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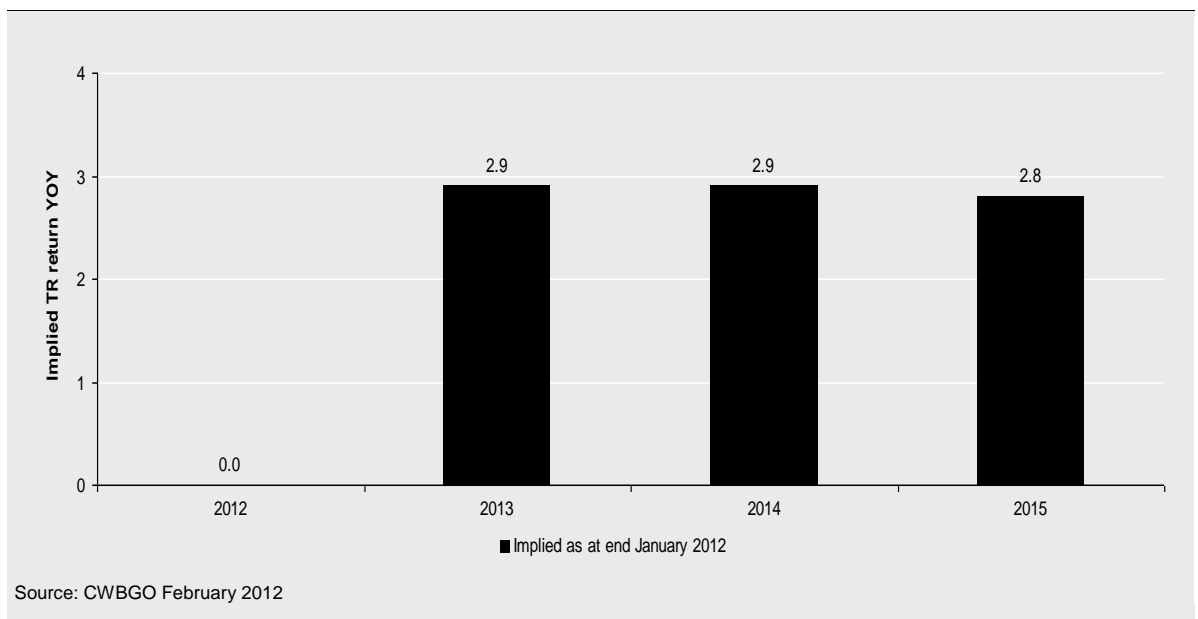
Commercial Property – Pessimistic forecasts could well prove wrong again

At this time of year, we traditionally look at the prospects for the 12 months ahead and reflect on what happened in the previous year. Back in early 2011, the derivative market was indicating that the UK commercial property sector would deliver a total return over the year of between 4% and 5%. Such an outcome would have implied a decline in values of between 3% and 4%.

However, property confounded the pessimists by generating a very respectable total return of around 8%. Values rose by just over 1% but, as always, the income component, amounting to 6.8%, accounted for the majority of the total return.

The derivative market is now implying a total return for 2012 of around 0%, and the general consensus is that values will indeed fall over the course of the year. But given the experience of 2011, when property performed much better than expected, is it right to be so gloomy about the sector's prospects?

Figure 1: Implied Derivatives Pricing – Implied All Property Returns



Grim economic outlook dominates investor sentiment

It is not hard to see why investors are so pessimistic. Capital growth in the commercial property sector generally tracks the wider economy and activity in the UK this year is likely to prove subdued at best, while many fear a double-dip recession as the government's austerity programme and the eurozone's woes continue. Thus, it is unlikely that we will see any capital growth in 2012.

However, that still leaves income and, here, the prospects are not as bleak as they might first appear. Take the issue of tenant default. Investors are naturally concerned about this subject given the highly visible demise of well-known retailers.

“Exaggerated concerns and misleading headlines suggest the property outlook is better than most investors anticipate”

Misleading headlines overstate retail problems

However, the pain being endured on the High Street is unlikely to have as big an impact on the commercial property sector as reports suggest. This is because insolvencies generally take the form of a 'pre-pack administration', in which the whole company, which may comprise of 200 or 300 shops, does not simply cease trading. Instead, there is a rational administration process involving the proprietors of the retail business and the landlords. They generally reach an accord whereby the retailer's worst-performing shops are handed back to the landlord, while those outlets that generate a reasonable profit continue to trade – and pay their rent.

Consequently, when a retailer such as Blacks, with over 300 outlets, encounters difficulties, all of the shops do not simply become vacant. The more likely outcome is that around 20 to 40 of the worst-trading stores will be handed back to the landlord and, in return, the retailer will make commitments that the remaining lease obligations will be maintained. Thus, the headline-grabbing collapse of a retailer is usually not nearly as bad as it seems.

Exaggerated fears regarding lease expiries

Lease expiries are another matter troubling investors. This is because a great many 25-year leases were granted in the late 1980s and are now coming up for expiry. There is a concern that tenants will leave as these leases expire. However, these worries may well prove unfounded. Unless the tenants are in financial difficulty, approaching receivership or administration, they will still need a place to conduct business.

Thus it is wrong to assume that a tenant will leave a building just because the lease is at an end. Our experience - and we have 5,000 tenants - is that the retention rate amounts to around 85%. This figure has fallen slightly during the recessionary environment of the past few years, but it indicates that most properties are retained at the end of the lease.

Banks unlikely to exacerbate downturn

The condition of the UK's banks is also preying on investors' nerves. These institutions certainly have massive exposure to UK commercial property - loans to the sector amount to around £250bn and the banks' strategic priority is to reduce this figure.

However, this is proving difficult. Many of the loans were taken out at the peak of the market (between 2004 and 2007) and values have since dropped by 30%. In a great many cases, the banks provided loans amounting to 80% of the value of the property and clearly they will not get all of their money back. Some investors are worried that the banks will simply foreclose on loans and a huge tranche of property will come onto the market, driving values lower.

But we do not believe that the banks will pursue such a rash course of action, which would simply aggravate the decline in values. Instead, the UK is likely to follow the experience of Japan, where an asset-backed lending boom was followed by a decade of de-leveraging. Thus, reducing the banking sector's exposure to commercial property will subdue the market over the medium to long term but will not have the dire consequences that some foresee.

On top of all these domestic issues, investor confidence has also been rocked over the past year by the apparently unending eurozone financial crisis, which has affected all asset classes and not just property. Given all of the factors weighing on investors' minds, it would be surprising if the derivative market were not pointing to a bleak year ahead!

Reasons to be cheerful

Yet apart from our view that the market is being overly pessimistic, there are other positive factors to consider. The income return on property as an asset category, for example, stands at 6.3% and the margin over the UK gilt yield, which is a reliable lead indicator of relative value, stands at a record high.

In addition, the resilience of returns in 2012 may also be explained by a little-known fact. The prospect of a tenant leaving at the end of a lease or a tenant becoming insolvent will be reflected in any independent valuation of a portfolio. The valuer will not, for example, simply assume a tenant will stay in the property if a lease expires in a year's time.

Rather, they will make allowances for the fact that the tenant could leave. This is despite the fact that, as outlined earlier, the majority of tenants do not become insolvent or vacate a property at the end of its lease. Consequently, the valuation will be very conservative while the income return is likely to be much higher than predicted. The influence of conservative valuations is often overlooked but we believe it largely explains the sector's resilience in 2011 and will play a role in 2012.

Finally, investors should remember a key and hidden virtue of commercial property – it provides an excellent hedge against inflation. This could prove very attractive in an era of loose monetary policy and quantitative easing.

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