

PROPERTY PANEL



THE PANEL

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HOT PROPERTY

From rental base rates to adding value to their bottom lines, this week's panellists reveal what is on their property market Christmas wish lists

JOHNSTON: If base rates might be headed to 1pc, could we be facing a downturn in rents on a similar scale to that of the early 1990s?

AITCHISON: We do currently expect base rates to come down to 1pc in early 2009, with a very real threat of zero rates thereafter. Economic growth is forecast to contract for a total of five quarters, with a recovery starting in Q4 2009. As a result, we expect a weak occupier market in at least the short term. At an all property level, we anticipate rents falling by about 12pc (in nominal terms) over a four-year period. Central London office rents will fall by about 25 to 30pc, in contrast to more defensive markets such as shopping centres and multi-let industrials, which should see a less severe downturn.

While rents will undoubtedly fall, measured in real terms, we expect rents to fall by only about half as much as they did in the early 1990s. The prime reason for this is that the credit crunch has severely limited the amount of finance available for development projects and we therefore do not expect to see a significant overhang of space, unlike in the early 1990s.

BALFOUR: There is no clear link between the bank base rate and rental growth. However, a base rate of 1pc is intended to stimulate demand in a weakened economy. If growth in prices is low or even negative there will be pressure to reduce rents as a key component of input costs. In a low inflationary or even deflationary economy this would lead to a more extensive fall in nominal rental values than would have been expected if inflation had remained at 5pc. However, it's worth noting that in the four years prior to the 90s recession, nominal rents grew at almost 15pc per annum, more than double the rate of inflation. In comparison, between 2004 and 2007 rents grew at less than 3pc per annum, leaving them more in line with the overall cost of living.

ELLIS: The rental downturn of the early 1990s was different from today in that, while it coincided with major global economic recession, it took place against the background of a huge speculative development boom. This speculative activity created a large overhang of commercial space that remained un-let for several years and helped push rents down even further. This is not the situation we currently face as development is more tightly controlled in most markets. However, we can expect to see voids rise as tenants come under increasing pressure and incentives on new lettings are set to increase as landlords are encouraged to let premises (not least by the abolition of commercial rate relief on void properties).

Overall we would not expect to see a decline in rents equal to that experienced in the early 90s across most markets; rents to date have held up pretty well. However, we are without doubt entering a highly challenging period.

GRIGSON: Despite the recent monetary steps taken by the Bank of England, it is likely that the headline reductions in rental values during this occupational downturn will be close to those of the early 1990s. In that downturn the IPD Monthly Index recorded a peak to trough nominal reduction of just over 20pc between December 1990 and June 1995.

However, with higher levels of inflation during that period the 'real' reduction in rental values was over 30pc. Our expectation now is that inflation will be reigned in to a low level. If we assume medium term average RPI of 2.5pc, then nominal rental values will have to fall by more than 25pc to cause a higher 'real' level of negative rental growth than that experienced in the 1990s.

As 2009 progresses we believe that even in a period of low inflation, the market will increasingly be attracted to RPI linked property funds offering longer term and more stable

income streams, less vulnerable to the relative volatility of rental values.

MARTIN: We've been relatively bearish on the economic outlook for most of 2008, but even so we don't foresee a reduction in real rents on the same scale as the early 90s. The volume of new development, which was so damaging in pushing up vacancy last time around, has been nowhere near as significant. However, we do expect certain sectors to experience very weak conditions; in particular, investors who make an indiscriminate shift towards retail space as a safe haven are likely to be disappointed. There is going to be a great deal of variation between different assets and locations and an understanding of where retailers are trading profitably will be key to identifying areas of outperformance.

MCNAMARA: Clearly, dramatic measures of this kind have been implemented to breathe life back into the UK economy and assist in breaking the credit freeze that even now persists. However, unlike the early 90s, the development side of the property equation is relatively under control. Yes, there is increasing "under-demand" for the foreseeable future in most markets, but this is not compounded by over-supply that was ubiquitous in the early 90s. As such, rents will certainly fall into negative nominal territory and will remain there for 18 months or so, but the scale of the rental falls will be below that seen in the last property market crisis.

