Real Estate Forecasts 2021-2025: Performance and Polarisation

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Key takeaways

Based on our current expectations for the progression of the pandemic and the associated economic and financial impacts, our central case for all property returns is 5.2% p.a. over the 2021-2025 horizon.

- Industrial is still expected to lead traditional sectors although constrained by the yield compression witnessed in the closing months of 2020, a favourable demand and supply balance has been boosted by extra ecommerce activity.
- Build to Rent Residential (BTR) is expected to lead overall.
- We expect a rapid recovery for leisure from 2022 (albeit with some permanent scarring); outperformance from offices (albeit with significant deviation therein), and underperformance from the retail sector (although we acknowledge investor interest in retail parks, we still feel risks outweigh opportunities).
- Strategically, issues of polarisation in performance will become more evident. This will apply to all sectors but especially offices. We also see a growing role for operational, turnover-linked income streams outside of the alternative sectors.
- ESG strategies will have an increasingly direct role in differentiating asset performance, managing portfolio risk and emphasising real estate's role in society post-pandemic.
- **Long income assets**, particularly those let to high quality occupiers, continue to provide resilient income returns.

Economic overview

UK GDP ended Q3 2020 around 9 ppts below its Q4 2019 level in real terms, and around 4 ppts behind major European economies.[1] Although this was partly due to the UK's measurement of GDP which penalised public service output during lockdown, it also illustrated a much sharper reduction in business investment related to Brexit.

Although a deal was agreed, business uncertainty persists. A relative lack of business investment (LGIM expect -6% in 2021 after -17% in 2020) will limit the bounce back in GDP expected for 2021 to +5.9%. Global GDP is expected to end 2021 c. 2% below its pre-pandemic trend; the UK, after an expected decline of -10% in 2020, will be somewhat behind this.

[1] EA 19, except for Spain, Source National Sources, Macrobond

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Economic performance in 2021 will be dominated by the virus and the vaccine. Vaccine progress remains encouraging. It is our estimate that society could start to normalise from Q2 and into Q3. Vaccine news has surprised to the upside so far, suggesting this time horizon could be brought forward.

Simplistically, this suggests a year of two halves for real estate with H1 still dominated by lockdowns and restrictive tiers followed by a return to more normal utilisation in H2 although, importantly, not all sectors are expected to pick up where they left off with changes to shopping patterns and office use dominating discourse.

Higher rates of unemployment (LGIM expect 6.4% in 2021 relative to 3.8% pre-pandemic) and elevated corporate delinquency will also drag the UK's recovery, but this is projected to be mitigated by an elevated savings rate driving household consumption growth to 20% year on year.[2]

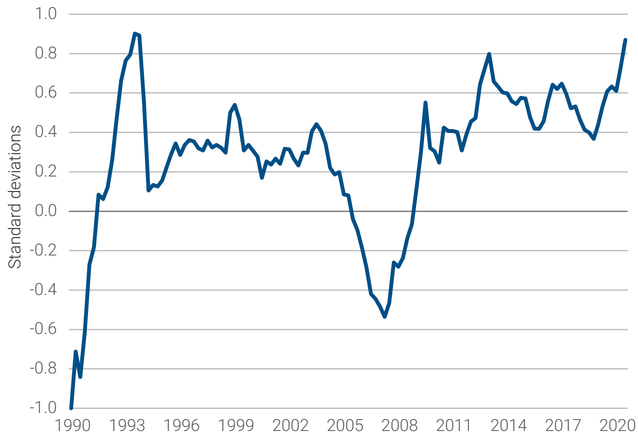
Real estate value

The 10-year gilt yield was 0.3% in mid-January 2021 with the market implied yield in five years' time just under 1.0%.[3] Low gilt yields – the risk-free rate - have emphasised the relative value of property income, a situation which has existed since the Global Financial Crisis. Although some outward movement can be expected, we expect gilt yields to remain historically low over the horizon.

Other asset classes also highlight property's theoretical yield and with the FTSE All Share dividend yield running at c. 3.26%[4] and investment grade credit spreads at 112bps,[5] property is looking increasingly good value on a relative basis.

