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LGIM Real Assets

Real Estate: Recovery themes

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Key takeaways

- Rental growth expectations have improved in line with a more positive view on the economy. This offsets the impact from higher real interest rates seen in the first quarter.
- We see continued momentum for industrial and certain alternative property types, notably residential.
- The firming of the view that employees will be returning to offices in greater numbers in the coming months does not negate the longer-term questions facing the sector. We continue to expect further divergence, with offices providing healthy, productive workspaces in well-connected locations best positioned to capture occupier demand.
- In this report we focus on consumer-facing sectors as the economy recovers. Understanding trends in consumer behaviour and how they interact with different elements of the real estate universe remains key to positioning investments and favours selected parts of leisure and retail warehousing.

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Economic overview

We expect UK GDP to grow by 6.2% in 2021 and 8.1% in 2022, compared with a consensus expectation of 4.4% and 6.9% respectively. Although above consensus, this view of recovery and growth is widely held. We acknowledge a remaining tail risk relating to virus mutations, further restrictions, and the removal of the furlough scheme in September 2021 which has kept UK unemployment low (4.9% as at February 2021).

Nevertheless, the outlook is more positive with UK GDP now expected to revert to pre-pandemic levels on an absolute basis during H2 2021 and to trend levels by H2 2022.

Growth expectations have strengthened further in the US where aggressive stimulus has driven inflation higher. Treasury yields have increased from 0.9% six months ago to 1.6% today. By contrast, we do not expect inflation to be a significant issue for the UK and forecast annual HICP (Harmonised Index of Consumer Prices) of 1.6% in 2021 and 2.0% in 2022. Nevertheless, inflation is a rising concern for investors as demonstrated by the movement in UK gilt yields which have increased from 0.3% to 0.7% over the last six months.[2] Nevertheless, inflation has been flagged as a rising concern for investors.

Real estate views

The increase in the UK gilt yield does not change our view that the risk-free rate will remain "lower for longer". The risk premium offered by real estate remains historically high at c.4.9% compared to a 20-year average of 3.0%. Our composite relative indicator shows that the increased gilt yield has had an effect, but real estate remains attractively positioned on a range of measures, in our view. This assumes rent collection normalises – and as the UK economy reopens, we would expect this normalisation to accelerate over 2021.[3]

Composite relative value indicator, UK Real Estate

Source: LGIM Real Assets Q1 2021

Real estate and inflation

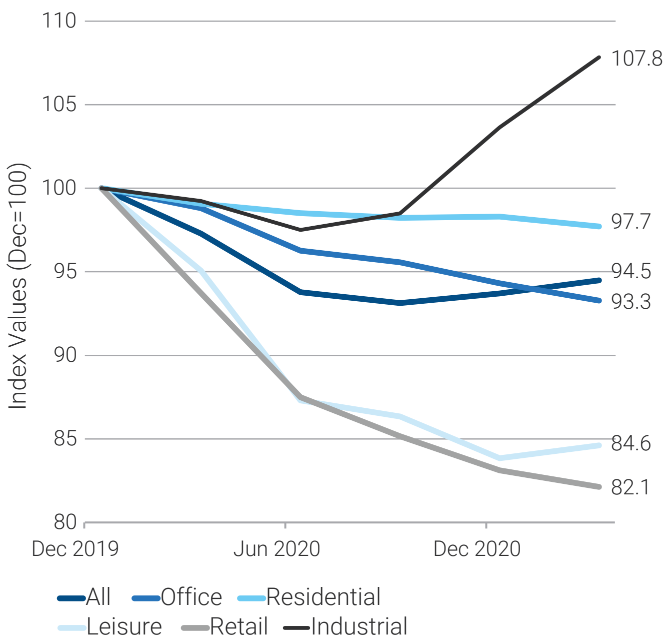
Real estate can, in certain market conditions, be considered a partial hedge against inflation. However, the ability to hedge depends on the cause of inflation and the property market conditions at the time. Should inflation become an issue due to the COVID-19 stimulus seen over the last 12 months, we think the ability of real estate performance to match or exceed it is dependent as much on investment style as on sector selection. This reinforces the need to ensure assets are suited to the changing dynamics we are seeing - good quality space in improving locations, effective refurbishments and repositioning, and strong sustainability credentials are likely to be the key drivers of performance, rather than purely segment selection.

Recent sector performance

According to the MSCI Annual Digest (the benchmark we use for our forecasting) UK Property returned -2.3% over 2020. On the Monthly Digest, returns over the first quarter of 2021 were 2.2%, led by industrial at 5.2% with offices at 0.1%, retail at 0.6% and alternative sectors at 1.1%.

