The commercial property market

Is it a bond, or is it an equity? No, it's commercial property

Alan Patterson MSc FRICS
VARE Consulting Ltd

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Presenter

Alan Patterson MSc FRICS IMC

Alan is the Director of Business Development & Strategy, and Head of Fund Management in Funding Partners. He is a Fellow of the Royal Institution of Chartered Surveyors and holds a masters degree in Property Development (Project Management).

Alan has worked in the property industry for the whole of his working life. His experience in CBRE (formerly Hillier parker) was as a fund manager, then financial services and latterly as the Head of Investment Research. He gained experience of the equities markets as a director at Panmure Gordon and HSBC Investment Bank, before joining UBS Asset Management where he combined being Head of Fund of Funds, head of UK real estate research with equities management. He joined AXA Investment Managers, where he became Global Head of Research and Strategy in what is now the Real Assets group. He was also the managing director and Head of Research and Strategy at Gingko Tree, the European real estate subsidiary of the People's Bank of China.

Alan's skill base is as a property market economist and analytical researcher, believing that understanding macro trends and secular change is as important as stock selection and asset management.

Direct and indirect commercial property

- There are **similarities** between the two main sectors, but also **differences**
  - **Residential is dominated by owner-occupiers** (utility and virtual rent)
  - **Commercial is dominated by professional investors**
    - But REITs/quoted property companies are dominated by equities investors
- Why professional investors invest in commercial property
  - **Asset class** relative returns and risk
  - **Diversification**
  - **Potential to add high alpha** by active management
    - Core, value-add, opportunistic
- All property is **capital intensive**
  - Desire to add debt to maximum level to both supplement equity and enhance returns
- **Each property is unique** and **transactions are 'non-standard'**
  - Due diligence requirement is enormous
- **Transaction tax (SDRT) is high**
  - Reducing liquidity

Commercial and residential property

- **Quoted REITs and property companies**
  - Are pricing in not just asset values, but management/structure costs/skills, debt, etc
    - The difference is calculated as a **discount/premium to NAV**
  - Show a **strong correlation in the long-term with the direct market**
    - But a **strong correlation in the short-term** with the **rest of the quoted market**
  - Where inflection points are driven by **financial factors**, the quoted market tends to have a better understanding of the pricing implications
    - Whereas when they are driven by **property factors** (erg supply/demand), then the direct market tends to have the better pricing response
  - **The quoted market tends to lead the direct market by about 10 to 12 months**
    - **That relationship appears to have broken down in the last couple of years**, with the lead not being reflected in the direct market

UK Commercial property market

- The UK is arguably the **most attractive market globally** because
  - The market has a high level of **transparency and liquidity**
  - **Agents are professional and fees** are relatively low
  - The **UK legal system is relatively fast and fair**
  - **Taxes are reasonable**
  - The language is **English**

- **London is typically the most traded market globally**
  - **First or second global financial centre**, with professional services and technology
  - **Largest city in Europe**
  - **Growing population**, particularly of high earners
  - **Over half of London commercial property is owned by foreign investors**

Valuing commercial property

In the industry, two methods have become standard

- At the **asset level**, the 'comparable' methodology, embodied in the 'Red Book'
    - Industry 'accepted'
    - Based on de-capitalising market transactions
    - Assumed perpetuity

$$\mathbf{V\ (value)} = \frac{\mathbf{r\ (rent)}}{\mathbf{y\ (yield)}}$$

'All risks' yield

Flaw in methodology

- At the **project or investment level**, an IRR or total return calculation
    - **Limited time-frame**, typically five to ten years (**greatest risk in utilisation**)
    - **Takes into account** debt, all costs , active management, etc (greatest strength)
    - **IRR can be ambiguous**

$$V\ (value) = \frac{a\ (revenue\ or\ cost)}{(1+i)} + \frac{b\ (revenue\ or\ cost)}{(1+i)^2} + etc$$

