1 2024

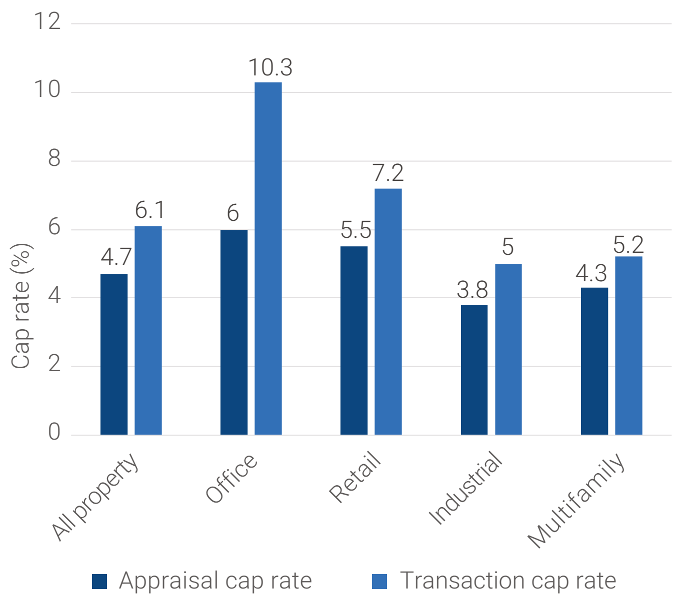
Valuations versus pricing: UK and international

By comparing valuation and transaction indices domestically and internationally we can develop informed views on which sectors are valued most efficiently and which regional investment destinations offer asset and fund valuations less likely to be subject to further adjustment.

In the UK, a comparison of MSCI values and completed transaction prices showed that, by the end of 2023, transaction prices had moved by more than 7% compared to valuations[13].

In the US, NCREIF has estimated office cap rates at 6% and pricing cap rates at 10.3%, with an average of 140 bps seen across sectors[14].

USA: Appraisal vs transaction cap rate, Q1 2024

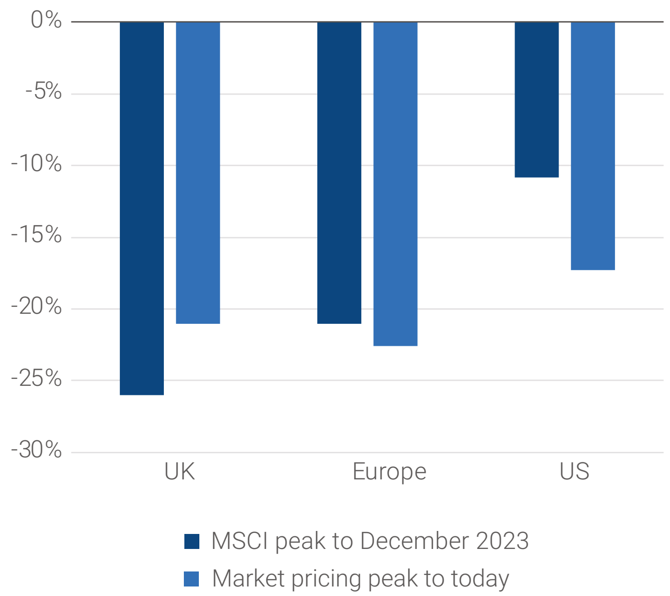


Source: NCREIF, LGIM Real Assets, May 2024. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Industrial is a sector that has been more liquid than other sectors and is therefore in our view more likely to see its valuations match market pricing. We observe the widest differential in the US, followed by Europe and then the UK, where market pricing has now recovered ahead of valuations[15].

It would seem, therefore, that the UK is further ahead in both its return to fair value and in efficient pricing signals, although we acknowledge persistent sector differentiation.