All property values, as described in the graph below, have improved over the last six months. Compared to December 2019, values remain -5.5% lower, according to MSCI Monthly, but this is an improvement from September's low point of -6.9%. Industrial values ended March 7.8% ahead of December 2019, but office, retail and leisure values were -6.7%, -17.9% and -15.4% lower respectively.

Capital value movements from December 2019



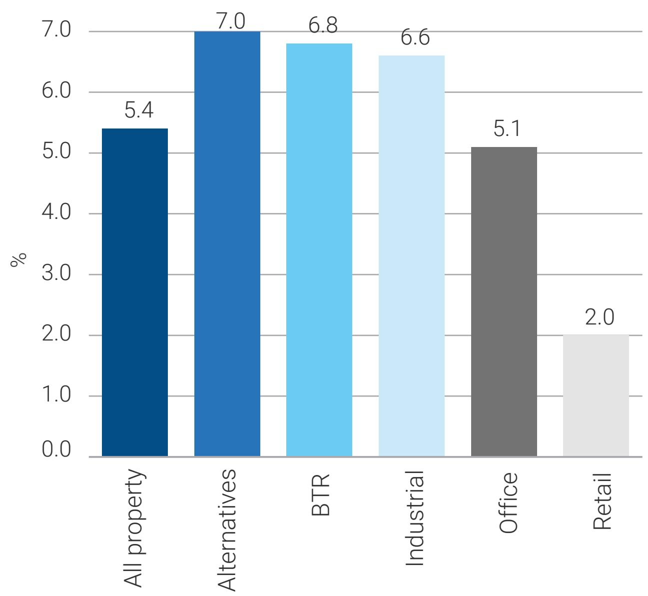
Source: MSCI Monthly Digest as at April 2021

1. Bloomberg Generic US 10year note (22/04/2021)
2. Bloomberg Generic Gilt 10year (22/04/2021)
3. Rent collection 90 days after the December quarter day was running at 79%, according to Remit Consulting (Apr 2021).

Expectations

We expect an all property total return of around 5.0% this year, elevated by the momentum seen in industrial markets where we expect double digit returns. However, continued weakness in retail (albeit much less bad than recent history), and a more subdued office outlook in the short term, are expected to drag overall performance. Over the five-year period 2021-25 we expect the market to deliver a total return of 5.4% p.a. The significant differences between sectors is expected to continue during this period.

Total return forecasts, 2021-2025 % p.a



Outperform	
Urban logistics	Northern industrials
BTR London	Trade parks
SE multilet industrial	Student accomodation
BTR Non-London	London multilet industrials

Neutral	
Distribution warehouses	Leisure
City offices	South East offices
West End offices	Regional CBD offices

Underperform	
Office perks	Unit shops
Retail warehouses	Shopping centres
Supermarkets	Care homes

Source: LGIM Real Assets Q1 2021. There is no guarantee that any forecasts made will come to pass

Offices – greater stability in prime office space

Our views on office demand – that it will be affected by pandemic-related changes to working practices, but impacts will be more modest than many expect – remain consistent. That said, we have reduced marginally our five-year expected return to 5.1% for two reasons: The 2020 outcome was less bad than originally expected, meaning we moved the risk previously assigned to 2020 into the forecast horizon and, in the short-term, we believe further increases in occupier-controlled supply will reduce rental values further with an associated reaction in yields. Importantly we would expect greater stability in prime property, after values reacted last year, than in average property benchmarks. This corresponds to increased risks associated with poor quality, poorly managed and peripheral assets.

Industrial – continued value in the sector

The momentum seen in Q4 2020 has continued and we expect an annual return of 12.5% in 2021 with value growth of 8.3%. The five-year average of 6.6% is broadly unchanged suggesting a lower performance expectation beyond 2021. Direct market pricing continues to provoke questions over value, but our analysis of target rates compared with yields on the MSCI measure suggest that there remains value assuming rental growth forecasts are realised. This is particularly true for multi-let estates in the South East and the rest of the UK.

Retail and leisure – challenges, with a clearer path to recovery in leisure

We will expand on our expectations for retail parks and leisure property in the following section. At a sector level we still see challenges to leasing markets and expect rental decline of -2.9% p.a. over the horizon with over-rentedness still challenging valuations. Shopping centres, with an expected return of -1.3% p.a., will drag the overall sector lower, in our view.

Build to Rent residential – optimistic on sector, despite pockets of oversupply

We expect returns of 6.7% p.a. in London and 6.9% in the rest of the UK, with rental growth of 3.1% p.a. and 2.5% p.a. over the next five years. While there remain areas of oversupply in the broader private rented sector, we expect targeted build-to-rent strategies to outperform the benchmark. Our less pessimistic view on office re-utilisation and, by association London office space, is consistent with this view on outperformance.

