Resilience, Re-imagining and Responsibility

UK Real Estate Market Predictions 2021

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On 14 January 2021, Dentons held its annual UK Real Estate Market Predictions Event at which industry experts gathered to share their views. Despite the unprecedented disruption and challenges caused by COVID-19 in 2020, the outlook of both our panel and our audience was surprisingly optimistic. The general consensus was that 2021 would be a year of two halves and that, while there will continue to be difficulties, in the latter part of the year we should see a strengthening of the market, growing confidence and more opportunities arising. Reflecting on the panel discussion, audience polls and our own extensive transactional experience, the three key trends emerging for 2021 are **resilience, re-imagining and responsibility**.

We were joined by industry experts:

Kevin Aitchison
CEO at Knight Frank
Investment Management

Sharon Quinlan
Head of Corporate Real
Estate at HSBC

Will Robson
Executive Director
& Global Head
of Real Estate Solutions
Research at MSCI

Rob Sumner
Residential Investment
Director at Sigma

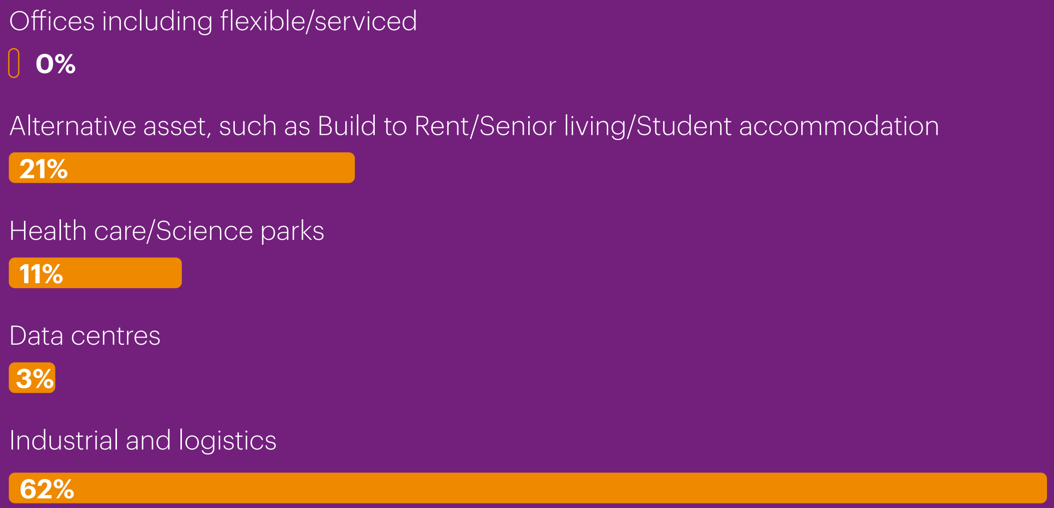
Resilience

2020 was a year characterised by resilience and that is likely to continue in 2021.

While COVID-19 negatively impacted some sectors, industrial and logistics continued to grow in strength. Our audience poll showed that, if they had the capital, 62% would choose to invest in this area of the market. Industrial and logistics was also the preferred option for new developments. It is not hard to see why. As one of our panellists commented, if and when the pandemic passes, we are not easily going to forget the convenience of home delivery. Both COVID-19 and Brexit have also encouraged greater awareness around supply chains, encouraging a degree of onshoring and a greater appreciation of their importance to key services. However, even with such a positive outlook, the sector is not without its challenges. Competition for suitable land, particularly for urban logistics, continues to be an issue.

> “If you can find land in and around a city centre where you can build urban logistics, I think you will make a lot of money. The challenge with a sector that is growing is finding that land.”
>
> **– Kevin Aitchison**
> Knight Frank Investment Management

If you had £100million to invest in the UK only, which asset class would you choose?



Resilience

But it is not just industrial and logistics that is showing resilience. Demand remains high for residential, fuelled by the ongoing supply/demand imbalance and the encouragingly steady rent collection rates seen in 2020. Alternative residential assets such as build-to-rent, senior living and student accommodation also drew favour with our audience, being the second most popular asset class for investment according to 21% of those polled.

And there are investors out there.