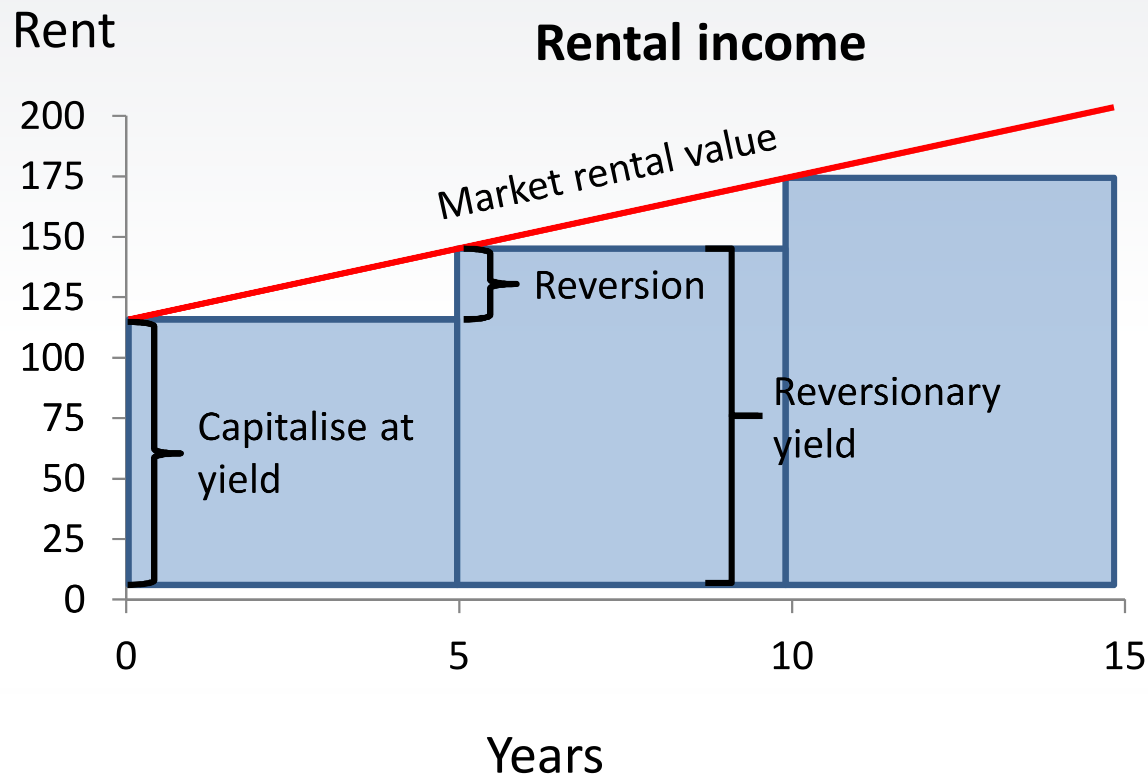
'i' is the number when the NPV is zero

Yields and rental values

- **Rental value** (landlord and tenant relationship)
  - In the **short-term**, determined by what the tenant (a) can afford to pay and (b) has to pay in a competitive market
  - In the **long-term**, determined by supply of new buildings and economic growth
  - **Econometric modelling** identifies the main economic growth factors driving rental values
    - **Offices**: GDP, services output, employment numbers
    - **Retail**: retail sales, interest rates
    - **Industrial/logistics**: manufacturing output
  - **Measured by floor area**, except for retail, which is typically 'zoned'

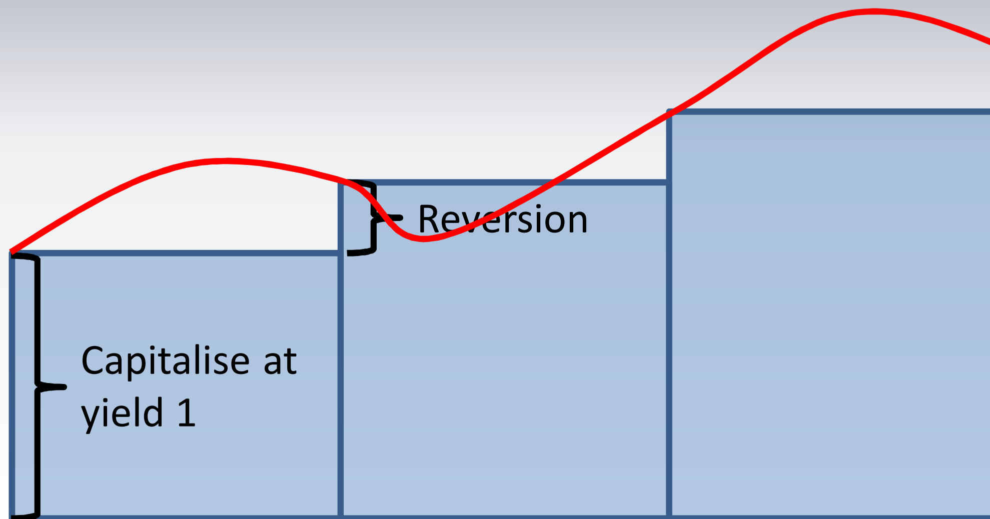
- **Yield** (buyer and seller relationship)
  - Theoretically, determined by **return expectations of the two parties** although, in practice, often largely determined by **comparable prices**
  - But should at least reflect **rental value growth prospects**, (economic) **age of building** (depreciation), **security of income** (covenant), **location**, **sector**, and other factors

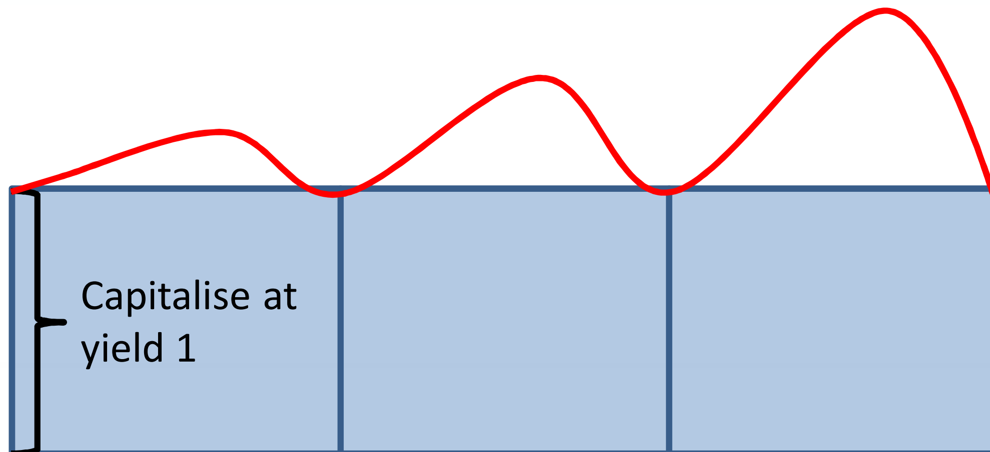
Valuing property by cashflow (1)



- The chart illustrates, in a very stylised form, the traditional concept as to how property investments perform
  - Rent reviews are at every fifth years and are to rental value
  - Reviews are almost always 'upward only'
  - Conceptually, risk to value is at its highest at the time of review
- It introduces the terms 'initial yield', 'reversionary yield' and 'equivalent yield'

