Sponsored by

__Adding value__ – Paul Crosbie discusses how to enhance value in the UK real estate market ***p66***

__The diversification game__ – Real estate investment in the UK has slowed somewhat over the past year, but for pension funds looking to diversify their portfolio, opportunities remain in regional and alternative asset classes, Theo Andrew explores ***p68***

Real estate focus:

Location, location, location

Paul Crosbie, fund manager, M&G Real Estate

Sponsored by

Adding value

Paul Crosbie discusses how to enhance value in the UK real estate market

UK real estate continues to trade at a historically high spread over bond yields and pricing remains favourable when compared to other global markets. This alone may be tempting enough for some investors, particularly those from overseas who are attracted by the liquid, transparent market, landlord-friendly leases, availability of large lot sizes, and of course the current relative weakness of sterling. Confidence in investing in UK real estate has been further underscored by the strength of the underlying occupational market. Construction levels across all sectors of the UK property market have still not fully recovered from the global financial crisis and the combination of muted levels of new supply coming to market and robust occupier demand for space is underpinning rental growth. Take up of office space in the UK in 2017 was above its five and 10-year average levels, with many occupiers now looking past the initial shock of the EU referendum result and adopting a 'business as usual' approach. This has resulted in vacancy rates on prime (the best quality) real estate falling to below 2 per cent in most of the core office and industrial markets.

Despite the relatively favourable occupational market dynamics, particularly outside prime central London, most investors have taken a 'flight to prime' approach in the wake of the Brexit vote. They have tended to focus on the best-quality core assets with relatively long leases; the definition of what is considered core has also narrowed during the past 18 months. This dynamic has created a divergence in pricing between core and non-core assets. Properties with perceived risk attached – whether it be vacancy, near-term lease expiry or imminent need of capital expenditure – are now on average at an 8 per cent discount to pre-referendum pricing. As a result, the net initial yield spread between core and non-core assets has increased by 50 basis points (bps) since March 2016 to stand at 300bps in December 2017.[1] At a time when the global real estate cycle is relatively well advanced, the UK stands out as offering relatively attractive value when considering long-run historic pricing, but also particular value, and therefore opportunity, in non-core assets.

Occupational market in focus

The combination of a shortage of quality accommodation and robust demand supports taking leasing risk, such as vacancy, which, when such risk is addressed through active asset management initiatives, should enhance a portfolio's income profile. Looking at the Investment Property Databank monthly index, rents at the all-property level have continued to grow every month since Brexit, but those sectors with tighter supply and demand dynamics have benefitted the most.

In the logistics sector, the supply and demand imbalance is particularly acute, especially for multi-let estates in London and the South East, and thus the sector has seen rents grow by more than double the average at 5 per cent p.a. in 2017. Strong appetite for space continues to be driven by structural changes related to e-commerce and competition from other land uses. Future returns are likely to be driven by rental income and rental growth, which can be enhanced through active asset management. However, investors are also likely to be well-compensated for taking development risk in particularly supply-constrained industrial markets.

Turning to the office sector, attractive income yields of above 5 per cent can be found in some of the key cities outside of London, including Manchester, Birmingham and Edinburgh. Such regional cities are set to benefit from transport infrastructure development, with £26 billion earmarked by the government for such purposes. In addition, the devolution of government powers to key regional cities should give them greater ability to unlock potential sites for urban regeneration. Coupled with the affordability of residing in the regions, this should encourage further migration from the capital to cities with high transport connectivity. Total employment growth in Manchester is following the same trajectory as that of London, with the city possessing the fourth largest tech company agglomeration in the UK. While in London development activity is more elevated, there are tighter supply and demand dynamics in the regions. Therefore, the relative shortage of quality commercial office stock in cities such as Manchester and Bristol gives us confidence to take on refurbishment and repositioning opportunities, transforming currently non-core assets to core.

So what do we expect the UK to look like post-Brexit? Over the next two to three years, we expect ongoing Brexit related uncertainty to weigh on GDP growth, but also on investor confidence, although both are anticipated to recover once the uncertainty starts to dissipate. This represents a compelling window of opportunity to acquire properties with strong underlying fundamentals at reduced prices, which are well-located and could benefit from capex or proactive leasing. Over the longer term, the UK is expected to see 2 per cent per annum GDP growth, the second highest G7 economy behind the US. [2]We anticipate that once the EU exit process

Non-core capital values have fallen since EU Referendum

CBRE PROPERTY VALUATION CAPITAL GROWTH, INDEX JUNE 16 = 100

Source: M&G Real Estate, CBRE (data to Dec' 2017)

has been completed, the UK economy and real estate markets will recover, leading to positive conditions to sell assets into a more favourable market.

