For investment professionals only

UK Real Estate View - the impact of Covid-19

LGIM Real Assets, May 2020

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Rob leads the Research & ESG teams and our approach to strategy as it relates to both real estate and private credit. Rob ensures that market intelligence, ESG and long-term trends are fully integrated into fund strategy and individual investment decisions.

Key takeaways

- Unprecedented circumstances mean high uncertainty
- Economic outlook shaped by Covid-19 progression and second round effects on economy
- UK all property MSCI index returns expected to average low/mid-single digits over the course of 2020-24[1]
- Prior structural challenges for non-food retail and poor quality suburban offices have been magnified by Covid-19
- CBD offices, industrial and logistics expected to feel GDP slowdown but structural effects more muted
- Leisure, hospitality and student accommodation facing severe issues in the short-term but believed to have good long-term prospects
- Build-to-Rent residential demonstrating resilient profile
- We expect opportunities to emerge as a result of Covid-19, both within the residential sector and more widely where short-term valuation declines over-compensate for long-term risk
- Progress to achieve ambitious ESG outcomes must be maintained
- Situation is providing opportunity to forge closer relationships with occupiers

Economic environment

LGIM is using three economic scenarios for global growth in the remainder of this year and into 2021 to structure its thinking for asset markets.

Scenario 1

Strong rebound in the second half of 2020, and return to normal by the end of 2021. The huge policy response acts as a bridge to limit the damage to incomes during the shutdowns and then further fiscal stimulus is deployed to turbo charge the recovery.

Scenario 2

Recovery but some permanent loss of output. Growth continues to be impaired as precautionary saving rises to repair balance sheets, and some of the support programmes run-off before demand has normalised.

Scenario 3

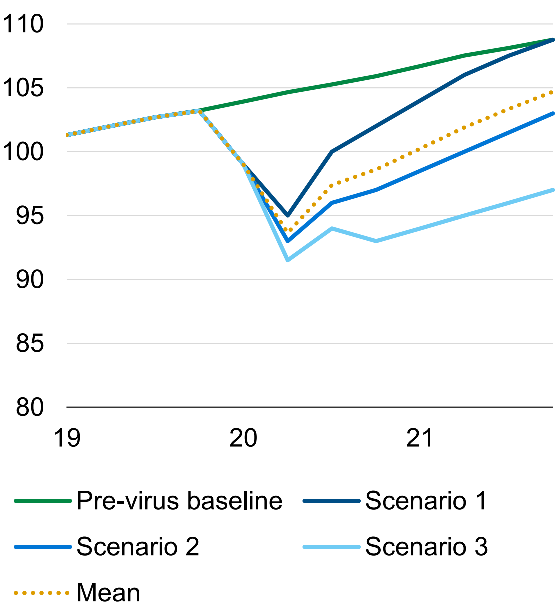
Restrictions are lifted more slowly than in the first two scenarios, but the virus flares up again, forcing renewed heavy restrictions and a double-dip recession.

[1]The forecasts are not a reliable indicator of future performance.

Legal & General
INVESTMENT MANAGEMENT

The degree of monetary and fiscal support provided to markets has in LGIM's view reduced the probability of Scenario 3 to a low level. Our current view is that the most likely path is somewhere between the first two scenarios. We believe the key factors in driving the outcome will be the progression of the virus itself, the transmission from immediately impacted sectors into the wider economy and the lasting damage to output.

Level of global GDP scenarios



Source: Legal & General Investment Management

Real estate market scenarios

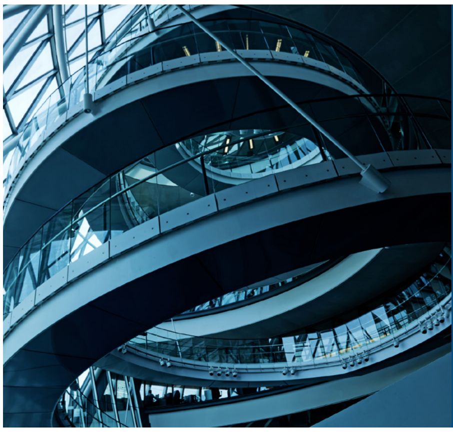
We have drawn on several perspectives to give a view on the potential impact on capital values out to the end of 2021;

- REIT and credit prices imply an immediate 5-10% drop in capital values. We would view that as indicative of **scenario 1** for the economy and would expect medium-term returns (2020-24) to remain in the single mid digits

- We have also drawn on prior experience of market volatility. The late 1980's boom/bust and the GFC led to 40-50% declines in value in real terms. We would see those outcomes as indicative of **scenario 3** - the persistent slump

- For **scenario 2**, we could expect a valuation decline for the market as a whole in the order of 15-20%. This would be a substantially worse decline than that seen for the Euro crisis in 2010-2013, reflecting the more severe impact on UK economic activity in the short term and resulting in total returns for the period 2020-24 averaging in the low single digits

We are increasingly thinking in terms of phases to the market progression from here. Whilst we have attached some indicative timing, these are of course dependent on the progression of the virus itself;



1st Phase
Lockdown

Stringent social distancing, closure of non-essential shops / leisure and comprehensive remote working

Indicative timing
Mar/Jun 2020

2nd Phase
Partial lockdown

Some improvement in mobility, continuation of mitigation measures, potential contagion resurgence / reimposition of stricter lockdown

