An update on the UK property markets

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Presenter

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Alan is the Director of Business Development & Strategy, and Head of Fund Management in Funding Partners. He is a Fellow of the Royal Institution of Chartered Surveyors and holds a masters degree in Property Development (Project Management).

Alan has worked in the property industry for the whole of his working life. His experience in CBRE (formerly Hillier parker) was as a fund manager, then financial services and latterly as the Head of Investment Research. He gained experience of the equities markets as a director at Panmure Gordon and HSBC Investment Bank, before joining UBS Asset Management where he combined being Head of Fund of Funds, head of UK real estate research with equities management. He joined AXA Investment Managers, where he became Global Head of Research and Strategy in what is now the Real Assets group. He was also the managing director and Head of Research and Strategy at Gingko Tree, the European real estate subsidiary of the People's Bank of China.

Alan's skill base is as a property market economist and analytical researcher, believing that understanding macro trends and secular change is as important as stock selection and asset management.

Brexit/trade deal and real estate

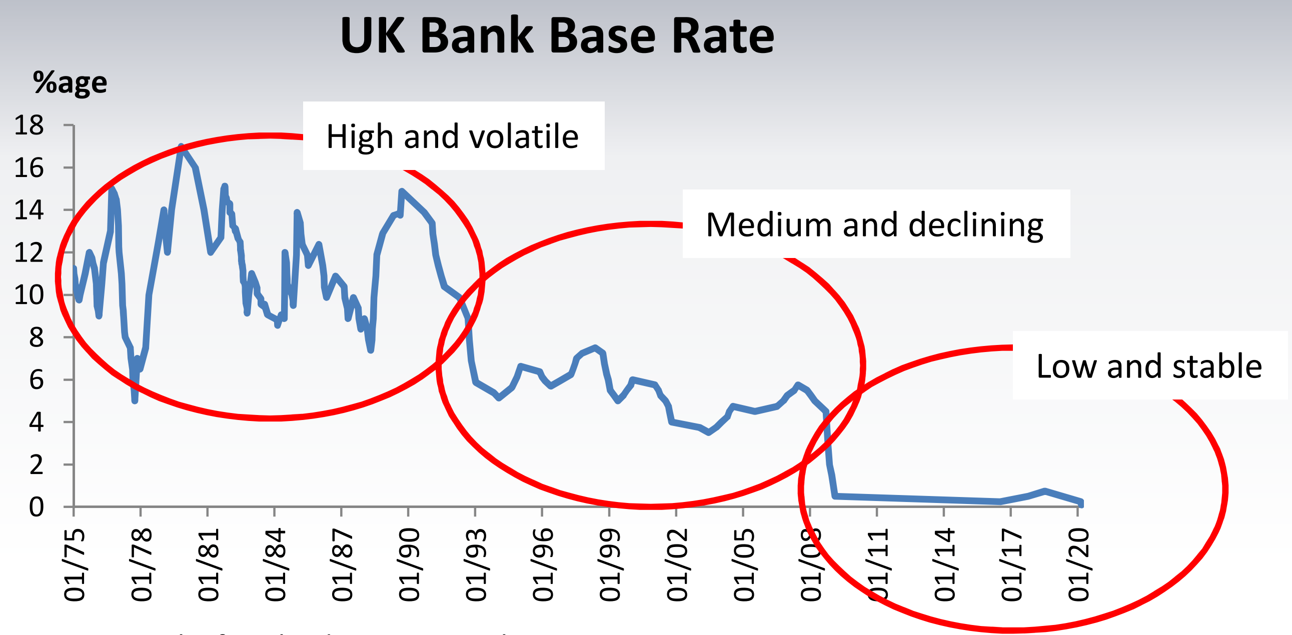
Construction

- In terms of the supply-side of real estate, its most important defensive characteristic is that it is **not subject to foreign competition**
- **However, the primary market is very dependent on foreign supplies**
    - Much of the materials are imported, such as windows, timber, wire,
        - About 60% of imports come from the EU
    - 45% of labour in London comes from foreign workers (of which 27% points is from EU)
- In negotiations, construction is categorised by the UK government as one of the **low priority areas**

House prices

- At the time of the Brexit vote, the BoE forecast that in a '**disruptive scenario**' (tariffs and other barriers to trade between the UK and EU are introduced suddenly), it would expect GDP to fall by 3%, **house prices to fall by 14%**, and inflation to rise by 4.25%
- It would also expect the pound to weaken (which it has)

