Investment Insight:
Secondary property – potential investment opportunity?

May 2014

Defined benefit: **Relevant**
Defined contribution: **Relevant**

Since the financial crisis a flight to safe haven assets by domestic and international investors has led to substantial investment in UK top end prime property, mostly in London. This latest Investment Insight looks at the relatively neglected secondary property market. We consider valuations, the asset characteristics and what trustees should consider before investing in this asset class.

What is secondary property?

Whilst prime property is typically classed as property of the highest quality, with a high specification, found in the best locations and let to strong tenants, secondary property on the other hand is often defined by a negative: ie it is not prime property. This lack of exact definition lends itself to a large and diverse range of properties that could include property that is 'almost' prime (but falls short of one criteria to allow it to be deemed prime) to properties that meet no prime property criteria at all.

This sweeping definition of secondary property complicates the task of looking at historical valuations and pricing and thus of choosing a suitable benchmark. A popular source of data for the property market is provided by the Investment Property Databank (IPD) which provides valuation-based performance measures for the UK in different sectors, within specific regional or sub-market categories. Within each IPD category, the data can be banded into separate quartiles, depending on the property's yield. In general, the historical performance of prime property is often represented by the IPD top quartile (lowest yields). Looking at secondary property is more complicated, though some analysts use the IPD's fourth quartile data that has the lowest prices and highest yields.

This paper focuses on UK commercial secondary property although inevitably there are also equivalent potentially interesting international investment opportunities[1].

[1] See, for example, CoStar UK: Investors turning to regions January 16, 2014

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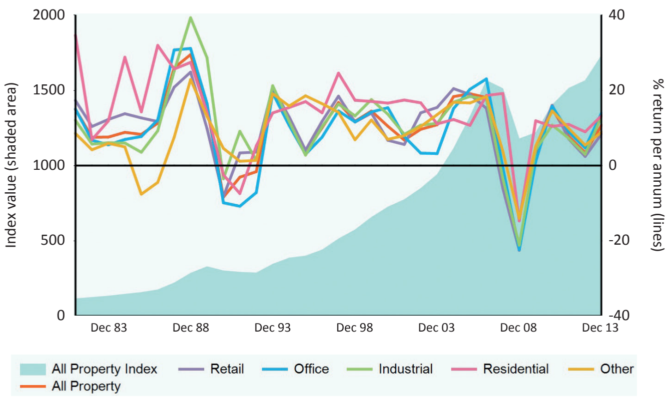
The Background

Following the major price correction in property prices from 2007 to late 2009, from 2010 property prices have started to recover but prime and secondary property have followed divergent paths to date.

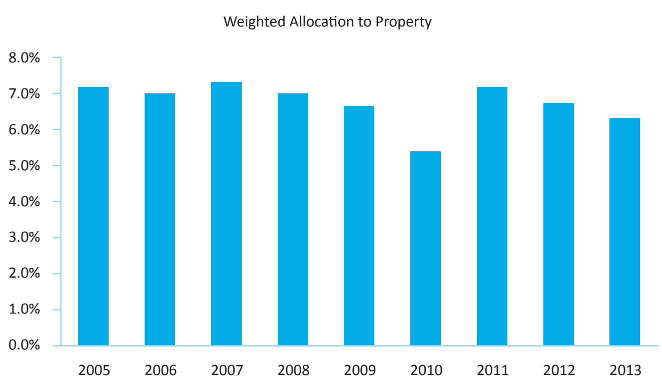
Chart 1: Overall UK property performance



Source: IPD, 2014

A flight to safe haven assets by domestic and international investors has led to substantial investment in UK prime property, with a particular focus on London. Secondary property prices have lagged significantly as investors have remained risk averse. The uncertain economic climate and regulatory pressure has led to investors investing heavily in inflation-linked gilts, investment grade corporate bonds and in liability driven investments in general in order to match their liabilities more closely. According to our Annual Survey the overall allocation to property has actually declined modestly over the over the last 9 years.[2]