"Let's not forget that we still have a significant imbalance in the UK (residential market) between supply and demand and while that balance isn't distributed evenly across the country that build imperative is still very much upon us."

–Rob Sumner
Sigma

"Investor sentiment, I actually think it is better than many might imagine."

– Kevin Aitchison
Knight Frank Investment Management

Resilience

Our panellists felt that there was good investor sentiment and capital (both domestic and overseas) waiting on the sidelines for the right asset. There have already been some early indicators of a willingness to deploy that capital in 2021 (for example, Korean investors showing a renewed interest in London offices). However, the difficulties of 2020 have driven a flight to quality and this is where supply may be restricted, certainly in the first half of the year. Even within particular sectors, there is a growing variance between the best and worst performing assets and so greater analysis may be required. While surveys often focus on pitching cities such as London, Paris, Glasgow and Berlin against each other, that is not necessarily the approach of investors who will be looking instead at the specific asset and, in particular, the resilience of the cash flow it generates.

"Our experience, (in advising Korean investors) is that it's not about London versus Paris versus Berlin or Edinburgh or Glasgow, it's actually about the specific asset, security of the cash flow, the location and quality of the asset. We've acquired anywhere from Glasgow, Edinburgh, London, Austria and so on and I don't see that changing."

– Kevin Aitchison
Knight Frank Investment Management

"You have got to remember that banks aren't in crisis this time round, as they were in the global financial crisis previously. So capital and liquidity from a funding and finance perspective is still there for investors and developers alike"

–Sharon Quinlan
HSBC

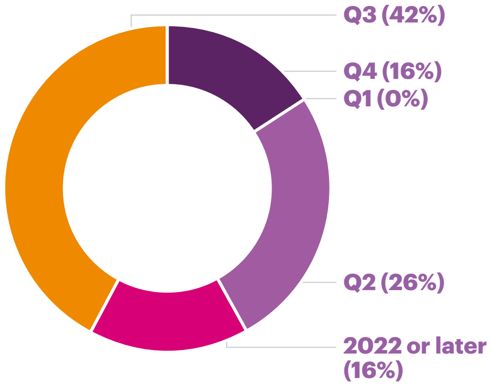
That too is the focus of lenders. Finance continues to be available but there may be greater scrutiny of the asset, the cash flow and the occupier and, as we discuss on pages 8-9, their ESG (Environmental, Social and Governance) credentials. This resilience within the lending market stems in part from the lessons learnt from the 2007 financial crisis. Firstly, there is a far more collaborative approach from lenders; secondly, loan-to-value ratios are more sustainable; and thirdly, there is a greater variety of lenders in the market. The availability of finance and continuing low interest rates create an encouraging environment for those who can see opportunities within UK real estate.

Re-imagining real estate

2021 will be a year in which real estate needs to discover the new norm and re-imagine how space is analysed, operated and used.

Clearly, COVID-19 has had an impact on the market but, as shown by our [2020 COVID-19 webinar series](), the consensus is that the pandemic has been more of a catalyst, accelerating existing changes, rather than creating new ones. So, while 39% of our audience saw COVID-19 as the biggest headwind for 2021, 93% felt that the roll-out of the vaccine would have a significant or very significant effect on increasing investor confidence. 42% of our xzconfidence would most likely start to emerge in Q3 of 2021. Meanwhile in the longer term, our panellists and 29% of our audience identified the downward pressure on rents as a key trend that will encourage the re-imagination of real estate.

When are we likely to see the next uptick in investor confidence in UK real estate?



"We are in such a low interest rate environment, and have been for such a long time. I think therefore that when you are looking at that balance of investment opportunities real estate will still remain attractive."

–Sharon Quinlan
HSBC

This trend is not uniform across all sectors – some have been hit more than others. It is more prevalent within (but not exclusive to) non-food retail and hospitality. Here we have seen a push for shorter, more flexible lease terms and lower rents. In turn, this will require a rethinking of valuations (how do you value an asset with a variable rent?), investment and lending decisions (how do you assess a property if the occupational arrangements are so flexible?) and also the landlord and tenant relationship (how do you manage the property to retain the occupier?). In each case, there will be a greater need to understand the operationalisation of real estate.

