Real Estate

UK economic recovery starts, but we advise real estate investors to stay DIGITAL and carry on

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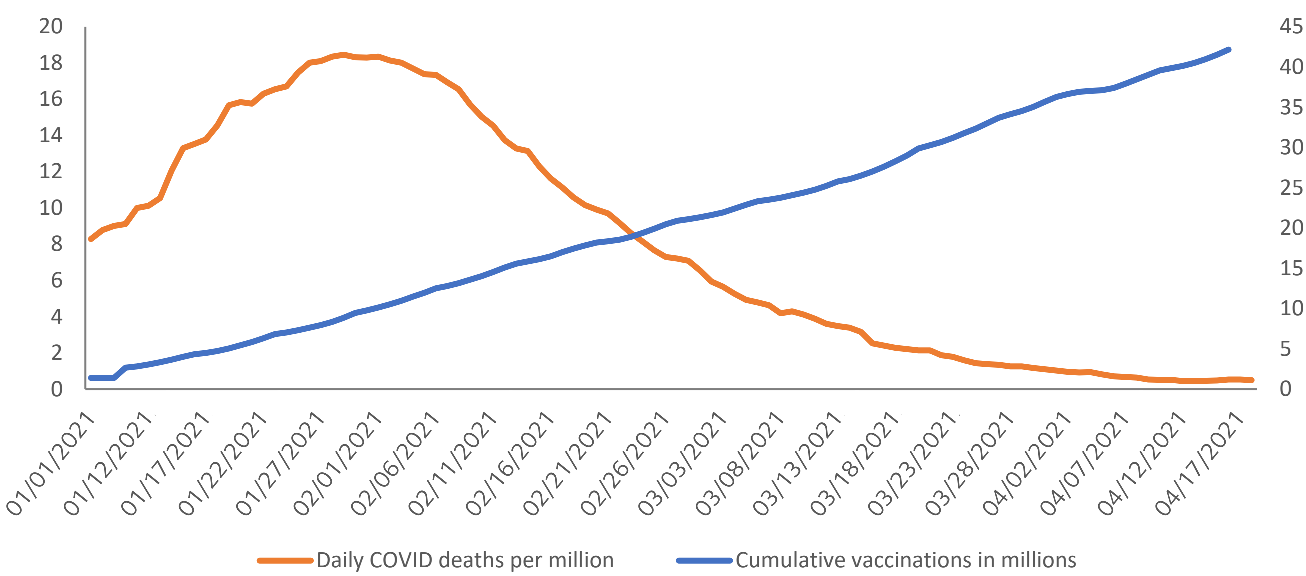
After enduring a torrid COVID-19 driven winter surge, the UK is finally beginning to see light at the end of the tunnel. Rapid and widespread vaccination has helped dramatically lower caseloads and fatality levels allowing the economy to gradually re-open. On a relative basis, the UK will outperform the Eurozone in the coming quarters. For real estate investors, the cyclical uplift expected will be welcome; however, given the broader unknown questions surrounding the UK's long-term relationship with the Eurozone, we believe that the best near-term opportunities remain in property types with structurally resilient DIGITAL drivers of demand that will be enhanced by the reopening of the economy and return to growth.[1]

Rapid vaccination and re-opening

The UK economy should start to reap the benefits of its rapid vaccination program which has ensured that nearly 50% of the entire population has received at least one dose and almost 15% is fully protected. As Exhibit 1 shows, quick vaccination has led to a steep decline in mortality allowing segments of the economy to re-open. As the most vulnerable segments of the population find protection, the re-opening of the economy should continue in a phased manner.

Exhibit 1: Rapid vaccinations are reducing mortality



Source: Our world in data, Principal Real Estate, April 2021

[1] See information about Principal Real Estate's DIGITAL strategy within Decisive Eye, June 2018 issue - DIGITAL refers to key long -term growth drivers centred around demographics, innovation, globalization, infrastructure, and technology that Principal has identified as metrics of long-term market outperformance.

