

# Real Estate House View

## United Kingdom

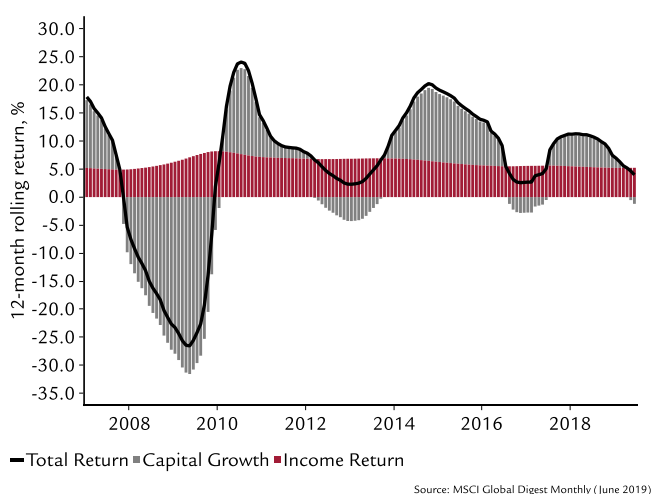
Second half-year 2019

## Key takeaways

- The MSCI All Property UK total return was 1.1% over the first half of 2019 compared to 4.5% for the same period last year. The total return was dragged down by All Retail which recorded a negative return of 2.2% in H1 2019. This compares to 2.1% for All Offices and 3.5% for All Industrial.
- The rolling annual total return for UK All Property has been decelerating for over a year. Rental value growth has fallen and yields in some sectors have softened. Retail has been most adversely impacted but Office and logistics (Industrial) also saw weakening performance. Income is now the primary return driver.
- In our view the UK will experience an elongated property cycle because gilt yields remain low, the real estate sector is not over-leveraged and there is a lack of new supply. UK real estate is likely to remain attractive to investors seeking income in this context.
- The value and the number of real estate investment deals done so far this year is below the five-year average, but the market is polarised by sector and stock quality. Investors are more risk-averse given the geo-political environment but there remains good bidding for high-grade, well-let property with secure income.
- Given the strength of occupational fundamentals in the Office and Industrial sectors, there are still selected opportunities to capture future rental value growth in supply-constrained markets. Prudent stock selection is critical.

Source: MSCI (2019), Mayfair Capital (2019)

## Chart in focus



UK All Property returns have been on a downwards trajectory since the start of 2018. The rolling annual return of 4.0% to June 2019 compared to 10.9% for the same period last year. Capital values declined 1.2% in H1 2019 compared with growth of 5.3% in H1 2018. Moderating returns are evident across all sectors, but it is the reduction in retail value that is largely responsible for the deteriorating performance. The annual All Retail total return of -3.9% in June 2019 was the lowest since 2009. By contrast, All Office returned 5.8% and All Industrial returned 10.8% over the year to June 2019.

On paper, the UK economy had a good start to 2019 as GDP numbers in the first quarter were boosted by an unsustainable inventory build-up. Data released so far confirm our view of a strong payback in the second quarter. For the full year, we only expect growth at around 1.2%. According to the Bank of England's Agents survey, investment intentions in both the manufacturing and services sectors are now at the lowest level since the financial crisis and are unlikely to improve given the continued Brexit uncertainty. Both candidates in the race to replace Theresa May as Conservative Party leader have vowed to re-negotiate a deal with the EU. If this attempt is unsuccessful, the candidates have not ruled out a "no deal" scenario at the 31 October deadline. We still think an extension of the deadline, potentially including an early election, is the more likely scenario, and we put the probability of a no-deal Brexit at around 30% at the time of writing.

## Subdued market activity

The UK All Property total return in the first half of 2019 was 1.1% compared to 4.5% for the same period in 2018. Rental value growth was flat with capital decline attributable to yield softening. Reflecting slowing momentum, the IPF Consensus All Property total return for 2019 was revised downwards by 0.6 pp to 1.8% in June. Stronger returns are expected in 2020 and 2021. Persistent uncertainty is restricting investment activity as most participants adopt a wait-and-see approach to Brexit. In Q2 2019 some £7.4bn was invested in UK commercial property in c.200 deals, based on Property Archive data, 54% and 64% lower than the 5-year quarterly average, respectively.