MORROGH: Falling base rates alone are clearly intended to arrest the UK's slide into recession and should be welcomed. However it is the broader recessionary environment and its inevitable impact upon corporate revenues, and therefore corporate demand for commercial accommodation, which creates the threat of any downturn in rents. We believe this chain of events will be acutely felt where recent speculative development has been most concentrated. For example, we believe that the Central London office markets could possibly suffer a downturn on a comparable scale to that experienced in the early 1990s.

Conversely much of the UK is not suffering immediate over supply issues, having experienced 16 years of continuous economic growth. We favour the defensive appeal of some of the more affluent economically diversified west M25 centres, which have effectively skipped an upturn in the development cycle, as well as the traditional high street, where there is no centre specific supply impact. It is hard to recall any previous occasion when the future development pipeline has been more abruptly switched off. Clearly the scenario of 1pc or even lower base rates, will make the corrected yield profile on the commercial property market look increasingly attractive.

SMITH: The prospect of an unprecedented bank rate of 1pc reflects a rapid deterioration in economic conditions. Credit markets are now pricing in a period of deflation. Occupier demand has been severely curtailed and rental falls next year could match or exceed 1992's record drop of 11.9pc. However, real rents are already low, and 30 to 40pc below the highs of the early 1970s and 1990s market booms. As such, peak to trough real term rental falls are likely to be less than in previous cycles, helped by the lack of a building boom, though the contraction will depend upon the length of the economic downturn.

YEOMANS: There is no reason why the fundamentals of supply and demand should be different this time around. Those markets that rose fastest and highest are likely to fall just as precipitately. For example, occupational demand from hedge funds pushed up West End office rents to £120 per sq. ft. but now many of these funds are struggling. So we are

seeing not just greater incentives but falling headline rents too. Retail is the other particularly vulnerable sector and we expect a massive post-Christmas hangover, both on the high street and in retail warehouses.

UK GDP is contracting at the fastest rate since 1990. The recent Investment Property Forum Consensus Forecast suggests total returns will be negative for all sectors in 2009, when the bottom of the market will be reached. There should be a return to positive total returns in 2010 but rental value growth is expected to remain negative: 2009 -6.6pc and in 2010 -4.1pc.

JOHNSTON: Is the property downturn truly global or are there still some places (within emerging markets, for example) to shelter from the worst effects?

AITCHISON: The vast majority of real estate markets have already experienced a capital shift due to the retraction of available debt. We are therefore seeing a growing realisation that real estate market fundamentals will be adversely affected across all parts of the globe. While the degree may vary from country to country, market to market and between the real estate sectors, few areas will be immune.

For a core investor currently holding real estate, it would pay to move to a defensive portfolio strategy in which an overweight position is held in the retail and industrial sectors. While investments in the emerging markets of Asia and Central and Eastern Europe are forecast to out-perform due to long-term demographic trends, it should be noted that these markets are inherently more risky and this should be accounted for in expected returns.

Investors with cash looking to enter the real-estate market can access some attractive opportunities in mature markets, which have already, or are expected to experience, significant losses in capital values. Such markets include New York, Tokyo and London. Initial yields in these countries have risen, or are starting to rise from their historic lows and asset pricing will start to look attractive in the near future, particularly when compared with long-term "fair value".

BALFOUR: The property downturn is undoubtedly global, with even the strongest emerging economies such as China, Russia, and India showing varying degrees of distress. However, by concentrating on socio-demographic trends rather than simply chasing GDP growth, it is possible to invest for respectable medium-term performance even during a global economic downturn. Even in the UK we have achieved significant outperformance through investments in alternative sectors such as student housing. In emerging economies such as China and Brazil, a focus on indigenous growth rather than international investment will help investors to ride out the economic downturn.

ELLIS: The globalisation of capital flows is an increasing feature of the real-estate market and this is likely to lead to stronger correlation of property returns than prevailed before property became a more international asset class. Even allowing for this, the current property market downturn has been unusually global in nature. The drivers of this are less to do with trends in property markets than with the synchronised nature of economic weakness across all major economies and by the near universal deterioration in financing conditions.