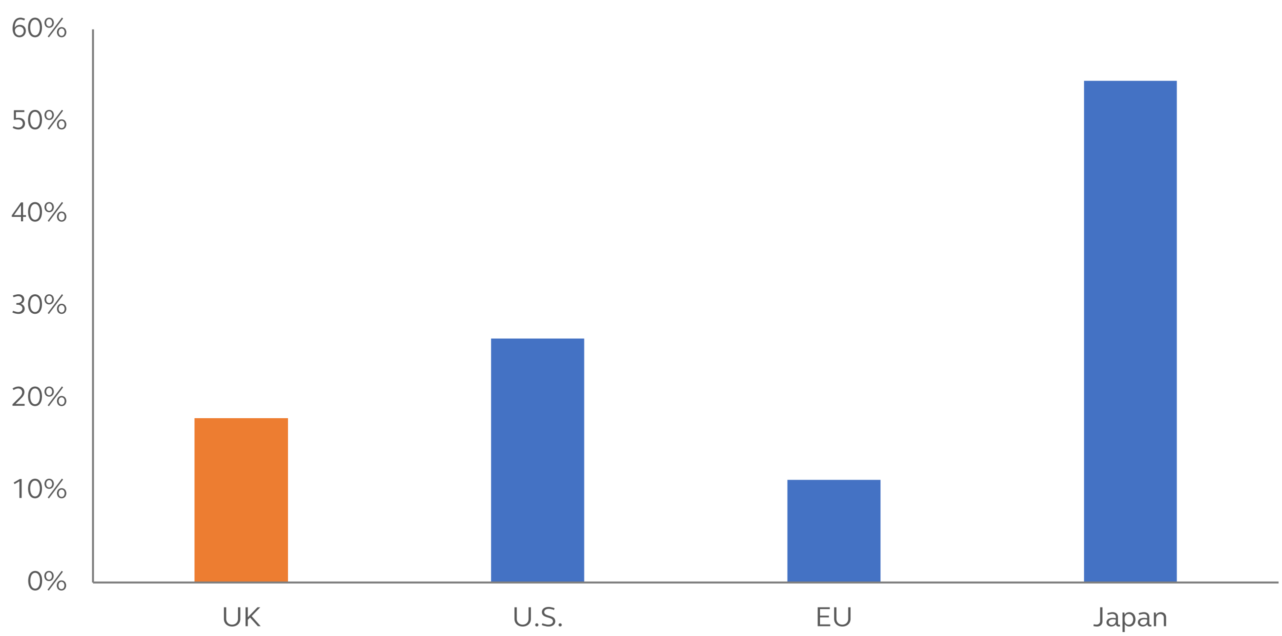
Consumers are likely to spend down savings

The strong pace of vaccination resulting in re-opening will be felt most acutely in the COVID-sensitive consumer sectors which should see strong gains as some of the pent-up savings are expended (savings are at a two-decade high of 16%). With approximately £170 billion of excess financial wealth, consumer spending should rebound strongly and will be a boost to the economy.

Fiscal backup is highly stimulative

Finally, the fiscal backdrop remains very supportive – the government extended the furlough scheme till September 2021 along with income support for the self-employed. The recent budget among other things provided direct grants to small firms, (particularly most impacted in retail and hospitality), and expanded the universal credit and working tax credit schemes until September 2021. In all, the fiscal package put in place by the UK amounts to nearly 18% of GDP placing it well above the EU but less than the U.S. (Exhibit 2).

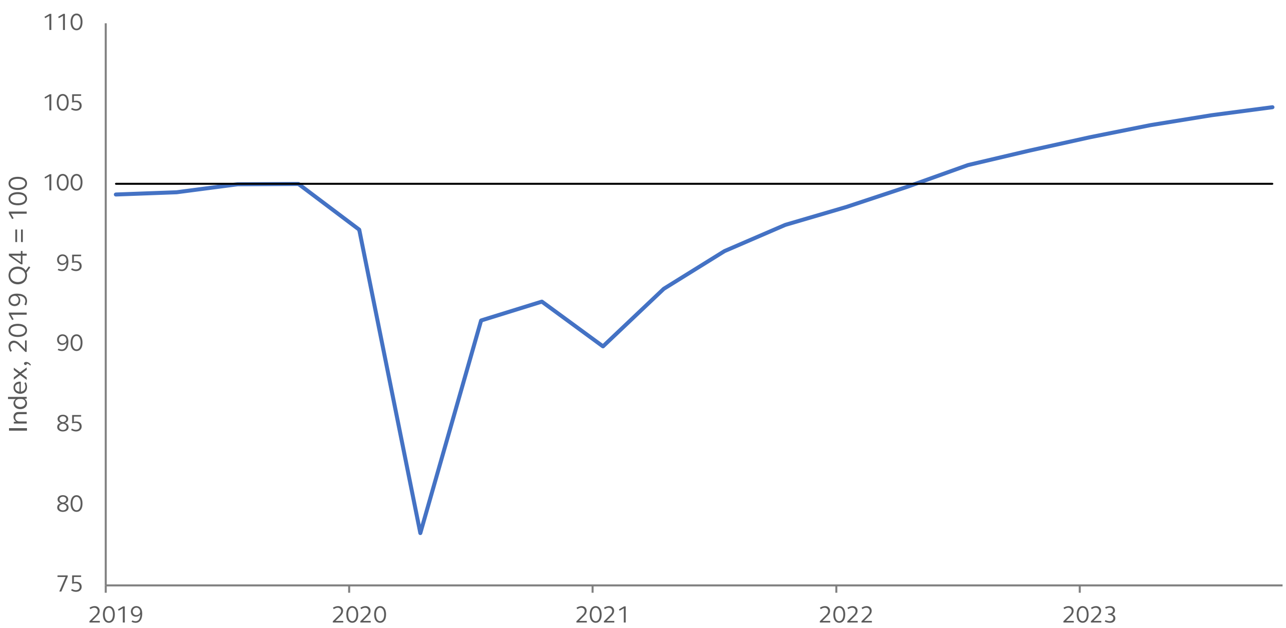
Exhibit 2: Fiscal spending in response to the COVID-19 pandemic as % of GDP



