Turning a corner

Property values are finally stabilising...

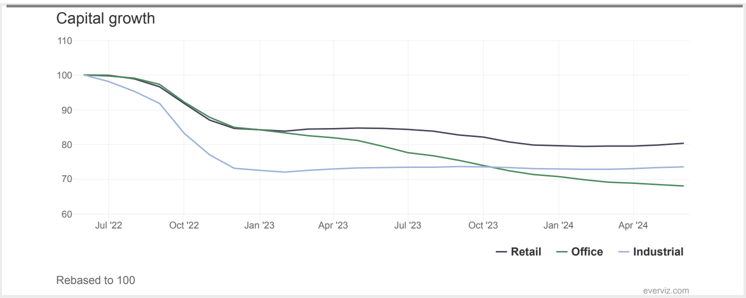
Update
21 August 2024

Investors have given the property sector short shrift in recent years, for plenty of well-rehearsed reasons: a continued preference for working from home, the unabated rise of online shopping and the impact of rising interest rates.

In the past two years, property capital values as tracked by MSCI are down some 25%. Offices have fared worst, falling 32%, with industrials (warehouses, manufacturing facilities and the like) not far behind, down 27%. Retail premises have fallen 20%.

Yet, despite the clear headwinds, there are reasons to be optimistic that we are close to (or even have already passed) the nadir for the property sector. Indeed, while office prices are still falling, both the industrial and retail sectors have seen three months of capital growth.

Fig.1: Property Capital Values Have Fallen...



Source: MSCI UK Monthly Property Index - June 2024

MSCI monthly capital growth rose in April, May and June - effectively the first quarter of growth since 2022.

One key tailwind is rental growth, which plays a big role in total returns for the property sector and has been strong over the past two years. Despite the price falls that we've already mentioned over the past two years, rents have risen by 8% during the same period. The industrial sector has seen 15% rental growth, with office rents up 4% and retail rising 1%.

Rents are rising for a few reasons, chiefly because there aren't enough good quality buildings to satisfy demand and because of rising build costs there aren't enough new buildings in the pipeline to bridge that supply-demand imbalance.

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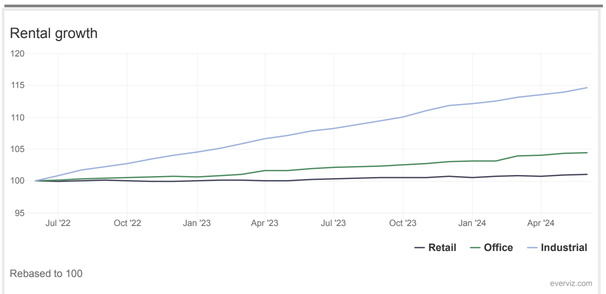
Fig.2: ...But Rental Growth Has Been Rising



Source:MSCI UK Monthly Property Index - June 2024

A further catalyst comes from forthcoming base rate cuts. The Bank of England reduced interest rates by 25 basis points in August, the first cut since March 2020. September may not see a second, but the direction of travel from here is undoubtedly down.

This will be helpful for businesses, potentially taking some pressure off consumers' wallets and giving them more money to spend in the economy. It's also good for property financing, as mortgage rates fall in earnest.

Add in the fact that the UK now looks more stable politically, and there's no wonder that confidence is starting to return to property markets.

You can see that in recent reports from investment companies. **Picton Property Income (PCTN)** reported that it saw a like-for-like portfolio valuation increase of 0.4% in the three months to 30/06/2024, for instance – the first positive quarterly valuation movement since June 2022.

PCTN, an internally managed REIT that invests in a diversified portfolio of UK commercial real estate, had already said in May that its dividend, which remains high and fully covered, would rise 5.7%. This illustrates the portfolio's strength as well as the manager's ability to raise rents and increase earnings, despite inflationary pressures.

Asset selection is key

Still, just because property looks to be turning a corner, doesn't mean you should go out and indiscriminately buy the sector. As with any area of investment, selectivity is key. Those issues we mentioned at the top remain relevant and real headwinds for some areas.

Rents might be growing at the headline level across the three core sectors, but there are significant divergences, for example industrial and West End offices have performed best.

Investing in property is all about asset quality and stock selection. There will always be winners and losers in a certain theme – the trick is identifying them.

PCTN has been on the front foot here, highlighting the benefit of an experienced management team that has seen numerous property cycles come and go. Chief Executive Michael Morris has over 25 years of commercial real estate experience, for instance.

Michael and property director Jay Cable who were both part of the ING Real Estate team that managed PCTN before the REIT became internally managed in 2012, are supported by a team of nine people with roles across asset management, occupier services, surveying, research, and finance.

Repurposing offices

The team is focused on proactive asset management of its portfolio of properties to create space that meets current and future occupier demand. The portfolio has been shifting away from offices and towards more in-demand areas like logistics and industrial assets.

This has been done by repurposing office blocks into alternative-use venues. It has had some early success, with some sales having already gone through and others in the pipeline.

In April, PCTN sold Angel Gate, an office block in central London, at a mark-up to prior valuations having received planning permission last October to repurpose the asset into residential properties.

A further potential sale is of PCTN's Longcross office block in Cardiff to a student accommodation developer, which has applied for planning permission to convert the building into a 700-bed student block. If the application is successful, the sale would be expected to be about 20% above the building's previous valuation.

PCTN has also secured planning permission to turn its currently void office spaces at Charlotte Terrace in Hammersmith, London, into six residential units to take advantage of the £1 billion redevelopment of close-by Olympia in Kensington.

Recent proceeds from disposals have been used to repay floating-rate debt to reduce financing costs. Total outstanding debt is already down to £210.8 million, or 25% loan-to-value, and the weighted average interest rate on PCTN's debt is now 100% fixed long term and has reduced to 3.7%.

There's certainly no getting away from the challenging environment that the property sector has seen in recent years, but as with any asset class there are pockets of opportunity to deliver attractive total returns for shareholders.

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