

Real estate debt in 2016

As we edge deeper into 2016, there are two dominant questions on the minds of investors within the UK commercial real estate (CRE) market. Where are we in the property cycle and which markets and sectors offer the best risk adjusted value? In short, there is no uniform or easy answer to either question. The current volatility of equity and bond markets, related to geo-political uncertainties and the impending UK referendum on EU membership, has done little to quell market belief that we are now in a more muted CRE outlook. The world may be in a completely different monetary policy stance compared to 2007, but by simply observing where pricing and rental tones are for selective prime, core markets relative to the past peak, one could conclude that we are in the late stages of a cycle, and that markets are either expensive, or, at best, keen. This theme is common not just in the UK, but also in wider Europe, Asia and the US.

However, it would be wrong to unfairly tag the entirety of the UK CRE market with this sweeping statement, plus there are also many other indicators that provide some comfort, not just on pricing, but also for continued good performance in the real estate sector. Firstly, the UK economy has just recorded its twelfth consecutive quarter of growth, and whilst there are some well-documented headwinds, there is evidence of improving occupier demand.

Aside of pricing, there is little market comparison to 2007.

The lack of development witnessed over the past decade, in part due to a scarcity of finance, should deliver real rental growth (albeit subdued) in this low inflationary environment. A key factor in this cycle, and one which should alleviate pricing fears, is that investments are more equity and less debt driven. This implies investors are more willing to accept more realistic performance going forward, and are not inappropriately using leverage to reach lofty rates of return. Credit channels, loan-to-value ratios, and lending policies, whilst thawing as economic conditions have improved, still remain far stricter than in 2006. This generally reflects a more sophisticated and strategic approach by lenders and borrowers alike, and an increased awareness of risk - a factor not unique to real estate but to all asset classes.

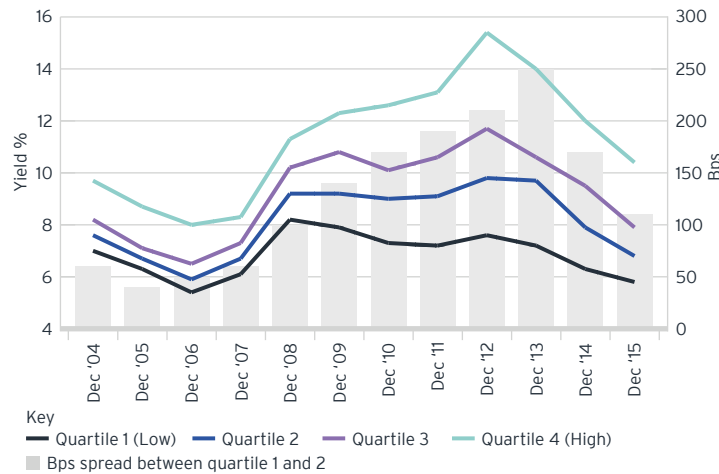
Prime CRE in the UK has repriced quickly, attracting both domestic and overseas investors hunting for defensive, trophy assets, who are keen to diversify their global exposures in the largest and most liquid markets. For certain overseas investors spooked by the unpredictability and weakness of equity and bond markets, there is an emphasis to provide a return of capital, and not necessarily a return on capital, which has driven investment to levels last witnessed in 2007.

Financial market uncertainties imply a delay in the CRE yield-to-occupier-driven cycle.

But this is not to say opportunities do not exist in the UK. Many sectors and markets, not on the radar for large overseas or UK institutions, still offer strong assets which remain attractively priced, both relative to 2007 and the wider industry. In 2006, the spread between the first (prime) and second (core-plus) quartile assets by yield for South East Offices was just 50bps. As of end Q4 2015, as Fig.1 shows, that value is 110bps. Adhering to the slow, but steady economic backdrop, and the robust demographic growth forecast for the South East, strategic positioning within this sector with promising rental forecasts, should deliver outperformance. This pricing opportunity is mirrored across other UK office regions. The low interest rate environment means that property currently enjoys a 360bps and 110bps spread to both the benchmark 10-year UK bond and the FTSE All-Share equity dividend.* This compares favourably to 2006, when the UK All Property initial yield sank below the 10-year government bond yield, whereby the market incorrectly factored in unrealistic capital appreciation and rental growth.