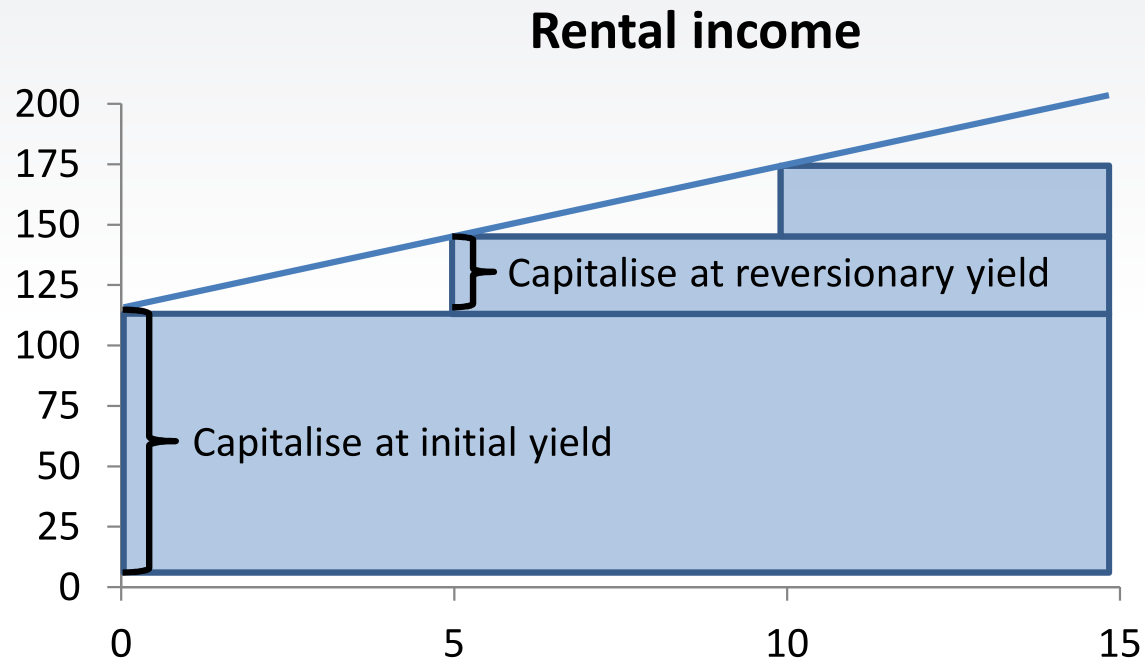
Valuing property by cashflow (2)





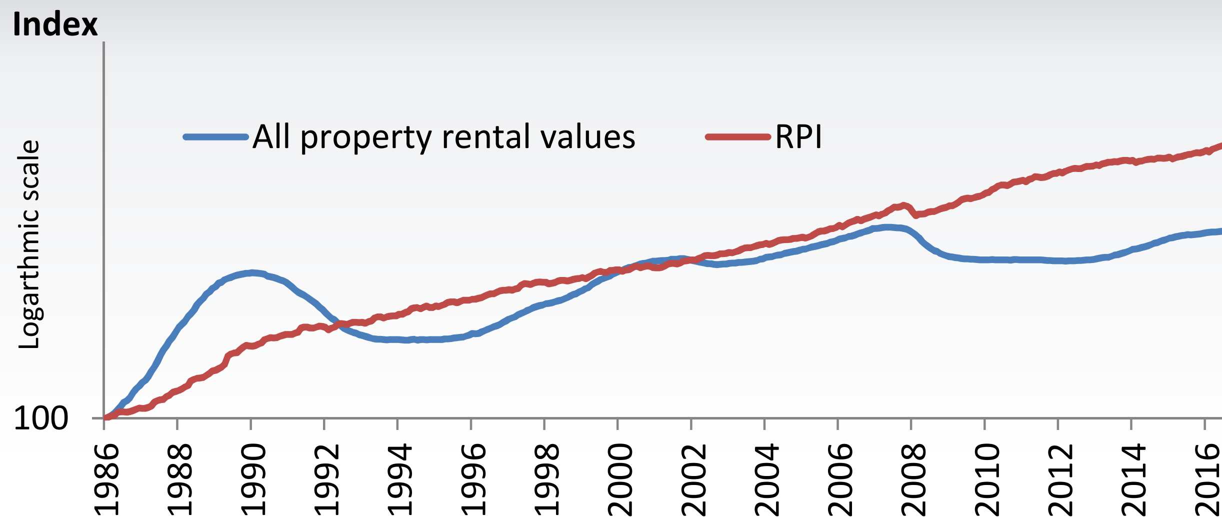
- Of course, the property cycle is not a straight line …
- If you are unlucky, despite an upward trend, your rental income may not grow

Valuing property by cashflow (3)



- A different way of considering value is by horizontal stripping
- This is not purely an academic discussion, as there are times when this can provide a better estimate of value

Long term secular shifts

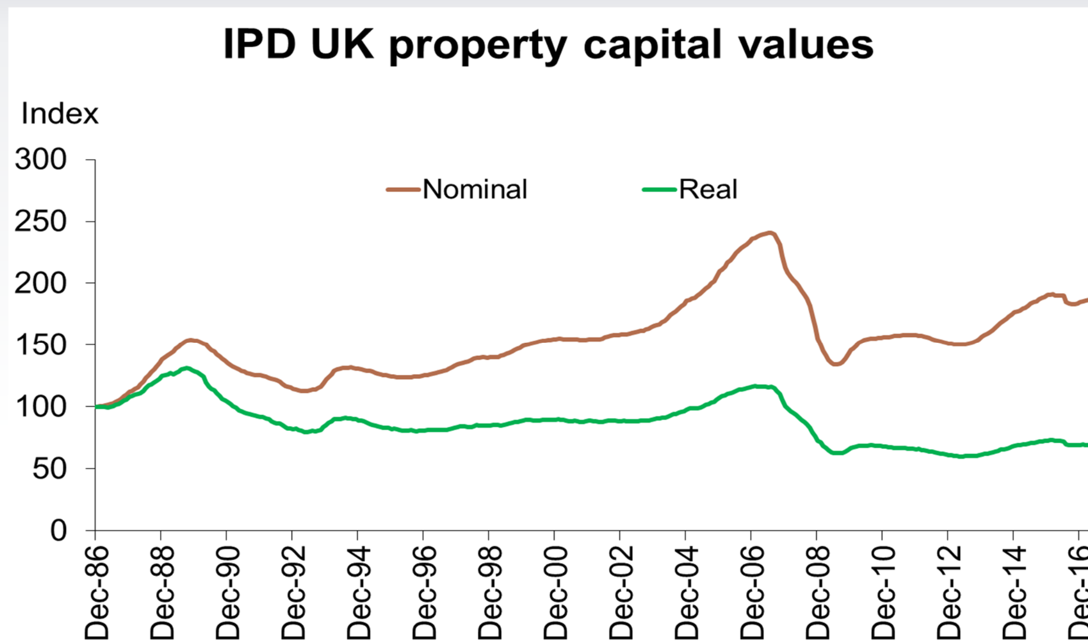


Source: MSCI IPD Monthly Index; ONS; VARE Consulting

- Two reasons underpin these shifts
  - **Secular falls in economic growth**
  - **An accumulation in the net stock of property**

