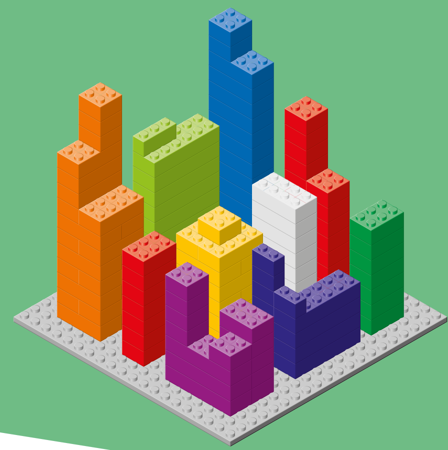


UK Real Estate: how to follow a record 2021?

James Coke, Fund Manager, Co-head of Institutional UK Real Estate

2021 was a standout year for UK real estate, which delivered annualised total returns of 14.7% to the end of October, as robust income returns were complemented by the return of capital growth. This represents the highest level of annualised total returns since the pre-Brexit days of mid-2015. While we don't expect 2022 to deliver the same capital value growth as 2021, it is likely to witness similar positive supply and demand dynamics which should maintain market momentum.

If 2021 was the year of recovery, 2022 is likely to be one of momentum. The prevailing broad-based occupational recovery is not immune to economic headwinds (the government's recent move to "Plan B" is the most tangible evidence of this, but supply-side pressures are also likely to remain as the economy adjusts to the recovery); however, it has proved remarkably resilient through challenging circumstances. Occupier sentiment, with some notable exceptions, remains positive and we are starting to see encouraging signs of business decisions which were postponed during the pandemic begin to translate into an increase in occupier activity. In the capital markets, investor sentiment remains broadly positive, as evidenced by a recovery in transactional volumes, with significant capital reportedly raised for deployment, targeting a market expected to outperform global strategies in the short term.[1] The "All Property" Net Initial Yield of 4.7%[2] continues to offer highly attractive relative income attributes over gilt and base rates.

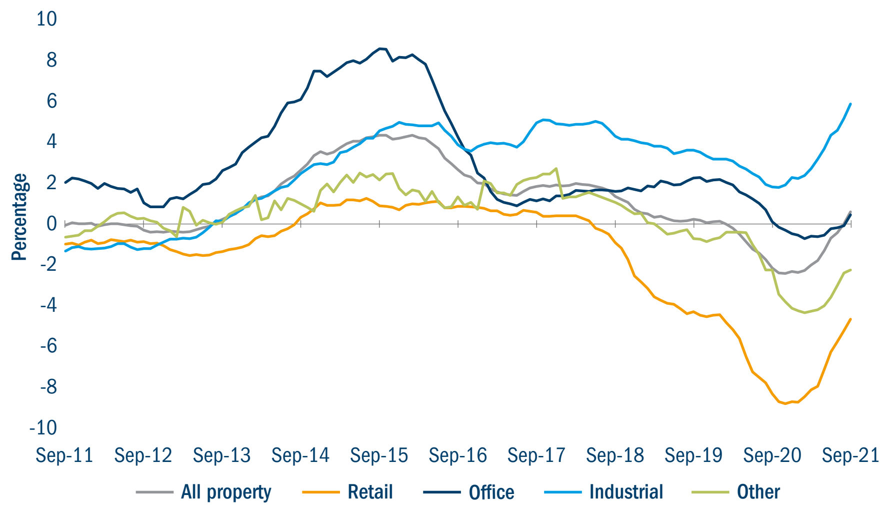
[1] Capital Economics forecasts 2021-25, September 2021.
[2] As per the MSCI UK Property Monthly Index, annualised total returns to the end October 2021.

Occupational dynamics differ at sector level, and portfolio managers will have to stock pick with increasing precision to deliver outperformance. Offices, retail and alternatives – for example, hotels and leisure – emerged from the pandemic having been profoundly affected by shifting sentiment. However, our experience from the front line is more positive, and we expect these sectors to continue to recover – albeit at different speeds and to different degrees. By way of illustration, we have been advocates of low-rented convenience/discount-led retail warehouses for some time, as evidenced by our deployment of significant investment in the sector in 2021. Yields contracted sharply through the year as investor appetite for the sector increased, however it still looks attractive as an income-led proposition.

Our high conviction view towards retail warehouses is based on intelligence from our asset management colleagues indicating a vibrant occupational market with tenants benefitting from reduced competition and online resilience, and in many cases online synergies – for example, "click and collect". We complement this high-level conviction with forensic asset-by-asset due diligence to ensure we invest in the right schemes in the right locations, let to tenants known to trade well.

Industrials continue to benefit from sustained structural imbalances in favour of landlords, which led to record levels of rental growth over the past 12 months (6.6% to the end of October 2021, as per the MSCI UK Property Monthly Index). Demand continues to increase as retail sales migrate online, and other, new occupiers enter the market, for example "dark kitchens" – shared physical premises where small businesses can set up to provide delivery-only takeaway meals. Investor sentiment, unsurprisingly, remains very positive towards the sector, and as a result we have seen significant yield compression for both logistics and multi-let assets throughout the UK. Given that industrials account for more than 40% of the index composition, this has a disproportionately positive impact at market level.

Fig 1: 10-year UK commercial property rental value growth (annualised)



Source: MSCI UK Monthly Index, as at September 2021.

ESG (environmental, social and governance) factors will rightly continue to influence investment decisions. Investment approaches are split broadly between those passively buying best-in-class, and those willing to actively manage portfolios to deliver building improvements. Prevailing pricing is likely to reward the latter more than the former, while the middle ground gets increasingly squeezed and at risk of stranding. We have committed to net-zero carbon in our portfolios by at least 2050, and we continue to implement workstreams aimed at quantifying works required to accelerate the trajectory towards net zero, implementing refurbishment and improvement works at a sustainable scale, and articulating the results of those activities to our clients.

Taken together, UK real estate continues to represent attractive value on an income basis, with modest but sustained growth potential in 2022.

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