Opportunities in commercial property

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With the UK economy finally on what appears to be the path of a sustainable recovery, the case for investing in real estate is arguably the strongest that it has been in quite some time. And considering recent central bank turbulence and geopolitical flare-ups, real estate is well positioned against other major asset classes for its ability to generate stable income, act as an inflation hedge and, if necessary, behave as a safe-haven instrument. Yet with strengthening occupational and investment markets, UK real estate may also offer the potential to generate real capital growth. In this article, I will explore these concepts further and suggest viable strategies that sit nicely within CBRE Global Investors' property investment philosophy.

The property market in context

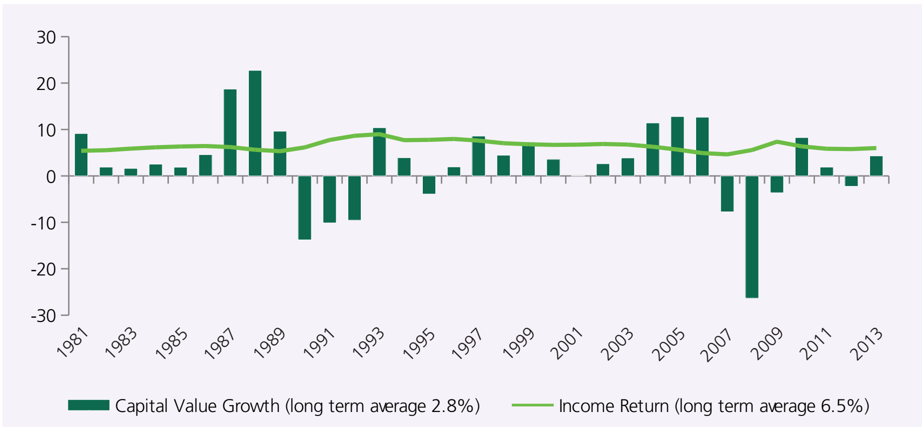
Since last summer, the UK has seemingly been buffeted by positive economic news. Output growth has strengthened meaningfully and is now ahead of its long-term average, an important development considering that the existing commercial property stock has been built for a trend level of growth. Forward-looking sentiment indicators have subsequently risen, compellingly so in the all-important services sector. With employment, real incomes and consumer confidence all likely to improve further this year, the environment is conducive for a mini-boom in economic activity.

This mentality is quickly manifesting itself in positive commercial property performance. Rental value growth has now turned positive and capital values have been strengthening since last April, meaning that UK property was able to generate low double digit returns last year. The outlook is even brighter this year as occupational markets shore up, regional advances gain pace, and investor confidence strengthens. Also, the positive run in global equity markets last year and the relatively subdued outlook for UK Gilts this year means that the "denominator effect" is returning. With some institutional investors now finding themselves technically underweight to property, we expect net allocations to increase and property yields to compress under a growing weight of money.

Predictable income is king

While some investors have been galvanised by the prospect of yield compression that

Figure 1: IPD capital value growth vs. income return (%)



Source: IPD Annual Index

commercial property will likely benefit from this year, the real attraction for liability-matching investors should be the predictability and longevity of the income that real estate can offer over the long run. After all, property returns in real terms have historically been driven by income rather than capital growth. Not only that, but the income component has been remarkably stable (Figure 1). An implication of this is that property returns are not reliant on securing superior rental growth to achieve investment objectives. While past performance is certainly no guarantee of future results, our property forecasts suggest a similar trend enduring.

Another attraction of commercial real estate is its ability to offer a hedge against inflation irrespective of where we are in the property cycle. While this topic has long been dissected by academics, the attraction for liability-matching investors is the possibility of acquiring assets let to very strong covenants on inflation-linked leases. Taking the form of supermarkets, hotels or ground leases, such assets deliver predictable returns, often over a long time horizon.

Best viewed as a hedge against conventional property performance, "high lease value" assets deliver returns more akin to the bond income they seek to replicate. This sub-sector has been keenly contested by annuity funds in recent years, but given the growth phase that the UK property market has now entered, in-going yields are unlikely to fall much further. With investor interest increasingly focused on short-term strategies, there may be the opportunity to enter the long market at attractive pricing.