- Real estate has been through three distinct phases in the post-war era
  - **From the early 1960s to early 1980s**, real estate was a real growth investment
  - **From the 1980s to 2008/9**, during which time bond yields were in a secular decline and rental value growth was close to but below zero in real terms, property has become a bond substitute.
  - **From 2009/9 to now**, when rental value growth has been negative in real terms

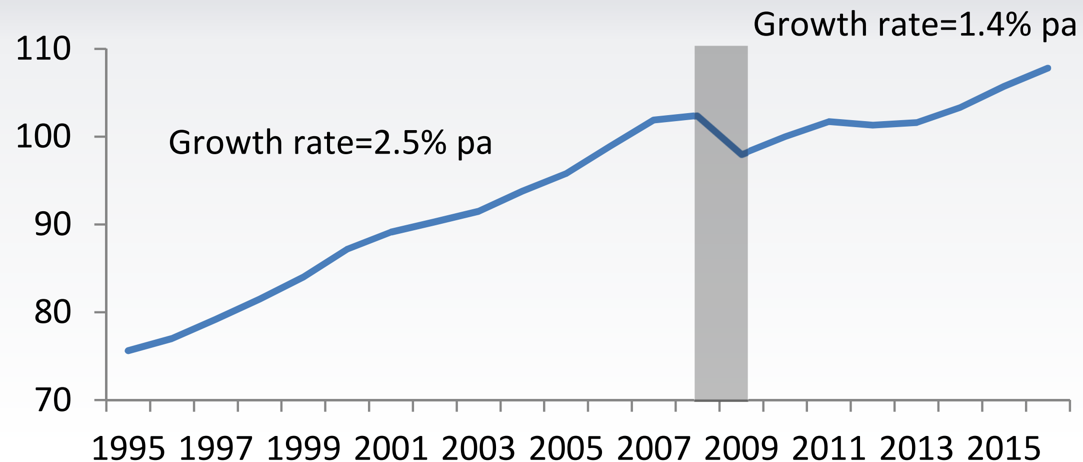
Support for current real estate pricing



Source: MSCI IPD Monthly Index; ONS; VARE Consulting

- Given the deteriorating growth in real estate fundamentals, we should have expected capital values to have similarly deteriorated.
    - There has, however, been one strong support for the relatively high income asset class: the 25-year secular decline in bond yields
- In turn, there are three causes of the falls in bond yields
    - Falling inflation
    - Accompanied by falling interest rates, particularly in the most recent phases
    - In the most recent phase, Quantitative Easing

The ‘New Normal’ for real estate

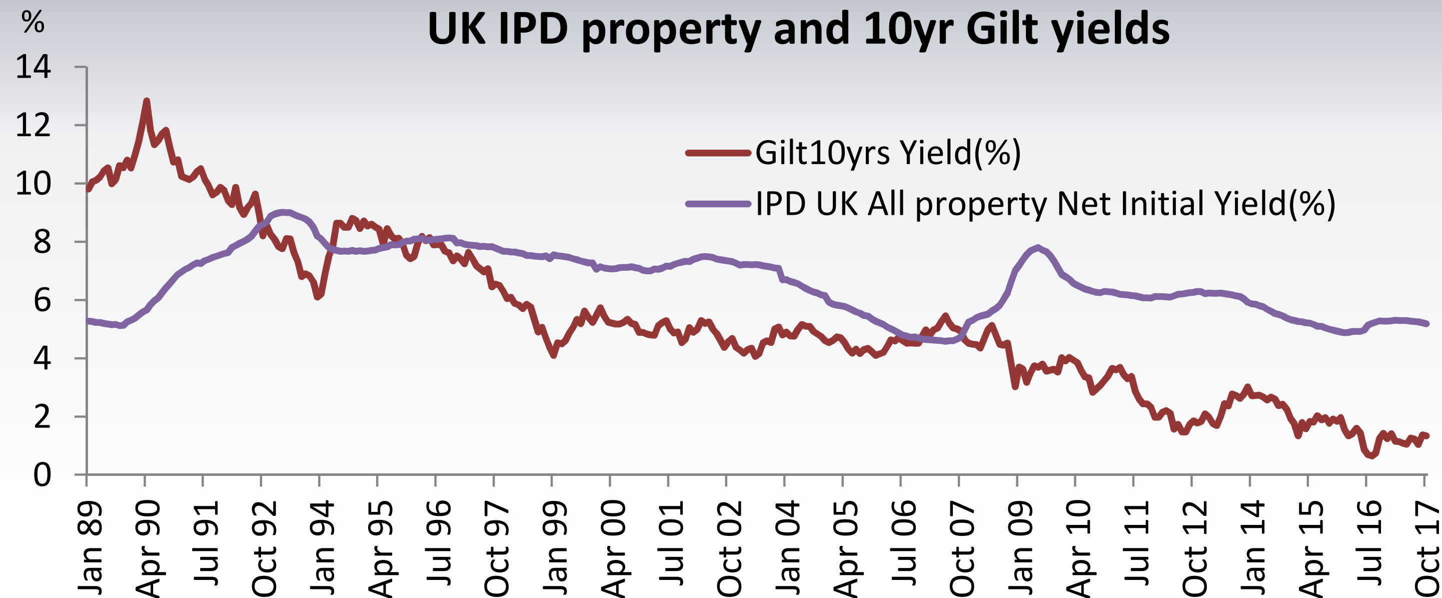


Source: Eurostat; VARE Consulting

- The ‘New Normal’ scenario is
  - **Low interest rates and bond yields** (but not as low as they are at present)
  - **Low growth** (lower than at present)
  - **Low performance** for all asset classes (recent outperformance is due to repricing)

- Although the rate of real estate development has slowed in the recent decades, it has not caused an improvement in rental value growth
- We are now at a position where both secular movements are to the detriment of real estate
  - We should expect the future trend returns to be lower than the historic trend returns