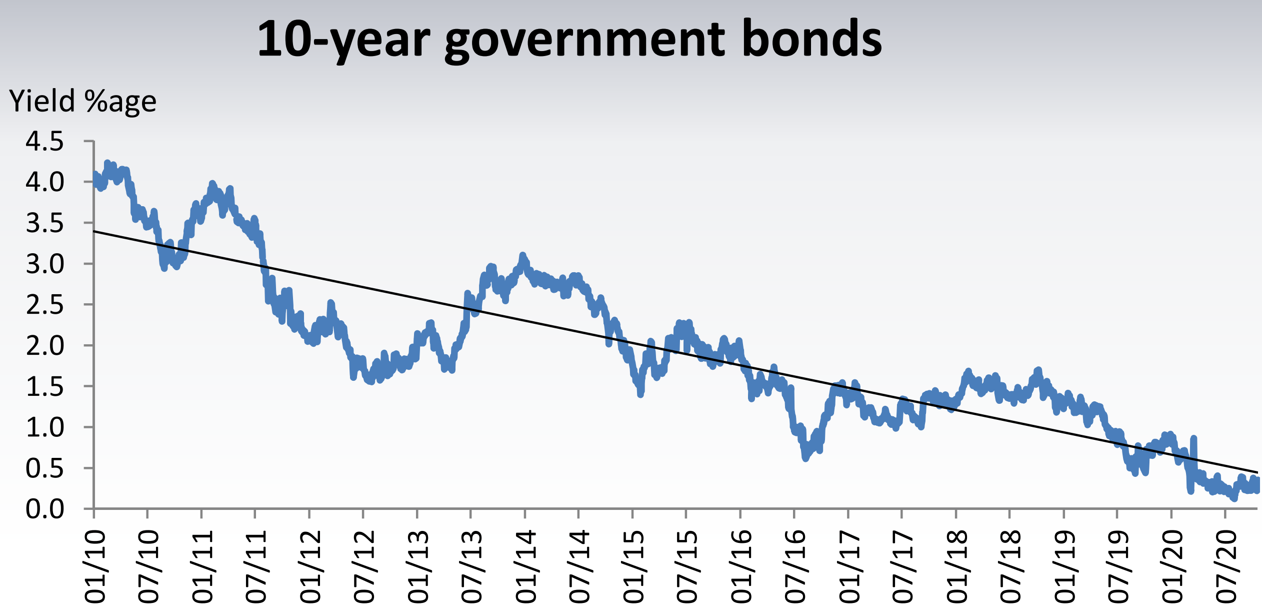
Interest rates – short term



Source: Bank of England; VARE Consulting

- At 0.1%, the base rate is the lowest in history
  - **The BoE is 'testing the market' for negative rates**
    - **This could have serious ramifications for the economy**