The safe-haven rationale still resonates

In the aftermath of the Lehman Brothers collapse, with credit markets frozen and equities in free-fall, risk aversion reached new heights. For those investors with the wherewithal to pursue live property strategies, the concept of "safe-haven" came to define the market. While activity dried up in less transparent markets, Central London office and retail assets, quite strikingly, were able to maintain transactional velocity. The expression "safe-haven" can connote different messages, but liquidity is one attribute that resonates during periods of crisis and stability.

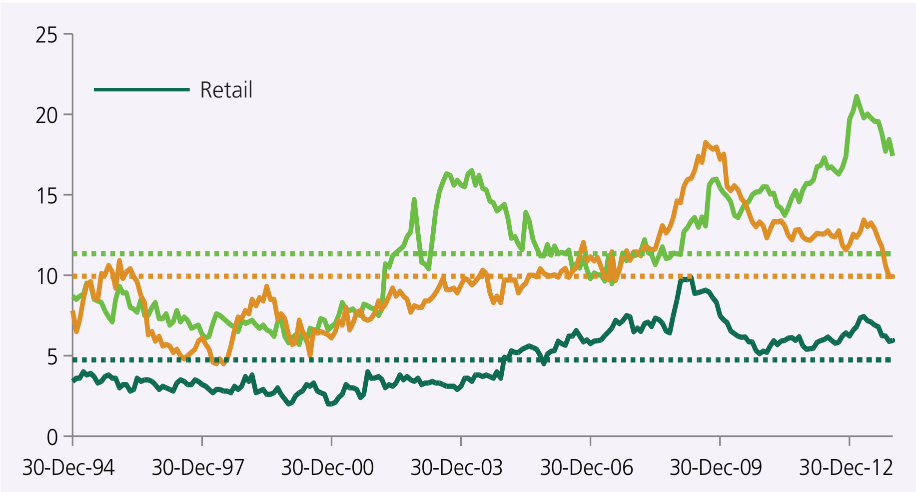
There may be the perception that property, unlike equities and fixed income, is an illiquid asset class. But the experience from the recent crisis tells us that well-let and well-located properties are sellable during what can seem like the absolute depths of the market. This enduring concept may have fallen by the wayside, especially in an improving market, but it is one that asset allocators should continue to be mindful of.

Identifying opportunities in an improving market

To our mind one of the greatest risks to the UK commercial property market is that capital markets get too far ahead of fundamentals and begin to misprice income. For the time being, however, occupational markets appear on the mend. And given the strength of business services' sentiment, we are cautiously optimistic that this will ultimately translate into improved leasing activity. Void rates have been retreating (Figure 2) and we take comfort from diminishing incentive packages that are required to attract new tenants. Against this backdrop, the mind-set toward rental growth is shifting.

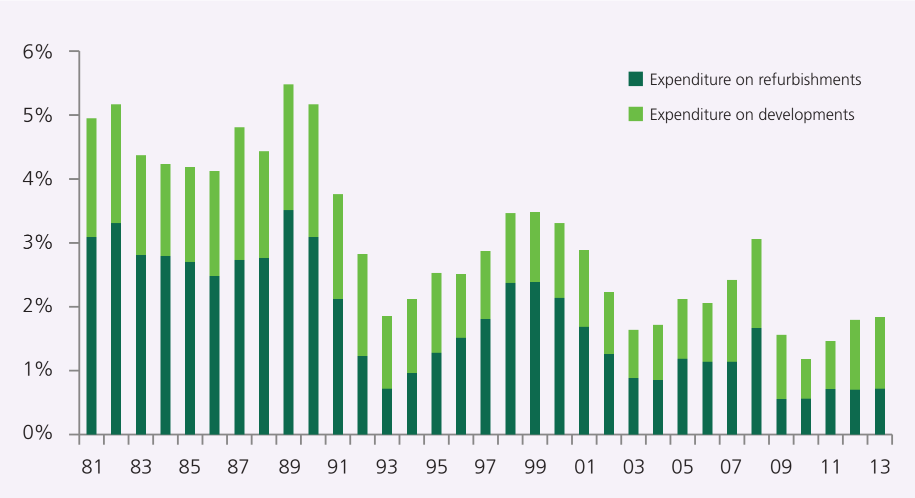
At a sector level, industrials are arguably best placed. Voids have subsided to trend while rents have rebased to economic levels, implying a potential for growth. The office market, especially beyond the M25, has seen a complete dearth of new development (Figure 3). Correspondingly, demand for grade A space is intensifying in the UK's most resilient cities, namely Bristol, Manchester and Edinburgh. In Central London, gross take-up has been

