Alternative Property Sectors

October 2009

Securing an income stream

With a 44% decline in values from peak-to-trough, the UK property market has faced one of its toughest tests during the past two years and has focussed investors on the importance of secure income.

Despite the cyclical nature of the market, property is resilient in delivering income, even through past economic downturns (see Figure 1 below). This highlights the importance of property within an investors' portfolio and is particularly true for those investors with more achievable hurdle rates (5-10% pa) to match liabilities. These property investors were also helped by the fact that as values fell the yields on offer became more attractive to those willing and able to buy.

In 2005, an property investment article suggested that *"investors don't need knowledge of the real estate market to take advantage of fixed-income offered by CMBS bonds"* and that *"if something goes wrong, and the rental income falls so that the bonds default on payments, the bondholder can claim the property and sell it to recoup their investment"*. We now know it is not this simple and the threats to receiving income from all types of property investment are well-known. This paper outlines the importance of property income and will be followed by a series of notes highlighting the less 'mainstream' property sectors that may offer more secure, longer or a less volatile income stream. Of course, the 'traditional' sectors of retail, office and industrials will continue to offer secure income depending upon the property characteristics, location and the strength of the covenant.

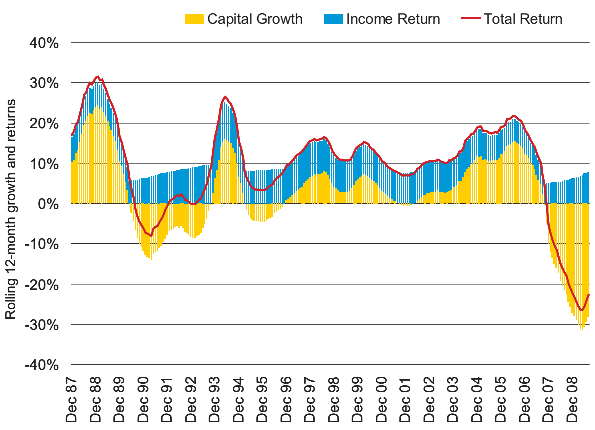
The importance of income from property

The UK market, and indeed the global property markets, has seen a marked deterioration in capital values during the past couple of years, which has seen a breach of loan to value (LTV) ratios. However, a degree of flexibility by some lenders has seen a shift to interest cover (payable with the income) rather than concentrating on the LTV breach. However, during this time, those properties with a high degree of debt have been buoyed by the income received to service the interest. Income is more important than ever.

Overall, property has a dual role of securing income return and capital growth for an investor. During periods of falling yields, and buoyant economic conditions, the less volatile income element gets smaller coverage than headline grabbing capital value movements. Income is viewed as the boring part of investment return, but over the years it is this element that has shored up the returns for property.

Those seeking an income 'play' would head towards government-leased property and large corporates, which are viewed as offering the securest income.

Figure 1 Importance of income in the UK market



Source: IPD ©

Figure 2 Void rates are heading higher

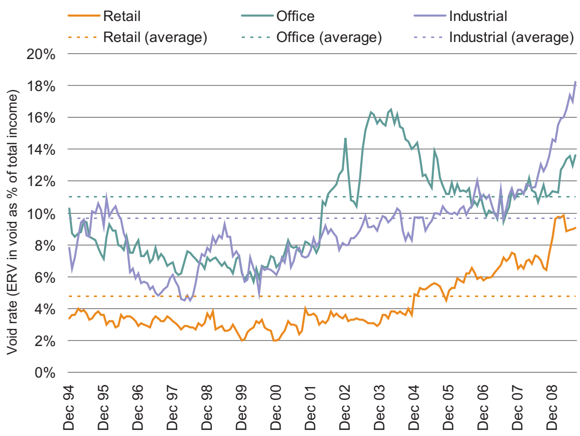


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Figure 3 Threats to rental income in the UK

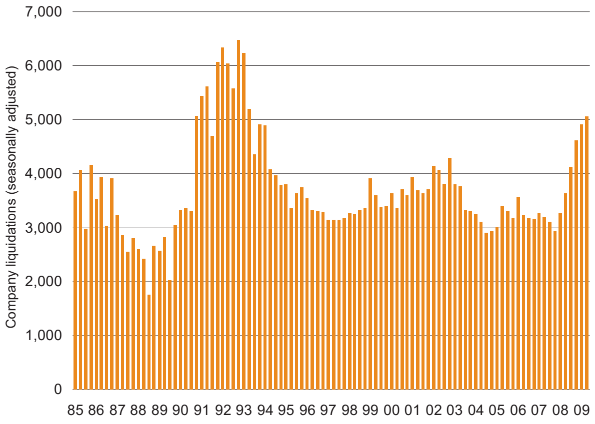

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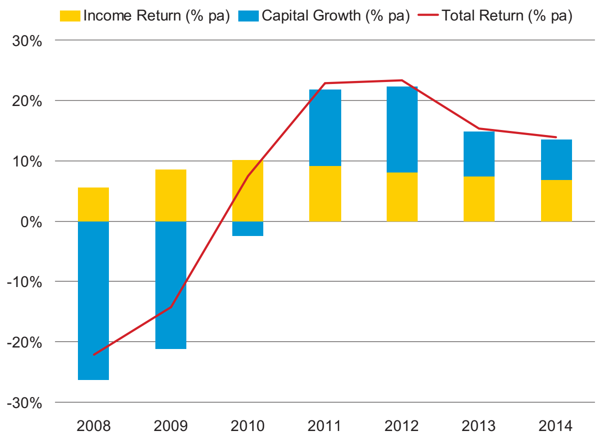
Figure 4 Income will help drive future returns



