On the front foot

PCTN is future-proofing its portfolio...

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Investors have always needed to react to evolving financial markets, and commercial real estate is no exception. Changing working practices, evolving technology and climate change have the potential to influence occupier demand and investor sentiment.

Flexible or remote working was once a relatively rare occurrence; today, it's the norm. The effect on the office market has been an increase in vacant accommodation and more office stock being removed from the market to be repurposed.

Take Canary Wharf, one of the best-known financial districts in the world. HSBC's planned relocation to a smaller site in St Paul's in 2027 after a 25-year stay has so far been the most striking defection, but others have moved on, too. Those planning to stay have reduced the office space that they occupy. Canary Wharf Group's reported vacancy rate was 17% as of September 2024, four times higher than its 4% in 2017, according to CoStar data cited by Reuters.

It's not just the office market that's seen structural changes. The increase of online retail sales has disrupted the high street, but many locations have adapted through change of use to residential and other property types. The industrial market however has greatly benefitted from this trend as the growth in ecommerce has provided opportunities in logistics warehouses.

The owners of 8 Canada Square, HSBC's soon-to-be former home, are planning on turning it from a single-use, single-tenant office building into a mixed-use space capable of meeting modern environmental standards and housing multiple occupants.

Therein lies the real skill for real estate investment companies. Understanding occupational demand is the key to delivering a portfolio capable of outperforming a changing and challenging property market.

The benefits of active management

Active management of property portfolios is required in order to mitigate risks and benefit from opportunities. A key example is the transition from brown buildings, which are generally older buildings that are not environmentally friendly, to green buildings. Many occupiers, particularly in the office sector, are looking for sustainable buildings, to help meet net-zero commitments.

Real estate managers can turn brown buildings green. Although this comes at a cost, it also provides scope for achieving a 'green premium' through increased rental growth and capital value. That green premium for London offices is about 20%, according to the consultancy JLL. The green premium for regional offices is 8% and for multi-let industrials is between 5% and 10%.

Another consideration is building obsolescence, the risk of which is twofold; physical obsolescence can be brought upon due to ageing, failing or legacy technology. These risks can be counteracted proactively, though. Buildings are adaptable and if you can adapt them, they last much longer and are more sustainable.

The risk of locational obsolescence can come about for a number of reasons, such as our aforementioned example of once-busy high streets now becoming vacant, or assets becoming stranded because of climate change and extreme weather.

Less can be done to mitigate locational obsolescence because you can't change location as easily as you can upgrade a building. Good-quality real estate investment trust managers can, though, identify this risk early on and disinvest if required.

Good decision making encompasses constant proactive thinking, both on the sustainability side (making buildings operate more efficiently) and the investment side (ensuring the occupational demand is sustainable).

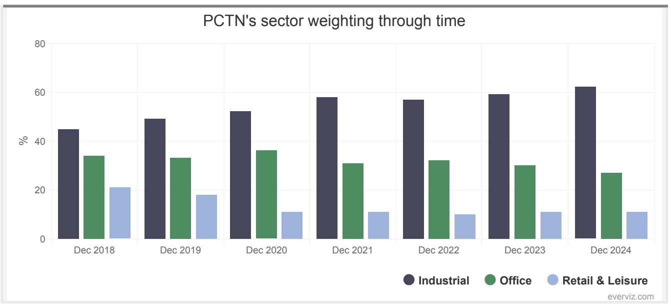
Indeed, these two strands are interlinked: making buildings efficient often impacts occupational demand.

Future proofing

Bringing all of these strands together, REIT managers can't stand still. **Picton Property Income (PCTN)** is a good example of an active property manager being very much on the front foot. PCTN has had some notable successes in gaining permission to develop office assets into higher value uses such as residential buildings and student accommodation.

You can see in the chart below that PCTN's exposure to the office sector has reduced, from c. 36% in 2020 to c. 27%, while it has raised its industrials weighting from c. 52% in 2020 to 62% as at 31/12/2024.

Fig.1: Reducing Office Reliance



Source: Morningstar

That looks to be a continuing trend. PCTN has now sold three of its largest void assets for alternative uses – the disposal proceeds show premium to carrying values and transactions have been structured to reflect the planning secured.

PCTN continues to improve the sustainability credentials of its buildings and now over 80% of the portfolio has an EPC rating of A to C. PCTN has committed to be net zero carbon by 2040 and is progressing their decarbonisation strategy, through initiatives like removing fossil fuels, installing solar arrays and increasing the energy efficiency of buildings.

This has all helped contribute to a recovery in PCTN's net asset value (NAV), which has ticked up for two consecutive quarters now to 98.5p per share on 31/12/2024, c. 2.6% higher than on 30/06/2024.

Navigating today's ever-changing real estate sector remains a real challenge. REIT managers must ensure that their assets remain future proofed, fit for purpose and continue meeting occupier demand, as well as turning the brown discount into a green premium and ensuring new investments are made in the right sectors and locations.

There is significant opportunity for good-quality, active REIT managers to future-proof their vehicles and provide outperforming portfolios. PCTN has shown a willingness and the ability to move with the changing times – and on a discount of c. 36.5% and with a yield of c. 5.9%, continues to look compelling value for both its income and capital growth prospects.

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