Figure 2: Voids as a % of income (to January 2013)



Source: IPD

Figure 3: Development & refurbishment expenditure (% of capital value)



Source: IPD Annual Index

bolstered by the Technology, Media and Telecoms sector, a trend which we believe has longevity. On the investment side, a significant amount of capital from a broad spectrum of investors continues to pursue what little stock is available.

The retail sector is admittedly a mixed bag. While the number of towns able to achieve sub-5% yields for prime high street shops is expanding, interest in secondary retail is scant as voids are stubbornly high, and near-term prospects for real rental growth are effectively non-existent. We are increasingly cautious with the retail warehouse segment, an area of the market which has consolidation and its starkly polarised between prime assets and everything else. While out of town parks selling bulky goods, in particular, are perceived to be over-rented, recently announced requirements from established occupiers could temper our concerns of this sub-segment of the market.

Getting granular

Over the medium term, the following strategies not only look increasingly viable but sit nicely within our house philosophy of targeting attractive income streams:

Multi-let industrial

High yielding properties providing good asset management opportunities are best positioned to outperform the market. This segment has benefited from a lack of new development and offers exposure to a broad cross-section of the British economy. Due to high land values, assets within Greater London offer the potential for conversion of use.

Nuanced approach to central London offices

Whilst we believe that the period of central London office outperformance is narrowing, we are not negative on this important segment of the market. In a rising bond yield environment, prime property is likely to see the sharpest slowdown in expected valuation growth. So for this keenly contested market, we favour submarkets in the capital that are slightly "off-piste", but by virtue of significant infrastructure investment are being transformed. Incorporating retail or leisure in underserved areas and pursuing residential conversion are ways to create value in core assets.

Regional office

Momentum has conspicuously shifted for offices outside of central London, with transactional yields rapidly moving in for good secondary product. Acknowledging that rents have fallen to economic levels, the attraction here is the medium-term rental growth prospects that this sector offers. We favour in-town offices with minimal capital expenditure requirements leased to strong national and regional occupiers close to transport infrastructure. As with multi-let industrials, this is a potentially high income-producing sector.

Retail

The retail sector is undergoing a pronounced structural shift. There are fewer viable high streets across the UK and internet retailing is shaping the shopping experience. Owing to this, we expect that secondary asset re-pricing will be slowest to express itself in the retail sector. The repositioning of regionally-dominant shopping centres and retail warehouses to include leisure or food store provision is a potentially attractive angle. Capitalising on gentrifying areas of Greater London is a viable high street approach.

Engineering bond-like income

Over the previous few years, assets with inflation-linked leases have seen a pronounced rise in values, and appetite remains strong for this type of product from annuity investors. This can be exploited through lease re-gears or structuring inflation-linked long lease-hold interests in existing ownerships.

Secondary units in funds

Throughout 2013, the volume and frequency of secondary unit trades rose as investors reassessed their allocations to property. Capital was specifically placed in "core balanced" funds, offering further proof of the recovery that the broader property market was seeing. Despite discounts to underlying NAVs having narrowed, the investment case for secondaries is strong. Over the near term, we expect to extract value from "core specialist" funds, those with specific, focused strategies, deploying low to moderate levels of gearing.

Conclusion

The UK economy is finally on the path of a broad-based recovery, suggesting that the case for investing in property is strengthening. With a handful of viable strategies, both time tested and pro-cyclical, we believe that now is an opportune time to get back into the market, increase allocations and start cautiously looking up the risk curve.