Real Estate Outlook

UK – Edition 1H20

UK returns to pick-up in 2020.

UBS

UBS Asset Management

As we enter a new decade we reflect on the previous 12 months and consider the outlook for the UK Real Estate market in 2020.

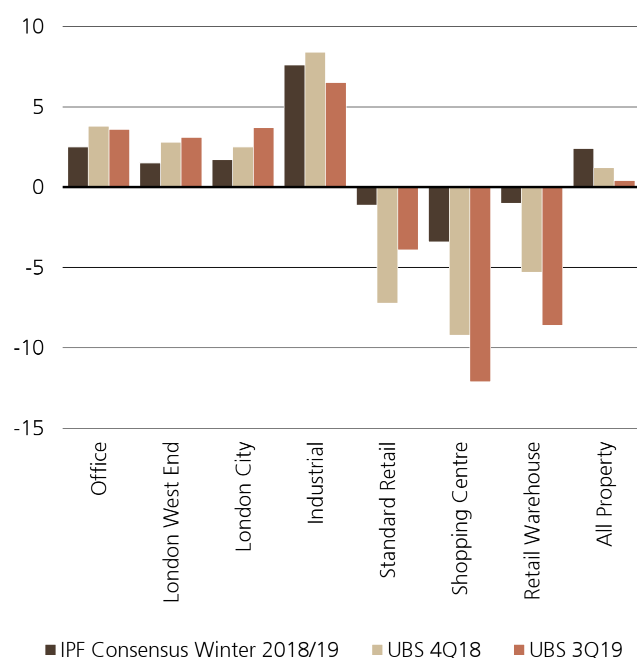
Zachary Gauge
European Research Analyst

Total returns for 2019 look set to come in well below a modest 2.4%, which was the consensus forecast from the start of the year. Economic growth is unlikely to pick-up in 2020 while Brexit uncertainty looms over the market, but interest rates will be supportive of yields. Returns should improve in 2020 as retail correction eases back with some upside potential in Central London.

2019 was, as expected, a tough year for UK commercial real estate

Consensus within a significant proportion of the UK property industry was that 2019 was going to be a challenging year. At the start of the year, the original 31 March Brexit deadline was looming large, while the retail revaluation showed no signs of slowing or even indicating where the eventual floor might be found. The IPF consensus forecast in winter 2018-19 was for an All Property total return of 2.4%, which has actually turned out to be slightly on the optimistic side. Our forecast for 2019 was 1.2%, which may still turn out to be too positive with the most recent forecasts for the annual level coming in slightly below.

Chart 1: UK MSCI Total Return Forecasts 2019 (%)



Source: IPF Consensus Forecasts Winter 2018/19; UBS Asset Management, Real Estate & Private Markets (REPM); 4Q18, 3Q19

Forecasters underestimated weakness in the retail sector

As with 2018, the consensus forecasts underestimated the severity of the revaluation of the retail sector. We had taken, and maintain the view, that valuations have been playing catch-up and that this correction would be long and drawn out. Part of the challenge is the absence of transactions that valuers, or indeed potential buyers, can use as a guide for a reasonable level of discount to apply to the current valuations, particularly with so much of the sector over-rented. To place the liquidity situation into context, shopping center transactions in 2019 totalled just GBP 514 million. Compare that with 2009, when at the height of the worst financial crisis since the Wall Street Crash, it was nearly four times the volume at GBP 2.1 billion.

We do expect that more liquidity will return to the retail sector in 2020; however, this is likely to be heavily driven by the higher quality segment of the market (and predominantly from retail warehouses). For this sector and level of quality we may therefore start to see values stabilize in the second half of the year as transactional evidence provides a basis for the bottom of the market. However, structural challenges mean that rental declines are likely to be more drawn out and these will continue to be factored into a discounted sale price.

Aside from the more core and dominant assets we believe the outlook remains extremely challenging for the foreseeable future, and that it will continue to be difficult to put a realistic value on secondary and tertiary retail. And if the listed markets can be used as any kind of guide, there is still substantial room for further downward movement before we reach any kind of floor. Our expectation is that retail will continue to struggle in 2020, with a negative total return of 3.9%, which makes us more bearish than the most recent consensus forecast of negative 2.7%.