Source: Statista, Principal Real Estate, April 2021

We are therefore increasingly optimistic on the UK outlook over the next 12-18 months and expect a strong rebound as COVID-sensitive industries and consumer sectors begin to normalize. Consequently, the UK economy is forecast to return to pre-COVID levels by 2Q 2022 (Exhibit 3).

Exhibit 3: UK real GDP peak-to-recovery forecast



Source: Moodys, Principal Real Estate, April 2021

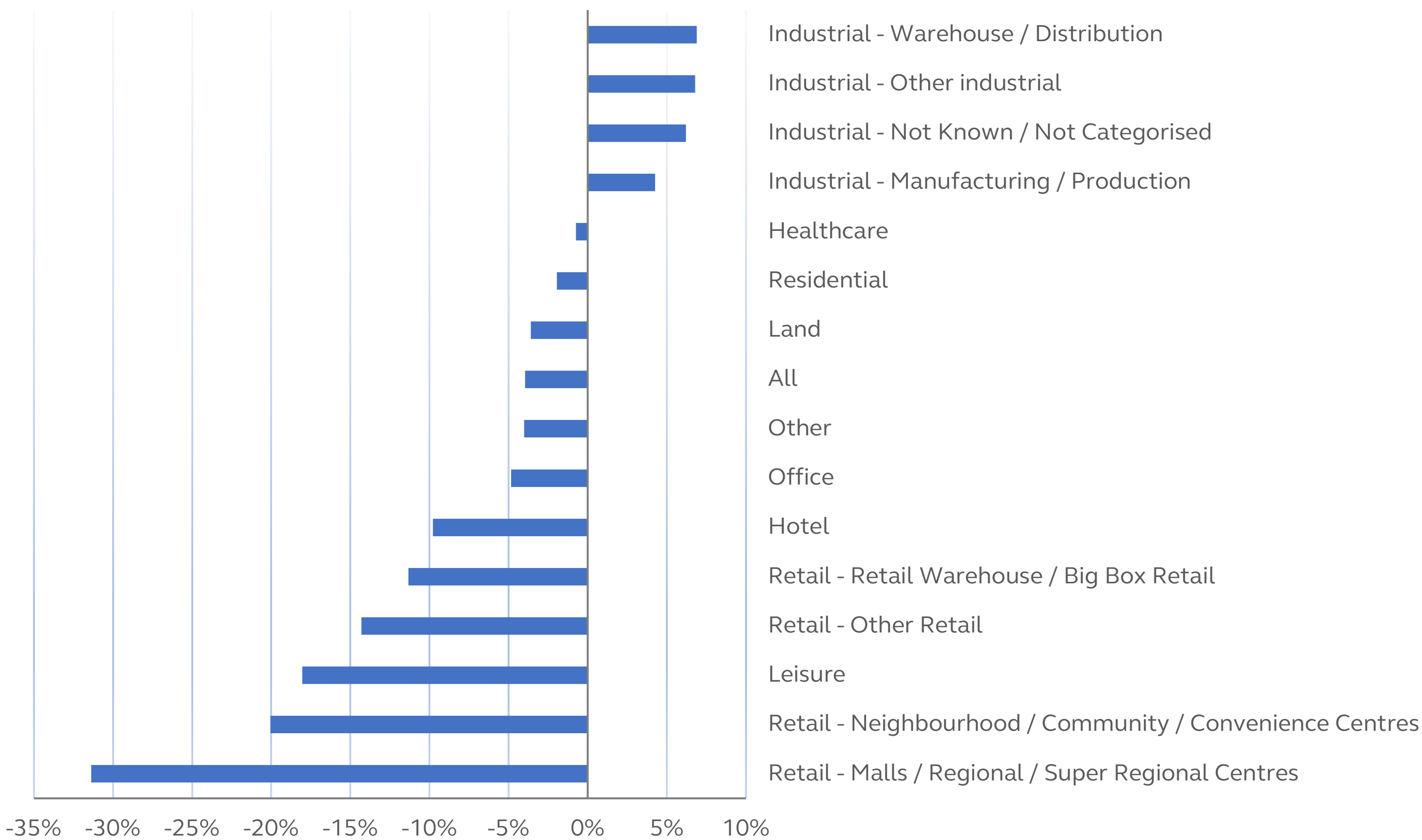
While cautiously optimistic that the tide is turning for the UK, uncertainty persists around the post-Brexit secular path to growth. While the UK managed to avoid the worst case of a WTO type outcome, the trade and cooperation agreement (TCA) that was negotiated is far from ideal since it involves material non-tariff barriers to trade and loss of market access. Businesses are likely to be disrupted leading to a drop in trade volumes from the EU dragging down GDP. Services are also most probably going to be negatively impacted as employers try and rationalize their footprint across Europe. Thus, while we are optimistic that the UK will lead Europe in its recovery path out of the COVID-19 pandemic, we are uncertain on its long-term structural path of growth.

