

Commercial property on firmer foundations

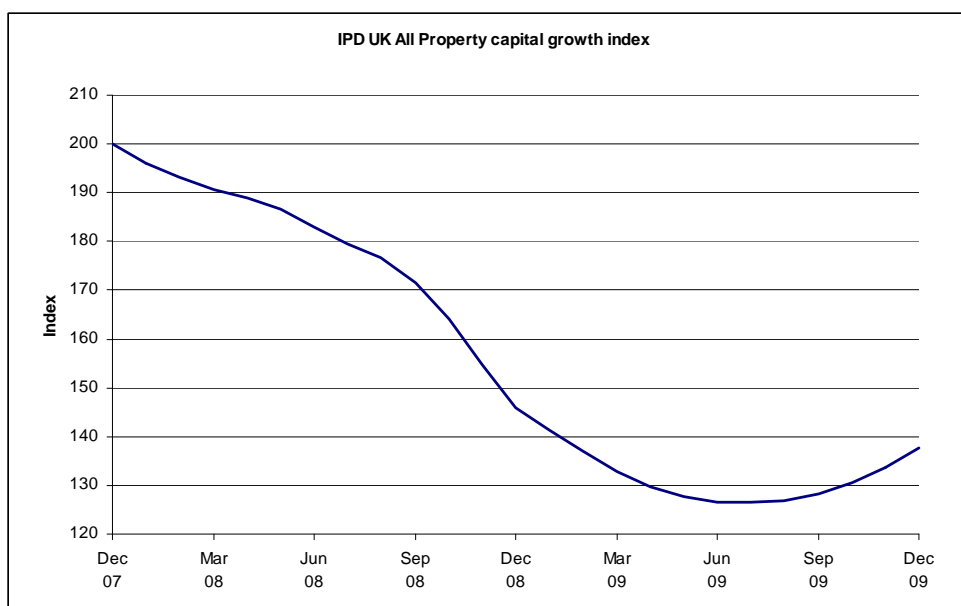
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Smart solutions made simple



By Mark Carpenter, Head of Retail Property Funds at Henderson New Star

Like the proverbial supertanker it takes a while for the property market to change direction but once it does, the trend tends to persist. As recently as a year ago, investors were still shunning commercial property yet in the final quarter of 2009 it was the best-selling sector in terms of net sales according to the Investment Management Association. This turnaround reflects the shift in investor sentiment towards the asset class as fears of financial Armageddon subside and investors seek to take advantage of the sector's attractive valuations and high income levels.

While anecdotal evidence had suggested prices of UK commercial properties were beginning to firm in spring of last year it was not until August 2009 that the Investment Property Databank (IPD), which compiles data on the sector, officially confirmed that UK commercial property prices were recovering. They have ticked up every month since. In December 2009 they rose by 3% – the strongest rise ever recorded for a single month. Whilst credit and equity markets rallied substantially over 2009, the commercial property markets have only just picked themselves up from their lows. Although property prices had climbed 8.8% from their July 2009 trough, the extent of the declines in the first half of the year resulted in an overall fall for the year of 5.6%. By comparison, the FTSE 100 index of leading UK shares had risen 54% by the end of the year from its March 2009 low. The chart below illustrates the movement of UK commercial property prices during the past two years.



