Hearthstone Investments: Impact of Covid-19 on UK residential property funds – one month into lockdown

One of the defining elements of any evolving economic shock is the lag of reliable data – this is even more the case with the current combination of Covid-19 and a shock to oil prices. Both led to something far different from a "normal" recession, and a reliable picture of what the world looks like now will emerge only slowly over the coming weeks and months. Despite that, we are trying to work with what we have to give you the most appropriate snapshot on the UK residential property market at this point in time, and the performance of the TM home investor fund.

UK residential property market

A. *Overall economic forecasts*

Every month, the Treasury tracks forecasts from some 40 economist on key macro data. Whilst the forecasts are highly uncertain at the best of times, we are tracking how the forecasts evolve from one month to the other. We hope that this gives us a month by month snapshot of the general sentiment:

Consensus Forecasts for the UK economy

Comparison of independent forecasts, month by month

		March	April	May
2020	GDP	0.6	-5.8	
	Inflation RPI, Q4	2.2	1.4	
	Unemployment, Q4	4.2	6.9	
	House price inflation, Q4	2	0.5	
2021	GDP	1.3	5.0	
	Inflation RPI, Q4	2.9	2.7	
	Unemployment, Q4	4.1	5.5	
	House price inflation, Q4	2.5	2.5	

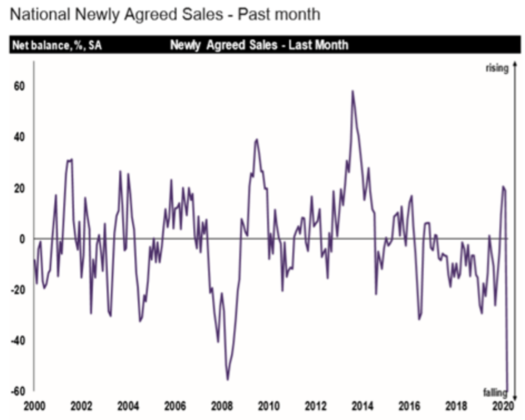
Source: HM Treasury

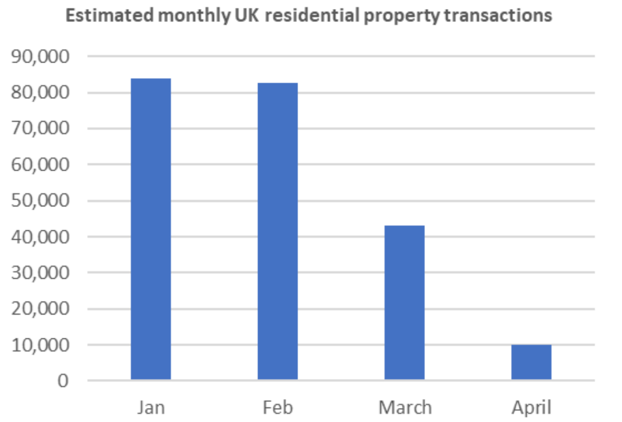
GDP, RPI and unemployment rate - average of latest forecasts

House price inflation - Q4 on Q4 a year ago. Median

B. *House price transactions*

As the UK went into lock-down in the second half of March, UK property valuers added a "Material Valuation Uncertainty" clauses to all their valuations – which in turn led to the suspension of dealing of open-ended property funds. Listed closed-ended funds expressed this uncertainty in the secondary trading markets by initial falls in share prices of over 30%.





Source: RICS

Source: ONS, Zoopla, Hearthstone

The shock to house price transactions was indeed immediate with a sharp drop in Newly Agreed Sales at the end of March. According to Zoopla, the "peak" in sales falling through was on March 23rd. Looking at preliminary data from ONS and Zoopla Estimates, transaction volumes for March are expected to result around 40-60% of normal monthly volumes, whilst April data will likely be around 10%. Richard Donnell, Zoopla research director, commented: "The crisis struck just as the market had been enjoying a resurgence following the general election in December. Agreed sales were up substantially: in its calculations Zoopla had sales running 5-10 per cent higher in the first quarter than in the same period in 2019."

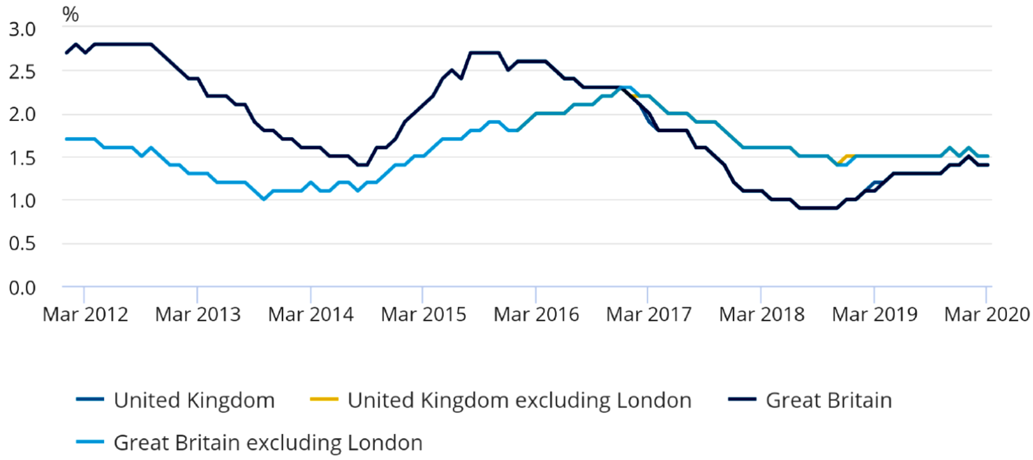
After the December General Election, the UK property market enjoyed a rebound partially driven by pent-up demand from 3 years of Brexit paralysis. This pent-up demand is now even higher – what remains to be seen is where house prices will level once the lock-down eases – will they retain some of their recent bounce, will sellers accept lower prices, how will different regions perform relative to each other?