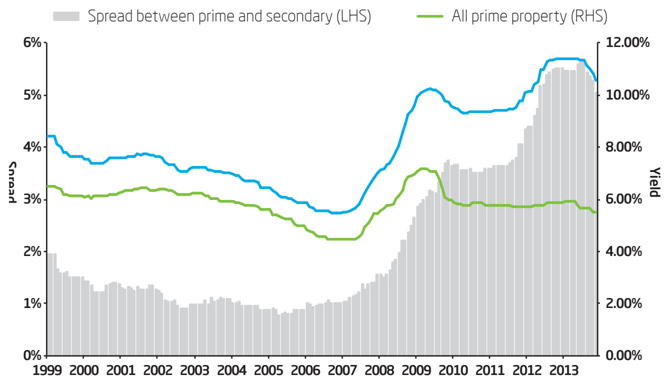
Chart 2: Asset allocation into property



Why consider secondary property now?

Prime property prices have performed very strongly since property prices troughed in 2009.

Chart 3: Divergence (spread) between prime and secondary property yields



Source: CBRE January 2014

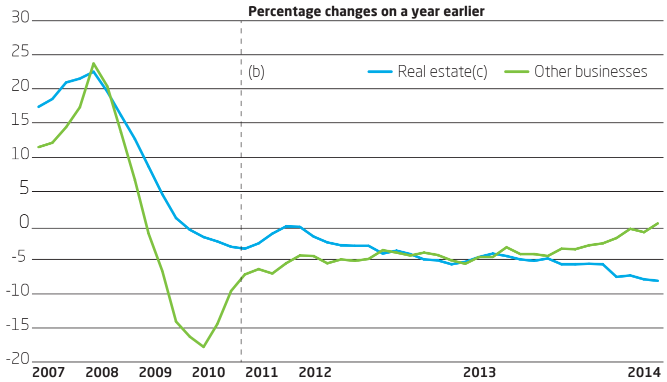
The yield on top end prime property moved up 2.7 percentage points in yield from the peak in prices in summer 2007 to the trough in prices in summer 2009. During the same period, the yield on secondary offices moved up by almost twice as much as prime, increasing 4.6 percentage points in yield. From the trough in prices in 2009, the price of prime property has rallied back to almost 2007 levels (the latest yield is 5.5%) whilst secondary property prices have continued to fall to yield 10.6%, on average, as seen in the chart. The gap in yields and thus performance between secondary commercial property and prime property is near its historical high but has started to narrow (the secondary market has started to outperform) over the last six to twelve months.

A second reason why the focus has turned to secondary property is because the UK economy is now improving and rents, in some areas, have begun to recover. Given this more sanguine backdrop, pension funds are looking for sources of extra yield and diversification and are willing to embrace a little more illiquidity in their investments in order to achieve this.

A third reason for pinpointing now as a time for considering investing in secondary commercial property is that there are a number of forced sellers in this market currently. UK banks are under increasing regulatory pressure to reduce their balance sheets and cut their property exposure. Other sellers include private equity funds, many of which have acquired debt packages from banks and other distressed borrowers.

[2] NAPF Annual Survey 2013. Defined benefit schemes' investments- private and 'other public sector'.

Chart 4: Growth in the stock of lending to the UK property sector and other businesses



Source: Bank of England, Trends in Lending. April 2014 [3]

Key characteristics of commercial property

Real 'tangible' assets

Property is a tangible asset with intrinsic value. Even if the building itself needs replacing, the land it stands on has intrinsic value.

Inflation hedge

Property leases are usually relatively long term and rents generally have an indexation element to them with either fixed increases or rent reviews linked to increases in RPI or CPI. Therefore it can be argued that property in general acts as an inflation hedge which has tended to correlate closely to inflation over the long term.

Income stream

With many defined benefit pension schemes closing and a growing need for cashflow, pension funds are looking for a secure and sustainable income yield – which commercial property can provide.

