Property Sector Review

The reaction of the sector to the COVID pandemic was understandably one of substantial caution, as participants reflected on a challenge which was unfamiliar, but which could have a deep and lasting impact on the sector. At the heart of a range of challenges was the impracticalities of lock down and restrictions on mobility and was manifested in two related ways; transaction volumes fell sharply, to barely a quarter of previous norms, and, in a defensive move, valuers marked down estimates of capital values. This was followed by warnings that valuation accuracy was uncertain, a development that led to the suspension of trading in sector funds until pricing clarity was restored in the early weeks of the autumn. Behind the headlines within the sector established trends continued. Areas of pre-existing weakness such as shops and shopping centres declined faster, a reflection of the increased threat from lock-down to rents and tenant viability. In contrast, winners emerged and demand for industrial assets, in particular distribution facilities, continued at a high level as shopping patterns were changing combined with a basic shortage of good quality supply.

The conditions also created a series of new challenges for fund managers, the first of which related to income. Most tenants had suffered a loss of cash flow and for some the loss had been both sudden and near total. Once again retail suffered badly, as did the hotel sector. Industrial assets were less impacted and indeed some areas actually saw activity increase. The impact on offices was more mixed and it became clear that staff working from home helped protect business revenues and so the ability to meet rent obligations. A past focus on strong tenants and strong tenant relationships proved helpful for rent collection, as did a sympathetic approach to those experiencing difficulty. Inevitably there was a small number of ‘ can’t pays’ and some ‘ won’t pays’ too, as businesses open for trading chose to use the government’s temporary tenant protection regulations to withhold payments.

As the economy showed improved signs of stability so did the sector. Transaction volumes rose back near to historic averages and valuations overall stabilised. Trends at the sub-sector level however remained distinct. Rents in the retail sector continued to fall and this was mirrored in further declines in capital values. The sub-sector currently has a void rate of just 6% compared with 9% for the industry as a whole, but the real risk is tenanted outlets currently closed by lock-down simply do not reopen. A problem for the sector has been the homogeneity of high streets and domination of retail space by a small number of large companies. Failures and closures by this group have been reflected in communities across the country. Almost all the retail sector remained firmly under a cloud but there was one area of improvement as a recovery began for retail warehouses, reflecting the resilience of bulk goods and discount sales, to both the impact of lock-down and the threat of online competition. Offices have come more into focus on concerns that flexible working practices which had become commonplace during the year would lead to a permanent decline in demand for space. There was no significant impact on values and rents but there was a defensive increase in sector yields to reflect the uncertainty.

Looking forward, the trends which have dominated the sector over the past year will remain the principal influences on returns in the near term. Realistically values for shops, on the high street and in shopping centres, can't be expected to stabilise until lock down ends and the longer-term effects on the sector are understood. Yields on industrial assets have fallen to levels from which capital progress will be more difficult, but demand for good quality properties in strong locations will continue. The main area of uncertainty concerns offices. It seems clear that space requirements will change, but for the time being less obvious that they will fall. Our expectation is that prime offices will remain supported, with those in poor condition or poor locations most exposed to changes in demand. In terms of likely returns we are expecting a positive outcome in 2021, supported by the sector's exceptional income yield. We anticipate more in 2022, when higher capital values are expected to make a more substantial contribution. Asset allocation will be a key source of return, whilst in a changing market, active management will support both capital and income returns.

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