MIPIM-Special

# UK property market: What investors should look for in uncertain times

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**Früher als in anderen Ländern reagierte der Immobilienmarkt in Großbritannien auf die globale Finanzkrise. Nach einer Phase des enormen Preisauftriebs waren die Korrekturen schmerzhaft und auch die Büromieten gerieten durch die Rezession immer mehr unter Druck. Gleichwohl sind Beobachter zuversichtlich, dass der britische Immobilienmarkt als einer der ersten die Trendumkehr schafft. Investoren, die sich jetzt nach günstigen Kaufgelegenheiten umsehen, rät der Autor zur qualitativen Selektion. Geachtet werden müsse auf sehr gute Lage, hochwertige Ausstattung und bonitätsstarke Mieter. (Red.)**

The UK is one of Europe's core property markets. This is a consequence of its scale, transparency and unparalleled quality of the income streams it makes available to investors. The recent short-term changes in pricing resulting from the global financial crisis notwithstanding, investors should not let their understanding of the relative attractions of investing in the UK over the medium to long term be undermined.

Conditions are challenging, of course. The UK's position within the global economy, its strength in financial services and high growth in the use of personal and commercial debt over recent years has made it disproportionately vulnerable to the fallout from the credit crunch. This has in fact generated a substantial buying opportunity, but it also makes a thorough analysis of tenant risk all the more necessary for investors in UK property. In particular, this must include an analysis of the indicators that can be used to both pinpoint opportunities and take control of risk exposure.

### UK properties in the investor's portfolio

The UK accounts for around 17 percent of European gross domestic product*). This implies that a neutral investment weighting to the country within a European portfolio would be at this level. However, European property markets are not as investible as one another given the very high levels of owner-occupation in much of continental Europe. The Investment Property Databank (IPD) estimates that the UK accounts for around 29 percent of Europe's actual investible property market size, and 41 percent of its European indices. If an investor were seeking a neutral weighting in the UK then it would be a third or more of their European property portfolio. It would be even higher if they thought relative strength or value in the UK was even better.

So what are the headline benefits of property investment in the UK? In terms of transparency, the 2008 Jones Lang Lasalle guide to the transparency of individual property markets ranks the UK as number one in Europe. This is based on criteria including performance measurement, market fundamentals, listed vehicles, legal and regulatory environment and transaction processes.

The lease structure available in the UK is also very favourable to investors. Not only are leases long but there are minimal cost reductions for the landlord and the upward-only rent review mechanism can protect investors' income as well. A practical and current analysis of lease length can be shown through the UK IPD Annual Index. The average unexpired term, assuming all potential lease breaks are exercised, is some 11.9 years for the 250 billion euros property within the UK IPD Annual Index at end-2007. Cordea Savills believes that against most European property markets, this certainty of lease length is well in excess of that which can be attained by the most conservative investment policy and given such times of economic uncertainty, investors should focus on the length and quality of income.

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The UK property market has also started to adopt attractive lease arrangements more typically found in continental Europe with regard to rent indexation. This can present a dual benefit for the investor in the UK, where the length and certainty of the typical UK lease is further enhanced by the knowledge that the rental uplifts will be supported by the national inflation rate or fixed uplifts. This is potentially very advantageous as investors are able to achieve security of income more typically found in fixed income assets whilst potentially offsetting concerns relating to short-term deteriorations in the market rental levels.

In summary, not only is the UK Europe's largest and most transparent market, but risks can be minimised and income quality best protected by the quality of the potential income streams available. Any current strategy for the UK at this time should take a very low tolerance to risk, focusing on income while preparing to take advantage of growth as it materialises.

### Economic fundamentals

The economic backdrop cannot be ignored, of course. UK economic growth reached a four-year high of 3.2 percent in 2007 but 2008 saw the economy enter its first recession in 16 years, which is expected to continue through 2009. Moreover, the ongoing credit crunch and weak global outlook pose significant downside risks to economic growth over the coming years, with potential for weakness in all property market sectors. With economic growth and sentiment weakening, the Bank of England cut interest rates in five consecutive months, with the latest in February, and they are now at an all-time low of 1.0 percent.

However, investors should take heart from the authorities' swift and decisive response to the situation as well as remember that recessions have historically been quite short. They should monitor signals which may well mark a reversal of economic fortune.

Given the situation, investors also need to disregard the top-down, sectoral or geographic view and instead focus on the fundamentals of an asset. In doing so, a robust approach to evaluating tenant risk is not only required when reviewing tenants at the acquisition and leasing stages, but should form a significant part of the ongoing assessment of portfolio performance. In the current turbulent economic climate, any covenant assessment must take into account not only how a company has performed in the past, but also should explore and assess indicators of future performance.