Industrial pricing and valuation around the world (as at year-end 2023)



Source: MSCI, Green Street, JLL, LGIM Real Assets calculations.
Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

13. Source: MSCI transaction backed data. It is only available to the end of 2023 and hence misses further valuation adjustment which we expect to bring valuations closer to market pricing. It also measures completed deals rather than bidding which can be slower to reflect actual market adjustment
14. Source: NCREIF, May 2024
15. Source: Valuation data from MSCI, pricing data for Europe and US is from Green Street's CPPI service. For UK it is JLL data, unweighted average for Birmingham, Bristol, Edinburgh, Glasgow, Leeds, London, Manchester
16. Source: Based on MSCI's UK Annual Digest
17. Source: Using the MSCI Quarterly Digest to reflect intra-year movements
18. Source: PMA Global Prime forecasts, Spring 2024. Prime reflects the change in estimated values for a high-quality well-located asset

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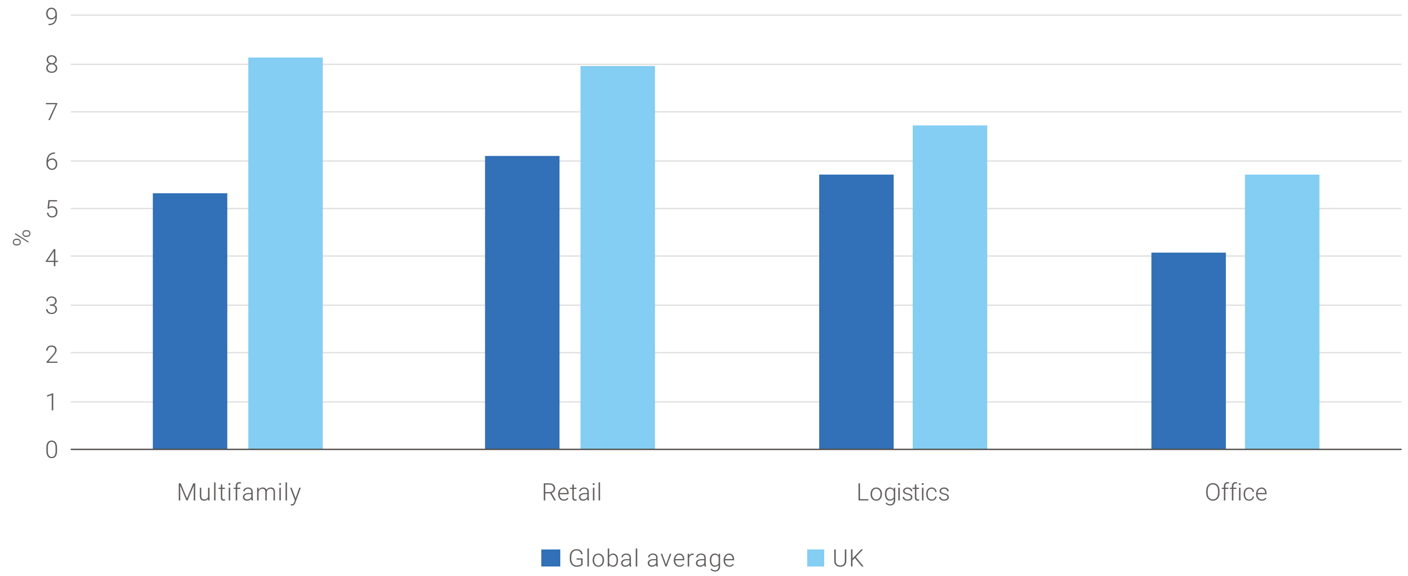
Forecasts and positioning

We expect UK real estate values to adjust -1% over this calendar year[16], led by offices, with a total return of around 5% before modest yield compression and rental growth support returns of around 7% p.a. between 2025 and 2028 inclusive. This would equate to a full peak-to-trough value adjustment for UK real estate of around 25%[17] with almost all of that now in the past.

This does, to some extent, rely on a managed path of interest rate reductions but as we explored above, the market appears well placed for most rate scenarios. The risk premium analysis above is suggestive of upside risk to these forecasts, with unlevered returns closer to 10%.

Forecasts for international performance show the UK is well positioned, with PMA's forecast of prime returns[18] showing outperformance across global averages for all main sectors.