UK property: economic recovery brings cautious hope to investors

With the UK on the cusp of a strong recovery, investors are also hoping that with it will come a brighter outlook to the property types most exposed to cyclical growth such as office and high street retail. Uncertainty over Brexit overlaid with the COVID-19 pandemic has been particularly challenging to values in the office and retail sectors (Exhibit 4). Retail shopping centers have been particularly hard hit dealing with the double blow of structural challenges of e-commerce along with pandemic-related social restrictions. Office assets in large metros dependent on mass transit, have also suffered with London particularly strained by weakness amongst occupiers. A large-scale pivot to work from home arrangements for large chunks of the white-collar workforce has raised questions around the potential scale and use of future office space.

Exhibit 4: UK property change in capital value

January 2020 – March 2021



Source: MSCI, Principal Real Estate, April 2021

*Data centers are included in “Industrial – other”, “Healthcare” includes medical centers and care homes.

However, property types with structural drivers of growth—related to demographic shifts, innovation and technology and global movement of goods (DIGITAL) have remained much more resilient. Data centers, logistics/warehouses, student housing private rental schemes (BTS/BTR), life sciences/lab space and medical offices have seen very strong take up from occupiers and investors and offer relatively attractive yields along with stronger rent growth expectations (Exhibit 5). While not clear if some of the changes are structural or deep cyclical, there is strong evidence that the growth in DIGITAL drivers has continued unabated through the pandemic. A tightening in yields in these DIGITALLY-driven property types also offers investors the possibility for build-to-core strategies to achieve attractive risk-adjusted returns as well as meet the changing requirements and ESG principles of occupiers.

Exhibit 5: UK rent growth and yield by property type

Source: Principal Real Estate, April 2021

Notes: Assumes Grade A prime and well-leased assets.
Regional office: Yield range for same Grade A product: Edinburgh, Cambridge (4.5%), Manchester, Birmingham, Bristol (4.75%), Leeds (5%).
Residential: Based on PRS which is a small part of the market though BTR homes are rapidly expanding.
Medical/senior housing: Very niche in the UK and varies on length of income and covenant. Strong covenant 4.25% NIY compared to weaker covenants at 6% plus.
Student housing: Large disparity between markets; 3.75% for prime London to 5% in Nottingham.
High street retail/malls: 6% for convenience stores, 5.5% for good retail parks, 8% for good malls. Tertiary malls are hard to price.
Warehouse: Long-term secure income London 3.5%, South-east 3.75%.

In terms of geographic exposure, London and the south-east has historically felt the most weight of capital given its density and affluence. However, a swing in political support to the Conservative government away from Labor in the north has led to a much sharper policy focus and capital allocation as well as consideration of greater autonomy to regional northern cities. "North shoring" of industries and capital is a top priority for the conservative government which should help broaden the investment universe in the years ahead. Further, the continued deepening of investment in the traditional university powerhouses of Cambridge and Oxford should benefit all real estate property types around those regions.

Conclusions: Keep DIGITAL and carry on

Our expectation is that cyclical economic growth should bring back some occupier demand in office and retail (particularly high street and shopping centers), but that potential long-term structural changes brought about by the pandemic and Brexit will take time to play out. We have much greater confidence that property types with DIGITAL drivers of demand will remain strongly sought after by occupiers and investors that will transcend the structural impact of COVID-19 and be well-positioned to take advantage of the cyclical uplift in the economy. Ensuring exposure to such property types, in our opinion, would provide the building blocks of a gainful long-term investment approach in the UK.

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