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However, the fall of some large corporates during the last couple of years has left some investors asking questions about the real security of their income. Some landlords are protected by insurance (tenant default cover), but the premium cost and relatively short time covered is not a consideration for most. As a response, the question is whether we will see a shift towards alternative property sectors.

Threats to property income

Controlling voids, i.e. empty property, is vital to manage income levels. Quite simply, it is about occupiers continuing to pay the rent and/or surviving the prevailing economic conditions. For existing investors, today's market has shifted increasingly towards managing income by retaining tenants. Stories of landlords concentrating more on property management are widespread with the aim of making occupiers feeling more 'loved'.

All property sectors have differences in average void rates, which is dependent upon the types of companies in occupation and their market conditions (see Figure 2; front page). At sub-sector level, there may be more secure income opportunities for investors as certain occupier types may be more resilient in a downturn. There may also be lower voids and/or longer leases on offer and some fund managers have already looked to alternative property asset classes to take advantage of higher income yields whilst offering diversification and stable cash flow. Securing and preserving this income will be even more important to property investment over the next few years. Identifying these property sectors is the purpose of this series of papers.

So what is the scale of the void issue facing property investors and landlords? The UK economy has been under huge pressure during this current downturn and corporate failure has been significant and will continue to rise during the final quarter of 2009 (see Figure 3).

The rise in corporate insolvencies has been severe and the acceleration in the number of these events has been fast. The result, as at the end of Q2 2009, is that nearly 10,000 companies have become insolvent during the year. This compares to 6,900 at the same point in 2008. The effect on property owners is clear. The income receivable on property investment may be zero for some time for certain property sectors. As well as insolvencies, lease events such as a break or expiry will also threaten the future delivery of an appropriate income stream to the investor as the prevailing economic turmoil has enabled occupiers to renegotiate aggressively at a lease event. Consequently, despite evidence showing that property income remains robust during the downturns, rents may be on better terms for the occupier. Additionally, rising level of supply in most markets, driven by space being released back onto the market, ensures that occupiers can achieve the more favourable terms with more choice available.

Income from alternative property sectors

There will be opportunities to receive a secure income by looking at alternative sub-sectors in the UK property market. A recent survey at a European level shows that pension funds have become 'downside protection managers' with assets heading to cash and fixed income (government and corporate bonds offering 3-5% yields in the UK). However, 'average' UK property is yielding 9.2% (as at end-August 2009). Focus in the UK property investment market has initially shifted towards a narrow band of prime investment stock offering stronger fundamentals including longer-term income streams and let to strong covenants. Consequently, this prime end of the market has seen yields begin to move lower again. Across all sectors, the average prime yield is now 6.7% after peaking at 7.4% in March this year. It is unsurprising, therefore, that the same survey suggests that a net balance of 12% of pension funds would like to increase property exposure. Alternative sectors and less prime assets

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will be on the 'buy' list over the short-term.

Overall, the short to medium-term will see a continued reliance on income to drive investment performance. The security and regularity of this income is vital to a success of a property investment. Many factors will affect this income; economic cycles; void rates; tenant default, depreciation and obsolescence, to name a few. Given the timing of this paper, it is our intention for the subsequent papers to concentrate on the maintenance of income through the economic cycle and resulting occupier demand (systematic or market risk) rather than individual property asset risk (unsystematic or specific risk), which can be eradicated, to some degree, with property management. The importance of income in delivering total returns is shown from the forecasts in Figure 4. Some property sectors will perform better and worse than this average. Finding the sustainable income stream is key going forward.

There is a large amount of money that could potentially hit the UK property market as sentiment improves and higher yields become increasingly attractive, but securing product will remain the challenge. Alternative property sectors will help. However, the lack of assets remains the issue, despite the expectation of distressed selling. The market will ultimately see more investments come to the market, but as yet this remains limited. Investor confidence is picking up and property funds are being built up to eventually spend in the UK market. The alternative property sectors may offer a release for this new wave of money.

Of course, the core property sectors, with their heterogeneous nature and specific risk characteristics will offer different degrees of income security depending on the risk appetite of the investor. However, as a broad approach, it is relevant to assess some alternative, less mainstream, property sectors. So the question is, 'what are alternative sectors to deliver the most sustainable income returns going forward?'. Some sectors have been covered in 2009. Throughout the remainder of this year, there will be a series of papers following this to assess the less mainstream sub-sectors, which may offer greater income security due to the nature of the business carried out in the property and likely future occupier demand. 2009 reports include:

- Serviced apartments (March; see website);
- Student accommodation (May; see website);
- Healthcare (October);
- Self-storage (November).

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