Total forecast returns, 2024-2028

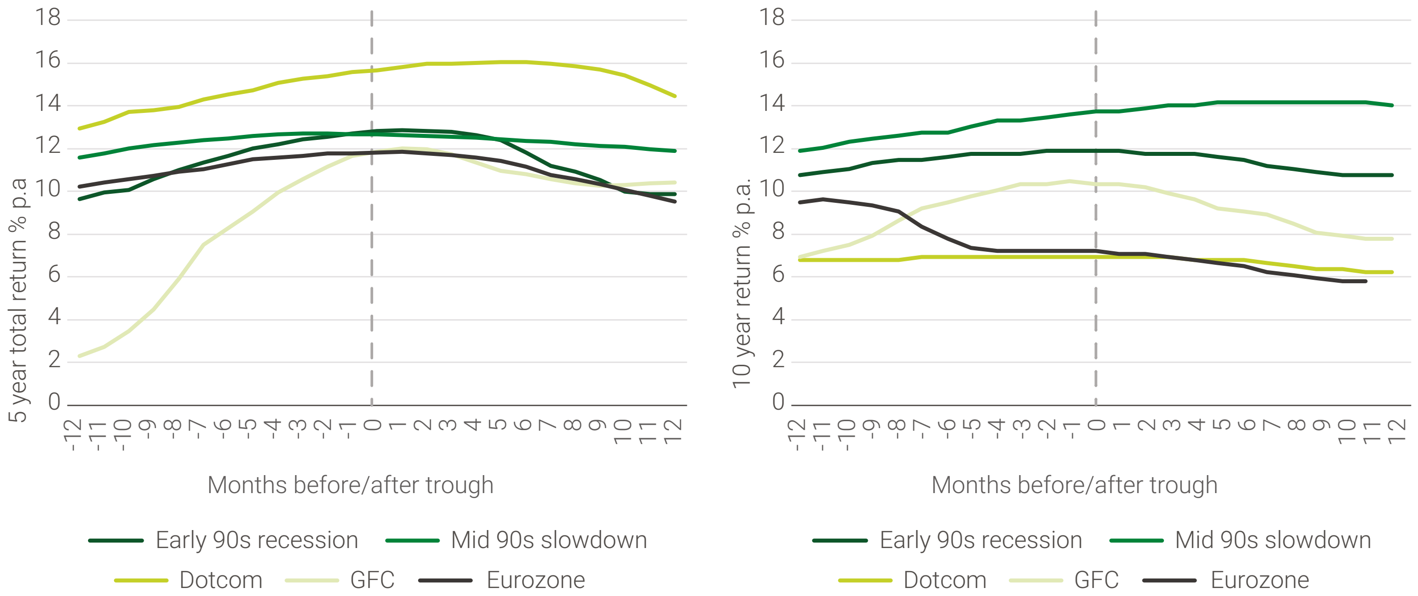


Source: PMA Global Prime forecasts, Spring 2024. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Although history is not guaranteed to repeat, analysis of subsequent performance after previous downturns can also be instructive. The graphs on the next page show returns on the MSCI quarterly digest in the five and 10 years after a cyclical low point, assuming an investment is made in the period immediately before or after a capital value trough. Given our view that income curation and growth are the best ways to navigate subsequent performance, with yield compression and cyclical recovery more difficult to forecast and therefore best seen as upside risks, we place lower weight on this analysis. This is, however, illustrative of potential returns – before the addition of leverage. It also shows that timing the trough of the market precisely, very difficult in practice, does not make a significant difference to subsequent returns.

After an elongated period of navigating external shocks, we believe the sector is positioned for a period of attractive risk adjusted returns.

UK all-property returns, unlevered, in the five and 10 years after a capital value trough[19]



Source: MSCI Quarterly Digest, Q1 2024, LGIM Real Assets calculations. **Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

19. Another caveat to this analysis is that some holding periods coincide with the start of another externally driven downturn (e.g. historically, the GFC and subsequent Eurozone crisis). Also, the MSCI index was more dominated by higher beta offices and retail historically.