We would emphasise that MSCI and similar statistics account for income receivable rather than income received. Remit Consulting's latest figures show a collection rate of 66% seven days after the December quarter day. Nevertheless, assuming these relative positions hold, and the vaccine is as effective as expected, we would expect the relative value case to gain traction encouraging greater capital into the sector over the course of 2021. On a longer-term view, the diminished pattern of rent collection will sharpen investors' sensitivity to the stability of income, focusing on assets and sectors with strong demand and supply fundamentals e.g. BTR and longer income solutions where the contracts and occupier quality create a bond-like income stream that is resistant to short term fluctuations in market conditions.

Composite relative value indicator 1990-2020



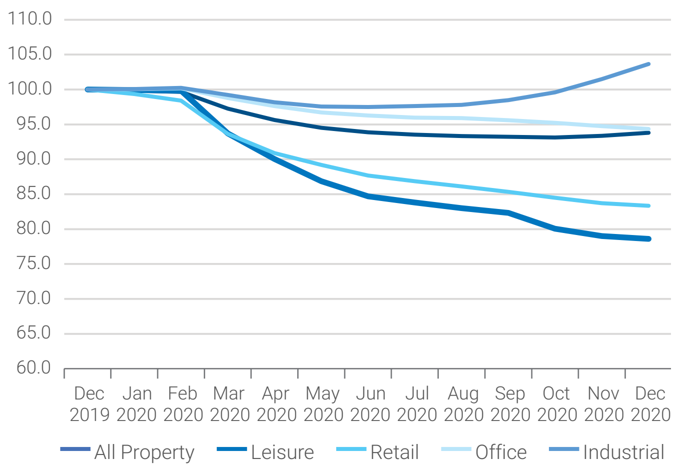
Source: CBRE, Macrobond, LGIM Real Assets

Recent performance

MSCI data from the monthly index showed a return of -0.8% over 2020 driven by industrial at 9.0% with offices returning -0.8% and retail -10.7%. Capital values were -6.0% lower over the year (+4.0%, -5.4%, and -16.8% respectively). The performance of industrial in the final quarter is of note and has significant bearing on our expectations for the forecast horizon. Capital values increased 5.5% over the final three months with growth of 8.6% in London.

We would also note leisure returns of -16.2% in 2020 with values falling -21.4%. Our views on leisure are explored in the forecasting section below.

Capital value movements over 2020, Dec 2019=100



Source: MSCI Monthly Digest, All Assets

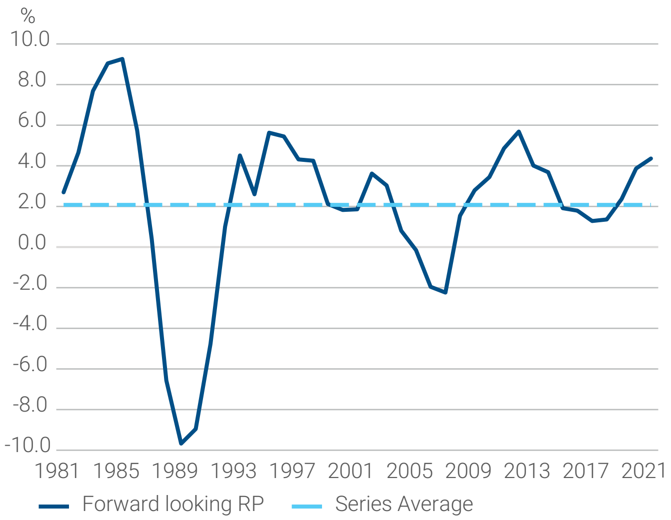
[2] Oxford Economics
[3] Bloomberg
[4] Macrobond (as at 20/01/2020)
[5] Bloomberg (as at 20/01/2020)

Forecasts 2021-2025

Key themes

The forward-looking property risk premium is calculated by taking the current property yield, adding rental growth expectations and removing the gilt yield and a depreciation assumption. It has averaged 2.1% over the last 39 years and, using our all property rental growth forecasts of 0.6% p.a., is now 3.9%, its highest level for eight years. This measure has a good (70%) correlation with subsequent returns. This would be expected given a return is, in theory, the sum of the risk premium and the risk-free rate, but the strength of this relationship using "real life" measures is encouraging and supports a positive return expectation.

