

Real Estate House View

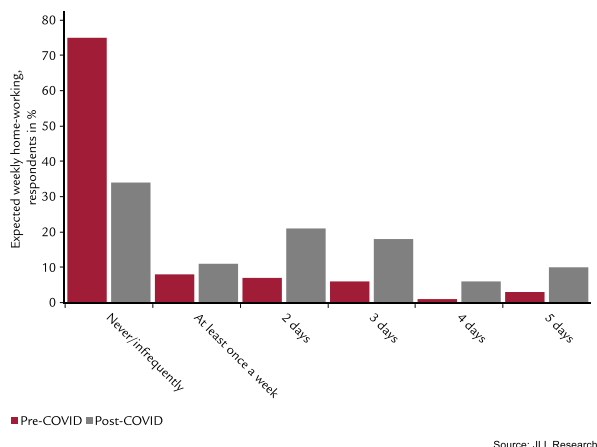
United Kingdom

First half of 2021

Key takeaways

- **UK All Property returns improve in H2:** six-month total returns in H2 2020 amounted to 1.5% compared to -3.7% in H1 2020 based on the MSCI UK Monthly Index. All main segments apart from retail saw a positive return. Polarisation between and within sectors remains a pervasive theme.
- **Moderate volumes which should improve:** H2 investment volumes improved on H1 but remain well below previous years. We expect liquidity to improve towards H2 2021 as the coronavirus recedes and following the removal of the threat of a no-deal Brexit. The income characteristics, low leverage and low supply remain appealing to investors.
- **Logistics performance remains exceptional:** logistics is the standout performer, having seen yield compression and rental growth in H2. The sector registered its strongest take-up levels ever in 2020. Permanently higher levels of online retail spending mean demand should remain robust.
- **Offices in a state of flux:** offices have been relatively resilient, with capital loss of -2.0% in H2 compared to -3.7% in H1. As office leases expire, we anticipate new occupational preferences emerging, which will cause performance divergence depending on the degree to which offices are aligned to structural change.
- **Retail at the epicentre of structural and cyclical trends:** while food-based physical retailers have had a strong H2, non-food retailers have been under extreme pressure that has led to administrations and closures. This has led to annual total returns of -10.9% with capital loss of -17.9%. More pain is likely in H1 2021.

Chart in focus



The future of office has been the subject of fierce debate. The pandemic has proven both the extent to which work can be done from home and the limits of this. Repeated surveys show that workers wish to return to the office. Employers also want them to return for reasons of office collaboration, wellness and serendipitous innovation benefits. This all suggests that occupiers will take less space in the future but that it will be of far better quality, which in turn points to a widening performance polarisation between offices depending on what they offer occupiers.

Compared with other major European economies, the UK has suffered even more from COVID-19 as the recovery in the second half of 2020 was less impressive than in Germany, France and even Italy. Uncertainties about the outcome of Brexit negotiations played a role and the financial sector had a less stabilising impact on aggregate activity during the crisis than elsewhere. As a trade agreement with the EU has now finally been reached, we expect the economic recovery to regain momentum in the first quarter of 2021. Short-term uncertainties remain high as the COVID-19 mutation poses a substantial risk for the domestic economy and the healthcare system in general. Meanwhile, a rigorous vaccination campaign has put the UK in a good position to become one of the first societies to reach herd immunity, thus permitting a widespread reopening of the domestic economy later in the year.

Activity set to improve

Preliminary data suggest that Q4 saw the largest quarterly UK real estate transaction volumes of 2020, amounting to some £10.8bn. This was nevertheless 38% below Q4 2019, largely due to weaker investment in offices and alternatives. Annual volumes in 2020 were 27% below the ten-year average and the lowest since 2012. Liquidity should improve towards mid-2021 in line with the broader economy. UK All Property returns came under pressure in 2020 but held up better than expected at the start of the pandemic. Based on the MSCI Monthly Index to November, quarterly and annual total returns came to -1.4% and -2.0% respectively. Polarisation between and within sectors increased. Performance should improve this year.