Indicative timing
Mid-20 to End-21

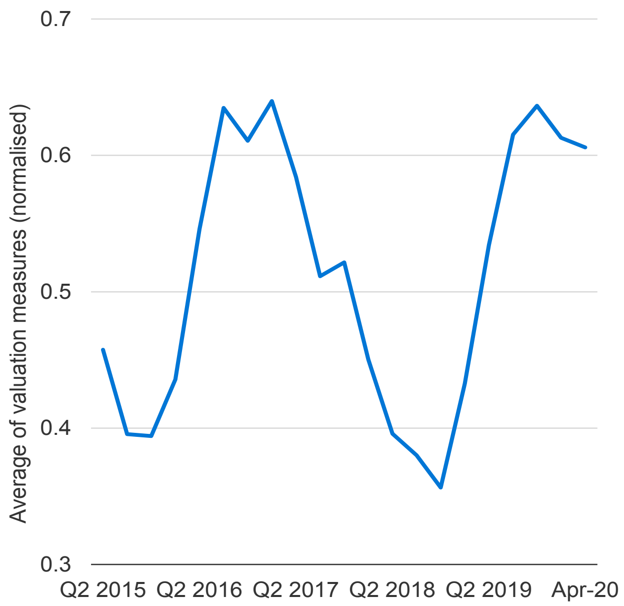
3rd Phase
Resolution

Covid-19 is 'beaten', vaccine or herd immunity is achieved and the world discovers the enduring effects of the crisis

Indicative timing
Post 2021

One of the supports we see for returns is the relative value position for the asset class. With fixed income rates so low, even with modest expectations for rents, the risk premium for the asset class remains around average levels. The income arbitrage to debt is very wide by historic standards. In what is such an uncertain environment for investing into companies, either through equity and debt, real estate still merits a place in portfolios.

Composite relative value measure



Source: CBRE, Thomson Reuters Datastream, LGIM calculations, April 2020.

Winners & losers

Whilst it may feel that this crisis has been with us for a long time, we are still very early in the process of how it will play out into the months and years to come. These are our early thoughts on how the short and long-term dynamics will play for different elements of the real estate universe. We are seeing four categories emerge as we explore the shape of the market in future;

1. **Structurally challenged** areas where Covid-19 has magnified the headwinds. **Non-food retail** was already dealing with a range of pressures – Covid-19 has contributed to driving more sales online and increased the financial pressure on occupiers.

2. There is a group of sectors seeing **severe impacts in the short term but where we see good long-term prospects, specifically leisure and hospitality**. Restrictions on trading are leading most operators to shut down most if not all of their operations. However, we see enduring demand for leisure in the broadest sense, supported by a basic necessity for physical presence, and are working with occupiers to help them manage through to recovery. **Student accommodation** will be challenged by disruption to overseas travel and the A-level process for academic year 2020-21 but the demand for higher education, and the UK's relative strength as a provider, should see the position improve significantly over time.

3. **City centre offices, multi-let industrials and logistics** may be affected by the GDP slowdown. However, we would see Covid-19 as accelerating existing trends rather than introducing a completely new dynamic into the mix over the longer-term. Whilst the forced move to remote working is driving a rapid adoption of agile working patterns, this is likely to lead to a more intentional approach to office space rather than a death-knell. The multi-let industrial segment remains supported by a lack of new supply and logistics asset will see the negative GDP impact partially offset by an increased need for deliveries.

4. **Build to Rent residential** is demonstrating the resilient profile expected. Although new letting enquiries have fallen and some tenants are exercising breaks, occupancy and rent collection remain very high. We would expect performance relative to other sectors to be robust.

Beyond Covid-19

We must deal with the here and now of Covid-19. But we must also keep a focus on the long-term and the world after Covid-19. This is a difficult task which is fraught with uncertainty, but one which will underpin future long-term performance of property portfolios.

We see an opportunity to use this time to forge a different style of relationship between asset owners and occupiers. If it hadn't already been clear, this must spell the end of the traditional 'I win / you lose' dynamic in favour of a partnership approach that stresses mutual success. Our new operating model aims to introduce better feedback loops into the landlord/tenant relationship and we have seen the benefit of this model during the last few weeks as close relationships and a partnership approach has been key.

The spotlight on ESG appears to be brighter than ever – the climate emergency is still with us and the short-term positive impact of reduced travel and consumption has been widely commentated on. The blogosphere is alive with debate over whether the crisis will accelerate or derail the transition to a low carbon economy. We are clear – it cannot be allowed to derail the transition.

At LGIM, we continue to evolve our ESG processes in order to meet our commitment to achieve net zero carbon across our portfolio by 2050, aligned to the climate objectives set out in the Paris agreement. It is often poorly understood how tough the challenge to meet net zero is; achieving it will require ambition and innovation throughout the whole real estate sector.

At the same time, we are now measuring the social impact of the assets we manage, which is consistent with the wider LGIM concept of inclusive capitalism. The Covid-19 crisis is having serious economic impacts on particular groups, often those least well-placed to weather them, and the work we are doing to measure social value will allow us to see the social implications of the assets we manage, thus enabling us to implement improvement measures.

The current crisis has encouraged individuals, companies, NGOs and government to rethink how they operate in response to a severe, immediate threat. The challenge for us as custodians of real estate is to hold on to that sense of urgency as we move beyond Covid-19 and into the long-term task of achieving a sustainable balance across environment, society and financial return.

Contact us

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