Forward looking risk premium 1981-2021



Source: LGIM, Macrobond

Offices

We expect office returns of 6.0% p.a. over the horizon. Although this is in line with consensus[6] it is more bullish than many might expect given elevated concerns over office utilisation. It is our view that there will be a structural reduction in occupied stock which will increase supply and reduce the natural rate of rental growth. However, positive rental growth is still viable over the horizon (after reductions in 2021) given the economic growth expected and the reduction in the development of new stock. More detail on this view can be found **here**.

The emphasis should be on a widening deviation around this benign average. The resilience of good quality, well-managed and well-ventilated offices will be emphasised while the risks for average and poor stock will be amplified. Although we have increased our depreciation assumption, we acknowledge that there may still be downside pressure given the expense of upgrading offices to satisfy occupier requirements post-pandemic and, importantly, ESG requirements as the journey to net zero carbon accelerates.

We expect London to outperform given a relatively high starting yield and an expectation for value recovery after 2021. We remain cautious on the South East given existing supply and on office parks in general, except for science parks. We do not see views on a "hub and spoke" realignment of corporate portfolios gaining traction.

Industrial

We expect returns of 6.6% p.a. This has reduced from previous expectations given the stronger than expected end to 2020. Industrial is expected to see less yield shift over the horizon than other sectors. Investors continue to desire an overweight industrial position[7] but there is an inherent conflict in that many are tempted into disposals by the appetite of aggressive specialist purchasers and by the known liquidity offered by the sector relative to office and retail.

We see limited risk to the medium-term outlook for occupier demand. This is supported by a further structural jump in ecommerce activity[8] and consistent views concerning the modest leverage amongst the SME sector, very limited new supply risk, structural pressure on land from housing need, population growth (i.e. new delivery addresses), and the prospect of increased onshoring (will be detailed in a forthcoming report). Performance is therefore driven more by rental growth (2.1% p.a.) than yield impact.

We expect outperformance from urban logistics and south east multilet estates. Although performance is expected to be strong from distribution warehouses in the near term, over the medium term we expect some deceleration dragging average performance below the industrial benchmark.

Retail and leisure

We anticipate the structural under-performance of retail to continue, driven by further rental declines throughout our forecasting horizon. Our expected returns of 1.8% are driven by rental decline of -3.4% p.a. and although yields may end the horizon lower at the sector level this is not ubiquitous, with compression greatest in high yielding retail warehouses and broadly unchanged in shopping centres. Although survey evidence suggests valuation yields are higher than investors' target rates,[9] and there are signs of investment traction in retail parks, we remain cautious on the sector.

[6] The IPF consensus for 2021-2024 inclusive is 5.7%, or 5.8% over the equivalent horizon if one assumes 2025 is similar to 2024. IPF Consensus November 2020.
[7] PMA Survey of Investor Preference
[8] Gerald Eve expect online sales as a proportion of retail sales to settle above 25% and continue the pre-existing trend growth thereafter. This is new alpha, supporting rental expectations.
[9] PMA SIP

We see a much stronger consumer story for leisure than retail given the structural trends observed before the crisis of an increasing proportion of disposable income being spent on experiences rather than products. We see the sector enjoying a relief rally – supported by enhanced savings rates - once society normalises, albeit with some permanent scarring of the occupier base. Pricing is historically attractive relative to both all property average yields and gilts as valuations have understandably focussed on the short-term crisis rather than the sector's fundamentals. We expect average returns of 6.0% over the horizon; this includes -3.5% in 2021.

Residential and student accommodation

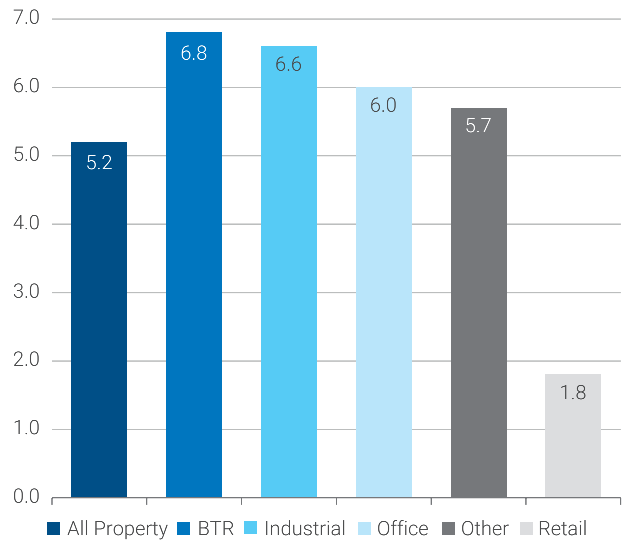
Investors continue to target an overweight position to residential, according to PMA's sentiment survey, encouraged by rental growth expectations which we estimate in the region of 3.0% in London and 2.3% p.a. in the rest of the UK. This has justified expected yield compression in 2021. Returns of 6.8% in both London and the rest of the UK are expected. There will be nuances around this, of course, with some areas within London still oversupplied relative to prevailing demand but there are sufficient undersupplied areas to continue to support performance.