Amidst improved business and consumer confidence, rental growth should accelerate as the occupational market strengthens on the back of an improving economy, further aided by the undersupply of 'Grade A' prime space across all sectors. Given the return of confidence, we anticipate the spread in risk premiums between non-core and core real estate assets will narrow, as occupier and investor risk aversion diminishes. On the capital growth side, a positive re-rating can be achieved from repositioning or refurbishing assets, which when combined with the timing of a market upswing can crystallise gains delivered through value enhancement. Delivering the best risk-adjusted returns from the property market requires expert delivery of active asset management initiatives to maximise the available returns from investing in attractive supply-constrained submarkets. Managers with access to the capital markets, significant experience of the UK market and asset management resources will be able to capture the opportunity and ultimately deliver better returns for investors.

Active management in action: 2 College Square, Bristol

Addressing leasing risk can contribute positive capital uplift to an asset. In September 2012, we acquired a 52,000 sq ft multi-let office building in Bristol city centre with a vacancy rate of just under 50 per cent, equating to 25,325 sq ft of space. The asset was fully let by December 2015. The size and flexibility of the floor plates, or the amount of rental area on each floor, were a key attraction of the asset, as there was a lack of quality large floor plates in Bristol's CBD, alongside strengthening occupational demand and diminishing 'Grade A' prime supply. The asset was bought for £13 million and sold for £22.8 million, representing a profit on cost of 65 per cent.

Written by Paul Crosbie, fund manager, M&G Real Estate

In association with

M&G REAL ESTATE

[1] *CBRE*
[2] *Consensus Economics*

This article presents the author's present opinions reflecting current market conditions. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product.

The diversification game

Real estate investment in the UK has slowed somewhat over the past year, but for pension funds looking to diversify their portfolio, opportunities remain in regional and alternative asset classes. Theo Andrew explores

Summary
- The search for a diversified portfolio has pushed pension funds towards real estate.
- Opportunities for higher long-term yields are an attraction.
- The private rented sector and ecommerce provide the best value deals for pension funds.

Over the past year or two the number of and amount that pension funds have been looking to invest in the real estate market has been on the rise, but as economic headwinds become more volatile, the hunt for yield in the real estate market may be starting to wane.

Despite this, there are still a number of valuable reasons why pension funds look to grow their involvement in the real estate, most importantly, according to M&G head of capital solutions Martin Towns, providing an income stream that is "not only higher than many alternative asset classes, but also long-term and sustainable".

Although real estate is a viable investment option for pension funds, there remains a huge amount for investors to consider, from the nuances of alternative asset classes to the competitiveness of the mainstream office and residential properties.

While some may consider it a defensive asset, it is still important to know where to look and how to look for it, in order to achieve the right returns for your members.

Lay of the land

Market commentators are keen to emphasise the period of global political and economic uncertainty currently plaguing the market, but many in real estate feel that the industry can be somewhat of a safe haven for pension fund investors.

While much of the news around what effect Brexit is set to have on the UK economy isn't the most positive, a number of real estate firms believe that the UK real estate market has the potential to be one of the strongest, supported by "positive macro trends".

Towns says: "Despite the headwinds associated with the ongoing Brexit negotiations, the economy has remained relatively robust and occupiers – particularly in logistics and offices outside of central London – continue to take new space."

According to a JLL paper, *The UK Big Box Industrial and Logistics Market 2018,* while occupier take-up in 2017 was 36 per cent down on 2016 and 11 per cent down on the 10-year annual average, the investment market remains strong, with the logistics sector set to outperform both the office and retail markets over the next four years.

"The longer-term prospects for these markets are also supported by positive macro trends, for example ecommerce and increased urbanisation, coupled with a consensus expectation that the UK economy will again be one of the best performing of the G7 in years to come," Towns adds.

Another sector that has experienced a significant uptick over the past couple of years is the private rented sector (PRS), also known as build-to-rent.

