MoneyMarketing

The income factor

Gregor Watt | 26-Mar-2009

Gregor Watt reports that commercial property may be down but it is definitely not out as the sector is still offering healthy yields

The last two years have been a torrid time for anyone with money invested in property.

Commercial property has seen record gains of the bull market between 2004 and early 2007 wiped out, with many investors finding themselves trapped in illiquid investments as property funds struggled to find cash to pay the redemptions.

Anyone who got into property on the back of the boom years will now be counting the cost. According to figures from the IPD UK monthly index, £100 invested in July 2007 would, on average, now be worth £66.65.

Investors in residential property have not had it much better after sharp falls in the last year and a half. The Halifax and Nationwide indices show very similar falls of 17.7 per cent and 17.6 per cent respectively over the last 12 months.

Many commentators still suggest the residential market has some way still to fall, with some predicting a further reduction of 20 per cent.

But it is not outright doom and gloom. Some managers of commercial property funds are now starting to suggest that market levels now offer buying opportunities. These arguments are explored elsewhere in this special report.

Another positive, for commercial property at least, regardless of your view on the long-term value of commercial property, is that of property as an income-generating asset.

Figures from Trustnet at March 18 show the top 10 open-ended property funds according to yield are all yielding in excess of 6 per cent, with the top 20 funds all yielding over 4 per cent.

Some real estate investment trusts are yielding far more, with British Land and Land Securities yielding 7 per cent and 14.8 per cent respectively.

These yields have been pushed up by falling property values but for investors willing to ride out fluctuations in value and for anyone with cash looking to generate returns, property does provide an option.

BDO Stoy Hayward head of real estate and construction Solly Benaim says he is already starting to see interest in property because it offers a decent level of income.

He says interest is coming from entrepreneurs with large amounts of cash and from UK institutions as well as from overseas investors who are looking to snap up bargains.

"Interest is coming from across the board. We are seeing a lot of interest from entrepreneurs looking for a home for their cash. We are also seeing interest from overseas, where buyers are getting a triple whammy of a reduction in interest rates, a reduction of exchange rates for sterling and a reduction in value for the assets."

The areas that he highlights as offering particularly good opportunities are supermarkets and central London offices with long leases - over 15 years - and tenants with a strong covenant.

He reports that one London office that met this criteria came up for sale recently and was inundated with offers.

Benaim says: "It had 55 expressions of interest, with 30 offers. It was eventually bought with a resulting yield of just under 6 per cent."

Research from Reit trade body Reita conducted in January shows that 60 per cent of IFAs would consider recommending property shares as an income proposition for their clients. Reita operating director Peter Cosmetatos says: "In principle, Reits are supposed to be income producers and high distributors."

He says most people in the property industry expect further falls in property values this year but for investors willing to look at the long-term picture and with cash to invest, Reits, in particular, offer an alternative to getting no interest on their deposits.

"There is clearly a fair amount of downside risk but if you are able to get a return on the income side and you are prepared to wait it out on the capital side."

One constraint on income, not just from Reits but from property investment of all descriptions, is if the rate of tenant defaults increases. Property companies could also reduce their dividends if they have to reduce their borrowing or to raise cash to ensure they do not breach their loan-to- value covenants on borrowing.

But Cosmetatos says there are some Reits that have very low levels of borrowing or even no existing borrowing, with secure covenants. "In general, property could offer quite a good place to park some money," he says.

Yellowtail Financial Planning managing director Dennis Hall says he is starting to look tentatively at property for his clients. His preference is for property investment trusts rather than open-ended vehicles. He says it is essential to only choose vehicles with a good spread of underlying investments and low rates of borrowing but if these criteria are met, property can offer a good long term investment.

"If you can find one with a good spread of property, with low gearing and is trading at a substantial discount, even the best are trading at a 30 per cent discount, with a 7 or 8 per cent yield, that is worth having."

There are still concerns about the impact of the economic downturn on the wider commercial property market but more specialist areas are starting to attract investor interest.

The traditional office, industrial and retail sectors are likely to continue to be hit hard by the recession but student accommodation and Government-backed properties are continuing to see solid rental growth and high occupancy rates.