However, with property values in all markets returning to more sustainable levels, we believe that there are opportunities opening up in a range of markets. As well as emerging regions such as Asia demonstrating strong potential, we

believe that there are promising medium-term, risk-adjusted returns now available for investors in developed markets such as the UK and the US.

At sector level we still see value in several alternative sectors, such as healthcare and student accommodation, which do not have a strong correlation to the traditional sectors. In terms of style there are many recovery or opportunity funds now being offered, and more to come, which should pick up on the recovery in prices over the medium term.

GRIGSON: Real estate across the globe saw unprecedented level of capital inflows between 2004 and 2007 as asset allocators recognised that property could deliver a high income return, relatively low volatility and capital growth linked to general economic growth.

However, combined with debt-driven arbitrage and a shortage of stock in established markets investors failed to satisfy their return requirements and invested in more adventurous opportunities, the result of which was the run-up in prices spreading widely across the globe.

While the UK property industry was the first to recognize the property downturn, it is now global, with the UK, Spain and Ireland leading the cycle and the US, Japan, Australia and Europe (ex UK) following. There are few, if any, areas which are likely to fully escape the downturn.

An inevitable consequence of the current economic circumstances has been the flight to quality across all asset classes. An example of this is investment in ultra long term over collateralised property angles such as UK ground leases. Their secure income profile and attractive yield premium over index linked gilts, make them an excellent place to shelter from the current downturn, although as with gilts, they do retain some capital value risk.

MARTIN: There is increasing consensus that the economic downturn will be felt in emerging as well as developed economies. However, as important as the occupational side of the equation will be consideration of some of the structural fundamentals that have taken a back seat in recent years; one of the defining characteristics of the volatility in asset markets that began in mid-2007 has been a rapid reassessment of risk. Commercial property yields in many emerging markets became extremely compressed relative to those in developed markets. Given that the UK corrected earlier and more deeply than most foreign markets, and continues to have one of the most transparent and liquid property investment markets in the world, it offers one of the strongest relative value opportunities at present.

MCNAMARA: Our research suggests that the downturn is truly global. We should remember that this has been a property cycle driven by capital market dynamics rather than by economic fundamentals. This has meant that there has been less variation between market performances around the globe than has historically been seen. All markets were driven higher and are now being driven lower by these capital market forces. In this recent investor-led cycle, the UK has been in the vanguard. It led global property markets up and now it is leading them down. Indeed, so severe and swift has the pricing correction been that, in our view, it is the UK that now presents the best value among the mature property markets around the world.

SMITH: Since the autumn the property market downturn has morphed into a global phenomenon as investors globally have shunned risk-taking. Emerging economies in Europe and Asia have suffered the most from capital outflows which has translated into weaker economic activity and occupier demand. Some



markets have so far been immune, such as the Middle East and Latin America, but the collapse of commodity prices also exposes them to a downturn in the short-term. However, the fundamentals of emerging economies are generally strong, such as low private- and public-sector debt levels, which put them in a better position to rebound over the medium term.

YEOMANS: Our work is focused on the UK, but we understand that the GDPs of most Eurozone and emerging Europe countries will contract next year. Even Dubai does not seem to be immune. However, Capital Economics say the UK has the weakest growth prospects, so perhaps it will be a case of looking for the least worst options.

JOHNSTON: Even if it's going to be difficult to make the bottom line positive, where will you be looking to add value in 2009?

AITCHISON: Income is our main priority in the current environment. We are continuing to "de-risk" all of our properties, by removing break clauses and extending leases where possible. We are also trying to minimise voids. By maintaining regular contact with tenants we hope to be aware of any risk of default, which will become increasingly common given the economic outlook, giving us the chance to react quickly and positively. Our portfolios have been moving to a defensive strategy for the past 12 to 18 months. Our main focus will be on the retail and industrial sectors, which we expect to hold up better than the office sector over the next three or so years. We are also looking to convert leases from open market rent reviews to indexation or fixed-uplifts where possible, creating a stronger, more defensive cashflow.

