Special Report

The tide is turning

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Income and ESG-focused investors shouldn't dismiss the real estate revival..

It's been a tumultuous few years for the commercial property market, but signs are there that a corner has been turned and things are looking up.

If you're reading this during your working day from the comfort of your home office for some light relief in between Zoom calls and taking in Amazon packages, it may not feel like that's the case, but hear us out.

It's true that office and retail buildings have been hit because working from home remains a popular option for many employees and e-commerce is still in the ascendency. Yet, as we will explore here, the reality is more nuanced.

In addition, rising interest rates have undoubtedly had an impact on real estate investment trust valuations, but they finally look to have peaked, meaning the direction of travel is reversing.

Green shoots

Certainly, valuations, on average, of most property sectors are now starting to climb in earnest and there's a feeling that we're at the foothills of exciting times for real estate investors.

We've touched on a few of the headwinds that have contributed to falling property capital values. The MSCI UK Monthly Property Index has fallen some 25% in the past two years, with offices taking the brunt of that and falling 32%. Industrial properties are down 27% and retail premises have fallen 20%.

However, property has a key role to play within certain portfolios and as we start to see interest rates drop, there are plenty of positives for the asset class moving forward.

Rental growth remains strong

FIG 1: 'Rents have been rising'

Source: MSCI UK Monthly Property Index

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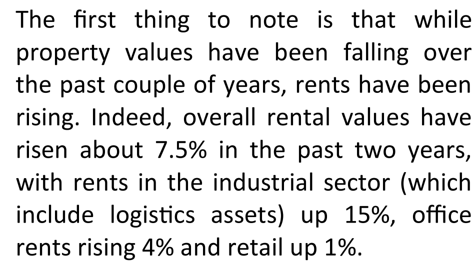

The first thing to note is that while property values have been falling over the past couple of years, rents have been rising. Indeed, overall rental values have risen about 7.5% in the past two years, with rents in the industrial sector (which include logistics assets) up 15%, office rents rising 4% and retail up 1%.

This has happened largely because there is a lack of good-quality buildings. In addition, the fact that rising build costs means there aren't enough new buildings in the pipeline to bridge the supply-demand imbalance we see in commercial property should see rents continue to grow.

This is important because, as we will discuss later on, rents provide real estate investment trusts (REITs) with their income-generating quality, which is a key component of their total returns, and their attractiveness to investors.

As you can see from the previous chart (Figure 1), most of the fall in capital values happened in 2022, with 2023 being a year of consolidation. This year has been more positive, with values rising through the second quarter of 2024. As things continue to improve, the worst may finally be behind us.

If rising property valuations pick up, this should feed through positively to REIT net asset values. Add this to the rental picture, and total returns from the sector could start to look much better moving forward.

Interest rates are reversing

We mentioned before that the rapid rise in interest rates that we saw from the end of 2021 has been negative for the property sector. Interest rates in the UK went from 0.1% to 5.25% in the space of 18 months.

This caused a repricing in REITs because higher interest rates increase the cost of their debt while simultaneously increasing the income available from lower-risk assets such as government bonds. Higher interest rates have also crimped spending in the economy and made it harder to finance debt.

Some relief came in August, when the Bank of England cut interest rates to 5%. There may not be another cut in September, but we've almost certainly hit peak rates and are likely to see them return to a downward trend.

This should take some pressure off consumers' wallets and give them more money to spend in the economy while also having a positive effect on property financing through lower mortgage rates and cheaper costs of finance for investors.

Income advantage

A second-order effect of falling interest rates is that the interest paid on savings accounts has started and will continue to drop. The 5% that you could get from a bank, money market fund or government bond has largely disappeared and been replace by somewhere around the 4% mark.

As this carries on falling, more people could start to consider investing in real assets again. There are plenty of places in the investment company space to find a yield north of the 3.9% that a 10-year gilt pays.

REITs are perfectly placed to take advantage of this. Most of the companies in the AIC: Property – UK Commercial sector have yields between 6% and 8.5%, meaning they can provide both a decent premium over the 10-year gilt yield and diversification away from an equity-heavy income portfolio.