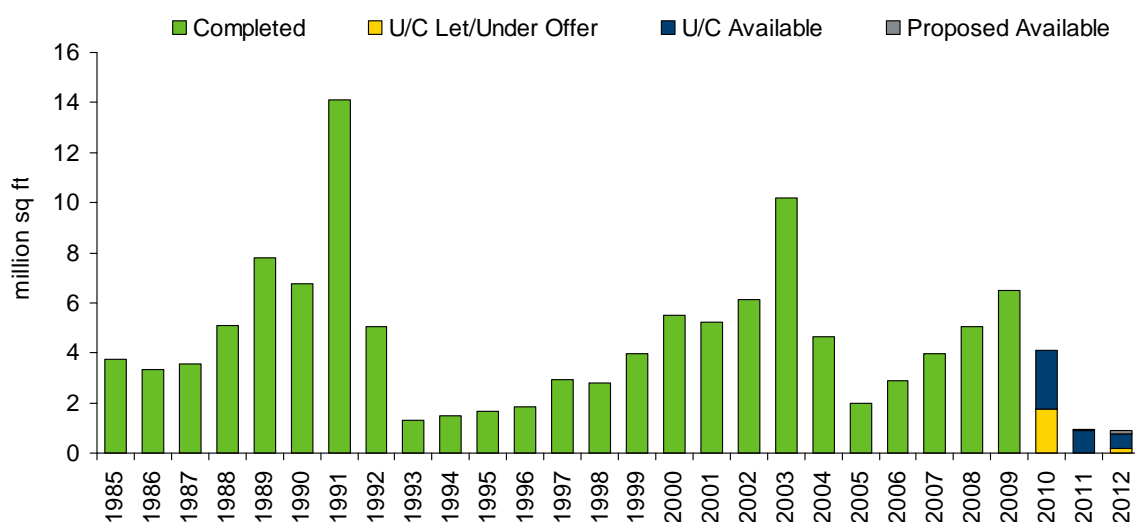
Source: IPD at January 2010

Despite the recent recovery, average prices remain 39% below their 2007 peak. More importantly, commercial property continues to retain a high yield relative to most other asset classes. At the end of 2009 the initial yield on the UK IPD All-Property Index was 7%. This looks attractive when weighed against a yield of 4.1% on a 10-year UK government bond and the Bank of England's bank rate of 0.5% – the benchmark rate for many savings accounts.

It is small wonder, therefore, that retail investors poured some £1.3 billion of money into property funds in the final quarter of 2009. The net inflows mean that retail funds are on the lookout for acquisitions, joining a growing group of opportunistic investors, institutions and overseas buyers seeking to take advantage of current valuations.

Overseas buyers have been a steady presence in the market for much of the last two years. The UK's landlord-friendly, established property market coupled with lower prices and a weak pound has made it both structurally attractive and inexpensive. For domestic investors, their numbers grew as prices reached a low last summer, with interest building as it became clear that the sector had passed through the worst and looked historically undervalued.

Although investor demand for UK commercial property has grown, supply has not. There are two reasons for this: one fundamental, the other behavioural. At the fundamental level, supply has shrunk because we are at a stage in the development pipeline where few new properties are coming on to the market. For example, the graph below highlights how tight supply conditions are becoming in central London offices.



Source: CBRE, January 2010

To some extent this owes its origin to the credit crisis: unable to gain finance in recent years many construction projects have simply been shelved. Added to this is the fact that many existing holders of property no longer need to sell. Listed property companies have spent the last two years rebalancing their portfolios, paying back debt and tapping the equity markets for capital whilst net inflows into retail funds mean these funds are cash rich.

At the behavioural level, in a rising market holders of an asset are reluctant to sell for fear of missing out on further gains. Banks, which had become de facto landlords because of delinquent property loans, fall into this category. They are disinclined to part with assets that are rising in value (or where losses are narrowing). Similarly, they are prepared to be lenient with over-extended borrowers. Why crystallise losses for both parties when the passage of time and rising asset prices might erase the problem?

Rising investment demand may help to lift prices but the occupier market needs to show improvement for the recovery to remain firm. It is, after all, the tenants who pay the rent that ultimately makes a building valuable. On that score, there are some welcome positive indicators. The Royal Institution of Chartered Surveyors reported that occupier demand moved higher for the second consecutive quarter at the end of 2009. They report that new occupier enquiries rose across the three principal sectors of office, retail and industrial although effective demand was strongest in offices and industrial, with retail still lagging outside the South East.

