INFORMATION FOR INVESTMENT PROFESSIONALS

UK Real Estate update: key takeaways from Q1 2020 data

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John Willcock
Head of UK Real Estate

In the second of our mini-series covering UK commercial real estate, we look at the Q1 2020 data and assess what it means for our industry as it comes to terms with the impacts of Covid-19 on the wider economy. Rent collection and capital value movements have been highly variable between sectors, evidencing trends we expect to continue. Stock picking, due diligence and diversification at both asset and tenant level remain key to managing risk in real estate portfolios.

Key Q1 data

Investment transaction volume	£12.7 billion
MSCI UK Monthly Property Index income return	+1.3%
MSCI UK Monthly Property Index capital return	-2.7%
MSCI UK Monthly Property Index total return	-1.4%
Rent collection across Threadneedle real estate portfolios	65% (as at day 21)

Beyond the quarter day

The week commencing 23 March 2020 was a busy one for our market even by the standard of the preceding weeks. The government announcement confirming the UK was to enter a period of strict isolation was made immediately prior to the 25 March quarter day, with implications for valuers, occupiers and managers of real estate assets, and returns for our asset class.

Rental income

Given the proximity of the government's lockdown announcement to the quarter day, many tenants had already set up rent payments that could not be rescinded. This was to benefit from the protection offered by the government from enforcement action as a result of non-payment of the March quarter's rent. This potentially flatters the rent collection figures, which currently stand at around 65% across all our portfolios as at 21 days beyond the 25 March quarter day.

Tenants fall into one of three broad categories; those who have paid rent in full, those who have requested concessions, deferments, or monthly payments, and those who have not paid, with or without notification.

Our real estate strategies are deliberately diversified, and we manage over 5,100 tenancies on behalf of clients. Of these, we have received over 1,400 requests from occupiers for some form of rent concession or deferment. We have not adopted a 'one size fits all approach', and instead are actively engaging with our tenant base to ensure rent collection across portfolios is fair and reasonable. Where a tenant has requested a rent concession, this is assessed on a case by case basis and an appropriate response is provided following discussions between our Property, Oversight, Asset and Fund Management teams.

Indicative of the prevailing health of different industries, rent collection varied significantly between sectors, with collection from office and industrial tenants typically above 70-75%, but collection from leisure occupiers below 30%. Collection from retail tenants averaged 42%, although this falls slightly when supermarkets are excluded. Unsurprisingly, requests for rent concessions follow the inverse trend to these collection statistics.

Valuation on sentiment

Having introduced 'market uncertainty' clauses during the week commencing 16 March, the independent valuation profession then turned its attention to the imminent month- and quarter-end values.

Reflecting the market optimism evident prior to the outbreak of Covid-19, investment transaction volumes for Q1 held up remarkably well in relative terms (£12.7 billion reflects a modest year-on-year increase over the £11.3 billion for Q1 2019, although both periods are below the 5-year average). However, investment activity was almost exclusively confined to the period prior to the lockdown announcement. In the absence of meaningful transactional evidence illustrating pricing in a post-lockdown environment, valuers were forced to attribute changes to property values based on prevailing occupational and investor sentiment, while also incorporating early data on rent collection.

In the short-term, valuation based on sentiment is likely to lead to some performance measurement volatility, as valuers digest and react to events at different speeds. However, we are starting to see some (limited) evidence of post-lockdown investment transactions completing, which will provide valuers with welcome evidence required to restore certainty later in the year.

Total returns by sector

These valuation changes resulted in negative capital value growth of -2.4% and negative total returns of -2.0% for the market in March, marking the end of a run of positive total returns stretching back to July / August 2016, when returns briefly turned negative following the Brexit referendum result.

Despite being cushioned by a consistent income return of +1.3%, quarterly total returns for the market also turned negative to -1.4%, as the accelerated valuation falls in March saw negative capital value growth of -2.7% over the first quarter.

Looking across the sectors, valuation movements broadly reflected the perceived impact of, or resilience to, the lockdown, accelerating existing trends and resulting in significant variation between sectors in the Q1 returns. The industrial and office sectors recorded capital value declines of -0.8% and -1.2% respectively, contributing to total returns of 0.4% and 0.0% in those sectors.

However, the retail sector recorded capital value declines of -6.3%, contributing to total returns of -4.7%. The poor performance of the retail sector therefore continues to act as a drag on returns at a market level, though it now accounts for a diminishing proportion of the overall index composition, representing just 26.1% of the index, down from a high of 47.5% in 2012/2013.

Note: all market returns data relate to the MSCI UK Monthly Property Index, as at 31 March 2020.

Not all retail is equal

Anecdotal evidence suggests retail footfall is down some 80% at market level since the lockdown was introduced. However, within the sector, the impact has not been evenly distributed.

Retailers selling goods deemed 'essential' have remained open for business, including supermarkets and pharmacies. A number of the 'discounters', including B&M, The Range and Home Bargains, also fall into this category and have continued trading, and DIY stores remain open for 'click and collect' services. However, shopping centres and fashion parks have almost exclusively closed their doors, with obvious cash flow ramifications for those retailers deemed 'non-essential' who have been unable or unwilling to satisfy demand online.

The longer-term impact of Covid-19 on the retail sector will be determined to a large extent by how long the lockdown is imposed (at least until 7 May, with tapered reopening the most likely scenario thereafter) and how quickly consumer spending returns to pre-lockdown levels. With unemployment already increasing, and spending habits changed by necessity as a result of the lockdown, it is unlikely consumers will return to the high street in sufficient numbers to prevent more businesses following the likes of Laura Ashley or Debenhams into administration.

On a geographic basis, an extended lockdown therefore has the potential to accelerate the structural decline of poor performing centres, as retailers seek to reduce exposure to non-profit making stores. Arcadia has already announced it will not reopen all its stores once the lockdown is lifted, which is reflective of the challenges affecting this part of the market.

However, the case for major destination / experience-led centres is likely to be much more positive. Once social distancing measures are removed, it is probable that retail and leisure occupiers in key cities may evidence a surge in sales, buoyed by a combination of pent-up demand and the nation re-connecting with family members / friends.

This environment highlights the value of stock picking investments based on tenant-by-tenant due diligence, which ensures assets generate sufficient revenues for occupiers to allow them to trade profitably and continue to pay rent.

The challenge for real estate managers

The Q1 data reflects well-documented impacts on our industry as it comes to terms with the impacts of Covid-19 on the wider economy.

Rent collection and capital value movements have been highly variable between sectors, evidencing trends we expect to continue. In the short term, valuers will have little choice but to continue to value on sentiment, though this will subside when meaningful transactional volumes return, most likely in Q3 this year.

Rent collection will remain reliant on collaboration between landlords and tenants, and though this relationship has resulted in a healthy level of collection in Q1, close dialogue will be required in the lead up to the 24 June quarter day.

Our portfolios are well positioned to deal with these challenges, being underweight across those sectors most likely to suffer – leisure, shopping centres and fashion parks – and overweight to industrial and logistics. Our consistent investment approach, centred on high and sustainable income from a diversified occupier base, will continue to deliver income returns, which will support and cushion capital value volatility. And our emphasis on stock selection, supported by forensic asset and tenant due diligence, means we can capitalise on opportunities which may present themselves later in the year.