A good rule of thumb when valuing commercial property assets is to compare their yields with the 10-year gilt yield. Often, a 150 to 200-basis-point premium over the 10-year gilt is seen as the 'right' number. The fall in the gilt yield may mean that there are opportunities within UK commercial property investment companies, but investors must make that judgement themselves, on a case-by-case basis.

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Taking **Schroder Real Estate (SREI)** as an example, earlier on in the interest rate cycle, our analysts thought that the share price was around the right level, with SREI's underlying property yield at around the same level as the 10-year gilt.

Today, things look more interesting. SREI's underlying property yield is 6.1%, putting the valuation at the 'right' level and suggesting that the current share price undervalues the portfolio.

The need for active management

Real estate should certainly not be dismissed. For all its challenges, a thriving property sector will always be necessary.

Employees might value having the option to work from home on Mondays and Fridays, for instance, but they still need an office to go to for some of the week, at least. Some 88% of full-time central London office workers go into the office at least one day per week, according to the Centre for Cities think tank.

FIG 2: 'Hybrid Working'

Source: Centre for Cities

In addition, e-commerce hasn't had a negative impact on all sectors or retail. Internet shopping will struggle to replace convenience stores in airports and train stations, for example, while out-of-town stores selling bulkier items such as garden furniture and DIY items remain defensive areas of the market.

Working from home has also been a benefit for high streets in wealthier catchment areas, while there have been positives to the rise of ecommerce, particularly where logistics spaces are concerned. These are buildings such as warehouses and distribution and fulfillment centres where goods sold online are stored, picked and distributed. Logistics assets make up a large part of the industrials sector.

This is why it's important to seek out real estate portfolio managers that are skilled at proactively managing their property portfolios. An additional challenge is how they repurpose outdated and obsolete property spaces into buildings that are fit for the 21st century.

Capturing the green premium

One factor that real estate lends itself to is on environmental, social and governance (ESG) grounds. You can be much more impactful for ESG in real estate than in many other asset classes.

The first point to make here is that real estate has one of the highest carbon footprints of any sector of the economy. The built environment generates 40% of global carbon emissions every single year, according to the International Energy Agency (IEA). Building operations are responsible for 27%, while building, infrastructure materials and construction – typically referred to as 'embodied carbon' – are responsible for 13%.

Most of today's building stock in the UK will still be in use in 2050, meaning that decarbonising the real estate sector is a crucial objective if we want to reach net zero carbon emissions by 2050 and

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to achieve the Paris Agreement's target of limiting global warming to 1.5°C above pre-industrial levels.

Fortunately, it's possible to profit from the transition from brown to green, with the right strategy and management team.

The green premium refers to the fact that environmentally efficient buildings can command both higher capital values and better rental yields than property in the same location of a similar age with a larger carbon footprint.

The green premium for London offices is about 20%, for regional offices it's 8% and for multi-let industrials it's between 5% and 10%. It works with rents, too. Each additional step improvement in energy performance certificate (EPC) ratings results in an average 3.7% increase in capital values and a 4.2% increase in rent for London offices, according to JLL.

Essentially, investors are prepared to pay higher prices for buildings with strong sustainability credentials because they tend to be rented out more quickly and have higher occupancy rates. They are, of course, less at risk of obsolescence from ever-tightening environmental regulation.

In real estate, ESG isn't just a box-ticking exercise; it's a clear and sustainable investment strategy that delivers modern buildings that are fit for purpose while increasing returns for investors.

The green premium in action

SREI has repositioned its investment strategy to capture and harness the green premium. Shareholders approved the addition of sustainability KPIs to the investment objective in December 2023.

The company aims to deliver a mixture of income and capital growth while achieving meaningful and measurable improvements in the sustainability profile of the majority of the portfolio's assets. Over recent years they have increased their exposure to multi -let industrial estates that now represent over half the portfolio value.