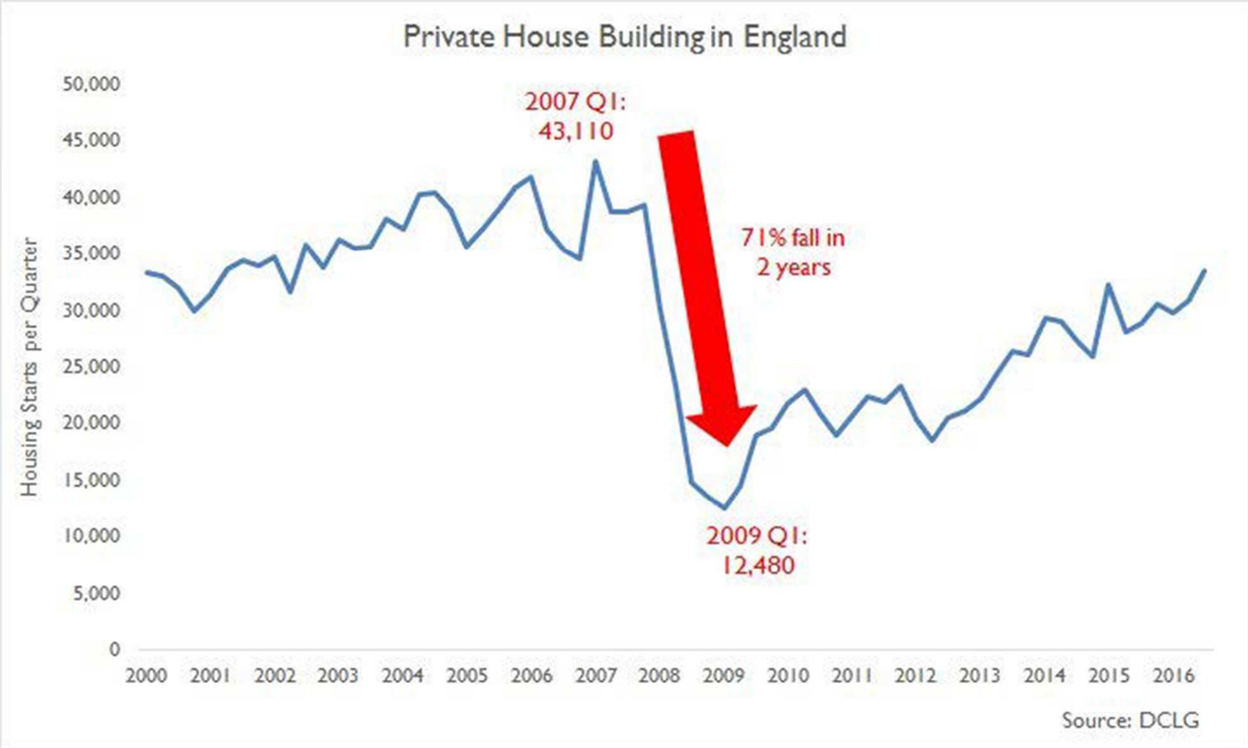
Interest rates



Source: Bank of England; VARE Consulting

- For the last two decades, bond yields have been falling, caused by
    - Reducing bank rates
    - Reducing inflation risk
    - **A retreat to safety**
    - In the last decade, ‘quantitative easing’
- But yields are not yet negative in the UK

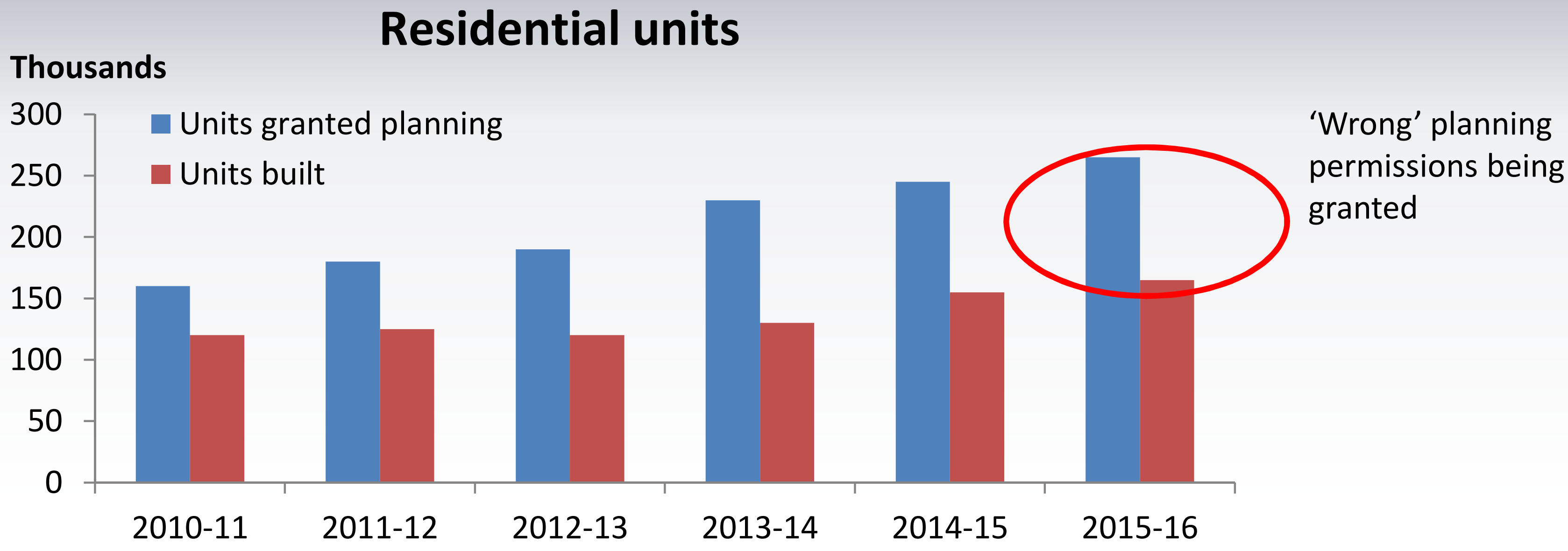
Residential supply (1)