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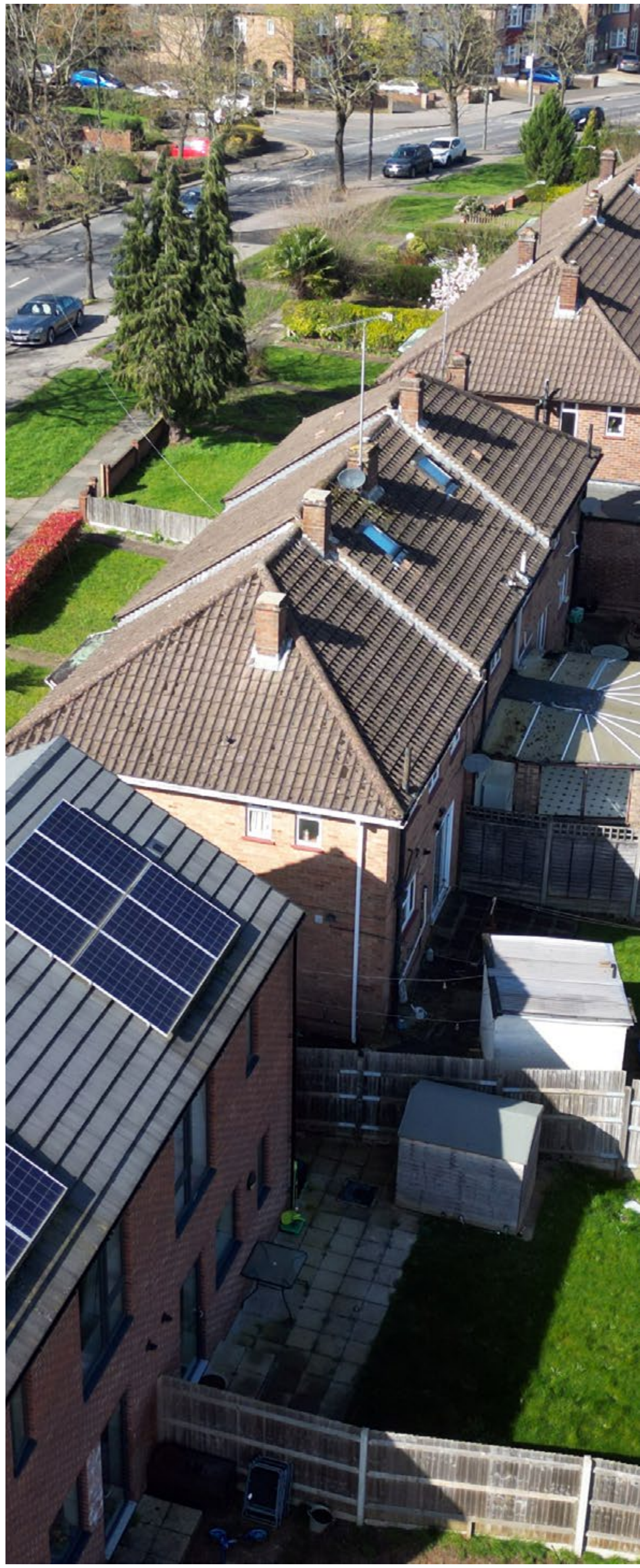
Conclusion

Analysis suggests the UK is well placed both domestically and relative to international peers in terms of fair value, sector relativities and growth potential. Equivalent yields in excess of 7% with net operating income yields at 5.0% compare favourably to other asset classes, with UK equities for example yielding 3.8%[20].

Real estate assets can provide investors with an income stream they can potentially access at a cyclically cheaper entry point that can be managed in an environmentally sustainable way and can offer social benefits.

Volatility in rates and potential shocks suggest portfolios tilt to income resilience rather than binary yield compression plays, with the latter seen as an upside risk. After an elongated period of navigating external shocks, we believe the sector is positioned for a period of attractive risk adjusted returns.



20. Source: MSCI Quarterly Digest, Q1 2024

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Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

It should be noted that diversification is no guarantee against a loss in a declining market. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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