C. Rental market

Over the past months, growth of rental prices accelerated outside London. As we await the official data for April, Zoopla published their rental market insights on April 21st. Their 3 key findings are:

- In the two weeks to 30 March 2020, demand for rental homes fell by 57%. This decline has since rebounded by 30% in the two weeks to 14 April
- The number of homes listed to rent is down by just 3%
- Despite signs of life, rental demand is still 42% lower than at the start of March

Index of Private Housing Rental Prices percentage change over 12 months, UK and Great Britain, January 2012 to March 2020



Source: Office for National Statistics – Index of Private Housing Rental Prices

D. Factors impacting Supply and Demand

Early guidance relating to allowable working practices for housebuilders was confusing – in the end, practicalities such as a need to protect workers Health & Safety as well as disruption to supply chains led to the vast majority of UK housebuilding coming to a sudden halt. However, many housebuilders have already started a gradual opening up of construction sites.

On the demand side, we previously commented on a massive monetary and in particular fiscal stimulus supporting, amongst others, tenants and potential house buyers. There is currently little visibility on specific policies supporting the housing sectors. Areas under discussion we are monitoring are a potential (temporary) review or reduction of current SDLT and an extension of Help-To-Buy.

Finally, and critically, in terms of the governments plans to gradually ease lock-down measures, it is needless to say that Estate Agents being able to get back to work is one of the most vital parts to revive housing transactions.

TM home investor fund

Since the suspension of dealing in the fund on March 18th, the property investment team had weekly calls both with the property valuers and the asset/tenant manager Touchstone.

CBRE continue to value the 203 properties in the fund in line with proper market practices, adopting a comparable method of valuation. However, given the low transaction volumes there is a dearth of evidence on which to rely, and there seems to be more reliance on agent sentiment and asking prices than one would expect within a 'normal' market. As such, their valuation continues to be caveated with the Material Valuation Uncertainty clause.

With our partners at Touchstone, we are working hard to support our tenants who rely on their homes more than ever. Where appropriate, we support those where Covid-19 has caused financial difficulties. We are looking to balance tenants' and investors' needs, wherever possible setting up payment plans to ease temporary difficulties. Our primary focus is on those who lost their jobs – once we have confirmation of a Universal Credit application, we work with the tenants to find a mutually agreeable solution. For tenants in furlough, we typically discuss temporary rent reductions couple with a repayment plan. Finally, we tend to delay rent reviews (typically rents grow with inflation) by a quarter.

Below a table of key metrics relating to the fund:

TM home investor fund

Key Performance Metric	Jan-20	Feb-20	Mar-20	Apr-20
Total return, C-Class Acc, month	0.28%	0.07%	-0.14%	-0.28%
Total return, C-Class , 1 year	1.83%	1.83%	1.48%	0.98%
Property valuations, in % of property portfolio (bps)	0.21%	0%	-0.22%	-0.38%
Distributed Income, C-Class Inc, in %	n/a	n/a	n/a	Launched 20/04/2020
No of voids (vacant properties), end of month	13	24	17	23
+ Completed Acquisitions / - Completed Sales	+ 0 / - 0	+ 11 / - 0	+ 0 / - 3	+ 0 / - 0
+ Move ins / - Move outs	+ 4 / - 9	+ 6 / - 6	+ 9 / - 5	+ 0 / - 6
Rent collected in % of rent invoiced	99%	103%	99%	95%

Overall, we are impressed and encouraged by how collaborative and resourceful our tenants are – and they in turn appreciate they have a professional landlord who is approachable and pragmatic. For April, rent collected as % of rent demanded stood at 95% which is encouraging. It is important to note that some of the rent not collected this month is expected to be paid at a later date in line with agreed payment plans.

As you can see, voids in the portfolio increased in February following the completion of our acquisitions in the East Midlands. Naturally, it is difficult to let properties during this period but we're pleased to see 3 rentals agreed in the past week for move ins during May and June. The agents followed an agreed social distancing protocol which was made easier as the units were vacant.

Stuart Springham

Deputy Fund Manager

May 2020

Important information

Past performance is not necessarily a guide to future performance and future returns are not guaranteed. Investors may get back less than the amount invested.

Residential property values are affected by factors such as interest rates, economic growth, fluctuations in property yields and tenant default.

Property investments are relatively illiquid compared to bonds and equities, and can take a significant amount of time to trade.

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