

## Conference call highlights

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## Property update

### The attractions of property

Commercial property is a very effective diversification tool: with near-zero correlation to other asset classes, it certainly punches above its weight within a mixed portfolio. The property asset class also differs from other income-producing investments such as bonds in that, if there is a default, you are not left with just a piece of paper, you own a real asset that can increase in value. Most importantly of all, UK commercial property provides an attractive level of income, via rent, plus the potential for capital growth.

### Owner friendly

The system in the UK is incredibly owner friendly, with longer leases than anywhere else in the world. Indeed, for leases in excess of five years it is still quite normal to find an upward-only rent review in place. This is particularly important in recessionary times, because with an upward-only rent review the tenant is still obliged to pay the original rent. The well-understood, transparent and historic nature of the UK commercial property market also makes it an attractive proposition for overseas investors and occupiers. Evidence shows that these investors rate London as one of their top three target cities around the world. What's more, many occupiers choose the UK as their European base.

### An eventful period

The past five years have been eventful for UK commercial property, with the market experiencing a collapse, then recovery and now uncertainty. In the first phase, a rally in commercial property had left the asset class looking over-valued and, when the credit crunch led to a wave of redemptions from open-ended funds, prices crashed. The next period commenced in the middle of 2009 and was characterised by additional liquidity as a result of quantitative easing being attracted to property by the very high yield offered by the asset class.

### Bank refinancing

We are now in the third stage of the market's recent journey, which we have termed the bank refinancing phase. Between 2010 and 2013, £160bn of property debt is maturing and requires equity or debt to re-finance. The majority of these loans were made five or six years ago at the peak of the boom, so we have to expect that current property values are, despite the recovery, around 30% lower than they were then. This was also an environment where banks were lending between 80% and 90%. One way or another, around a quarter of all outstanding loans are believed to be impaired, either on the loan-to-value covenant or more significantly an impairment on the interest cover payments. The approach that banks take to this debt will be an important driver of property market returns over the next few years.

***“Using BBB corporate bonds as a basis, property valuations look relatively cheap.”***

### Is property cheap?

Comparing the property yield with that of long gilts, we would say that property has never been cheaper. Unfortunately, life is not that simple because property de-coupled from long gilts back in 2007. A more relevant analysis, therefore, is to see property in terms of a bond rating. For example, if you take the underlying covenants of a typical portfolio in the market it would probably be rated BBB. There is a significant harmony between the movements of yields in the commercial property market and movements in the BBB market. Using this as our basis, the argument is less compelling but property still looks relatively cheap.

### **A hedge against inflation?**

Property is a long-term hedge against inflation. Over three to seven years, increasing economic activity normally generates greater demand for prime commercial property, which then translates into both higher rents and building valuations. In addition, as construction costs rise in line with inflation, this too will be reflected in a property's value and the subsequent rents that can be charged. However, this is a long-term phenomenon – there is no automatic feed-through from inflation to rental income and property values over the shorter term.

### **Building our portfolio**

The UK market consists of around 500,000 individual properties, 1,200 of which we own. Across our portfolios we currently have 5,000 leases. More specifically, we have a long-term strategic bias towards South East England, while maintaining very low exposure to London itself. The South East has performed just as well as London, but prices in the region do not carry the same London premium. In terms of sector exposure, the gloomy economic backdrop means we are cautious of the entire market – retail, industrial and offices. However, of these we still like the retail sector given its lower depreciation characteristics over other asset classes. An important point to note is that our portfolios are very well diversified, which means we are able to minimise any specific risk associated with a particular property, location or tenancy.

### **Subdued returns**

In the short to medium term, commercial property returns are going to be subdued as banking sector asset disposals will depress values. The property derivative market is currently predicting a 0.5% total return for 2012. However, at the same point last year this market predicted that total returns for 2011 would be 2% to 3%. In the end they turned out to be more than 8%. So, there is some room for hope as the property derivative market tends to capture more pessimism in the market than optimism.

### **Summary – looking ahead**

We have been buying more in the past few months than we have done in the previous two years. With bank disposals expected to last anything from five to ten years, there will be many opportunities going forward and we are in a very strong position to acquire the best of these for our portfolios. In particular, we hoarded cash throughout the exuberant QE period and, as a result, we can now take advantage of any depressed pricing. Regarding the current phase of QE, we do not believe that it will affect property in the same way as the first phase, especially as the banks are now unable to lend so freely. In addition, commercial property is not the oversold, distressed sector it was a few years ago. Elsewhere, yields are currently sitting at 6.3%, which, historically speaking, appears to be fair value. Finally, using data from our long-term absolute value model we can see that the income advantage of commercial property still stands out, particularly in relation to bonds.

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