We're now more optimistic on student accommodation. This view is supported by expectations for domestic student demographics: 17-18-year olds are expected to grow by 16% between 2020 and 2025, according to ONS projections. Several non-EU jurisdictions are also seeing increase in tertiary education enrolment which should result in UK demand.[10] Not all universities will benefit from this demographic support and we expect widening differentials based on quality of provision. Indeed, over the last eight years we have seen the growth in applicants for the highest tariff providers increase by over 40% compared to a reduction of almost 4% for lower tariff providers.[11] We expect average returns of 5.8%.

Overall

Our expected All Property return of 5.2% p.a. compares to 6.4% p.a. over the last five years and 9.3% over the MSCI series (39 years) but, in the context of COVID-19, is encouraging. We are close to the consensus average but there is important nuance to our views on leisure versus retail, industrial performance and in our broad outlook for offices.

Total returns 2021-2025



Source: LGIM Real Assets[13]

Outperform	
Urban logistics	Northern industrials
Build to Rent London	Trade parks
SE multilet industrials	City offices
Build to Rent non-London	

Neutral	
Distribution warehouses	Leisure
London muiltilet industrials	Student accommodation
West End offices	South East offices
Regional CBD offices	

Underperform	
Office parks	Retail parks
Retail warehouses	Unit shops
Supermarkets	Shopping centres
Care homes	

[10] UNESCO
[11] UCAS
[12] IPF consensus is 5.4% p.a. for the four year 2021-2024 or 5.6% if one assumes 2025 is similar to 2024
[13] The information /analysis above are derived from proprietary and non-proprietary sources deemed by Legal & General Investment Management (Holdings) Limited and its subsidiaries to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. Estimated or forecasted information/data presented are not a promise nor guarantee of future events and are subject to change.

Implications, summary and outlook

Based on the preceding sections, we would highlight the following investment implications:.

Investor flows: We would expect increased capital flows to property over 2021 supported by the relative value case. This is likely to coincide with investor confidence in improvements to rent collection later in the year and as such there will continue to be liquidity challenges for some in the near term. This capital will not target indiscriminately and this will increase polarisation. We would also expect capital to continue to target longer income property due to its ability to insulate against short term fluctuations.

Polarisation: Polarisation will increase significantly and structurally in offices as occupiers increasingly select well managed and well specified offices. Further polarisation is also expected in retail. Investors who can navigate this – and risk mitigants are reasonably well understood - will outperform. We expect a much greater standard deviation in performance.

ESG and H&WB: Environmental, Social and Governance strategies will be enhanced as a depreciation mitigant as well as a channel to communicate the role of real estate in society. Matters of Health and Wellbeing will also be amplified, especially scrutiny on air quality, ventilation and humidity which have provable links to virus transmission. Pressure will come from employees as much as employers and investors will need to respond and fully understand the science.

Depreciation: The above factors will accelerate depreciation, particularly in offices. This will be further exacerbated by funds moving more quickly towards net zero carbon targets.

Operational: COVID-19 has accelerated and accentuated the need to diversify income streams and embrace operational risk. Operational styles are quickly moving beyond alternative property types and into retail and offices, as investors are increasingly willing to disintermediate flexible office providers. Specifically, LGIM Real Assets is working with retail occupiers on new models which allow for a greater partnership. Whilst this means reducing the protection of the lease, we are convictional that increased owner control, risk sharing, and lease flexibility is required to deliver a relevant offer.

We regard it as an inevitable consequence of structural changes accelerated by COVID-19 and some investors will need to embrace different approaches and skillsets to underwrite investment.

Contact us

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