It's an area of real estate that has capitalised on the unaffordability of house prices and in 2015 to 2016, 4.5 million, or 20 per cent, of households in England were renting in the private

sector, a number that is set to rise to 5.79 million, or 24 per cent, by 2021, according to Knight Frank research.

Furthermore, Knight Frank found that nearly 16,000 build-to-rent units have been completed across the UK, with another 20,600 under construction and nearly 50,000 with planning, as of August 2017, and is certainly an area pension funds are turning to.

In February, Hearthstone Investment Management's Residential Fund 1 (HRF1) raised £100 million of commitments from five local authority pension funds, which will invest in regions across the UK where there is anticipated to be string rental demand. The fund is targeting a 4 per cent return on a £200 million investment into housing.

Staffordshire Pensions Panel chair, Philip Atkins, says: "This is an opportunity for funds to make an investment that firstly meets our investment requirements, but also contributes in a small way to the housing need of the country.

"The growing demand and undersupply of quality housing, in particular in the private rented sector, makes residential property more resilient to economic downturns and attractive to long term investors. The HRF1 will provide a reliable income stream over the next decade while the underlying assets will act as a hedge against inflation."

Elsewhere, leading developer and operator of PRS, Platform_ , has revealed its plans to expand its housing portfolio to Exeter and Scotland with global investment giant, Invesco Real Estate.

The regional strength of this sector might make local pension schemes sit up and take note, and when you throw an attractive long-term yield into the mix then it starts to look like a good investment.

Rate of risk

While some areas of real estate can paint a rosy investment picture, there are a number of important factors for pension funds to consider and BlackRock's UK real estate team director, Paul Tebbit, holds a somewhat more apprehensive approach to the UK real estate holding a more mixed outlook.

"The UK real estate market outlook is somewhat mixed. On the one hand, political risk from Brexit looms large, the economy is lagging other developed markets and valuations are at an all-time high", Tebbit says.

"On the other hand, some markets remain supply-constrained and are experiencing strong tenant demand, but the UK remains popular with foreign investors, and low rates support high valuations."

While assessing the risk is the key component for any type of investment, Tebbit believes that for pension funds looking into real estate, risk factors include development, liquidity and leverage and investors need to measure these three factors accordingly.

It is this state of middle flux that has meant real estate has faced increased headwinds over the past year, but once Brexit has been taken out of the equation, the fundamental principles of the property market remains the same, which as UBS Asset Management head of real estate UK, Howard Meaney, points out, remains friendly for pension funds.

"Even taking Brexit uncertainty and the modest rental growth outlook of the UK aside, the principle of long-term secured income in the current environment presents an obvious draw for pension funds due to the structure of long leases, which enable them to use real estate income to meet distributions further into the future", Meaney says.

Part of the move towards real estate as an asset class is can be seen as traditional fixed-income investments fail to achieve adequate returns.

"With traditional fixed-income strategies not currently generating meaningful returns, the appeal of long-income property is attractive in that it provides stable income based on contractual real estate leases at a similar risk profile but offering a significant yield premium, circa 4.5 per cent versus circa 2.5 per cent from similar risk corporate bonds or 1.65 per cent from gilts", adds Meaney.

Bedding in

It is clear that there are asset classes out there that can provide opportunity for pension funds in the UK market, so for those willing to take the risk in the right way, the members will be the beneficiaries.

Towns says: "We believe that UK real estate will become an even more prominent choice for pension funds, adding greater diversification to portfolios and enabling funds to reap the benefits of sustainable, long-term income to help match their liabilities."

BMO Real Estate Partners head of business development, Angus Henderson, agrees that it is the hunt for diversification that is driving pension funds into the property market, as well as inflation-linked income streams, which offer an alternative to traditional bond portfolios.

"The UK is an obvious entry point for UK pension funds looking to increase their allocations to this sector, offering one of the world's most transparent legal frameworks and property ownership structures, which is particularly advantageous for long-term holders.

"A long-term investment horizon helps with both smoothing the impact of portfolio construction, transaction costs and ownership costs, which tend to be higher in real estate," Henderson says.

It is the alternative asset classes that are offering the most opportunity for investors, and technology is disrupting the traditional real estate game. For those that want to find it there are rewards to be had, it's just about knowing where to look.

Written by Theo Andrew

In association with M&G REAL ESTATE