Real Estate House View

United Kingdom

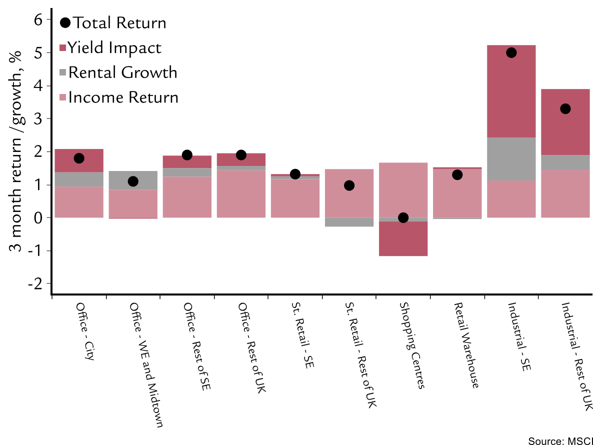
SwissLife Asset Managers

Second half-year 2018

Key takeaways

- MSCI All Property UK returned 2.9% in the first four months of 2018. Capital growth this year has been driven largely by continued yield compression, although rental value growth still contributed 0.5 percentage points.
- Performance between sectors remained highly polarised. Industrials recorded the strongest performance of the three traditional sectors, returning 5.5%, while retail – the weakest performer – returned just 1.5%.
- Cyclical and structural changes are causing this divergent performance between and within sectors. For example, the growth in online retail spend has been underpinning industrial performance at the expense of high street retailer in mid-sized centres that lack either convenience of a broad experiential offer.
- This divergence is set to persist over the next year and investor stock selection therefore remains critical.
- There remains strong investor demand for quality UK real estate and a lack of investment opportunities. Yields are at cyclical lows and there is competitive bidding for assets which stand to benefit from structural change.
- The economic outlook for the UK is uncertain. GDP growth is expected to slow but a four-decade low unemployment rate, limited construction activity and occupational flight to quality are underpinning take-up in the office and industrial sectors. These factors are keeping the vacancy rate for high-quality properties low.

Chart in focus



The property market has continued to perform well into 2018. However as the chart illustrates headline MSCI total return numbers mask significant variation between the segments. Industrial property was the best performing traditional sector for the 26th consecutive month in April, with total returns of 5.5% so far this year. This compares to 2.3% for the office sector and 1.5% for retail. The polarisation across the market between sectors, locations and assets means that careful stock selection is critical.

Economic dynamics have deteriorated during the first half of 2018. Annual GDP growth slowed to just 1.2% in the first quarter. While bad weather is partly to blame for the soft start to the year, data for the second quarter suggest that growth has continued at a sub-potential pace. We currently expect the UK economy to grow by 1.1% over the year, a noteworthy revision from the 1.5% projected in December 2017. On a more positive note, UK labour market data remained firm, with unemployment in April falling to the lowest level recorded since 1975. Inflation has fallen from its peak of 3.1% in November 2017 to just 2.4% in May this year. In response to this development, the Bank of England abstained from tightening monetary policy in May, which resulted in a weakening of sterling's trade weighted value and supported the stock market.

Solid performance

In the first four months of the year, MSCI All Property returned 2.9%. As a result, a double-digit annual rate of return has been maintained and it is feasible that the latest IPF consensus forecast of a 5.2% return may prove marginally pessimistic. However, the performance so far in 2018 does reflect a slowing in momentum, and a further moderating in the pace of returns is anticipated. £13.8 billion of stock was traded in Q1 2018 according to Property Archive. This represents a relatively subdued start to the year, which is thought to be indicative of a lack of buying opportunities. Where available, bidding for good-quality assets is fierce.