An important part of income analysis is at portfolio level because a portfolio can offer a diverse and balanced income stream. The Investment Property Databank (IPD) offers an income analysis tool called IRIS which enables the analysis of the income by a variety of factors, including lease structures, expiry profiles, covenant strength (factoring in D&B credit ratings) and income concentration by sector, to identify exposure to potential sector-level issues. It also enables the comparison of tenant income security relative to a sector-wide benchmark.

Another major factor to consider for performance purposes is that the tenant should not be viewed in isolation; the building that it occupies can have an important influence. In certain circumstances a building may even be worth more with vacant possession if its location is sufficiently good and the unit is suitable for alternative more valuable uses. Past performance can be analysed via examination of corporate accounts and credit ratings but looking forward, analysis should take into account sector and industry trends and peer group performance in general. Media searches can provide valuable insight into both the tenant and peer group, while interviewing the finance director can provide additional information on the current standing and future business growth. Equity analyst reports and corporate bond ratings also contribute to an overall picture of the tenant. But – and not to be forgotten – a heavy dose of common sense is also required.

With covenant strength of increasing importance as tenant default concerns rise to the fore, corporate bonds can be of use in identifying company and sector-level trends regarding implied risk and investor confidence in future performance. It is possible to evaluate earnings quality at a portfolio level by attributing bond yields to the tenants' strength, income length and where available, any fixed/inflation increases. This can be compared to the price or current value of the property to identify the split between income and residual value. However, bonds also price in wider investment sentiment and therefore such an approach must form part of a comprehensive covenant strength analysis.

## Properties versus bonds

An analysis of relative pricing against a number of other measures points to the possibility that the UK market is entering a 'buy zone'. Firstly, the IPD monthly index has re-priced markedly. The capital values from UK property have deteriorated by around 35 percent from the peak in June 2007. Actual price falls are likely to be more extensive even than this by now, meaning UK property is now at highly attractive valuations relative to long term averages. Secondly, the pricing of low risk, fixed income bonds implies an opportunity gap with fixed income-oriented property. Such is the distress from some vendors that we are seeing substantial discounts to such fixed income properties amongst corporate occupiers. For example, Cordea Savills has identified a long-leased industrial property in the South-East of England, near to London, which is let to one of the UK's largest retailers. While the company has a very high financial rating, the property is being priced at a discount, at a net initial yield of 8.0 percent or higher. This yield is higher than which is available on the company's bonds.

This situation is mirrored extensively elsewhere, presenting opportunities to the informed investor. While analysis of comparative yields can be a good indicator of whether an investor should pull out of a property investment, the implied risk premium we have frequently seen in the market is too wide and indicates that there will be a movement of investor money from pure bond assets to their property equivalent, leading to price rises.

Considering property as a fixed income asset also provides four further levels of advantage over the fixed income bond itself. Firstly, property rents, in most cases, are paid in priority to bond payments. Thus in financial default, a rent is paid in advance of the coupon on the bond. Secondly, property provides what is referred to as an equity warrant. This means that the nature of the UK lease structure provides a potentially free ride on any future market rental uplift; no such mechanism exists on standard bonds. Such a characteristic is uniquely strong in the UK compared to the rest of Europe. Thirdly, property also provides opportunities at the termination of the lease: The asset provides both a residual value and of course the potential advantages of alternative tenants and building uses. Fourthly, certain types of asset management can add value during the period of ownership (for example, lease restructuring) without increasing the investment's risk profile.

## The outlook of the UK property market

In summary, the UK property market continues to experience a fundamental change as commercial property returns from core sectors decline and market uncertainty prevails. With substantial capital value falls and improving income returns observed across all sectors, All property total returns for 2008 were minus 22.5 percent, according to the IPD Monthly Index. With further falls in capital value expected in all segments, Cordea Savills forecast total returns of minus 8.9 percent in 2009. Our projection is for All Property returns to average 5.2 percent per annum over 2009 to 2013 as total returns rebound over 2010 to 2013 as capital growth resumes.

Despite concerns over the UK property market, the fact remains that attractive income streams are available in the UK to prudent, long term investors. While concerns about the economic outlook and consequent market rental prospects remain, much can be done to avoid such market risk by strategically favouring investment in long and secure fixed income assets. Sector or geographic considerations are much less relevant in the current situation. Instead, the tactical focus should be to look for the highly protected income quality from secure investments that are well defended on all grounds, seeking little compromise on the quality of tenant, lease length, building and location quality.

Recent short-term changes in pricing should not deflect investors' understanding of the scale, transparency and the highly attractive income streams the UK's property market offers over the medium to long term. The pricing changes are now presenting value unseen in recent years, especially versus the European peer group but also against other asset classes, especially fixed income, with which UK property shares similar investment characteristics. This presents some exceptional opportunities for investors.

**Footnote**
*) IPD Analysis of European countries where it presents national indices (end 2007).