Alternative sectors

Views on care homes and student accommodation are consistent, with expected returns of 4.2% p.a. and 7.0% p.a. respectively. We see value in certain hotel assets as the economy reopens to both business and recreational travel but acknowledge challenges for the sector as a whole may persist beyond 2021.

A focus on retail and leisure: the importance of stock selection and an agile business model

Understanding trends in consumer behaviour and how they interact with different elements of the real estate universe, we believe, remains key to positioning investor holdings. As the sector looks to recover from the severe impact of COVID-19, the ability of owners to identify and create future-ready places is vital, in our view.

Sector outlook

The reopening of non-essential retail and leisure over April and May in the UK has provoked the question of whether this represents a pathway to normality.

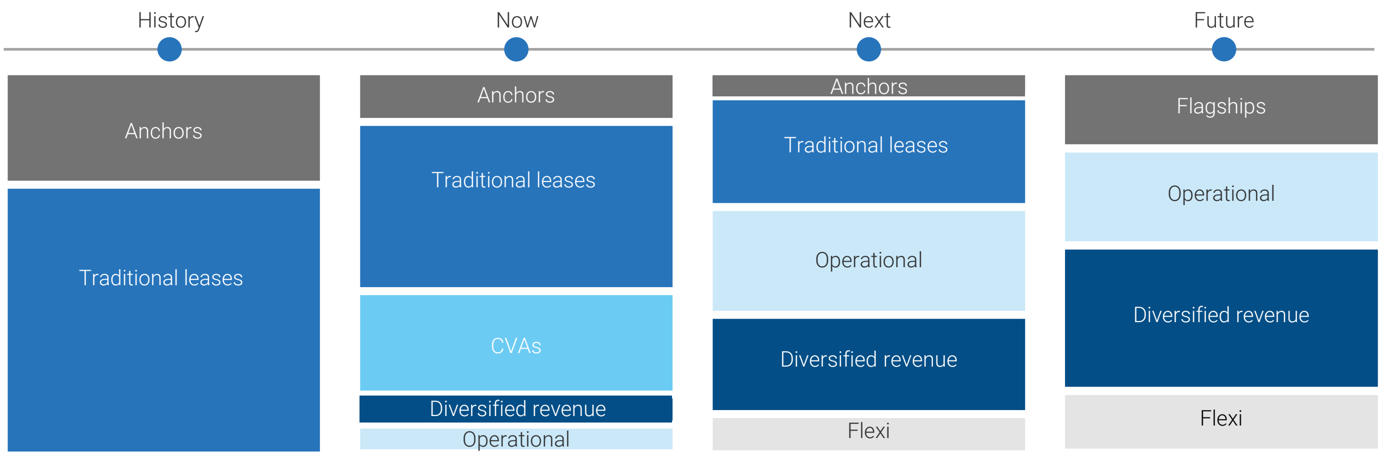
Our overarching view on retail – over-supplied and over-rented, contributing to the structural underperformance of the sector – has been consistent since well before the pandemic. On a more positive note, footfall in the first two weeks of reopening suggests consumers have returned to shops faster than after the first national lockdown finished in June 2020; however, footfall remains materially down versus pre-pandemic levels.[4] The recovery is likely to be gradual with significant variance by format and location. A materially higher level of e-commerce sales post-pandemic appears structural, putting further pressure on in-store sales. While the reopening of the sector should herald more normal rental collection levels in the second half of 2021, it ultimately represents a double-edged sword. Government support for occupiers is scheduled to be phased out over the summer, and we anticipate that a combination of reduced financial support and sluggish occupational demand means that vacancy levels, which ended 2020 at 13.7%[5], will continue to rise.

We do, however, expect the drivers of retail returns to shift. Outside of supermarkets, the re-rating of UK retail yields in recent years has been universal and justified, reflecting a sector that now has a fundamentally different risk and income profile. We anticipate yields to be relatively more stable over the next 12 to 18 months. This will result in attention increasingly shifting towards the income on offer.

However, until there is meaningful evidence of a structural reduction in retail floorspace, supporting growth in in-store sales in real terms, we anticipate continued downward pressure on rents for the sector as a whole, which we expect to be the primary drag on returns. We are forecasting further rental declines of -2.9% p.a. on a five-year view, contributing to lacklustre total returns of 2.0% p.a.

Greater attention on income will increase the focus on rent sustainability and asset relevance, in the eyes of both the occupier and consumer. We think the ability of owners to demonstrate a relevant and engaged audience, whilst also generating new revenue sources from non-traditional retail uses, thereby diversifying their income streams, will be crucial. This requires greater operational expertise, more dynamic, data-driven insights into consumer behaviour and occupier performance, as well as investment skills in measuring corporate risk. Our chart below illustrates how we anticipate the income model for retail to evolve in the future, shifting away from traditional retail anchors on long leases towards more flexible and performance-related leases ('flexi' and 'operational') alongside non-traditional 'retail' revenue streams.[6]

From past to future: how the retail model could evolve



4. Footfall for the week ending 24th April -26.5% vs 2019, Shoppertrak.
5. Local Data Company, March 2021.
6. Note: the size of the component parts within the chart are for illustrative purposes only.

