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Looking Forward to Recovery in UK Property

Joanna Turner, Head of Property Research at Canada Life Asset Management, discusses the future of UK commercial property and the importance of getting the basics right with a well-balanced core-plus portfolio.

The arrival of COVID-19 triggered extreme market conditions for UK commercial property investors as transactional activity evaporated and many questioned the future of entire sectors of the UK economy. With even highly liquid markets such as US Treasuries struggling at times, it was inevitable that illiquid investments such as property would be badly hit.

With the worst now behind us and offices, shops and the hospitality sector reopening cautiously, it is worth reflecting that lockdown served as a reminder of some fundamental aspects of property investing.

Commercial property is by nature a long-term investment in which the bulk of returns are provided by core holdings that provide income streams and (hopefully) capital growth over the longer term. Getting the core elements of the portfolio right depends firstly on thorough research to develop long-term views of which economic sectors and locations are likely to offer good returns, and how ESG will transform UK property. Once acquired, assets must be managed efficiently to maximise returns.

Often overlooked, the role of asset management in developing good relationships with tenants can make a significant contribution to overall returns by reducing voids, optimising rent collection and identifying ways in which buildings can be developed to cater to tenants' requirements. During lockdown, for example, our asset management team's close engagement with tenants enabled us to agree flexible rent terms where needed.

Perhaps the most immediate lesson of COVID-19 and lockdown has been the importance of holding a well-diversified and resilient portfolio. While All Property total returns in the MSCI UK Quarterly Index fell by -1.3% quarter-on-quarter in Q1 2020, this masked wide divergences in performance between and within property sectors. The retail, leisure and hospitality sectors were the hardest hit by enforced store and business closures, while the office and industrial sectors were more resilient, supported largely by home working and a sharp rise in e-commerce demand.

Looking under the bonnet of the retail sector, the worst performing segment was shopping centres, with a quarterly return in the first quarter of 2020 of -9.1%, compared to the retail sector average of -4.6%. Supermarkets were one of the most resilient segments, producing a meagre but welcome 1% return.

Few can claim to foresee specific extraordinary events such as the COVID-19 pandemic, but one thing we can do is to ensure that portfolios are suitably diversified to ensure a good degree of resilience.

Time to reimagine the office

Much has been written about how COVID has accelerated change, for example through proving the viability of mass home-working. We believe that some aspects of the UK property market will inevitably evolve in response to the social and economic changes caused by COVID, but it is easy to overestimate the degree and speed of change while we are still in the throes of the pandemic.

It is, for example, too early to write the obituary for UK offices, which will continue to be a central, and growing feature of the LF Canlife UK Property ACS portfolio. In a post-COVID world, prime Grade A offices occupying central locations and boasting enhanced sustainability and wellbeing features will be highly valued by investors and occupiers.

Surveys suggest that more people will take the opportunity to work from home after the pandemic, but offices will continue to be the key place for employees to meet, collaborate and generate new ideas. The office now has a competitor in the form of the home – or at least the study, back bedroom, garden office or kitchen table.

With fewer people working in offices for a full five-day week, supply of office space could exceed demand over the long term, especially in secondary office locations. In the short to medium term, limited supply of office space in prime locations, combined with pent-up occupier demand and the need for more workspace per employee due to COVID-related social distancing requirements, will mitigate the impact.

Offices must raise their game though and, rather than focusing on basic workspace provision, we are likely to see more generous open spaces, enhanced areas for meetings, videoconferencing facilities and additional services enabled by technology.

This is likely to result in a more personalised occupier experience with better ventilation and natural lighting, and a focus on health, safety and wellbeing features in order to enhance productivity and increase tenant satisfaction and retention. Landlords will therefore need to have the asset management capabilities to provide occupiers with flexibility in how they use office space, requiring a high level of engagement with tenants and end-users.

Younger workers in particular may prefer to work in central locations, close to areas where they can socialise. They are also less likely to have suitable space at home in which to work. To continue to attract younger, talented people, employers will need to provide centrally-based offices that cater to the needs of this demographic.

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Polarised markets

We fully expect offices to be a key part of a well-diversified portfolio for some time to come. That said, investing successfully in the sector will depend on identifying suitable locations for long-term holdings, together with the ability to deploy asset management to meet tenants' evolving expectations.