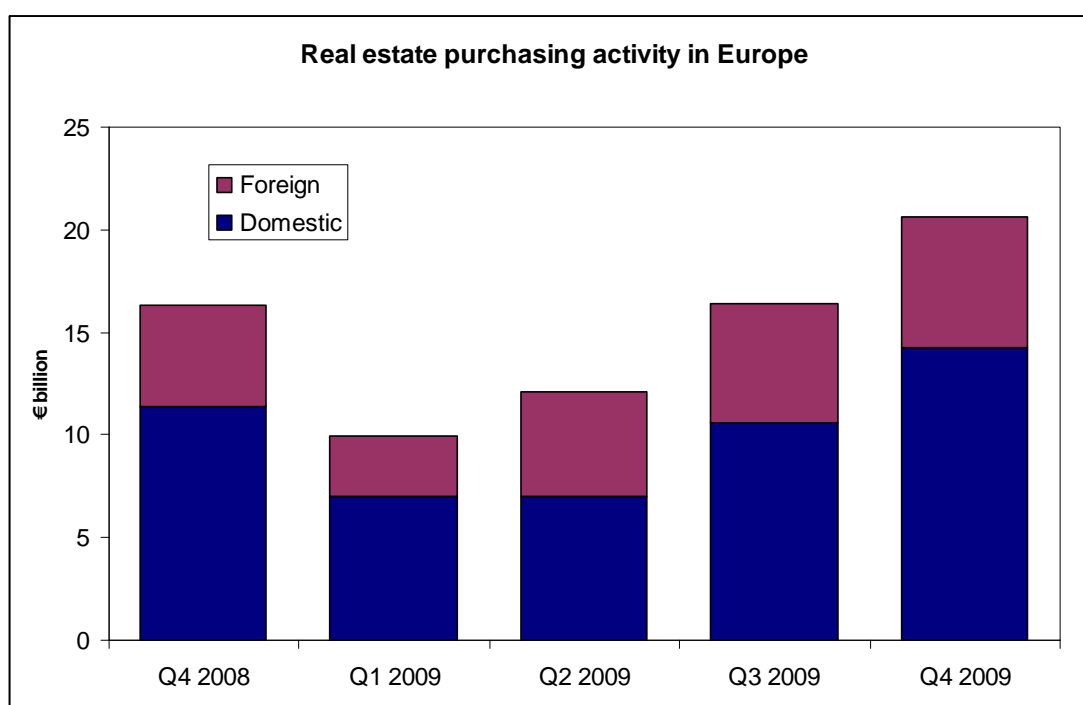
The office sector has been the most resurgent. The steep fall in headline rents that characterised the sector in 2008 and 2009 appears to be drawing to a close. In the final quarter of 2009, prime rents in the City of London actually rose to £45 from £42.50 in the third quarter according to GVA Grimley, the property consultant, whilst the vacancy rate fell to 9.7%, down from a high of 10% in the second quarter. The industrial sector has been surprisingly buoyant and may be responding positively to the marked decline in sterling over the past two years making UK production more competitive. The CIPS manufacturing survey for January 2010 reported a rise to 56.7, the highest level in 15 years, indicating expansion. This is following through to less available floorspace and landlords offering fewer inducements to tenants to take up space.

With the UK economy seemingly stabilising the outlook for rents should start to improve, although the UK's lacklustre escape from recession – a mere 0.1% growth in the final quarter of 2009 – cautions that the economic recovery remains fragile. The headwinds of a general election and potential fiscal and monetary tightening on the horizon mean we expect price rises to moderate in 2010. This should help to prevent an unhelpful bubble forming in the asset class.

The UK was the first to enter the downturn so it is not surprising that its commercial property market has recovered ahead of those in other countries. There are, however, signs that overseas property markets are beginning to stabilise and in some cases are already starting to turn up.

In Asia there is a wide divergence between markets but the region offers some of the strongest growth potential. Prices in China have been climbing as liquidity finds its way into the property market, and in Hong Kong, landlords in Central district have increased asking rents in response to more robust demand for space. In Australia, the economy has been relatively resilient during the global recession and markets were showing signs of stabilising in late 2009. Expectations are that prices will start to recover in early 2010 with the office sector in Sydney likely to lead the way. In Japan, the weak economy has tended to weigh on rents despite vacancy levels being relatively low. The surprisingly strong economic growth recorded for the fourth quarter of 2009 is encouraging although it may be some time before this feeds through to recovering rents.

In Europe, there has been an improvement in activity levels and this should start to feed through to prices in selected locations. France has seen strong demand as investors are attracted by the country's stable economic outlook and well-established property market. In recent months prices for offices have risen in the central business district of Paris. Investment volumes have also risen considerably in central and eastern Europe. The following chart shows the purchasing activity within Europe by type of investor, with domestic investors stepping up their purchases.



Source: DTZ at January 2010

Lot sizes have also begun to increase, which suggests that credit tightness is beginning to ease. Institutions and listed property companies have also returned to the acquisition trail broadening the buyers beyond managed funds, sovereign wealth vehicles and German open-ended funds. DTZ, the property consultants, estimate that up to €106 billion of capital could be targeting property investment opportunities across Europe in 2010.

Such a figure seems feasible and may prove conservative if investor sentiment towards the asset class continues to improve. We believe that the renewed interest in commercial property is warranted: property prices across the globe are considerably down from their peaks and yields on commercial property remain high relative to other asset classes. Moreover, with property still in the early stages of recovery a diverse portfolio of properties on strong leases and with quality tenants should offer both a decent income and the potential for long-term capital gain.

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