Real estate is cyclically expensive despite …

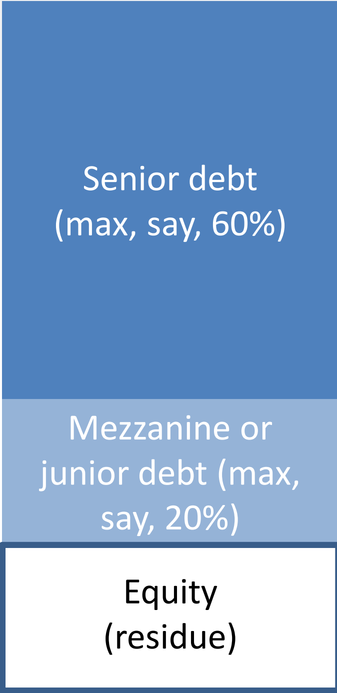


Source: MSCI IPD, Bloomberg, VARE Consulting

- This **chart is regularly used by agents and analysts to show that the 'risk premium' is high and, therefore, that real estate is 'not expensive' compared to its historic pricing**
- One of the problems with the chart is that the gap is **not the risk premium** but the **yield premium**
- Ignoring the current short-term downturn, it is estimated that the **risk premium for equities is 3.5%**
- For real estate, it is **possibly at zero**

Property debt

The addition of debt converts equity in real estate from a low risk asset to a high risk, high return investment. Over the whole of a typical cycle, in practice, debt adds no performance advantage to the equity component and debt holders receive inadequate returns. **Gearing is a cyclical tactic.**



Was typically 70% prior to the last recession
The average ratio for senior loans secured by secondary property was by the end of 2016 was below 60% for office, retail and industrial property (source: De Montford Commercial Property Lending Report end-2016). **Anything above 50% should be considered risky at this point in the cycle.**

Needs to be reduced or eliminated entirely as interest rates rise

My 'rule of thumb at least 20% difference between property income and interest payment (assuming debt interest payments fixed)

Can be partially diversified away

Tends to zero in case of tenant default
UNLESS equity is above 40%
Tends to zero in recession (yield rises)

High covariance means that diversification benefits are low

Above particularly relates to secondary property

Commercial property sectors

- The UK was the global leader in property data and has exported it methodologies to the rest of the world

- Initially, these were defined by
  - **Geography** – the standard ONS regions, although institutional interest has increasingly shrunk from towns to cities
  - **Sectors** – retail, retail warehouses, offices and industrial (with the latter becoming increasingly dominated by logistic units0
  - **Sub sectors or segments** – eg for retail: unit shops, shopping centres, other

- The data provider, IPD has been taken over by MSCI and the data rationalised, so that the data is now in six main sectors + All Property

Differentiating office drivers from retail drivers

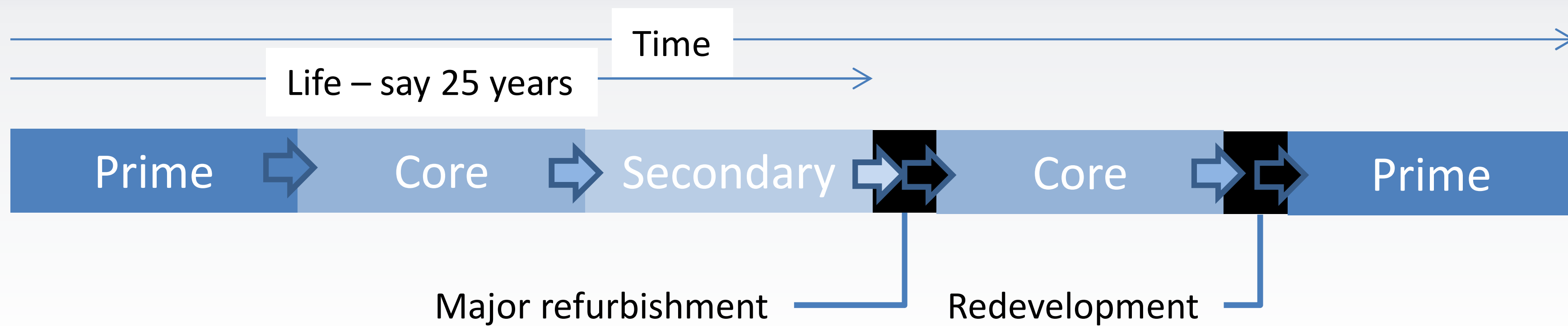
Offices are a cost centre
(rents represent, say, 5% to 7% of revenue)

- **Supply** can increase letting turnover, but typically not net absorption
    - **Accelerated obsolescence** is a problem
- **Demand** is indicated by
    - Employment
    - GDP growth
    - Business investment
- **Polarisation** is characterised by
    - Large businesses vs small businesses
    - Macro locations
- **The internet**
    - Helps efficiency (better service)
    - Reduces demand for 'back office' functions

Retail is a profit centre
(rents represent, say, 10% to 20% of revenue)

- **Supply can increase net absorption**
    - Cannibalisation of business and dilution of profits are problems
- **Demand is indicated by**
    - Real retail sales growth
- **Polarisation is characterised by**
    - Affluence of catchment population
    - Critical mass
    - Micro locations
- **The internet**
    - Is growing competition

Prime and secondary



- By definition, **prime is where tenant demand is greatest**
  - **Yields are lowest**, to reflect that

- Nobody builds secondary, so **prime is susceptible to supply competition from development**
  - In a downturn, this might be an **overhanging risk** from the growth period (short-term)

- Demand, in a downturn, is weak , and **secondary property values decline the most**
  - But the effect swill depend on **a number of factors**
  - **Prime is normally the most defensive**, followed by core

Depreciation – the unacknowledged risk

Academic studies have **largely failed to identify rates of depreciation** and have even failed, in many instances, to identify its existence