Office demand evolving

Offices returned -0.4% in 2020 and capital values fell by -5.1%. Take-up was weak and availability has risen, especially for sublet space. Occupiers are fundamentally shifting their preferences, which will only become truly visible at lease events. The future office will be human-focused for collaboration, socialising and creativity, while also serving as a corporate showroom. Repeated surveys show that most employees expect a mix of office and home-based working after the pandemic. This may mean less short-term office demand overall but with a greater emphasis on quality. We expect performance polarisation between assets able and unable

to provide this. Less overall demand, as occupiers opt for smaller and more flexible leases, could prompt further capital loss in H1.

Logistics the star performer

On an annual basis the industrial (logistics) sector returned 6.7% in December, with yield compression and rental growth emerging. Occupational activity in 2020 was the highest ever recorded at over 4.6 m sqm for big box (> 9300 sqm) warehouses, according to Savills. This was fuelled by the boom in online spending, with 42% of big box take-up in 2020 related to e-commerce, according to JLL. Online penetration rates will settle permanently at much higher levels after the pandemic, maintaining occupier demand especially in supply-constrained urban locations. The impact of the new EU trading agreements remains to be seen. While more inventory is likely to be stored domestically, more direct shipments between Ireland and Europe could curtail demand.

Physical retail struggling

Retail is at the epicentre of structural and cyclical trends. Food and discount retailers remaining open have traded strongly but most others are under extreme pressure. Annual total returns for retail were -10.9%, with capital loss of -17.9%. Shopping centres were the worst affected. Owing to lockdown impositions ahead of the crucial Christmas trading period and thereafter, more retailers without an online platform are set to close stores or enter administration in the short term. Periods of lighter lockdown have been accompanied by retail spending increases and a high savings rate suggests significant pent-up consumer demand to be unleashed once the virus is contained.

Residential a major focus

Resilient performance coupled with strong fundamentals suggests that the residential sector remains a major investor focus. Accessing stock is challenging, so investors need to adopt more active and committed strategies than forward funding and developer/operator partnerships.

Chart 1: All Property returns (Q4 2020)

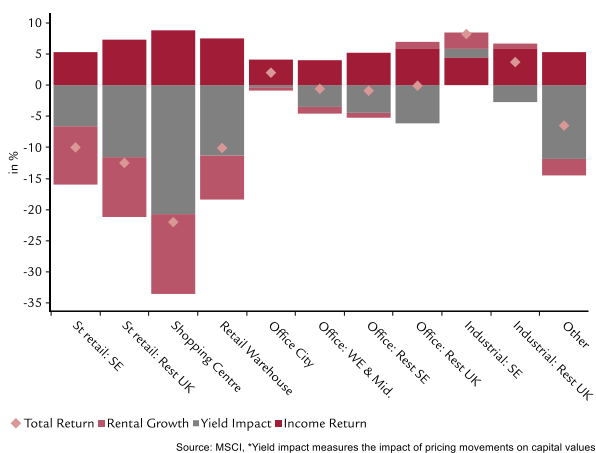
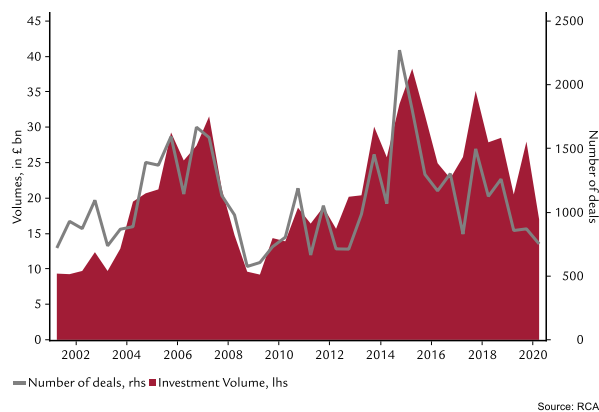


Chart 2: UK property investment volumes (to Q4 2020)



Authors

Mayfair Capital

Tom Duncan

Senior Associate, Research, Strategy & Risk

tduncan@mayfaircapital.co.uk

Fintan English

Associate, Research, Strategy & Risk

fenglish@mayfaircapital.co.uk

Swiss Life Asset Managers

Francesca Boucard

Head Real Estate Research & Strategy

francesca.boucard@swisslife.ch

Marc Brüttsch

Chief Economist

marc.bruetsch@swisslife.ch

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