BALFOUR: The bottom of the cycle offers the opportunity to pick up interesting investments at discounted prices. Even better if these opportunistic deals offer solid income in the short to medium term. In relation to existing investments maintaining and enhancing the occupancy rate and seeking to encourage a longer-term relationship with tenants is key to improving cashflow.

ELLIS: For those mandates that permit it, and for those clients with sufficiently large funds to make it practicable, we firmly believe that the diversification opportunities offered by global real-estate exposure can add substantial value and this is a strategy that will continue to be pursued by many investors, predominantly through unlisted private vehicles. For UK-only mandates we see the most important features to add value being protecting income quality, intense active management of the existing portfolio and, in the short term, having a long cash holding until attractive buying opportunities emerge.

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GRIGSON: Consensus views for 2009 suggest that the UK market will deliver a second calendar year of negative total returns. For an investor with a long-term commitment to UK property, this will focus their immediate attention on the income performance of their funds. Investors will therefore expect three key outcomes during 2009.

First, that their managers continue to take advantage of asset management opportunities that can be generated from individual properties (for example a simple lease extension that improves the level and duration of cashflow). Second, the letting of empty property and a high level of tenant retention on lease expiry. Third, the continuation of an entrepreneurial approach to ensure that investors are well served by their fund managers as the market gradually stabilises and then recovers.

MARTIN: Further price falls are likely to put renewed pressure on geared investors, presenting opportunities for equity-rich, long-term investors to purchase prime assets let to strong tenants at prices which more than discount the weak short-term occupational market prospects. With existing holdings, scope to add value will remain – for instance by adding value through the planning process or by doing creative deals with tenants that offer them flexibility to respond to their business needs as well as protecting the interests of investors.

At the same time, while the backdrop will create a difficult environment against which to restructure lease agreements or undertake capital projects, we remain convinced that improving the sustainability performance will protect the long-term value of the portfolios we manage and we will continue to progress initiatives in this area.

MCNAMARA: With respect to adding value from tactical asset allocation within the property funds, most of the work has already been done, namely, to position client funds to be short to central London offices and secondary shopping centres. This will tend to benefit client funds in late 2008 and into 2009.

More generally, there is a need to actively manage property assets to protect and, where possible enhance value and performance. The days of property investors being gifted strong returns through widespread and indiscriminate yield compression are gone. Attention must be given, in particular, to working with tenants to protect, strengthen and lengthen income streams where possible. To this end, we believe our integrated business model, where fund, asset and property management are brought together under one roof, should pay dividends in this environment. This sector is about taking a long view: investment in property is a strategy, which, when measured over the long term, delivers significant returns. Taking a 12-month horizon on returns is rarely inappropriate in property investment.

MORROGH: A by-product of the dramatic pricing correction in the UK commercial property investment market is that the asset class has once again established its main structural attribute, that is its high income return. Our emphasis in 2009 will remain on constructing portfolios capable of generating and sustaining considerably above average income returns and then applying maximum asset management input to capture as much of this as possible. Well diversified property portfolio income returns of 8pc or above provide significant insulation against negative capital movements. There is a fantastic opportunity to exploit the pricing anomalies borne from widespread

strains on existing debt facilities and liquidity by committing available cash into such a sparsely populated marketplace.

SMITH: The UK market was the first to drop in response to the credit market crisis and has reached valuations which look more attractive than in much of Europe or the US. UK yields by mid 2009 will be at levels only previously recorded during deep recessions over the previous three decades, and therefore represent a good buying opportunity for medium and long-term investors. Indeed, based upon long-term historical performance, relative valuations against risk-free interest rates are now consistent with five- and ten-year outperformance of over 5pc per annum against government bonds.

YEOMANS: We are much more optimistic about the opportunities to add value. Income is king and we are working closer than ever with our tenants to ensure voids are kept to a minimum, particularly now empty rates represent a direct hit to the investor's bottom line.

It is a good time to carry out construction and our clients are happy to fund building improvements for tenants in return for e.g. removing break clauses or extending leases, all of which help improve investment values

The latter part of next year will provide some spectacular bargains for long-term investments such as pension funds. Plenty of good quality properties with sound income streams will be available at heavily discounted prices. These properties will have good medium and long term growth prospects, so this is an excellent time to start thinking about increasing property weightings.