I believe that the **root cause** of this is that depreciation that

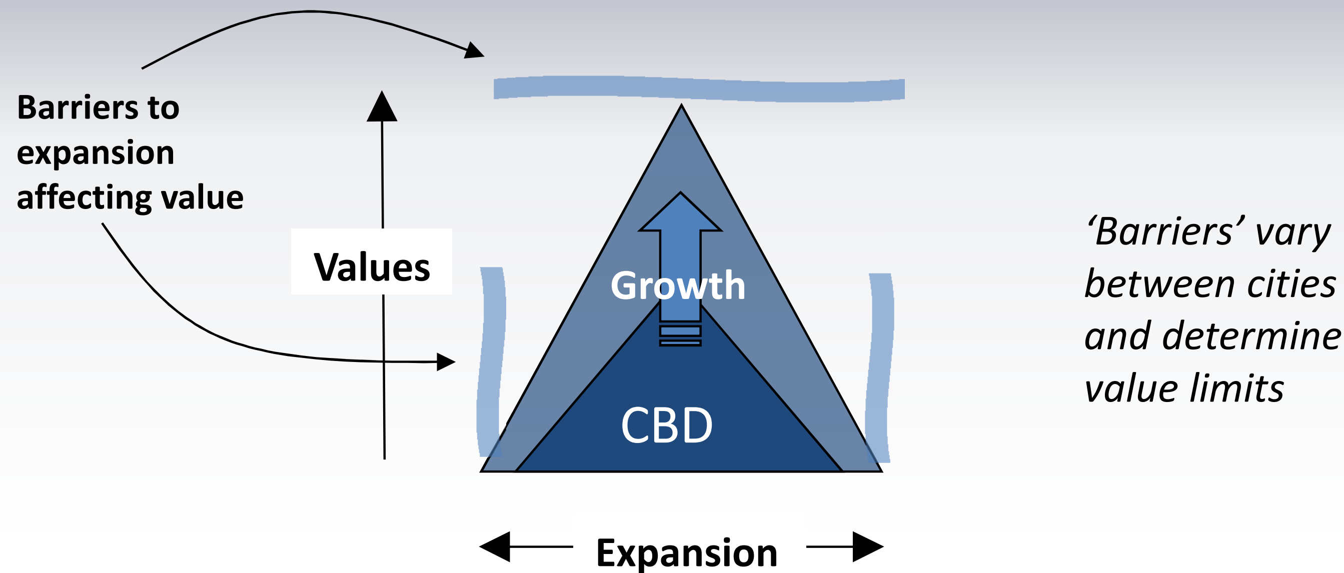
- Is **not consistent or continuous over the life** of an asset
- Is hidden by infrequent rent reviews, tenant activity, inflation, capital expenditure
  - **Is is only really evident in downturns/recessions** when capital expenditure is not applied and maintenance is neglected, coupled with tenants vacating

Depreciation can be partly or completely offset by appreciating **land values**

- This factor may only be reflected partially by the initial rent, implying aa trade-off between income and long-term value defensiveness

Depreciation is likely to become **more significant** in a period of **lower growth and low inflation**

Location, location, location – counter to depreciation



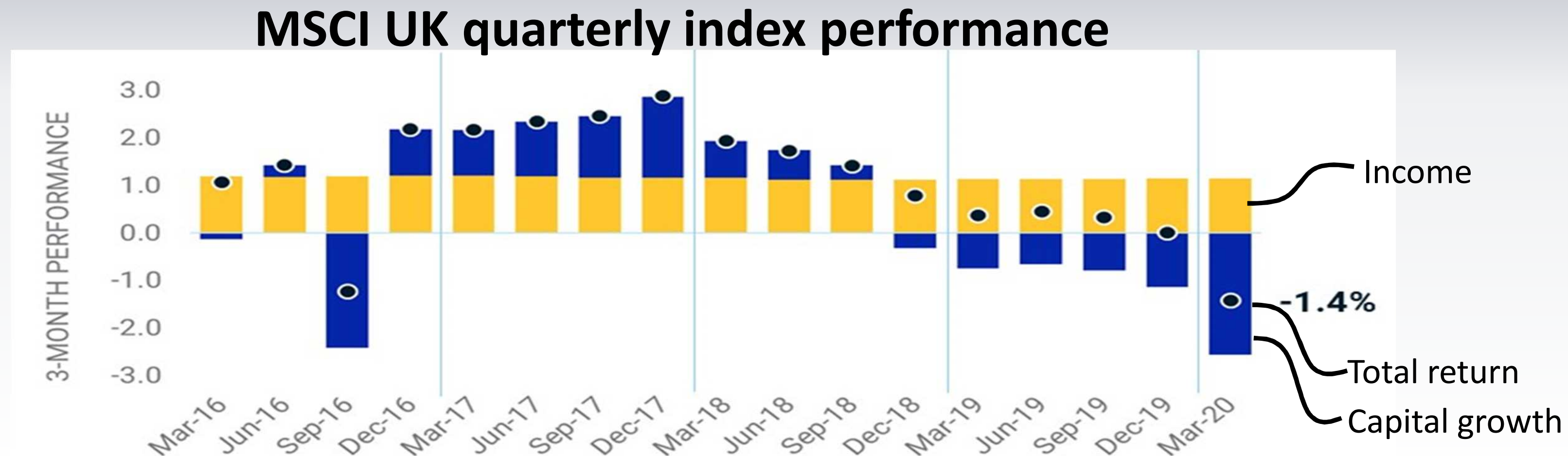
'Barriers' vary between cities and determine value limits

- **Urbanisation** reflects the shift from manufacturing to service-based economies
  - It is happening globally, but particularly in the emerging economies
  - The US is about five years ahead of the UK, which is, in turn, about 10 years ahead of Germany and France
  - It is important to note that this is **not about land shortages**, but a mode of living and working
  - Land values are becoming more **concentrated and polarised**

    See, for instance, the article in the FT's House & Home, 20 January 2018, which describes zero land values in up to 20% of Japan