Regional offices in demand

Performance in the London office market has varied between the City and West End so far this year (to end-April 2018). City offices outperformed, returning 2.4%, as yields compressed further. In contrast, yields were stable in the West End, resulting in a lower return of 1.7%. Occupational markets in London are active. Q1 2018 take-up was up 10% y-o-y (JLL) with the highest number of under-offers recorded in a decade. Nevertheless, leasing activity continues to be inflated by flexible office providers and the availability of second-hand space has grown by 74% in three years. The overall vacancy rate fell 20 basis points to 5.5% in Q1. Regional offices are performing well in locations where there is a supply/demand imbalance, which is putting upward pressure on rental values. Many regional office markets saw record take-up in 2017 and are subject to shortages of quality stock. With a lack of new office construction and ongoing occupier decentralisation away from London, the future occupational prospects for the most popular regional markets are positive.

Industrial strength

Capital growth this year (to end-April) in the industrial sector equates to 3.8%, driven by rental growth and yield compression. Prime logistics yields are at their lowest level ever recorded, standing at 4.25% according to Savills. This is attributable to strong investor interest, given that the occupier market is favourable to landlords. Industrial take-up in Q1 2018 was double the long-term average (BNP) largely due to activity by online retailers, and there are severe supply constraints of Grade A stock. This has led to occupiers increasingly building their own stock to fulfil their supply chain needs. Speculative starts are on the rise, which may begin to ease current shortages; but many regions remain acutely undersupplied.

Divergent retail performance

The high street retail and secondary shopping centre sectors are undergoing a painful transition in response to changing consumer tastes and the growth of online competition. There is little upward pressure on rents as a result, and MSCI has recorded rental decline in some locations this year. This is also being reflected in some parts of the out-of-town retail sector, but the discount end of the retail warehousing segment has demonstrated improving performance. A flurry of long-established retail occupiers entered a company voluntary arrangement (CVA) in early 2018, enabling them to cut rents and close under-performing stores. More are expected to follow suit in the short term, which is likely to weaken retail performance further. However, there are clear winners and losers. Modernising retailers who have an integrated omni-channel offer or those focusing on discount or experiential retail are seeing improving trade and are actively expanding their portfolios. Consequently, successful locations and formats will remain viable investment opportunities. In contrast, some parts of the market may need to explore alternative uses.

Chart 1: MSCI UK All-Property total returns (to April-2018)

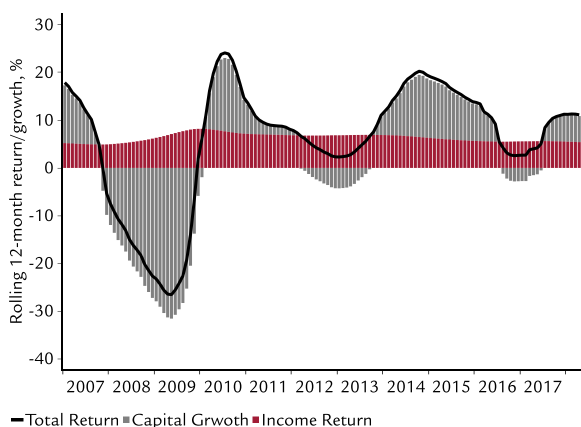
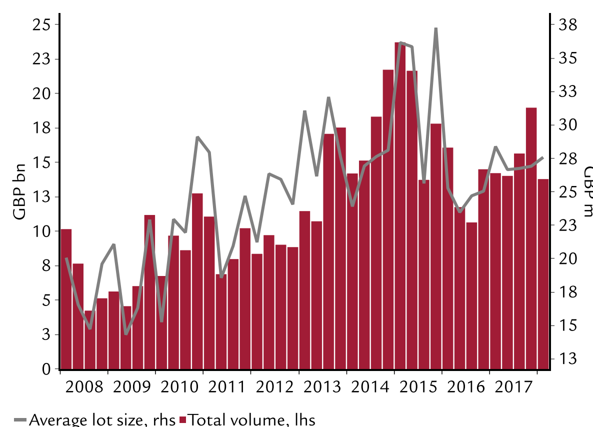


Chart 2: UK investment volumes and average lot size (to Q1 2018)



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