Prospects for commercial property in 2015

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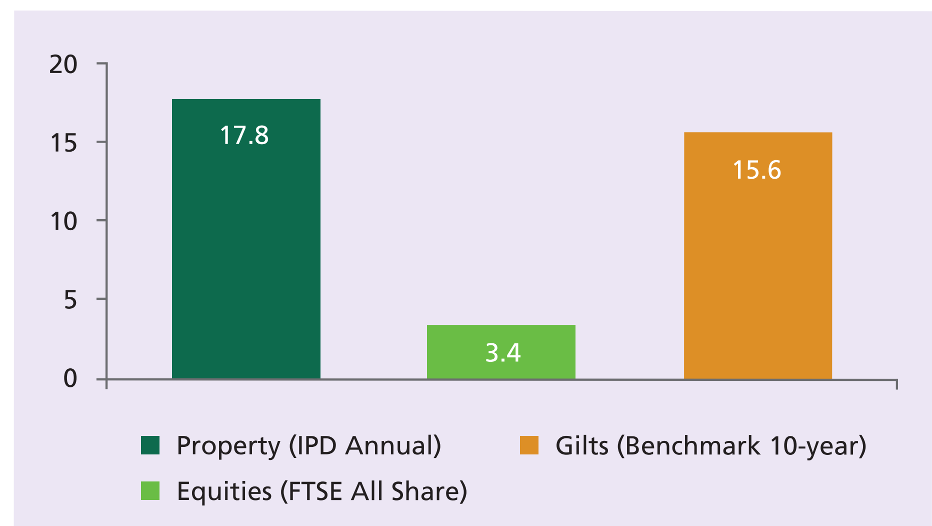
Last year was a great year for UK property and we believe that the case for investing in real estate remains strong but that's not to suggest, that challenges are few. Politics, changes to monetary policy and historically keen prime property pricing mean that navigating this environment requires guidance. The intent of this piece is to evaluate the opportunities that lie ahead for the sector as well as propose some viable investment strategies.

The UK economy rebounded in a meaningful fashion in 2014, contributing to historically strong commercial property performance. According to the IPD annual index, which many of our investors are benchmarked against, returns at an all property level were in the high double digits last year, driven by capital value growth. This reflected the strongest outturn since the global financial crisis, and was a higher return than both UK equities or Gilts (Figure 1).

Encouragingly, significant improvements were seen in the rate of rental value growth across the market, which comfortably exceeded inflation at an all property level. Quite strikingly, performance has become less polarised. While London has continued to deliver strong returns, the regional story has sustained momentum. Admittedly, the components driving performance have been different. In the regions, yield shift is by far the biggest contributor to capital value growth. In contrast, rental value growth is making a notable contribution in London and the South East.

The obvious question is whether the outlook for UK property remains as bright as the recent past has been. The UK economy has entered 2015 on a firm footing and there are numerous reasons for optimism. The sharp fall in oil prices and rising wages should ensure that household incomes pick up, providing more sustainable foundations for retail spending growth. The strength of

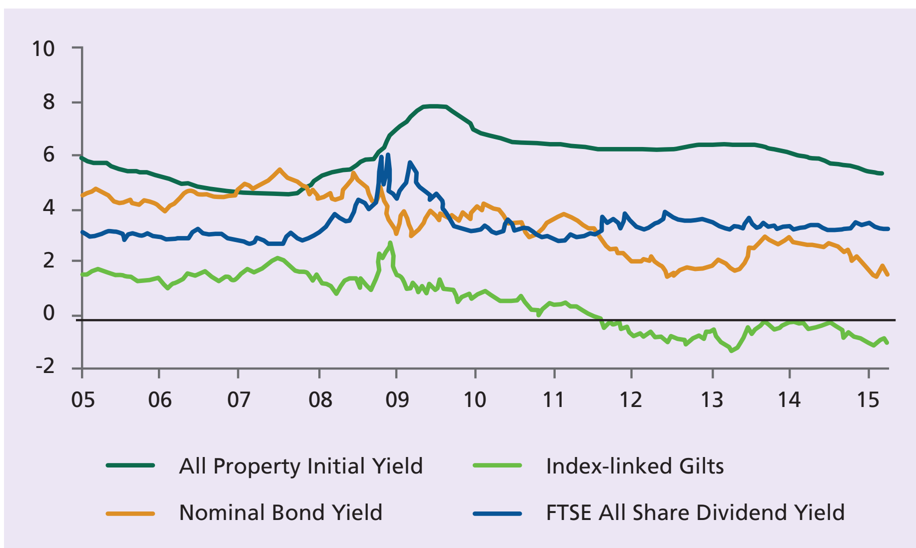
Figure 1: 2014 Annualised total returns (%)



Source: IPD, Thomson Reuters Datastream

"The UK economy has entered 2015 on firm footing and there are numerous reasons for optimism"

Figure 2: 10 year UK Gilts, linkers and IPD All Property Initial Yield (%)



Source: BoE, IPD

corporate surveys and firms' balance sheets suggest that the recovery in business investment has further to run, which should positively impact demand for commercial property. And with exports still competitively priced in foreign markets despite recent currency volatility, net trade should support growth.

