DTZ INVESTORS

Are the best years behind us?

The Case for UK Property
2018 / 19

UK commercial property has had a good run; over the one, three and five years to December 2017 the asset class has delivered 8-11%p.a. total returns for investors, significantly outpacing UK bonds and closely matching the returns from UK equities. Performance has been reasonably buoyant in the first six months of 2018 also; while growth in the broader economy has been stunted by weather related issues, continued momentum in the UK real estate market has produced c.4% total returns for H1-2018 versus -0.3% and 1.1% for long-dated UK Gilts and UK equities respectively[1]. Even so, this year has started off more challenging than the last; and the recent changes in market conditions will make it difficult to emulate last year's success.

Hardly a day goes by without some mention of a CVA (Company Voluntary Arrangement) or a well-known retailer announcing store closures. Cited by many as the 'year of the CVA', the first half of 2018 has seen several retailers pursue a CVA to offload unprofitable stores, surrender their lease liabilities and re-negotiate rental terms in a bid to turnaround struggling businesses. To the detriment of landlords and investors in UK real estate, the consequences are now being felt in commercial property performance. Retail total returns were barely positive over the quarter to June 2018, after six consecutive quarters of +1% total returns, and further downward adjustments to rents and capital values are anticipated.

Aside from the woes in the retail sector, downside risks are growing elsewhere too, with the most immediate threat to financial markets being Brexit. The UK government has less than six months left to secure a deal with the EU that also wins the support of Parliament. Failure to do so could lead to several unattractive outcomes: a no-deal Brexit; the collapse of the government and the downfall of Theresa May; a general election that results in a Corbyn Labour government; or a second referendum, all of which could have implications for the UK economy and financial markets.

To date, the UK commercial property market has proven resilient to political risk: valuations quickly recovered from their brief decline immediately after the referendum result and segments that were forecast to be most affected by the referendum outcome (central London offices) have experienced increased take-up, subtle declines in vacancy rates and a steady improvement in total returns. Nonetheless, with a challenged retail market and the potential for a disorderly Brexit to unfold, it is more likely than not that short-term performance will be lower and the dispersion in sector total returns wider than in 2017, see figure 1.

Figure 1: Dispersion in sector total returns since 2014

Source: MSCI, DTZ Investors

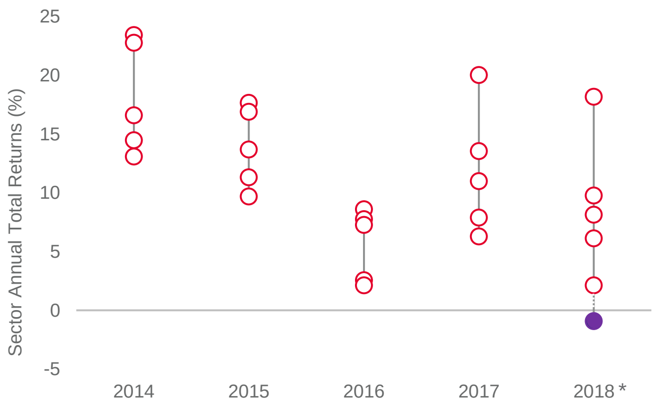


**Figure 1 shows the annual total returns for each of the main use sectors (retail, office, industrial, hotels and the other sector) since 2014. The figures for 2018 are the 6-month annualised total returns, and therefore provide an estimate for the range in sector total returns by year-end, assuming that the performance in the second half of 2018 continues in a similar trend to the first half of the year. In reality, the dispersion in sector total returns for 2018 could be far larger, for instance the purple marker shows DTZ Investors' 2018 expected return for the retail sector, if this were to happen this would lead to a 19% difference in sector total returns for 2018.*

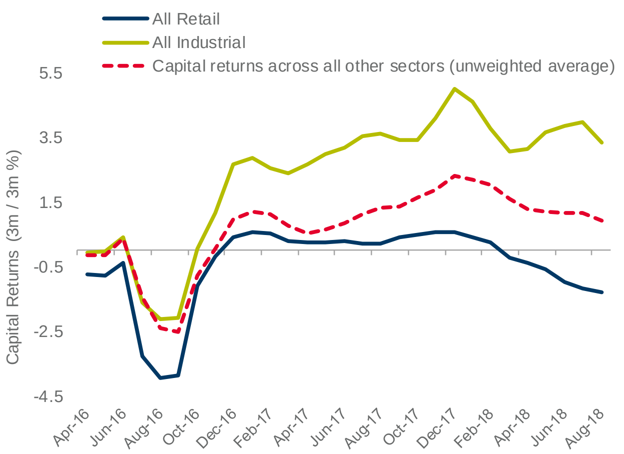
[1] Source - Schroders, Pictet Asset Management

Is the UK commercial property market at risk of a correction?