Re-imagining real estate

Even referring to the landlord and tenant relationship may be outmoded. Increasingly, landlords are realising that tenants are customers. Here the build-to-rent sector has taken the lead that others will need to follow. It is no longer enough to provide a unit of space. Landlords need to do more to attract and retain their customers, especially if they cannot rely on legal contracts to tie in occupiers for 10 or more years, or to guarantee an upwards-only rent pattern. They need to differentiate their offering – whether that is through the design of space, brand reputation or the services they offer.

Many have speculated that COVID-19 has triggered the decline of the office. Our panellists did not agree. Instead, as one panellist commented, everyone wants to get back into the office in some form (something perhaps echoed by overseas interest in this area). While there might be a return to the office once the pandemic restrictions are lifted, most would agree that the sector needs to re-imagine the use of office space. We are likely to see more sophisticated working strategies around where we work, how we work and when we work, and this needs to be reflected in the bricks and mortar spaces we inhabit.
For offices, this means providing space that meets the needs of the workforce – from collaborative spaces to quiet thinking areas and wellbeing zones.

Collaborative and shared space is already a feature of a number of residential products. While COVID-19 restrictions have encouraged social distancing, our panellists felt that the benefits of communal space (for example, generating social interaction and supporting affordability) would prevail and we would not see a significant retreat from this type of residential model.

Non-food retail perhaps is the area that will require the most re-imagination. Having been hit hard by the online shopping trend, it was already having to reconsider its offering before the pandemic struck. While there has been a lot of negative press around the non-food retail sector, our panellists still felt that, in time, retail could provide opportunities, particularly around repurposing that space. Those opportunities may come quicker and easier for certain sub-sectors, such as out-of-town retail, than others, such as high street shops. What is clear is that the repurposing of retail could be one of the key factors in revitalising our town centres.

"The biggest change hasn't just been the technology it is a cultural change that CEOs have realised things can get done from home, some things can get done better at home, other things do suffer and so there is just going to be a more sophisticated strategy around, how we work, where we work, when we work and who with."

– Will Robson
MSCI

"Even at the depths in April and May last year, (residential /BTR) rent collection was still at 98% and we've just reported last quarter and rent was at 100%. That degree of resilience is something to be believed and we are delighted."

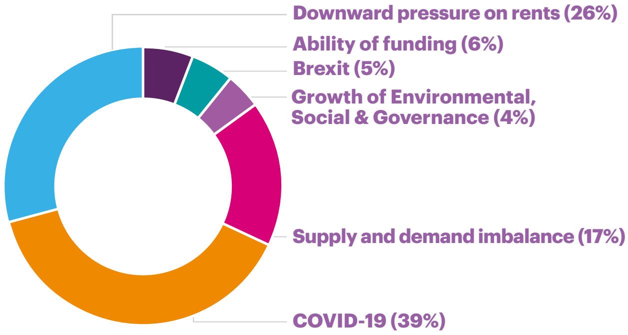
–Rob Sumner
Sigma

Responsibility

Responsibility was a theme that we identified in our 2020 Predictions Report. It continues into 2021.

ESG issues, which featured largely at our 2020 Predictions Event, have arguably become more important in light of COVID-19 as organisations realise the significant correlation between real estate and matters such as community cohesion and mental health. Interestingly, while ESG was viewed as a headwind for real estate by 4% of our audience, one of our panellists rightly pointed out that, if embraced in the right way, ESG strategies have the potential to be a significant tailwind. An organisation that steps up to its ESG responsibilities, having a strategy that runs through its core rather than just applying an ESG-veneer to its assets, will be able to unlock these opportunities.

What is the biggest headwind for UK real estate?



"It (ESG) is an increasingly important factor and that's not least because as a bank HSBC is committed to it, but it is an increasingly important aspect of our consideration across lending into the real estate sector."

–Sharon Quinlan
HSBC

On the lending side, ESG is a feature of lending decisions but is perhaps not yet at the stage of being a deciding factor. A turning point will come when numbers start being placed around ESG issues. The general view is that ESG matters will soon start influencing values and, in time, might even be reflected in rents. As and when that occurs, we will see a welcome, if somewhat overdue, acceleration of ESG responsibilities.