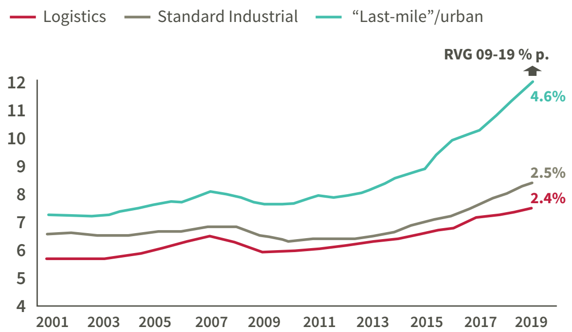
The LF Canlife UK Property ACS uses the office sector to provide exposure to multiple areas of the economy, with a bias towards London and South East office markets, where more than 40% of UK GDP is generated and almost 15% of the UK working population live. We also favour offices in 'knowledge centres', major cities that have strong links to universities and world-class science and research institutes, as these are dynamic areas with high employment, growth and innovation.

One area where we are seeing swift change that has been accelerated by the pandemic is in online and mobile retailing. Customers increasingly expect next-day and even same-day delivery, which is in turn creating demand for more 'last mile' delivery centres in urban locations, and fuelling rental growth in this property segment. In recent weeks, some supermarkets have even announced that they are considering repurposing larger stores in high-density urban areas as last mile logistics centres.

Alongside the cutting-edge world of e-commerce, we have also witnessed the unlikely revival of the local convenience store. Once considered an endangered species, in the hands of major supermarket chains smaller convenience stores have become a major success and this has been amplified by the pandemic as consumers have developed the habit of combining online food shopping with top-ups at local stores.

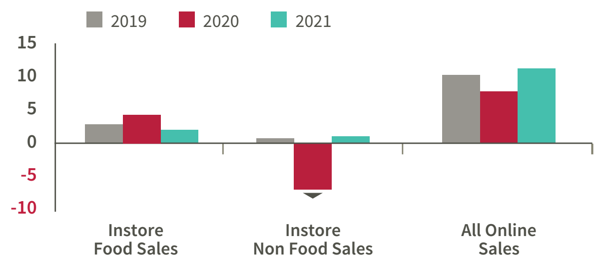
In stark contrast to this, lockdown accelerated the decline in discretionary non-food retail in physical stores. Enforced store closures triggered an explosion in consumer online shopping that has placed huge pressure on physical retailers' profit margins, in turn accelerating a decline in rental and capital values. We therefore have a highly polarised retail market in which it is sensible to tread warily around shopping centres, weaker out-of-town retail parks and fashion-based high street stores, in favour of select resilient supermarkets and local convenience formats.

Prime logistics vs standard vs urban industrial rents, £psf



Source: PMA

Retailer sales value growth (% p.a.)



Source: ONS, PMA (Recession scenario, Spring 2020)

A window of opportunity

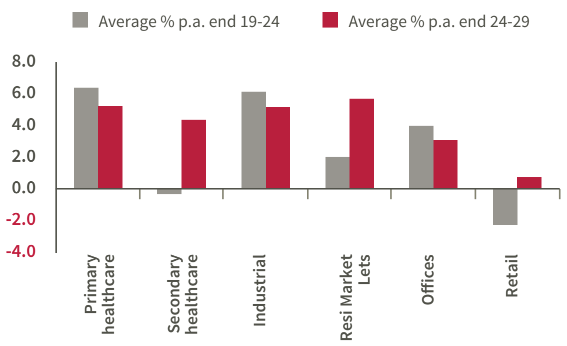
There is still a great deal of uncertainty ahead for the UK economy. Much depends on the speed of economic recovery, Brexit negotiations, the availability of COVID-19 vaccines, and the willingness of consumers and employees to resume 'normal' life. However, we are long-term investors who are used to thinking of property investment and development in terms of years and economic cycles.

One near certainty, however, is that interest rates will be at low levels for quite some time. This is likely to make one of the key attractions of property, namely long-term income streams, more attractive. The LF Canlife UK Property ACS will continue to be well-diversified, with a focus on income-generating office and industrial assets, while underweighting retail assets other than major supermarkets and multi-let retail warehousing.

Some of the strongest performance over the next five years could come from non-cyclical alternative sectors such as primary healthcare, senior housing and data centres as investors seek long-term, secure sources of yield. In the LF Canlife UK Property ACS we are actively looking to increase our exposure to the alternative sector.

Overall, we expect a slow recovery in property to emerge during the fourth quarter of 2020, led by the industrial and office sectors, while the retail sector is likely to produce negative performance until the end of 2021. This has been a bruising and tumultuous year, but it has also offered a reminder that, every so often, there arise windows of investment opportunity. In hindsight, 2020 could prove to be one of them.

Total return forecasts by sector



Source: PMA base case   *Recession scenario, Summer 2020

Case study: Forbury Square, Reading

Looking after the health and wellbeing of our tenants is a key priority in the LF Canlife UK Property ACS. The recent refurbishment of Forbury Square, Reading is an example of how engagement with tenants can produce higher-quality working environments with a focus on health and wellbeing.