*as of end February 2016.

Fig.1: South East offices equivalent yield



Source: MSCI IPD Quarterly Digest, Q4 2015

So what do we expect for 2016?

Against a prolonged period of low borrowing rates, low inflation and modest economic growth, but high equity market uncertainty, strategic real estate investment in the UK should prove resilient as investors look for income and security. However, after three years of double-digit, largely yield-driven returns, performance is projected to moderate notably this year, unaided by growth assumptions being downgraded across the globe. Our CRE market forecast,

which implies benchmark bond yields edging out very glacially over the next five years, incorporates little likelihood of further yield compression. Performance, instead, will be very much income orientated, with active asset management and occupier demand-led rental growth key to delivering market outperformance, as long as the economic outlook does not deteriorate materially. In such light, it would be naive to assume that June's impending UK referendum on Europe, following on from the Chancellor's March budget, which increased the Stamp Duty Land Tax on property transactions, will not have a dampening impact on both occupier and investor appetite, and hence near-term, and potentially medium-term, market performance liquidity and sentiment.

Look through the financial noise, and there is real evidence of rental growth across selective markets.

Do healthy real estate returns, without taking unnecessary risk, still exist?

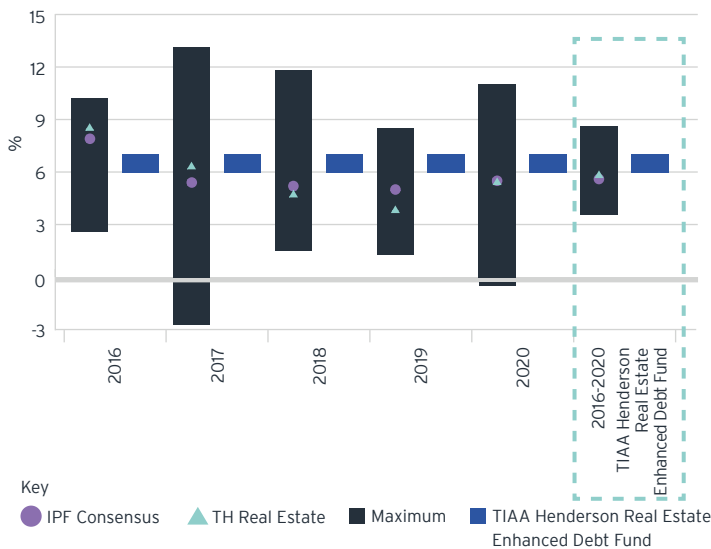
Most definitely, although returns will be subdued and sourcing appropriate opportunities will be more challenging as the field has become increasingly competitive. The market recovery may have been more immediate than initially envisaged, but it has not been uniform; a route the market is unlikely to deviate away from as investors contemplate the potential economic implications of a Brexit. As such, the path and timing of improved property returns remains very location and asset specific. Good assets in Tier 1 and 2 cities in the UK, underpinned by solid fundamentals, remain attractively priced. Good market relationships and partnerships with developers, agents, local authorities, private and institutional players are essential to source these attractive value and return-enhancing opportunities.

This approach isn't without risks, however, given potential occupier and structural market demand shifts. The key will be to find assets that are not over-rented and in markets where the supply/demand angle will be beneficial to the core-plus market. Development activity has and still remains muted, so established markets and existing stock can deliver performance with appropriate coordinated asset management, whether through strategic leasing arrangements, or the repositioning of assets through refurbishment and planning. As we transcend this complicated cycle, investors need to realign themselves to markets well-suited to realise rental growth driven outperformance, or where the long-term economic and demographic fundamentals are the strongest to support returns; regardless of the result on the Brexit vote. The South East markets would offer the largest and most diverse opportunities given this rhetoric, over the long-term, but it would be remiss to ignore certain national markets that certainly can deliver an attractive income and risk-adjusted return.