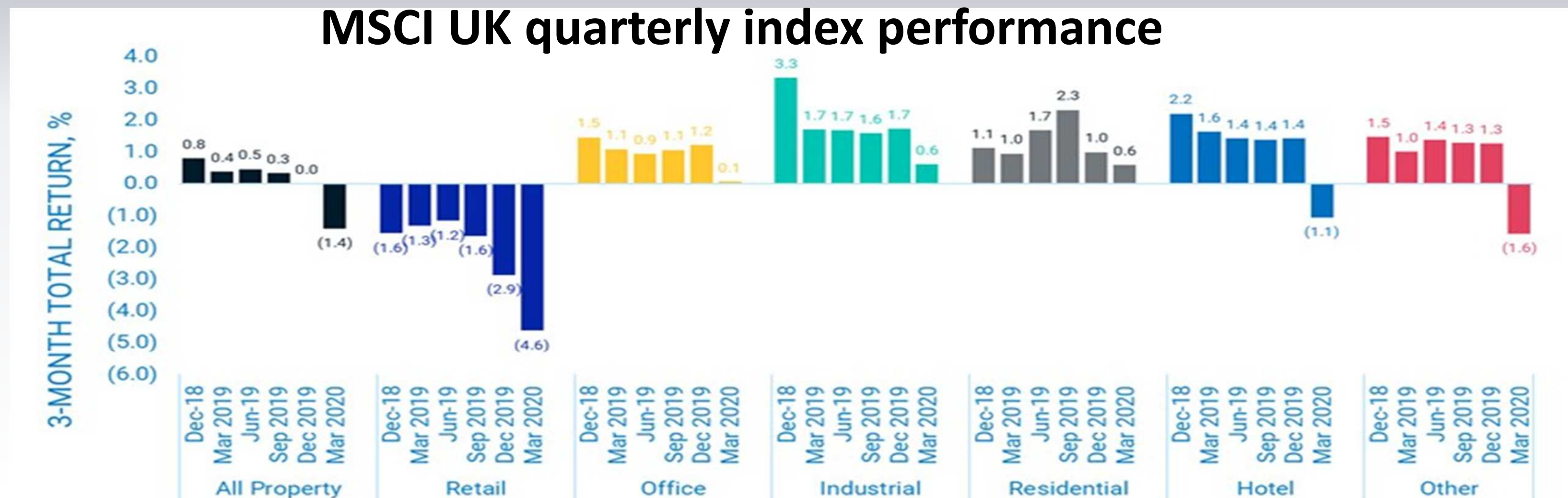
First: cyclical change

MSCI UK quarterly index performance



- Even before the crisis caused by COVID-19 (and most particularly by the social restrictions), the UK real estate market, excluding residential, was falling in value
    - **In Q1 2020, total returns became negative**
- In our opinion, this was not due to, as some claim) the effect of Brexit – the unemployment rate was close to a record low and employment numbers at a record high – but due to a **cyclical deterioration**
    - The bond driver – reducing property yields – had run its course while the fundamental driver – tenant demand – was weakening
- Initially, the falls were small, but the **rate of fall has been increasing**
    - We now expect the rate to accelerate as the economic conditions deteriorate

Sector differences



- Due to the secular shifts, **retail** sector total returns have been **negative for a few years**
  - But there is a clear **acceleration** in recent quarters
- **Offices** have dropped to zero in Q1
  - This is, we believe a prelude to become negative from the cyclical and secular shifts
- **Hotels** have produced negative returns
  - A cyclical change, particularly exaggerated by COVID-19 and likely to accelerate sharply
- **All other sectors are showing a deterioration**
  - This is, again, cyclical, exaggerated by COVID-19