Industrial returns slow faster than expected

One sector we were slightly too optimistic on at the start of 2019 was industrial/logistics. It was still comfortably the top performing traditional sector, but the pace of capital growth has dropped to around 2% from the double digit levels of previous years. The sector is now the lowest yielding of all the UK segments – ironically just two years ago this was the retail sector – and it is becoming increasingly hard to underwrite deals at even higher prices, particularly as the pace of rental growth has also eased back. It remains positive, but 2019 was probably the first year that affordability constraints in some parts of the market started to kick in.

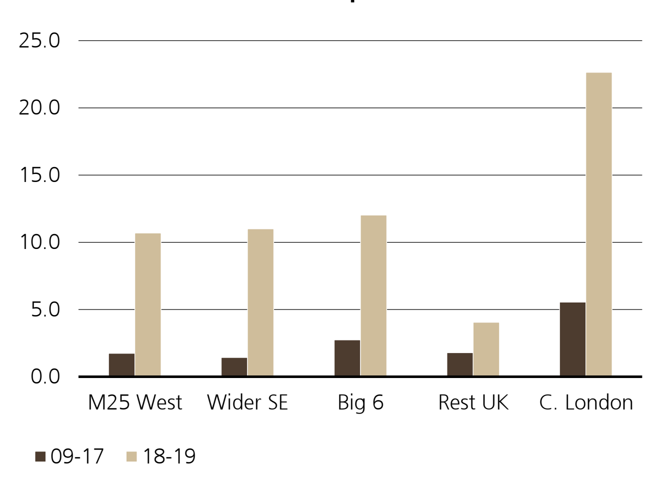
The increased competition from ecommerce-related demand has pushed rents up for more traditional occupiers, but these companies ultimately have a ceiling for occupational costs which they can pay and remain profitable. We have started to see some companies forced into relocations as they simply cannot compete with the rental levels being paid by the logistics firms who can justify seemingly ever higher rents by the efficiencies gained and continual demand for ever quicker delivery services. So we are now seeing a greater gap emerging between the top rents in the market and the more average level, which can be afforded by the traditional occupiers, and it is in this area that affordability constraints will really start to limit rental growth in 2020. Industrial occupiers will also be aware that the next business rates revaluation will come into effect in 2021 (based on 2019 values), and given the significant change in rental values since the last assessment in 2015 there will be a further significant increase in occupational costs particularly in London and the South East.

Offices outperformed expectations in 2019 but WeWork concerns linger

Clearly a key question going into 2020 will be whether the fallout from the failed WeWork IPO will have a detrimental impact on the office market. Our view is probably not. We have long publicized concerns over the business model of that particular company, which were ultimately mirrored by equity investors in 2019. But developments since the failed IPO suggest that the risk of defaults within their existing leased portfolio are relatively minor.

The company still has powerful financial backers, and with the largest now taking an 80% stake in the business we have seen a clear shift away from the ambitious growth projects and a focus back on the core business. This essentially involves making the existing serviced office portfolio more efficient and profitable. And it is important to remember that this entire business model rests on the company being able to do deals with landlords for office space across the world. Should the company default on any of their existing lease obligations they would immediately lose all credibility with landlords and make it extremely difficult, if not impossible, to acquire future space with the business in its current form.

Chart 2: Serviced office take-up as % of total



Source: PMA; 3Q19

WeWork has been a major contributor to occupational demand in Central London over the past five years, and more recently in the regional markets. But with their expansion plans on hold, there will inevitably be an impact on take-up levels in the short term. We also expect to see a growing caution in 2020 among landlords in leasing space to serviced office occupiers in general, which will ultimately act as a constraint on demand levels. However, with supply in many markets hovering around record lows and limited development activity coming through, we still have a moderately positive outlook for average rental growth in 2020, with prime expected to see stronger growth across the main markets.