Responsibility

Other responsibilities that are overdue, but which are soon going to be called in, relate to unpaid commercial rent arrears. The government will, at some point, have to start withdrawing support to occupiers such as the moratorium on forfeiture and, in Scotland, the restrictions on irritancy. As and when that occurs, those tenants who have not been keeping up to date with rental payments will need to face up to their responsibilities or seek co-operation from landlords and others to reach a compromise. This transition away from government support could cause further disruption to the market, certainly in the first half of the year.

While there may be some who feel the government could have done more to support landlords through the COVID-19 crisis (such as requiring parties to be more transparent over their trading data), at least one of our panellists felt that part of the problem was the public perception of real estate. This is where real estate, as an industry, needs to step up and take responsibility for its public image and role in society.

More could be done to raise awareness of how some property investors give back to the public. For example, notable amounts of commercial real estate are owned and managed by pension funds and charities who indirectly give back to society. Such investors are becoming more sensitive to reputational issues and, as such, they could help to fuel the industry's drive to self-regulate on ESG matters.

> "The other good thing is that it (ESG) is not just about climate and energy. The S and the G are also really important. And I think it is happening without regulation."
>
> **– Kevin Aitchison**
> Knight Frank Investment Management

There is also a misunderstanding of the role real estate can and should play in society – the "S" in ESG. Real estate has the potential to make a significant and positive difference. For example, buildings are a significant contributor to our carbon footprint, so it is essential that the industry continues to be actively engaged in tackling climate change. Our high streets could be revived by capturing the COVID-19 trend for localisation (for example, providing openings for independent retailers and services) and the intelligent repurposing of space to provide thriving communities. The design of space can make a significant contribution to the mental health of individuals. As ESG goes higher up the real estate agenda, it is likely to drive these changes and the opportunity to show what real estate can give back will be maximised.