Retail warehousing

Retail warehousing has attracted the greatest interest from investors over Q1. Stronger trading during the pandemic, thanks to the higher proportion of essential retailers present, open-air environments and superior private car accessibility versus town centres, combined with attractive income returns, has helped pricing to seemingly find a floor. There are several long-standing reasons why, we believe, retail warehousing should be treated differently to high streets and shopping centres, most notably:

- lower occupational costs
- more resilient footfall pre-pandemic
- the ability of larger, more accessible stores to better integrate into retailers' omnichannel business models.

We believe stronger trading locations on sustainable rents, with occupiers operating in more online resilient categories, can play an income-producing role in portfolios. However, this will be for select assets and will not be universal: we remain cautious on the extent of the 'bounce back' story on aggregate. The sector remains over-spaced with a shallow occupational market, which means we still expect the general trajectory for rents to be downwards. Stock selection and income resilience is key.

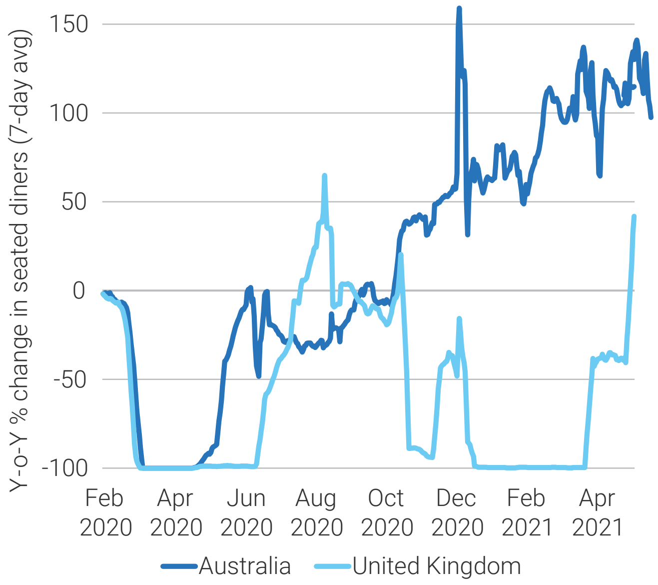
Leisure

We have a fundamentally more positive outlook for leisure property than the consensus, albeit one that remains highly dependent on the pathway of the virus. The sector has suffered over the past year, with 9.7% of casual dining restaurants closing in 2020, however government and monetary support looks to have prevented deeper and more permanent scarring.

There are two underlying reasons for our positivity towards the sector over the medium-term.

- Firstly, the sector is fundamentally about shared experiences in a 'third place'; real estate remains crucial to business models. Research from Savills found that just 6% of leisure units impacted by insolvencies in 2020 closed; the equivalent figure for retail was 28% - leisure operators ultimately need physical space to generate revenue.
- The second reason for our positivity is that we expect the long-term trend of consumers favouring experiences over products will return. Evidence of strong consumer demand in international markets with more open economies supports this view. February represented China's strongest month for box office revenues on record, while Australia has seen sustained double-digit growth in restaurant reservations during 2021 versus 2019 levels. Despite ongoing restrictions, the sector is already seeing demand from new, innovative leisure businesses looking to tap into this long-term trend.

Change in restaurant use, year on year



Source: OpenTable

Conclusion

Portfolios that have an overweight position in industrial and growth sectors within the sphere of alternative investments are likely to benefit from structural tailwinds, but we recognise that, as a consensus trade, acquiring assets in these sectors is competitive.

Polarisation in performance between and within sectors and in terms of asset quality will increase. ESG considerations are a vital consideration within this and the drive to achieve net zero carbon emissions has renewed impetus. Investors are increasingly seeing the performance benefit of these interventions; it is no longer viewed as a cost to be borne.

Finally, operational real estate has previously been perceived as part of alternative segments like BtR or hotels but is now moving quickly into offices and retail. A greater exposure to the underlying business within our buildings should offer compelling opportunities as the economic recovery gains further momentum.

7. Sustainable rents are where rents (plus wider occupational costs) are affordable for occupiers, indicating a more secure income stream for investors. In retail, this is typically assessed by calculating total occupational costs as a percentage of sales achieved through the store and comparing versus market indices for the appropriate retail 'category' (i.e. grocery or fashion).

8. CGA Market Recovery Monitor, January 2021.

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