The value in UK real estate debt

Against heightened risk aversion and continued downgrades to economic growth and inflation assumptions, one asset class that could prove to be a shining star in a potentially challenging investment landscape is CRE debt. Having become a regular feature of a balanced real estate (and arguably fixed income) investor's portfolio, CRE debt remains a viable and compelling asset class in the UK. The February 2016 IPF Consensus Forecasts have annualised equity returns for UK real estate of 5.6% between 2016 and 2020; which although well ahead of that delivered presently by the FTSE-All-share, 5/10 year gilts or REITs, is shy of the net 6-7% p.a. IRR associated with the TIAA Henderson Real Estate Enhanced Debt Fund.

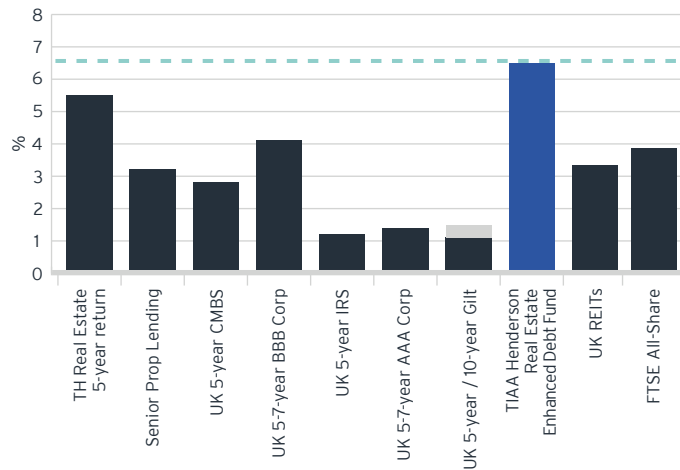
Fig.2: Debt vs. Equity: UK CRE equity return in comparison



Source: TH Real Estate forecast Q4 2015, IPF, Savills, Macrobond, February 2016
Note: Target forecasts are not a reliable indicator of future performance.

With expectation of a rise in interest rates being pushed into 2017 or beyond, and some question marks on the strength of rental assumptions, more conservative investors, or those looking for diversification, should participate in CRE debt, benefiting from its solid, stable and predictable income return. From an equity position, it is the duty of experienced portfolio managers to enhance cash flows and add potential value by cherry-picking the right assets in the right location, no matter the competitive nature of the market. The comfort CRE debt offers is that even if the sponsor's asset management or business plan is unable to achieve all the desired success, debt investors are still likely to receive their target returns as a result of the cushion to the asset value ranging between 15% to 50% depending on the debt fund. The TIAA Henderson Real Estate Enhanced Debt Fund makes investments up to 75% LTV suggesting a

Fig.3: Range in projected distributions from alternative asset classes



Source: TH Real Estate forecast Q4 2015, IPF, Savills, Macrobond, February 2016

minimum 25% buffer. This is an attractive alternative or diversifier to equity in the current market; appreciating that the implications of a Brexit for the UK economy, business, consumer and real estate industry could be substantial. To ensure successful debt financing, a local presence, good market knowledge and a strong asset management resource will determine the best loans with strong borrowers and underlying asset quality.

The sea change in UK interest rate expectations reflects economic headwinds and belief of a lower growth and inflation outlook, and ultimately lower CRE returns.

Consensus believes equity returns for real estate sector will be income-led going forward; with some yield correction as borrowing rates gradually normalise. However, the UK economy is enduring some notable headwinds, both domestically and externally. Against this uncertainty, CRE debt provides significant real estate value downside protection, whilst matching core equity driven returns, but offering a stable, low volatility return profile with a relative value risk premium.

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