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UK real estate: a consistent approach to weather uncertain times

UK Real Estate | March 2020

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Real estate is not immune from the forces affecting the global economy; however, our market is well placed to weather the storm. We expect potentially significant variations in sector performance, in part accelerating trends already apparent prior to the COVID-19 pandemic. Our portfolios are well positioned to navigate the challenges ahead, and our long-standing investment approach, centred on sustainable income and proactive asset management, will help to cushion capital volatility.

What a difference a month makes…

March 2020 evidenced the most dramatic fiscal and monetary intervention in decades, as the threat posed by the COVID-19 virus was increasingly understood, and the actions to halt its spread necessarily more severe.

As markets grappled with the implications of the virus, risk appetite evaporated. The FTSE 100 lost a third of its value between 21 February and 23 March, though at the time of writing has rallied in response to stimulus programmes announced by Western governments totalling around $3.5 trillion. Gold has rocketed over 18% in price since the start of the year, and UK gilts are now at all time low yields of sub 0.4%, in response to the Bank of England lowering the base rate to 0.1%.

Social distancing and self-isolation have already had a huge impact on our society and our service-based economy, albeit the swift action taken by the government will mitigate the fallout in the short term. We have already seen early reaction within our industry, but the full implications, positive and negative, are likely to be longer lasting.

Immediate impact

The impact of the virus on UK commercial real estate was initially subdued, with the traditional long-term horizons of the asset class offering a relatively safe harbour from equity market volatility. Prior to this, the market benefited from favourable supply / demand dynamics in most occupational sectors, a compelling income yield of 5.1% (MSCI UK Monthly Property Index, February 2020), and low levels of leverage (especially by historic standards).

However, as the severity of the virus became apparent, culminating in its classification by the World Health Organisation as a 'global pandemic' on 11 March, independent property valuers faced an unprecedented set of circumstances on which to base judgement, and were able to attach less weight to prior market evidence for comparison purposes, to inform opinions of value.

This view, sanctioned in an RICS guidance note on 19 March, led to the industry-wide adoption of a 'market uncertainty' clause, which effectively limited reliance on the valuations provided and was to have immediate ramifications for fund pricing and, hence, dealing.

Suspension

In light of this valuation uncertainty caveat, and to ensure all investors, whether subscribing, holding or redeeming shares / units are treated fairly, our open-ended real estate funds were obliged to suspend trading until certainty over share / unit pricing can be restored. Trading in all of our open-ended funds is currently suspended and we are closely monitoring the situation to ensure the suspensions are reviewed regularly. In the very short-term, valuation uncertainty is also likely to lead to some performance measurement volatility, as valuers digest and react to events at different speeds.

Our primary focus over the past two weeks has centred on communication to our clients, making sure they are fully informed and aware of the reasons for suspension. Unlike in 2016 or 2019, when a small number of retail funds in the market suspended trading due to insufficient liquidity, in 2020 all funds have sufficient liquidity to meet redemptions and, as things currently stand, it is therefore likely trading may resume once pricing certainty is restored.

Tenant engagement

As has been well publicised in recent weeks, many UK businesses will come under increasing short-term cash flow pressure as revenues decline sharply. Many are seeking to reduce their cost base as a result, including via deferral of rent. As responsible investors in real estate, we have taken the opportunity to engage with our tenants and ensure a measured outcome for all parties, and we support the Government announcement on 23 March that no tenant will face enforcement action as a result of non-payment of the March quarter's rent.

However, the impact on occupiers will not be evenly distributed. Given the deliberately diverse nature of our occupier base, we have not adopted a 'one size fits all approach', and instead are actively managing our tenant base to achieve the right result for our investors and occupiers alike.

What's next?

The situation is clearly still evolving, and the medium-term impacts on our asset class are only starting to come into focus. However, some trends are becoming apparent, and it is clear there will be significant differences between sub-sectors.

It is likely the fallout from COVID-19 will accelerate trends which were already apparent prior to its outbreak. In our market, high street retail and shopping centres, already out of favour, are likely to be hardest hit, with some occupiers (e.g. Laura Ashley) closing their doors for good. Enforced closures will hasten the demise of poorly run businesses, which may otherwise have limped along on the promise of cheap credit for a few more years.

What’s next? (continued)

Conversely, logistics will continue to benefit from the structural change in the way we shop and has undoubtedly been boosted by a population confined to their online shopping accounts. Tesco’s publicised intention to reoccupy warehouses in Milton Keynes and Stakehill, Manchester is an early indicator of a trend of increasing demand we expect to continue.

But the virus will also make us question the solidity of in-vogue sectors, most obviously the alternatives sector. Cinemas, restaurants, hotels and student housing have all been adversely affected by restrictions on social interaction. Operators saddled with high levels of corporate debt will likely require collaboration with lenders to survive reductions in revenue, but this in turn will allow the stronger operators to thrive.

More generally, operational assets (such as student housing) where investors are more closely aligned to the underlying income profiles generated by buildings, will feel immediate pain, as management agreements do not offer the same protection as leases.

Finally, serviced offices, for so long the darling of the industry generating significant occupational take up, may find their moment in the sun has come to an end. That is not to say the long-term demographic trends favouring these sectors will reverse, but we are reminded to properly consider the merits of each opportunity on an asset-by-asset basis.

Consistency is key

We stock pick assets offering high, sustainable income yields and proactively manage those assets to drive rental growth. In an environment where capital values become exposed to increased volatility, we believe the income advantage generated by this approach offers the best potential for relative outperformance.

Our portfolios offer a high degree of asset and tenant diversification, which limits volatility, and our focus on smaller lot sizes offers the greatest degree of liquidity, as we can sell to different investor groups to capitalise on the strongest demand.

This investment approach has remained consistent through multiple market cycles and has been tried and tested in challenging macroeconomic conditions before. We remain confident it will weather the present uncertain times.

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