Alternatives remain a key focus in 2020

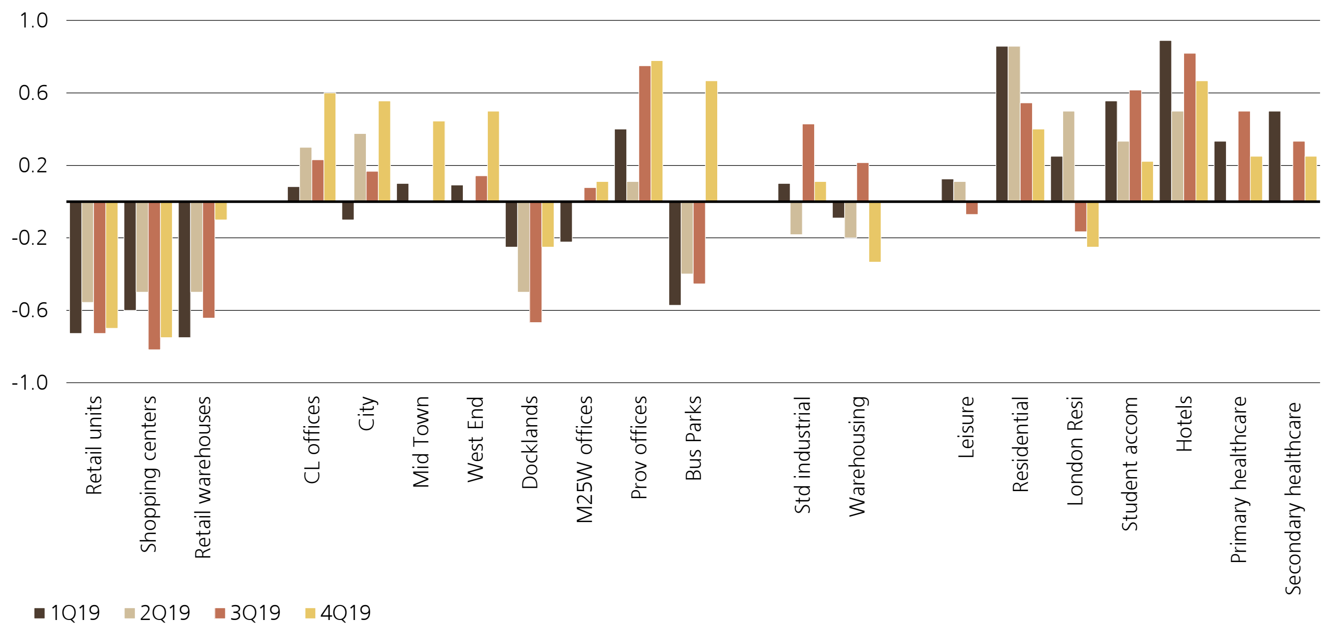
One of the clear investment trends from 2019 was a continuation of the shift towards the non-traditional asset classes, with the share of investment volume rising to 44% of the total and comfortably a new record high. And with these non-traditional sectors generally ranking very highly in the investor preference survey, 2020 will see a continuation of this trend. However, yields for the long-income structured alternatives have been driven down to very low levels, partly in response to the strong demand for income security in an uncertain environment and against backdrop of record low interest rates.

Low interest rates and sluggish economic growth will persist through the new year (and beyond)
We have persistently argued that an initial Brexit deal will not be sufficient to provide a boost to GDP growth. It will not be until the future trading agreement is actually agreed that UK businesses will have sufficient confidence to invest significantly in their UK operations – essential if GDP is to move back towards the 2% mark. With economic data indicating a soft end to 2019, a new "no deal" risk just 12 months away and persistent weakness in the global economy, we actually expect GDP to slow further in 2020 to around the 1% mark.

The "silver lining" for real estate is that interest rates will stay low throughout 2020 and likely beyond. And on top of that UK real estate looks very attractively priced compared to other European markets. This will not be enough to stop the ongoing correction to retail pricing, but may provide some support for yield levels for industrial/logistics and particularly Central London offices if we start to see foreign buyers becoming more active in the market. Brexit uncertainty subdued this supply of capital in 2019, and it will be interesting to see whether the political developments at the end of the year will be enough to encourage more buyers back into the market to take advantage of the attractive yields on offer.

But the likelihood is that with the risk of a no deal continuing to hang over the market, 2020 may also see relatively subdued investment volumes. However we, and indeed the consensus forecasts, anticipate better property performance as the retail correction starts to bottom-out with some liquidity returning to the retail warehouse market in particular. We expect the office sector to outperform expectations again with more focus returning to Central London, but with industrial/logistics returns easing back again as yield compression draws to a close.

Chart 3: Survey of UK investor preferences (net balance)



Source: PMA; 4Q19

Real Estate & Private Markets,
Research & Strategy – UK
Zachary Gauge
Gunnar Herm
Sean Rymell

For more information please contact

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy

Zachary Gauge
+44-20-7901 5534
zachary.gauge@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investment in real estate/infrastructure/private equity (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of January 2020 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at January 2020 unless stated otherwise. Published January 2020. **Approved for global use.**

© UBS 2020 The key symbol and UBS are among the registered and unregistered trademarks of UBS. Other marks may be trademarks of their respective owners. All rights reserved.