## Offices remain robust

Offices returned 2.1% in the six months to June 2019, down from 3.5% a year ago. Moderate yield decompression is evident but rental value growth is proving resilient, averaging 0.9% over the period. The strongest rental growth was in London's City office market. Despite economic uncertainty, London's office market is expected to retain its attraction to occupiers and investors given the strength of its underlying characteristics. Selected regional office markets will also remain resilient due to ongoing demand, occupier decentralisation and the battle for talent. The development pipeline has increased over the last year but supply is under control

in most locations. This should maintain the low availability of quality stock. Investors looking to access the office market should choose assets wisely and seek fit-for-purpose product in the most desirable submarkets or those with improving infrastructure or urban renewal.

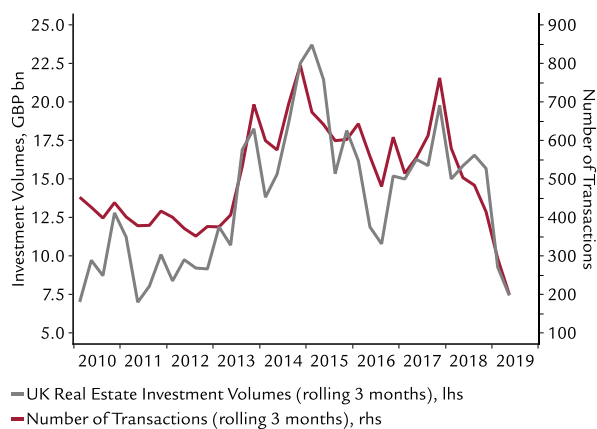
## Logistics still the best performer

Industrial (logistics) recorded a total return of 3.5% in the first half of 2019. It remains the highest returning traditional UK sector, although its performance has been softening. Over the equivalent period last year, the sector returned 9.7%. This slowdown is due to weaker capital growth. Values have increased 1.1% so far this year compared to 7.0% in the first six months of 2018. The South East was the strongest performing segment, despite yield softening, recording 1.7% capital growth and 2.2% rental value growth. The sector is expected to carry on benefiting from the structural shift towards online retail and rising consumer expectations regarding responsive, fast supply chains. The development pipeline has responded and there is a risk of floorspace over-supply in some markets, particularly for big-box units of over 100,000 sqft.

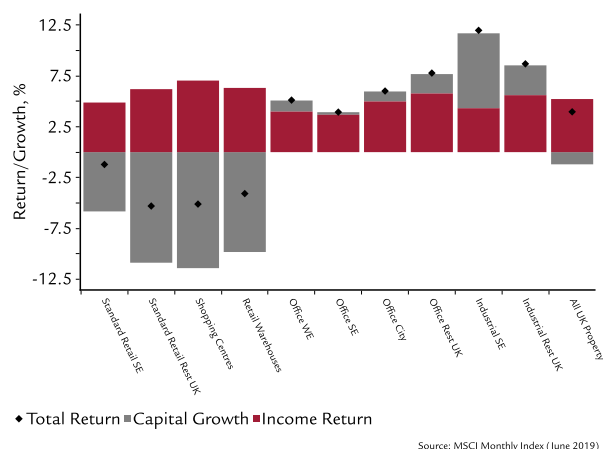
## High street retail woes

Based on MSCI data, all retail segments are experiencing declining values but it is most pronounced for regional high street retail and shopping centres. So far this year, 24 retailers have entered administration, according to the Centre for Retail Research. Many other retailers are closing stores or cutting floor space. Despite this, retail sales are resilient. The latest ONS data indicates that the volume of goods bought (excl. fuel) in the three months to June 2019 rose 3.4% on an annual basis. Online retail continues to capture market share, accounting for 18.9% of the total retail spend in June. Physical retail formats which provide what consumers want – convenience, value or experience, are still trading well and are expanding. Total retail returns are expected to deteriorate further in the immediate future due to the size of legacy portfolios, the speed of structural change and an overall oversupply of floorspace. The market may over-correct for selected locations which are expected to be resilient to structural changes, such as mixed-use city centres or modern, accessible retail warehousing.

**Chart 1: Quarterly UK commercial property transactions**



**Chart 2: Composition of total returns by segment (12 months to June 2019)**



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