Completed in February 2020 by Canada Life's property asset management team, the refurbishment of Forbury Square includes the extension and comprehensive refurbishment of the main office reception and new enhanced communal building facilities, as well as conversion of the ground floor restaurant into office accommodation.

Indoor air quality monitoring equipment was installed to each floor to track various criteria including humidity, carbon dioxide, dust and chemical levels to ensure that the quality air within the building is not compromised. All monitoring data is shared with the occupiers. An array of PV cells and new air-handling units are being installed to enhance the building's energy efficiency and performance rating. In response to the COVID-19 pandemic, a virtual tour facility was created to enable remote viewing.

The LF Canlife UK Property ACS provides a one-stop fund for well-diversified UK core-plus property exposure. The managers aim to provide an income yield of ca. 5.0% from property assets and capital appreciation through active asset management.

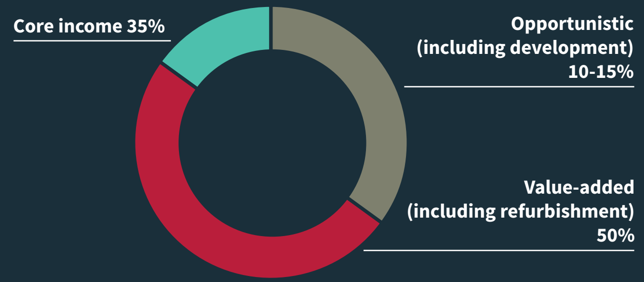
The fund has been Global Real Estate Sustainability (GRESB) benchmarked for two years.[1] The managers will only invest in new acquisitions that meet the fund's strict ESG policy, or can be improved to meet our ESG standards through asset management initiatives, and target an Energy Performance Certificate rating of C and above.

The fund's transparent tax structure, whereby investors handle their own tax affairs in relation to the fund, provides a flexible alternative to open-ended investment funds and authorised unit trusts that can reduce the administrative burden of direct property exposure.

The portfolio uses a 'three-legged stool' approach that combines core income exposures with value add investments and some exposure to alternative investments, such as healthcare or student housing, which tend to have longer leases.

This core-plus profile enables investors to benefit from strong, stable income streams provided by core properties, balanced with the potential to capture growth from value-add programmes such as refurbishment and exposure to higher growth property sectors.

LF Canlife UK Property ACS Strategic Risk Profile



[1] Founded in 2009, GRESB has grown to become the leading environmental, social and governance (ESG) benchmark for real estate and infrastructure investments across the world.

LF Canlife UK Property ACS	
Inception date	27/10/2017
Fund size	£340.9m
Sector	IA UK Direct Property
Benchmark	Historic: MSCI/IPD UK Quarterly Property Index From 05/08/19: MSCI/AREF UK Quarterly Property Fund Index
Dealing frequency	Daily
Income payments	Quarterly
Legal structure	Authorised Contractual Scheme (ACS)
Number of properties[1]	31
OCF I shares, acc.	0.90%
AMC I shares, acc.	0.70%

All data expressed as at 31/08/2020 unless otherwise stated.
[1] Includes properties held through the Canlife Jersey Property Unit Trust.

Joanna Turner

Head of Property Research, Canada Life Asset Management

Joanna has held the position of Head of Property Research at Canada Life Asset Management since 2015. She is responsible for managing property research, which includes forecasts, thought leadership, house views, quarterly reporting and writing regular research content.

Joanna has 25 years' experience in global, European and UK property research and strategy. Prior to joining Canada Life, she worked as an Associate Director in DTZ's Global Forecasting and Research team, and also gained experience at AXA Real Estate, LaSalle Investment Management, Invesco and Cushman & Wakefield.

Joanna holds an MSc in Real Estate Investment from Cass Business School, City University London and a BA (Hons) from Manchester University. She also speaks Spanish, German and French.

She is a committee member of the Society of Property Researchers and a member of the Investment Property Forum. She is passionate about ESG and climate change, diversity and inclusion in the real estate sector.

Joanna Turner,
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The value of investments may fall as well as rise and investors may not get back the amount invested.

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The LF Canlife UK Property ACS (ACS) is an Authorised Contractual Scheme and is suitable for institutional and professional investors. For more information, see the ACS prospectus available at www.canadalifeassetmanagement.co.uk. Property held by the ACS may not be readily saleable. This means that investors in it may not always be able to realise their investments when they choose. In such cases the encashment of units in the ACS may be postponed by up to 6 months. The value of property is generally a matter of a valuer's opinion rather than fact. Costs of buying and selling real property are generally much higher than for other types of assets. Property investments may be subject to significantly wider price spreads than bonds and equities which could affect the valuation of the fund by up to 8.00%.

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