It is difficult to see what factors could counteract the upcoming weakness in the retail sector. The market has reached a mature stage in its cycle, where the principal driver of asset pricing (quantitative easing and falling interest rates) has more or less concluded. What's more the exuberant investment market activity that emerged post referendum has softened, and even the most resilient sectors of the market (industrials) are experiencing less yield compression and rental growth, see figure 2.

Figure 2: Capital Returns by Sector 3m / 3m %

Source: MSCI



But equally, a major property correction of the size and severity of past adjustments, this year or next looks unlikely. The factors that triggered the last two corrections (the supply-boom in the late 1980's and the credit fuelled crisis of 2007) are reasonably contained. There are no excessive supply imbalances in any of the property segments, construction activity is low relative to historic averages and future development is likely to be constrained by a lack of bank finance and low return expectations for property developers. And in contrast to the last cycle, property investment has been funded by equity as opposed to debt, lowering the probability of a major correction in property values by a credit-led boom.

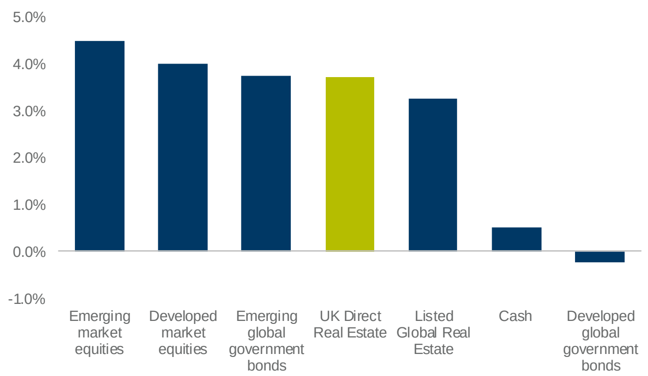
Moreover, macro-economic and monetary policy conditions remain generally supportive. There is no immediate risk of a recession on the horizon (the HM Treasury's Consensus Forecasts predict modest GDP growth of 1.3%y/y and 1.5%y/y for this year and next), and employment, which has historically been a good barometer for rental growth, continues to grow. Plus, with Brexit risks on the rise, the Bank of England are likely to leave interest rates on hold until some of the political uncertainty has subsided. The combination of these factors should result in one of two things from UK commercial property: a high income yield that provides an attractive risk premium to other asset classes, and the chance for rents to modestly increase in segments where occupational conditions are reasonably solid and supply pressures are contained. All things being said, a modest decline rather than a major correction in property values looks the most likely prospect.

So, are the best years behind us?

Quite possibly, even on the assumption that a 'soft-Brexit' deal is agreed and the UK moves into its transition phase, investors can expect c.3-4%p.a. total returns from UK property over the next five years (2019-2023); less than half the long-term average total return of c.9%p.a. Whilst low and relatively uninspiring, the outlook for other asset classes is unlikely to be any rosier. The share prices and revenue streams of the firms that make up the FTSE All Share are likely to remain vulnerable to Brexit's developments, and given the close historic relationship between UK and US equities, any potential developments that could affect US stocks (e.g. further increases in the Fed's rate, less expansionary monetary policy and a strengthening in the US dollar) could cause UK shares to be repriced too. As for government bonds, while they may benefit from financial market uncertainty in the short term, a gradual rise in interest rates to a new, albeit lower norm could supress return prospects over the next five years. Thus, against this backdrop, UK property should still maintain its rank against other traditional asset classes outperforming bonds, but possibly undershooting the performance of UK stocks over the period, see figure 3.

Figure 3: Asset Class Forecast Returns 2019-2023

Source: DTZ Investors, Robeco



But perhaps the principle reason why investors should consider exposure to UK commercial property is for its income. In a climate of subdued growth and scarce income, c.5% income returns from UK property remains attractive against c.3.6% and 1.7% income returns from equities and gilts respectively, making the case for holding commercial property in a multi-asset class portfolio justified.

Investors that are currently exposed to UK real estate should be able to beat our 3-4% market expectations for UK property by holding an overweight position to our favoured property sectors and complimenting this position with assets that offer defensive income characteristics in strong locations. Limiting transactional activity and minimising exposure to high risk, capital intensive asset management projects over the forecast period will help to preserve performance further. For those investors that are still in search of high income investments and have yet to invest in UK real estate, adopting this strategy once capital values have moderately adjusted should reward investors with even greater income returns.

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