- Although the government estimates that the UK ‘needs’ 300,000 houses pa, this is a **mathematical calculation** to meet household formation and growth

- The **real need – economic demand – is based on affordability**
    - In turn affordability depends on savings for deposit (capital) and mortgage availability (earnings)
    - With the cost of mortgages declining over the last 10 years, the regulator (BoE) has greater restrictions on mortgage provision

Residential supply (2)



Source: ONS; VARE Consulting

- If it is argued that houses cost too much to purchase, then it might be argued that this is due to supply-side restriction – maybe land availability
- One of the paradoxes is that many **more planning consents are granted than units built**
  - Some argue that there is an **artificial restriction by housebuilders**
  - I would argue that the **difference represents the 'unviable' schemes**

Commercial supply

- **Housebuilding is a volume business**, whereas commercial building development is a very focussed business
- Like house-building, it is **strongly correlated with the economic cycle**
  - But commercial property building is even riskier than housebuilding and this limits development capacity
  - The **volume of commercial building has declined over the years**, because physical demand (same as economic demand) has largely become satiated
    - Productivity improvements that are not attributable to the workers but to improved technology mean works become less important/valuable and fewer are required
- Again, this is a demand-driven market
  - But the **demand is pivoting towards the high value-add worker** – those who need to be in the office
  - The poor performance expected from commercial property (which I have discussed in another presentation) may, however, be **stimulating new supply to achieve extra 'alpha'** (a misinterpretation of alpha) **by building more**
    - **Expect increasing depreciation**

Economic growth

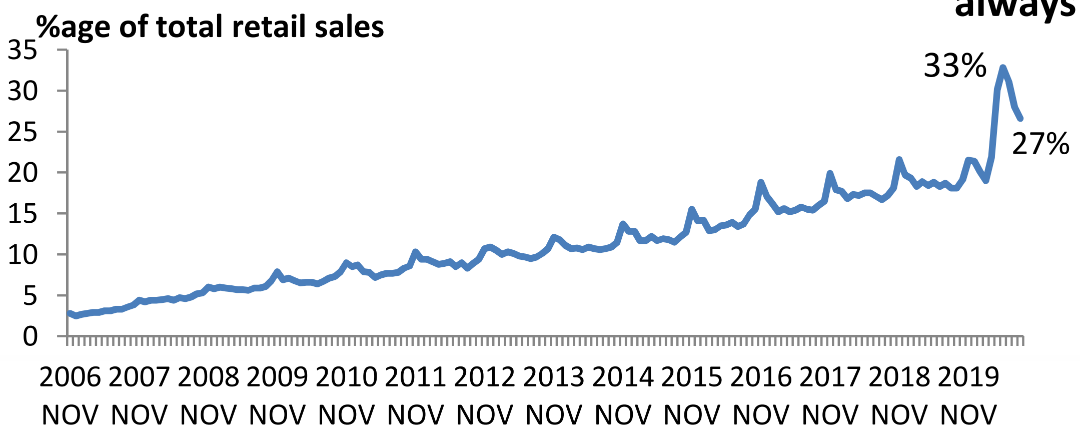
Source: ONS; VARE Consulting

- The recovery continues, although the latest data is from August before the 'second wave' (and the consequent new restrictions)
  - **The previous forecasts for this year and 2021 are likely to be optimistic**
  - **A second dip is looking likely: it is possible that this could be a depression**
- **Unemployment** was at **3.9% in January** (source: ONS), and the BoE is forecasting **7.5% (2.5m unemployed) by the end of 2020**, with the **independent forecasters having 6.6%**

Commercial real estate demand - retail

- The case for the decline in high street and shopping centre retail has been well rehearsed, so I will not go this in much detail but
  - This is competition problem and a space over-supply problem
    - At an **individual retailer level, reducing rents is a way of significantly cutting costs** and improving profitability
    - But at a **sector level, this only increases competition and lowers prices**: it does nothing to reduce supply of retail space
      - Even **reducing rents to zero will not solve the problem**
        - **Distributing from warehouses is almost always cheaper than from shops**

Online retail sales



Source: ONS; VARE Consulting

- **The solution lies in reducing the supply**
  - **Demolition**
  - **Repurposing**