Managers Nick Montgomery and Bradley Biggins believe that there is a significant green premium on the right property assets in the UK, with tenants willing to pay more for energy efficient buildings and for a good environment for employees. This is where active asset management of a property portfolio really comes into play.

The Stanley Green industrial asset in Cheadle, Greater Manchester, is a key example of SREI's brown-to-green strategy in action. The asset was bought in late 2020 for £17.3 million. At the time it had a 150,000 sq ft warehouse space, trade counter units and a 3.4-acre development site.

A further 11 units were added in May 2023, bringing the asset's total space to around 229,000 sq ft. SREI made sure that it minimised the carbon used during the construction phase and designed the units to be as efficient as possible for its future occupiers. This included using partly recycled cladding that is highly thermally efficient, and adding in a higher proportion of roof lights and more natural light, which means it requires less energy.

The units have air source heat pumps, which absorb heat that is then used to generate heating and hot water for the warehouse. There are also rooftop solar panels across the site, where any unused power is sold back to the national grid. Those solar panels also power the 24 electric vehicle charging points.

The new units achieved an A+ EPC rating and an Excellent accreditation from the independently run Building Research Establishment Environment Association Method (BREEAM).

Stanley Green was last valued at £40 million on 31/03/2024, which gives a reversionary yield of 6.4%. Capital expenditure on the project totalled £9 million. In addition, a 4,000 sq ft unit on the existing estate with EPC 'C' rating was recently let at £14 per sq ft, whereas the comparable operationally net zero carbon units with EPC 'A+' have been let at around £19.50 per sq ft, reflecting a 39% premium.

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At the time of writing, the site is partially let with negotiations for the rest of the site underway. The goal is to have it fully let by the end of SREI's current financial year.

Nick and Bradley's knowledge of the industry is reflected in the sectoral make-up of the portfolio: while many peers are reducing their office exposure, SREI is maintaining its exposure in line with the benchmark index, albeit with almost half the office space used for university and other non-traditional office uses. Lots of parts of the office market are struggling at the moment, but others, particularly those that pay attention to ESG-related factors, are still seeing demand. With SREI's more explicit ESG strategy now in place, the office sector could be a significant opportunity for the trust in the coming years.

Diversification

Up until now, we've been focusing on the UK market, because almost all the UK-listed REITs focus on the UK, a specific country or a specific sector. As with any investment portfolio, though, it's important not to put all your eggs in one basket. Diversifying away from the UK brings plenty of benefits.

Broadening your search out just a little bit can bring positive results. Consider hopping across the English Channel and adding some exposure to Europe, for instance.

The Continental European real estate market is much larger and more diverse than the UK market. France and Germany have large and mature office and industrial markets , while the Netherlands is home to Rotterdam, Europe's largest seaport, which has an abundance of industrial and logistics assets.