A countervailing force to all of this is the unpredictability of the outcome of the May general election. While politics is often a topic that the fund management industry is wary advancing an opinion on, we take the view that what really matters to commercial property performance is the underlying strength of the economy as well as the approach toward monetary policy. From both perspectives we are in a very favourable position. Now, to be fair, it is important to acknowledge the capital market environment that we are currently operating in.

Lower for longer

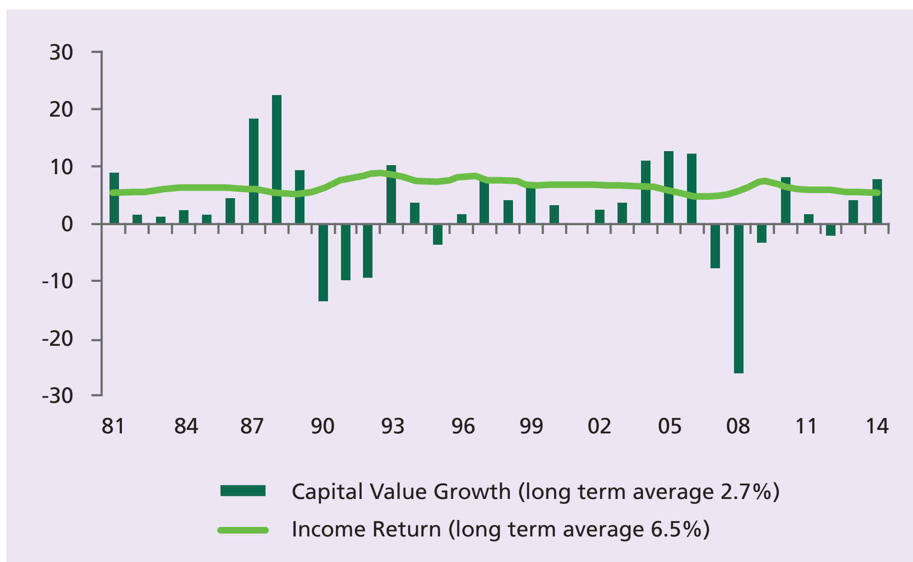
The overarching theme that is colouring our view of property markets is "lower for longer", that is lower interest rates, lower bond yields and lower inflation. When we incorporate these inputs into our commercial property forecasting models, there is one stark output: core property returns in the future are likely to be lower than they have been in the past. This has manifested itself in a new pricing acceptance of lower initial yields.

The reasons for this are multifaceted. Highly accommodative monetary policy by the world's central banks has positively impacted asset pricing. This is underscored by the negative yields witnessed on select government and corporate debt. But also, a relatively soft global growth outlook is weighing on equity market momentum and geopolitical uncertainties continue to foster a flight to safety. Demographic shifts are also at play. There are simply not enough income-producing real assets to satisfy an aging population in the developed world searching for yield and a growing middle class in the emerging world that is looking to invest new-found wealth. The result is high prices being paid for assets delivering a predictable return.

Predictable income is king

The two most commonly-cited reasons for wanting to invest in property that we currently hear are the "relative argument", i.e. property's comparative yield advantage to other assets (Figure 2)

Figure 3: Components of IPD total returns (%)



Source: IPD Annual Index

and the prospect of further yield compression, especially for secondary product. Whilst we can appreciate both rationales from their respective positions, the real attraction for pension fund investors should be the predictability and longevity of income that real estate can deliver. After all, property returns in real terms have historically been driven by income rather than capital appreciation. Not only that, but the income component has been remarkably stable (Figure 3). An implication of this is that property returns are not reliant on securing superior rental growth or sustained yield compression to achieve investment objectives.

Identifying opportunities

While our working assumption is that monetary policy remains loose, interest rates are likely to rise in the near future. Yet despite an imminent hike, we still expect a fairly benign bond market backdrop, against which UK property looks very well placed. So the "relative argument" should endure in a "lower for longer" environment.

The coming twelve months are likely to offer more sustainable growth across most property sectors. Election-related uncertainty may induce some stasis in the market in the first half of the year and yield compression may wane. But the fact remains that a 5% income return in an low inflationary environment with rental growth as upside is a pretty attractive proposition.

In terms of our top picks, regional offices and industrials, and the broad category that is "other", are expected to offer the most exciting opportunities within the traditional direct space. The retail sector remains a mixed bag, but real wage growth should spur consumer spending, and investors are becoming increasingly literate to the structural factors impacting the sector. This suggests that the retail assets should perform better than they have in recent years. And owing to favourable demographic trends and limited modern supply, the private-rented residential sector looks increasingly attractive. Admittedly all of these strategies satisfy different risk/return objectives.

Conclusion

The UK economy is enjoying broad-based expansion, so the case for investing in property continues to resonate. With a handful of viable strategies, both time-tested and pro-cyclical, we believe that now is an opportune time to be in the market, increase allocations, and start looking up the risk curve.