The future for retail

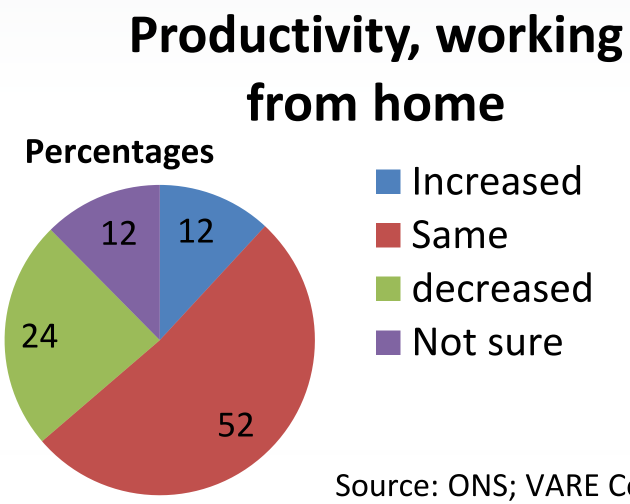
- For the last five years, the **property industry has been in denial** about retail capital values
  - Retail investments amounts to around 40% of the total commercial market
  - Valuers were reluctant to reduce values even as liquidity was reducing
- In the early stages of decline, there was sense this was a **secondary (poorer-quality) stock problem**
  - **Prime locations**, occupied by the multiples would be unaffected – even though the circularity of this argument was largely ignored
  - Multiple store operators' coverage requirement fell from, say 700 towns to cover the UK to less than 200
- Now the problems are spread throughout the whole of the sector
  - **Multiples no longer have to compete** for the best locations
  - **Retailers can dictate rents**
  - **Covenant strength from multiples has significantly declined**
- The future is now skewed towards
  - **Services** as opposed to goods (but clearly not in the short-term
  - **Convenience**
  - **Independent retailers**

Commercial real estate demand - offices

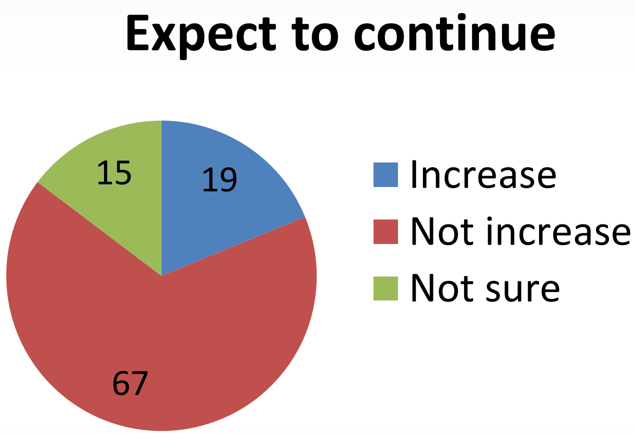
- The case for the demise of the office has been discussed for decades – BT introduced hot desking about **30 years' ago**
  - But it is only in the **last decade that it has grained some traction**
  - It has become particularly pertinent in the COVD-19 period
- Hot desking typically **reduces space requirements by 20%**
- To that you can add – although there is an overlap – space released by working from home
  - HR departments were seeking more of this to 'help attract staff' – **not for more efficient working**
  - This **will release amounts** of (particularly lower-value) offices in city centres, which will be obsolete
  - Some of this **may be re-utilised** for alternative uses, such as residential, although such conversions are not easy, typically end up with sub-standard housing, and may lack proper amenities

The future for offices

- In April 2020, **47% of workers** (London 57%) did some work at home
  - Of those, 86% did so as a result of the pandemic
- Occupations **requiring higher qualifications and more experience** were more likely to provide homeworking opportunities than elementary and manual occupations
  - Least likely to continue: accommodation and food services, real estate, construction, arts, manufacturing



Source: ONS; VARE Consulting



Source: ONS; VARE Consulting

The future for residential

- **More than half of the global population live in cities** and, prior to the virus, this was continuing to increase: **from 55% in 2018** to a projected 68% in 2050 (with a world population growth 2.5bn people by then)
    - Governments, including that of the UK, has **encouraged this process**, citing efficiency of providing services, particularly transport
    - The attraction to residents is the **availability of work and shared facilities**: restaurants, art, schools, which means that the home is of lesser importance
        - The pandemic has changed that to an extent, but only for those who can afford to alter their lifestyle
            - In the longer-term, the WFH expectation is really only marginally available to **professionals, managers, etc**, but **they will want bigger houses further out**
            - **Renters** should take advantage of it in the short-term but cannot in the long-term – **'buy to let' buyers could be making a mistake**
            - The housing stock remains unchanged, so this is a **re-allocation of value, not of numbers of residents. To some extent, that will adjust back**

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Sources

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