JOHNSTON: What's on your (property-related) Christmas list?

AITCHISON: On a sector basis, we prefer industrial and retail to offices. Drilling down further, our preference is for open A1 retail warehousing and food stores (as opposed to bulky goods), multi-let industrials (against distribution warehousing) and shopping centres (against high-street shops).

We like high income assets, index-linked rents and long leases. We also prefer prime assets let to tenants with a strong covenant. Protection of income is fundamental in the current economic and investment environment.

For investors with cash however, there are strong opportunities outside of the sectors that we favour. For example, high-street retail is currently looking cheap on an historic basis. As the amount of distress in the market intensifies, as we expect in 2009, assets will be available to buy at large discounts, especially for 100pc equity purchasers. We are therefore actually considering each opportunity on an asset by asset basis.

BALFOUR: The repeal of the recent legislation on empty rates. The adjustment made in the PBR will have no impact except for the smallest occupiers. The status quo will cause higher costs for businesses seeking to downsize, encourage investors to unnecessarily demolish serviceable buildings and deter new development in the recovery phase of the cycle.

ELLIS: My wish for Santa is that investors will begin to reconsider the UK market in 2009, with real-estate values moving to more attractive levels and strong concerted policy action by central banks and governments hopefully beginning to point to some light at the end of the tunnel, it will be approaching the right time for long-term investors to re-enter the market. I would wish for larger investors, looking to build global portfolios, to start their research and look at the opportunities becoming available outside domestic markets

as well. My wish list would also see both investors and managers increasingly recognising the importance of sustainability considerations when developing and investing in real estate.

GRIGSON: A UK market that better reflects risk against reward!

MARTIN: If we address our list to Gordon Brown (who makes an unlikely Santa!), at a macro level, we are looking for some positive steps to resolve the further deterioration in financial conditions that have emerged post-Lehman Brothers.

The UK banks in particular are currently being expected to respond to a frequently conflicting set of objectives, many of which emanate from Westminster; the Government must evolve a clear and coherent plan for the banking system as soon as possible. For commercial property, just because it hasn't been granted yet doesn't mean it isn't still top of the list. The events of the past few months and the likely scale of the economic downturn underline how important it is for the government to repeal the legislation on empty rates.

MCNAMARA: For the short term, the wish is for consistency from property valuers. This won't be easy but the property industry will be watching with intense interest as to how the valuation profession carries out its duties. IPD's usual annual review of this question will be given even greater attention this time around.

Looking further forward into 2009, the wish is clearly for liquidity to re-emerge in investment markets generally and, from my perspective, in property in particular.

My two other "stocking fillers" would be (a) to see the UK property fund management community properly embrace UK sector-based derivatives for tactical asset allocation purposes and as extra pools of liquidity; and (b) to see empirical evidence emerge that sustainably-run properties relatively outperform. Both seem eminently possible – let's hope 2009 sees them both become a reality.

SMITH: Christmas may prove too early to bottom fish as valuations are still falling in response to tighter credit conditions. We rather wait for the New Year sales! The battery of monetary and fiscal measures being instigated world-wide should start to bear fruit in terms of economic growth by the end of 2009 and early 2010.

As such, investors should be ready for opportunities that will arise as banks impose forced sales on highly leveraged investors. The UK property market offers the most compelling prospect of major developed markets as outlined above. We also see Asia as a good play on a global economic recovery, particularly as forceful policies for stronger domestic demand are also coming into place across the region.

YEOMANS: I hope Santa brings Mr Darling a change of heart and a measure of understanding of how the property industry actually works. The ill-conceived empty rates policy is a continued blight. Introducing an exemption on the smallest properties in the pre-Budget report was just an empty gesture.

The three-year life of outline planning consents means that at a time when very few schemes are getting built out, owners are having to waste cash in order to renew consents. We would like to see an extended life of at least five years.

Finally I hope all bankers spend Christmas reading Dickens' "A Christmas Carol", contemplate the conversion of Mr Scrooge and then act quickly to put more liquidity into the economy, which we need desperately to kick start a rise in property values.