Harry Hyman, manager of the Primary Health Properties Reit which invests in local GP surgeries, admits the sector has not been immune from negative investor sentiment but says valuations have held up well.

He says: "Doctors' surgeries are rock solid and 90 per cent of the rent is paid by the British Government. Our properties are 99.9 per cent let and we are receiving a 12 per cent increase on our rent reviews, which is very good in the current economic climate."

Despite this, PHP's share price has halved since launching as a Reit in January 2007 but Hyman says the trust's 6.09 per cent yield and the fact that this is Government-backed has resulted in cash buyers returning to the market this year.

Howard Meaney, head of property investment at LV=, says the company is also attracted to Government-backed or leased properties.

He says: "You get the longevity of the lease and it really trades as a quasi-gilt because of the quality of the backing behind the income stream."

Student accommodation is also coming on to many investors' radar as a counter-cyclical play. In times of recession, student numbers tend to increase as more people stay in higher education to improve their chances of getting a job.

University applications are up by 8 per cent year on year, and the Government has set a target of 50 per cent of all 18-year-olds going into higher education within the next five years.

Unite chief financial officer Joe Lister points out that student numbers have already grown to 650,000 a year more than 15 years ago but the net new supply of purpose-built student accommodation has only been 150,000 lets.

He says: "Students receive less subsidy and require more parental support than in the past recessions of the 1970s and 1990s but we have seen an increase in occupier demand compared with last year. This gives us the confidence that the inherent supply and demand imbalance remains, and even more so than in other recessions."

Indeed, Unite has already filled 65 per cent of its lets for the 2009/10 academic year, compared with 62 per cent at this stage 12 months ago. Added to this, Lister says rental income is averaging at 7-10 per cent.

The recently launched Coral portfolio, a fund of funds focusing on student accommodation providers, is targeting a similar 8-10 per cent annual return. Manager Lawrence Frampton points out that well managed companies can achieve close to zero void rates and bad loans for the sector as a whole average under 1 per cent.

He adds that the sharp fall in the value of sterling has also been a positive for the sector and the number of overseas students applying to UK universities is up by 2 per cent year on year.

"Sterling falling is attractive on two fronts. The number of overseas students will continue to rise and they pay the full year's rent in advance," he says. "The fact that this income stream is so secure and valuations have fallen is resulting in increased interest from overseas investors who also benefit from the currency pick-up."

Again, the sector has been dogged by negative sentiment and, in particular, concerns about corporate financing. Lister says Unite has sold £1.2bn of properties over the past year to reduce its loan to value ratio from 65 per cent to try to calm market fears.

These concerns at the corporate level prompted Frampton to favour the fund of funds' approach. He, along with the fund's adviser, Strutt & Parker Real Estate Financial Services managing director Philip Ingman, will pick five to 10 best of breed firms from what he describes as a "fragmented" market with over 30 suppliers.

The agricultural land sector has far fewer points of entry for UK investors and the 10-15 per cent price falls seen since the peak of the commodity boom early last year have brought its counter-cyclical credentials into question.

Carl Atkins, head of research at Bidwells Agribusiness, which acts as fund adviser to several institutional investors, believes the medium-term outlook is positive. He says the key drivers of a major structural change in agriculture, such as growing populations and water shortages, remain intact.

"If you believe in the fundamentals, you have to look at it on a five, 10 or even 15-year view," he says. "Commodity prices came off sharply in the second half of 2008 but a lot of people think this was due to speculation when the main reason was in fact the bountiful harvest in 2008 after the very poor one of 2007."

Atkins says supply remains tight and the outlook is "considerably better than at any time seen in the past decade".

Meaney is not convinced, however, and says although he likes the fact that the sector is less reliant on bank debt than many others, he expects land prices to soften further.

At the more esoteric end of the property scale, Assetz launched a hotel room investment scheme at the end of last year. The sector had been under a cloud following the collapse of Guestinvest last October.

But Assetz chief executive Stuart Law is upbeat, saying that he is focusing on budget hotels which will benefit from travellers trading down.

Ingman is sceptical and says the schemes are high risk because investors have no control over the running of the hotel or the booking system used.

He says: "We looked at hotel rooms but do not like the fragmented ownership and the fact that you have no control over the common parts, such as the bar and lobby."

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