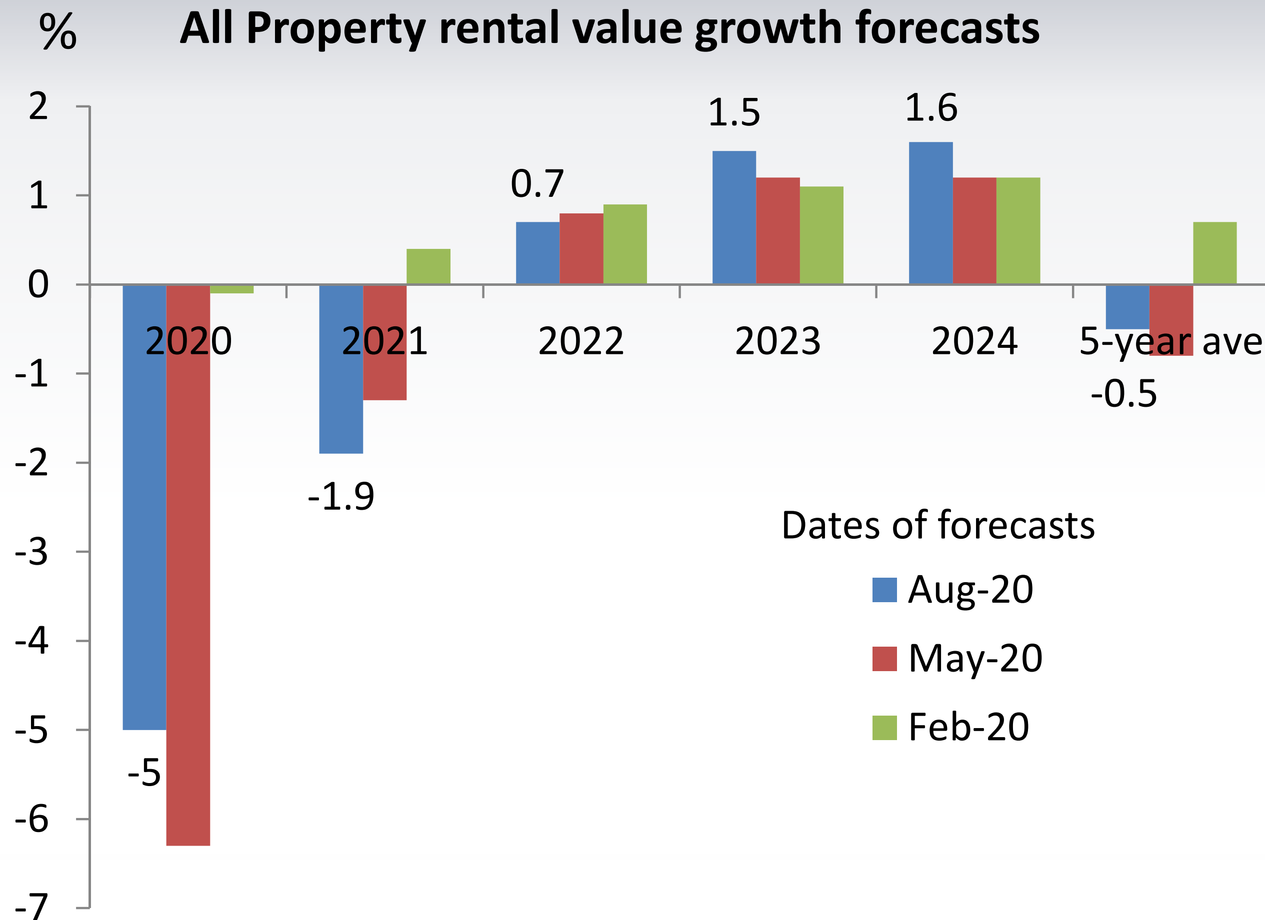
Second: secular change

- The largest secular shift in the UK commercial real estate market has been in the **retail sector** over the last five to ten years
  - Triggered by the move to **online shopping** but primarily the result of **severe competition** cutting into profit margins
  - Originated in **secondary grade stock** but has spread to prime in the last few years
  - For most of the last 10 years, the real estate market has **been in denial**, but acceptance has come in the form of write-downs in the last few years
  - Even before the crisis, **rental values have fallen by 25% to 33%,** and vacancies have risen dramatically The **crisis and recession** will accelerate the **falls in rents and cause further vacancies**

- The **office sector** was suffering as well
  - **Moves to home working** (one day peer week was not uncommon) and hot desking (meaning that fewer desks were required per capita) reduced space requirements for many/most businesses
  - The crisis has **dramatically accelerated this trend**, although I do believe that most of the jobs will return to the office environment
    - We should expect the back-office functions to be most affected

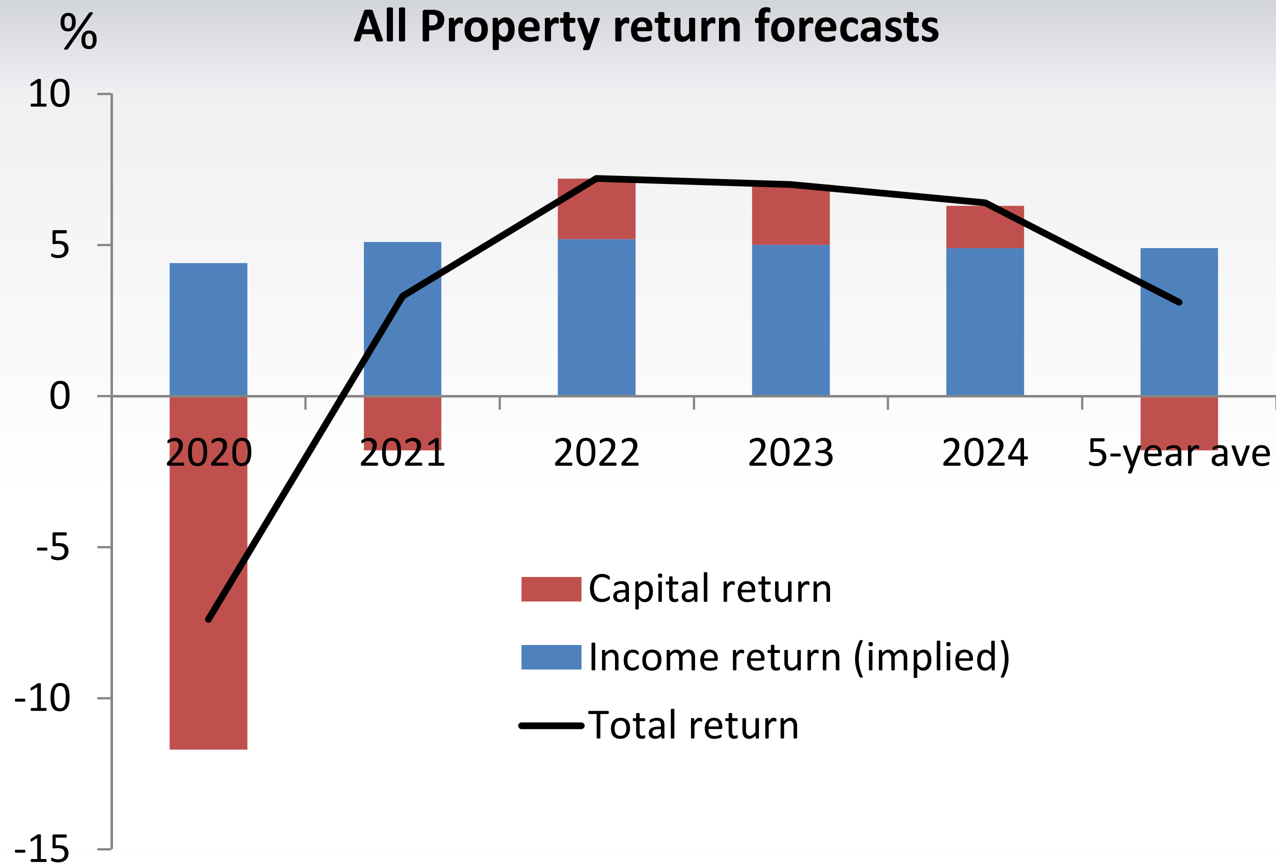
- Investors have sought refuge in the **logistics sector**
  - But they are **fooling themselves in terms of value and performance**

IPF consensus forecasts (1)



- All forecasts appear wildly optimistic, but particularly the most recent
- Five-year average forecast have a tendency to change little over the year of forecasting. This is to avoid the need to remodel at every forecast point

IPF consensus forecasts (2)



- All these forecasts also appear wildly optimistic, but particularly the most recent

Seeking better returns

- Before the pandemic, property investors were
  - **Almost completely ignoring cyclical risk, and maximising beta using debt**
  - **In many instances, buying into projects with higher alpha potential, but not necessarily understanding the specific risks (too much reliance on financial modelling)**

- Recognising that returns from the core sectors **(offices, retail, industrial) were going to be inadequate, moving into 'alternatives'**
  - **However, this typically has meant a move from assets into businesses, and property investors are ill-equipped to assess risks and returns in such investments**

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