Market conditions' impact on real estate

Summary
- Although UK real estate has significantly repriced, DB schemes remain wary of investing due to uncertain macroeconomic conditions.
- The investment landscape has changed and there is a significant bifurcation between quality and underperforming assets.
- There are selective opportunities in newer sectors such as the private rental market as well as the more established logistics and urban industrials.

Lynn Strongin Dodds explores how current market conditions are affecting real estate investment for pension schemes

Rising interest and inflation rates are never good ingredients for real estate but the asset class has also suffered from the denominator effect over the past two years. This overexposure to illiquid assets in general forced UK pension funds to pare back their holdings and despite lower valuations, property is still out of favour. However, they may be missing out on selective pockets of opportunities.

Market conditions

There is no doubt that macro-economic conditions have weighed heavily on UK defined benefit schemes. Inflation may have dropped to 6.7 per cent, but the country still has the highest levels among many advanced countries. For example, figures for the US and the eurozone are 3.7 per cent and 5.2 per cent respectively.

The big question is whether the Bank of England (BoE) will raise interest rates again. For now, the central bank is holding fire, with many economists noting the latest set of results were not enough of an upward surprise to prompt the BoE's Monetary Policy Committee (MPC) to resume its rate-tightening cycle.

The benchmark rate was left unchanged at its last meeting in September, ending a cycle of 14 consecutive hikes. At the time the Bank's governor, Andrew Bailey, said there were "increasing signs" that higher rates were starting to hurt the economy.

The economy though is not the only issue. "The general wider market sentiment has been challenging," says AEW head of UK, Nick Winsley. "There's been a compounding of negative factors from the war in Ukraine, the fallout from the mini-Budget and then the issues experienced at Silicon Valley Bank and Credit Suisse. The knock-on impact has been a relatively stagnant real estate market for the majority of 2023."

Real estate growth

According to the MSCI Monthly Index, all property capital value growth fell in June 2023 by 0.5 per cent. This followed a flat reading in May 2023, and rises of 0.1 per cent and 0.2 per cent in April and March 2023, respectively. The industrial sector was the only one with a positive reading of 0.3 per cent. Residential and retail both recorded negative capital growth of 0.1 per cent in June 2023, while offices continued to drag on performance, with capital values declining by 2.2 per cent.

Against this backdrop, it is not surprising that transaction volumes slid 64 per cent to £5.6 billion in the second quarter from the same period in 2022 and 63 per cent below the 10-year quarterly average. A gap between buyers and sellers continues, despite the significant correction that has taken place in the UK real estate market. Prices started to fall in the second half last year and into the first quarter of 2023, although they seem to have steadied, particularly for those segments of the market that saw the greatest capital declines.

According to UBS Asset Management head of real estate research, Zachary Gauge, values dropped around 25 per cent since the middle of last year, largely in response to higher borrowing costs and risk-free rates, "as the UK has corrected much faster than other global markets, pricing for most sectors is now stabilising," he says. "At higher yields some assets are looking attractive again

but the short-term pain from rising rates was unavoidable and certainly not unique to property."

A different investment landscape

Aviva head of real asset global investment specialists, Mark Meiklejon, echoes these sentiments. He believes that the UK economy is in a so-called K-shaped recovery with the repricing in the UK real estate market leading to a different investment landscape.

In real estate terms, this means, for example, a division between top tier, high quality, office space where firms streamline and develop ways to incentivise their workforce to return to the office and those offices where there is an oversupply of space and substantial reduction in demand.

"Managers have to be increasingly judicious where they invest" he says. "We are seeing a massively bifurcated market where there are swathes of uninvestable real estate such as secondary offices in secondary locations that have been impacted by market dynamics and the need to fulfil ESG standards. However, this is also a great opportunity to buy assets in sectors such as data and life science that are being driven by demographics and market trends."

LGIM head of real estate research, Bill Page, also sees the appeal of alternative assets, such as data centres, due to the additional demand from AI-driven sources. "We also like long income styles, following last year's repricing, as well as operational styles," he adds. "The latter sits at the other end of the risk spectrum to long income as it removes the protection of a lease but allows the owner to choose and work with the building's operator and share upside. We see it working strategically for asset types like hotels and self-storage and more tactically within retail and offices."

In addition, Page favours parts of the industrial market, especially urban logistics and multi-let estates, based on higher yields and consistent expectations for long-term income growth. "The repricing seen in H2 2022 coupled with enduring occupational tailwinds for the medium term is suggestive of good performance," he says. "Parts of the residential market, in particular build to rent residential and purpose-built student accommodation also look attractive. Although yields are low relative to other sectors, rental growth prospects are strong in this under supplied market."

Currently, the private rental sector, which has attracted investment from Legal & General and Aviva Investors, is around £1.4 trillion, or just 19 per cent of the UK's £8 trillion housing market. Institutional investors though own less than 1 per cent of this, which means there is huge potential for growth. At the moment, many are cautious about valuations while spiralling construction costs have also cast a shadow. This explains why transactions in the first half of the year dropped to £1.9 billion, down from £2.5 billion a year earlier, according to Cushman & Wakefield data.

Future prospects

Market participants though are optimistic about its future prospects. "We believe there is significant opportunity in the PRS sector because of its long-term sustainable growth," says Columbia Threadneedle Investments co-fund manager of the CT UK Residential Real Estate Fund, Emma Gullifer. "This compares to the UK commercial market, which can be more cyclical."

She notes that there is a structural supply and demand imbalance due to several reasons, including changing demographics, affordability of mortgages impacting first time buyers and increased expenditure aimed at improving environmental ratings. "We are seeing cultural shifts, and it is much more difficult to become homeowner as it was in the past," she adds.

The numbers tell the story. Gullifer cites a recent study conducted by SAY, on behalf of the fund manager, which showed a dramatic increase in demand for quality affordable rental homes in the UK. This is set to increase, with an estimated 50 per cent of UK households renting by 2039. In the 10 years to 2021, over 1.3 million additional tenants entered the private rented sector, with an estimated 1.18 million new rental tenancies started, on average, each year across England and Wales alone.

Winsley also believes there is value for UK DB schemes in the more established markets. "For example, in the logistics market, prime yields in the UK are 150-200 bps cheaper than they were two years ago, and whilst yields have moved out, we haven't seen a material change in the occupational market, which has remained strong," he explains.

According to Winsley, investing in offices also look interesting especially where they can be repositioned to best in class assets in terms of sustainability credentials. "Over the past 18-24 months we've seen pricing fall between 40-50 per cent and as value investors looking for mispricing that presents a great opportunity for the right sort of assets," he explains.

Looking ahead, Page believes that the UK is further along in its real estate 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 and significant deviation from benchmark averages," he says. "Although there remains value risk, the UK is close to the end of its repricing journey, and we forecast all property returns in the regional of 7 per cent p.a. over the 2024-2027 horizon."

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