Diversification

In the fifty years post the end of the Second World War, investment returns from UK commercial property had a low but positive correlation with equities (0.30) and gilts (0.15). During the same period gilts and equities were much more closely correlated to each other (0.50).[4] This suggests that commercial property can have diversification benefits within a pension fund portfolio.

Market maturity

The UK property market is considered one of the world's most mature and liquid markets. It benefits from a large and investable universe of properties and has a transparent and well-established legal and valuation process.

Checklist before investing in secondary commercial property

The following issues are among those that need consideration by any scheme contemplating an investment in this asset class:

- As an investor, what is your view of the UK economy over the longer term? How sustainable is the recovery?
- Is the property attractively priced given its specification and location?
- Is there scope for improving the quality of the property asset through refurbishment or change of use/planning permission? Does the investment manager running the fund have the necessary skill and experience to identify such opportunities and be able to add value in this way?
- Often a fund will have a target Internal Rate of Return (crudely defined as the return on the property relative to base rates) and a target distribution yield (income received from the property). These two measures are targets and these levels of return are not guaranteed so this needs to be clear.
- Fund manager fees may have a performance-related element that needs to be thoroughly understood at the outset.
- The investment constraints are likely to include concentration limits so that no one asset dominates the overall portfolio. Moreover, pension funds should also be comfortable with the level of concentration in one sector (eg retail warehousing) and ensure that all constraints are transparent in the fund objectives.
- Will leverage be used? If yes, what percentage of the value of the fund can be leveraged and is this for short term or long term purposes? Is any leverage or variation in leverage appropriately reflected in any performance-related fee structure (important not least as the IPD data usually used as a benchmark is ungeared)?

[3] b) From January 2011, data are on the SIC 2007 basis. Changes in the SIC codes have led to some components moving between industries. As a result, growth rates in 2011 may be affected.
(c) The real estate sector is defined as buying, selling and renting of own or leased real estate and includes real estate and related activities on a fee or contract basis. The development of buildings is included in the data prior to 2011.
[4] IPD Annual Digest 2012 & P.Scott 'The Property Masters'.

Examples of investments in secondary commercial property

In order to bring the subject to life, here are a few examples of the types of possible properties, their location and the yields on offer from a selection of fund managers (naturally, other managers are available and this selection does not amount to an NAPF endorsement):

1. Kames Capital

One of Kames Capital's property portfolios comprises eight office buildings around the UK including Manchester, Brighton and Glasgow. The initial yield on the fund was 10.2% with a lease length of 8.6 years. The fund manager aims to add value to the properties through lease extensions, change of use and possible redevelopment.

2. F&C

Guy Glover, F&C's UK Property manager, has recently been on the wires explaining that he has been busy diversifying his fund's investments outside the South West and South East of England. He does not hold any property in central London, preferring to hold properties in the 'top 100 retail destinations such as the cathedral towns of York, Chelmsford and Edinburgh'.[5]

3. Aviva

Aviva has a portfolio comprising of 14 secondary assets throughout the UK. The primary focus is on the south east (outside London) and includes offices in Epsom, Slough and Teddington. It also has exposure to industrial property in Warwick, Rugby and Dover where the fund manager sees the greatest re-pricing opportunities as well as retail warehousing in Southend and North Shields.

Conclusion

There is growing interest in investing in secondary commercial property among pension funds in the UK. The search for yield and income amongst schemes is palpable. The historically large gap between prime, top end properties and secondary properties appears compelling (despite being off its best levels) but of course the gap could narrow further and yet yields on both could go up (prices down) from here. The extent of forced selling in the pipeline is a big unknown and banks could take any strength in the secondary property market as an opportunity to sell, thereby potentially depressing prices.

> "A key attraction of investing in regional secondary property is that it is offering historically high yields. The gap of around 500 basis points between prime and secondary yield is effectively saying that pretty much every risk investors can identify in the regional property market will materialise: this represents an opportunity to invest."
>
> *Phil Clark, Kames Capital*

If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our lead investment policy adviser: **Helen.Roberts@napf.co.uk**

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[5] Citywire 'Property- is it time to favour secondary markets?' September 2013