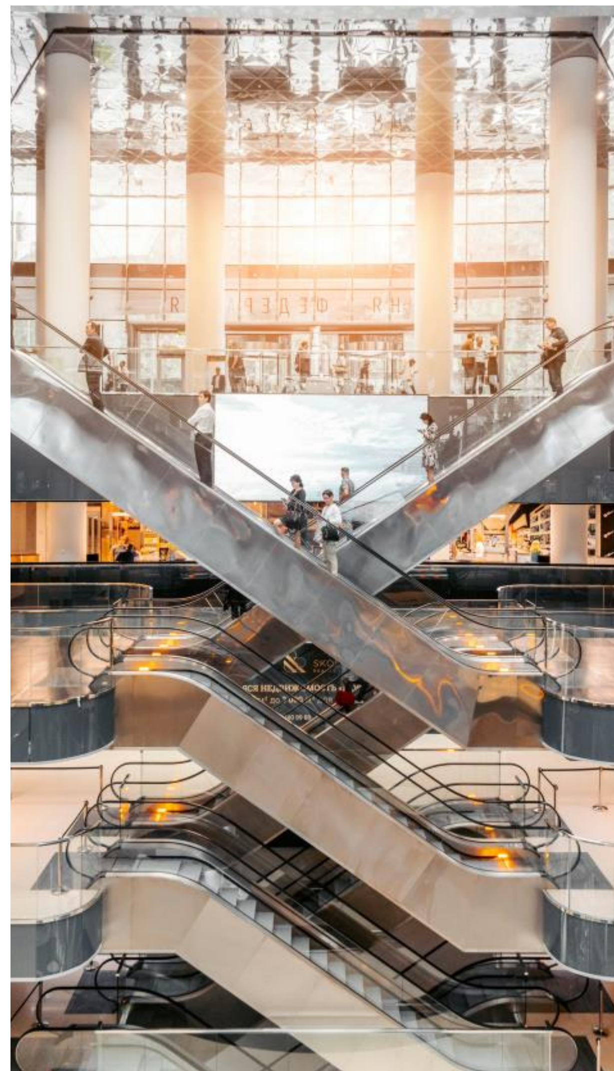
A unique offering

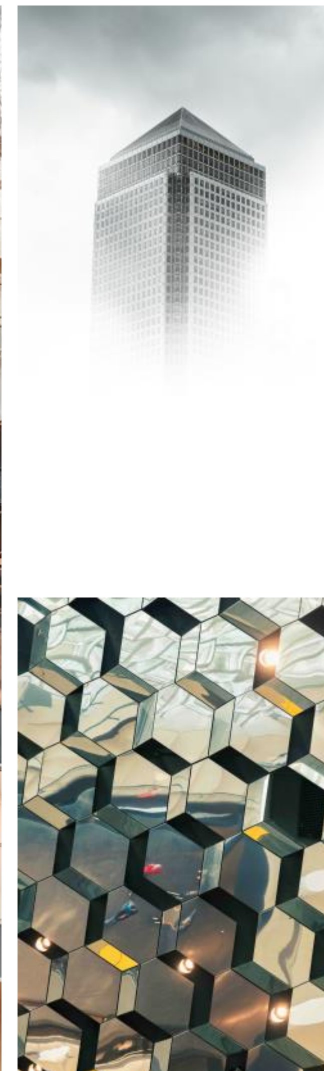
As the only generalist REIT focused on Europe, **Schroder European Real Estate (SERE)** is a compelling proposition for investors who want to diversify their property exposure beyond UK shores.

SERE has a balanced portfolio across the main sectors of office, industrial, and retail, with exposure focused on growth cities in Germany, France, and the Netherlands.

This diversification allows the managers to search in a much bigger pool of opportunities. A recent acquisition that few other REITs would be able to make was that of a car showroom in Cannes, France, for example.

Manager Jeff O'Dwyer argues that demand for property is increasingly concentrated in 'winning cities', which is where he and Schroder Capital's team of c. 200 real estate professionals focus.





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Winning cities tend to give the trust access to competitive advantages. They often have a good diversity of business, a deep talent pool, show good governance and infrastructure and hence generate above average economic, employment and population growth. Some of the trust's assets are in smaller economies that boast higher-value industries.

Active management is important here because winning cities change over time. Jeff has over 25 years' experience in real estate including over 20 years in Europe, with periods of working in Germany and Italy, as well as Australia and New Zealand. The wider team is based in cities such as Paris, Frankfurt, Munich, Amsterdam, Stockholm, and Zurich.

SERE is also able to create value by repositioning assets. It recently upgraded one office building in Paris to a higher technical standard, spending less than €40 million buying the building, investing about €30 million in upgrading it and selling it for more than €100 million. The 39% uplift in rent and 35% profit when it was disposed of allowed SERE to pay shareholders a special dividend.

Looking ahead

It's been a tricky few years for property investors, with a changing environment and the risk of obsolescence for many sectors. However, REIT managers have shown a remarkable ability to move with the times, repurposing buildings to become fit for purpose in an ever-changing world.

As some of the headwinds that have contributed to historically wide discounts for REITs dissipate and conditions become more favourable, investors are likely to start focusing again more on the sector's more enduring characteristics, such as its income-generating ability, inflation-linked cashflows and ESG story.

Read more about the Schroders range of property trusts

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