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UK real estate: Performance after repricing?

LGIM Real Assets head of real estate research, Bill Page, considers where UK real estate may be heading after its current bout of repricing

In the UK, there has been persistent upward pressure on yields for some time, but this has eased in parallel with inflation.

British real estate in turn appears closer to the end of its repricing journey than other geographies – but what frictions could still cause issues? And what opportunities could the sector offer?

Reduced drag in UK economy

LGIM expects both the UK and the US to enter recession before the middle of 2024. This forecast positions LGIM at the lower end of consensus, although the absolute reduction in GDP expected is modest compared to previous recessionary periods. The alternative view, reflected in consensus expectations of a 'soft landing' characterised by subdued growth, is arguably supported by recent retail sales values and consumer confidence. LGIM's more bearish view is supported by recessionary PMI data, increased unemployment, and weaknesses in higher-frequency job placement data.

It should be noted that a softer landing scenario is not necessarily a 'goldilocks' outcome for the economy. Continued growth, albeit at low levels, may not be sufficient to bring inflation back to target and might necessitate rates staying higher for longer, ultimately choking medium-term growth. For rates to fall and allow asset prices to grow in the medium term, more economic slack is required in the near term.

The debate about rates has therefore shifted away from the terminal level of rates to the length of time rates will linger at those levels.

Property pricing

Some economic indicators have remained robust in tandem with persistently elevated inflation, and markets have priced in a higher-for-longer interest rate environment. The five-year SONIA swap rate had risen to 4.8% at the start of September, having been 3.8% in Q1, while the 10-year UK gilt yield rose 90 basis points from 3.5% to settle at 4.4%[1]. A squeezed risk premium for UK real estate, combined with our expectation for real-term rental declines at an all-property level, means we anticipate continued upward pressure on yields in the near term. However, some of this pressure has lessened relative to highs over the past 12 months and suggests a slightly lower peak in yields than forecasts made six months ago.

Transaction volumes remained weak over Q2, with £3.7 billion traded versus the five-year quarterly average of £13.6 billion[2], reflecting a disconnect in expectations between buyers and sellers, as well as expensive debt. However, we note that investor sentiment towards UK real estate, as measured by surveys from PMA and Preqin[3], was net positive at the end of H1, suggesting capital continues to target UK real estate – at least more so than this time last year – but it may remain on the sidelines until fair value is perceived. We anticipate more motivated sellers will emerge over the next 12 months in response to refinancing pressures and an increasing number of defined benefit pension schemes disposing of riskier assets. This should support price discovery and potentially present attractive acquisition opportunities, particularly for all-equity purchasers, in our view.

The repricing of UK real estate has been ahead of Europe and the US, albeit with both regions catching up over 2023[4]. From the valuation peak in mid-2022, the UK has seen a decline of -19% as of the end of Q2 2023, versus -14% in Europe and -11% in the US. Values continued to decline over the summer, with the MSCI monthly reading for August showing a -22% decline from last year's peak. We believe that we have seen the greater share of the correction. The expected disposal of assets by leveraged investors unable or unwilling to refinance and the strategic disposals by DB investors are in our view likely to create some potential opportunities to create attractive entry positions.

Construction costs: Reducing supply risks and creating new opportunities

The consensus among cost consultants is that after historic highs in tender price inflation (TPI) in 2022 (8.6% YoY according to RICS BICS[5]), the rate of TPI inflation is likely to fall, but remain elevated. Growth of around 5% is expected over 2023, before falling to an annual average of c.3.0%. This compares to an expected increase in commercial real estate capital values of 0.8% a year[6], implying a lasting impact on development viability, all else being equal.

Recent peaks in TPI were driven by materials inflation, which rocketed after COVID and again following Russia's invasion of Ukraine. Average material price inflation peaked at 27% YoY in June 2022[7], with many critical materials inflating much more. Much of this impact was absorbed by contractors

reducing margins to keep the contract prices experienced by investors more manageable.

Although average materials prices have fallen -4% over the 12 months to July 2023[8], they remain 42% higher than before COVID and prices for some critical components for commercial property remain stubbornly high. Cement prices, for instance, are 7% higher than they were 12 months ago.

However, this may also impact the market positively by:

1. Reducing supply risk over the 2025-2027 period that otherwise may drag on growth.
2. Increasing the scarcity value of any new development, especially where high specification and exemplary sustainability credentials are offered.
3. Increasing opportunities for forward funders to enable the viability of development and regeneration in the relative absence of bank funding, whether for structural reasons (banks' concerns over real estate risk) or more cyclical factors (uneconomic terms[9]).

Is the UK nearing the end of its repricing journey?

Although we remain cautious on aggregate real estate performance in the near term, in line with broader economic concerns, the pricing adjustment seen to date, coupled with positive growth expectations for specific sectors and strategies are suggestive of higher absolute returns than over the past two years.

We think the UK is further along in this journey than other regions. Portfolios that actively position to resilient sectors in the near term and growth sectors in the medium term are, of course, expected to offer robust performance potential and scope for significant deviation from benchmark averages. This includes long-income styles which, after the re-pricing seen at the end of last year, could be viewed as an adjacent strategy to real estate debt in providing highly stable cashflows with a robust underpin.

As the above analysis explains, we believe that overweight positions to BTR, PBSA, specific parts of industrial, and emerging sectors like data centres could be beneficial. More tactically, we think high-quality and well-managed offices, leisure parks, and specific parts of retail like supermarkets and fairly priced retail parks could potentially present good opportunities once yields stabilise.

Although debt markets may yet provoke further direct pricing pressure as leveraged investors dispose of assets because of sharp swings in repayment costs, the prospects for debt returns creates a real estate opportunity set away from direct ownership. There are also compelling opportunities for lending from non-bank lenders, in our view.

As we move toward 2024, we believe real estate equity is nearing the end of its repricing journey and is positioned well for growth, while real estate debt has the potential to offer compelling risk-adjusted returns. Meanwhile, we believe the maturity of real estate loans made over the five years to 2022 will increasingly influence market function and price discovery.

Written by LGIM Real Assets head of real estate research, Bill Page

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[1] Bloomberg as at September 2023
[2] RCA, September 2023
[3] PMA Survey Of Investor Confidence, Summer 2023; Preqin investor intentions survey
[4] MSCI data as at September 2023
[5] Royal Institute of Chartered Surveyors BCIS forecast, as quoted by CAST July 2023
[6] IPF Real Estate Consensus Forecasts, September 2023
[7] Monthly Bulletin of Building Materials and Components - August 2023, Department for Business & Trade
[8] Monthly Bulletin of Building Materials and Components - August 2023, Department for Business & Trade
[9] Bayes estimated that, at the end of 2022, average margins for speculative development were 481 bps compared to 270 bps for prime offices, for instance

Key Risk Warnings

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