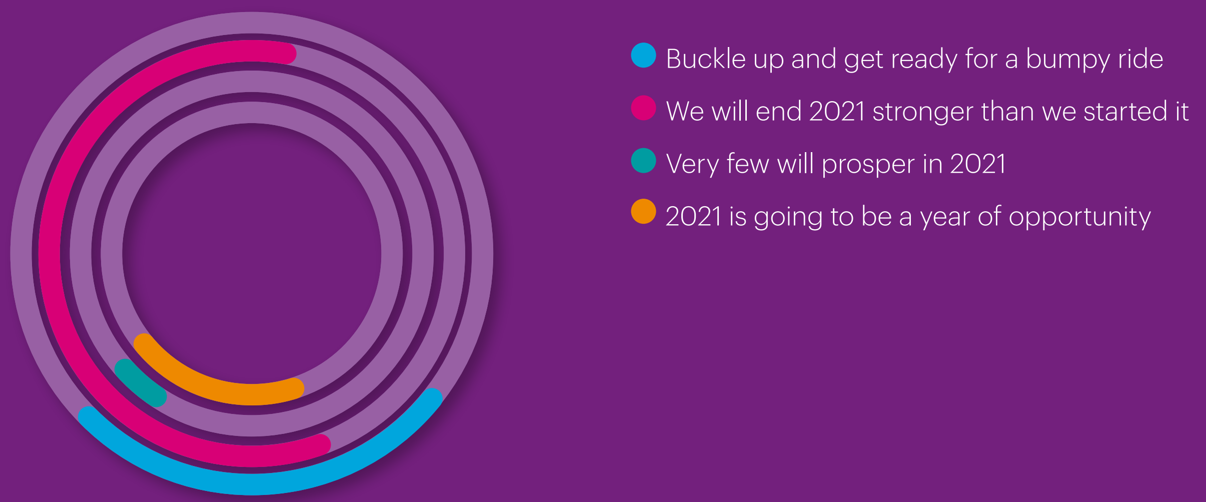
Conclusion

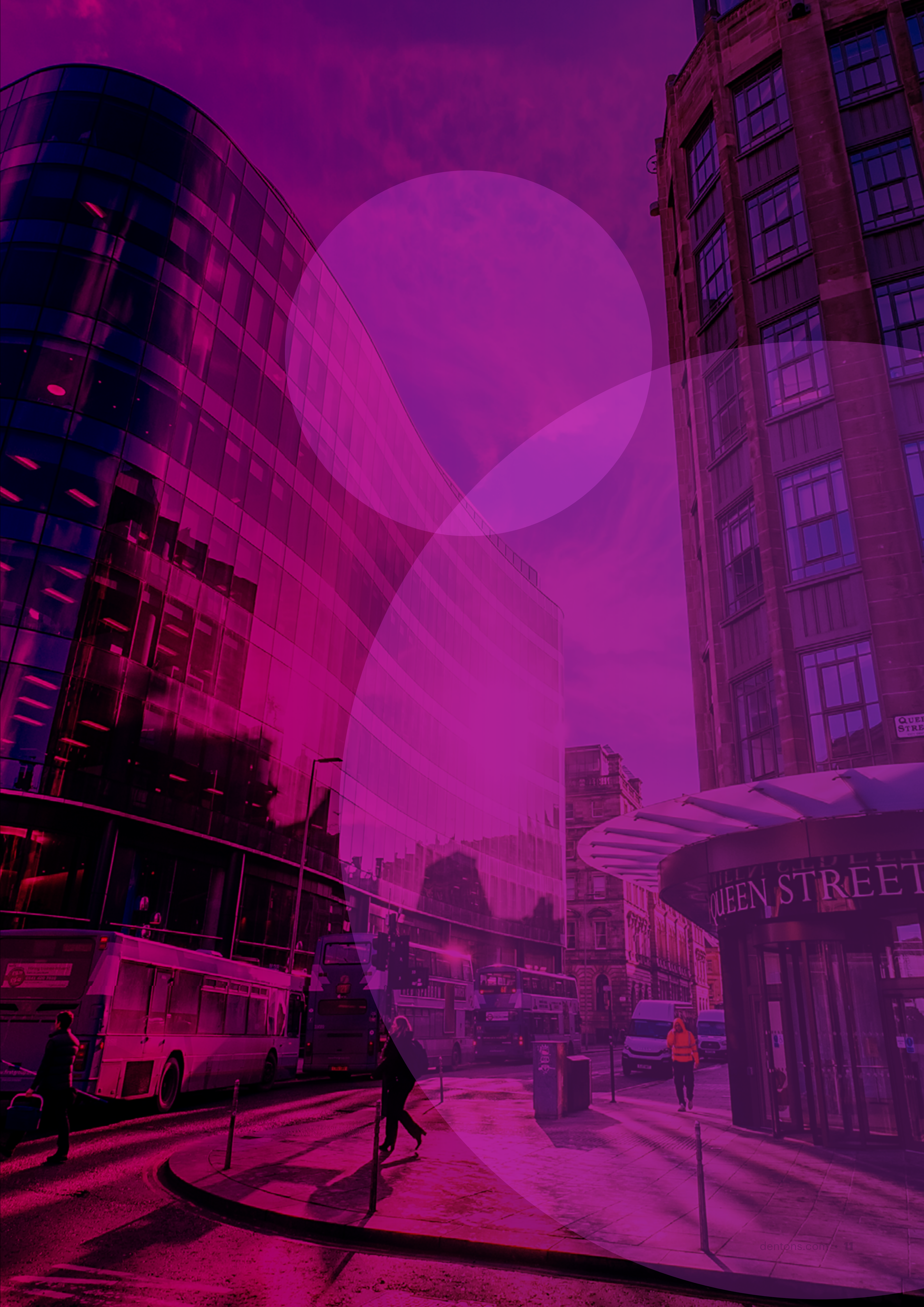
There is no doubt that there will be challenges for UK real estate in 2021. In the shorter term, COVID-19 and the withdrawal of government support have the potential to cause further disruption. However, the market has shown resilience and this is expected to continue. In the longer term, trends such as the downward pressure on rents, supply/demand imbalance and the growing importance of ESG matters are likely to see real estate re-imagining the use of space and taking greater responsibility for the industry's wider role in society.

In our final audience poll, 2% thought few would prosper in 2021, 25% thought we were in for a bumpy ride, 57% believed that we would end 2021 stronger than we started it and a very optimistic 16% thought 2021 would be a year of opportunity.

So, while 2021 will not be a year without difficulties, the view is that it will also not be a year without opportunity.

What is your prediction for real estate market activity in 2021?

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