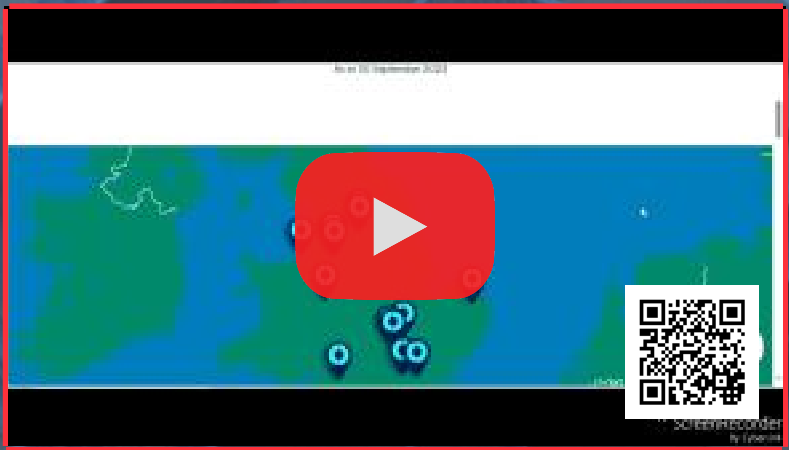
Kepler Trust Intelligence

Building back better

Why the future's looking brighter for the UK commercial property sector...



Rob Arnott, the self-styled 'godfather of smart beta', once remarked: "In investing, what is comfortable is rarely profitable." Without wishing to besmirch the reputation of the commercial property sector unfairly, investors have endured a rather uncomfortable ride over the last couple of years as rising interest rates and recessionary fears have weighed on valuations.

However, investors may be encouraged by a distinctly more optimistic outlook for commercial property: base rates are heading downwards, property valuations are climbing and rental values have continued to rise despite the challenging backdrop.

The sector also offers some eye-catching yields and provides a valuable asset class for those seeking to diversify their portfolio beyond equities, bonds and commodities.

The best of both worlds

The falling base rate may be prompting income-seeking investors to seek out pastures new, with the 10-year gilt yield dipping below 4% and interest rates on savings accounts heading the same way. The UK commercial property REIT sector currently offers a substantial premium to other defensive assets, with many trusts offering dividend yields in excess of 6%.

Current valuations may also offer an attractive entry point for investors, given that average UK real estate values have fallen by around 25% since their high in mid-2022. Current forecasts suggest that the sector is currently at a turning point, with a modest increase in capital values in 2024 followed by higher capital growth in the following four years, as shown in Figure 1.

As a result, the sector is currently forecast to deliver above-average returns over the next few years, with a steady income stream and the potential for capital upside.

The drivers of growth

An improving macroeconomic backdrop

The property sector is highly sensitive to interest rates, with higher interest rates pushing up both the cost of debt and the yields from more defensive assets such as bonds.

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FIG 1: 'Healthy returns are forecast over the next few years'

Source: MSCI, Schroders, January 2024. Forecasts for average grade (not prime) buildings.

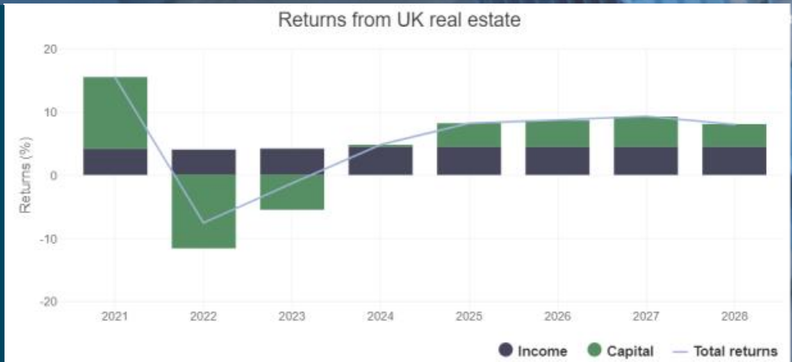

FIG 2: 'UK commercial property rents have shown healthy increases'

Source: MSCI factsheets (as at 30/06/2024)

Conversely, falling interest rates should prove a tailwind for returns and inflation finally dropping to its 2% target has provided the wriggle room for the Bank of England to cut the base rate. While the timing of further cuts remains subject to some uncertainty, Capital Economics is currently forecasting a base rate decline to 4.75% by the end of this year, with a further drop to 3.25% by the close of 2025.

Looking at the broader economy, the UK has returned to growth (after the shallowest recession in history) and business confidence indices have hit a two-year high. A more supportive economic backdrop should boost demand for commercial property, improve the availability and terms of debt finance and enhance investor sentiment towards the sector.

Healthy fundamentals

Property values may have been falling but the opposite has been true for rental values, in sharp contrast to the drop in rental values during the market corrections in the late 1980s and post the global financial crisis in 2007.

As shown in the chart below, average rental values for the UK commercial property sector have increased by 8% in the two years to June 2024. Notably, the industrial sector has shown particular strength with an average rent increase of 15%.

One of the primary drivers has been supply constraints as the repricing of real estate, together with the steep rise in construction costs, has led to a significant reduction in new developments. Supply is further limited by the availability of land in the UK and restrictive planning regulations.

Turning to the demand side, the industrial sector has enjoyed strong tailwinds from structural changes such as the rise in online shopping and the restructuring of supply chains, in addition to strong demand for prime and 'green' office buildings. As a result, robust demand and constrained supply has continued to support rental values over the last two years.

A key ESG role

The real estate sector will play a critical role in meeting net-zero commitments by 2050, accounting for 40% of global annual carbon emissions each year according to the International Energy Agency (IEA).

However, this also presents an opportunity for property investors to capture the 'green premium', whereby environmentally efficient properties typically command higher rents, suffer lower vacancy rates and require lower capital expenditure over the long-term.

Examples of these sustainable attributes include energy-efficient building systems, protecting against extreme weather events and access to high-quality green space and communal facilities to improve employee wellbeing.

Why it pays to be active

The highest returns in commercial property are typically generated by active management rather than

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a passive buy-and-hold strategy. It's also a sector where on-the-ground expertise is essential to identify the most promising opportunities on a local and regional basis.

One such fund is **Schroder Real Estate (SREI)** which is managed by Nick Montgomery and Bradley Biggins and supported by the 300-strong team at Schroders Capital Real Estate. This extensive team provides specialist knowledge of local markets, including employment and transportation factors, and generates significant deal flow (including the purchase of off-market assets).

SREI offers a well-diversified portfolio of around 40 properties (let to more than 300 tenants), with a balanced exposure by sector and region. Around half of the portfolio is allocated to high-quality multi-let industrials, 25% to higher-growth office locations and the remainder to value and convenience retail units.

The trust received shareholder approval last year to focus on sustainability as a key investment objective. The managers believe that capturing this 'green premium' will enhance returns for shareholders by driving higher property and rental values, as well as occupancy rates and the speed of leasing units.

One example of a successful 'brown-to-green' project is the 50,000 sq. ft. Churchill Way West retail park in Salisbury. Planned improvements include solar panels and a transition to fully electric cooling and heating systems with a targeted EPC rating of at least A. Terms have been agreed for a new five-year lease to Sports Direct and (assuming the remaining vacant unit is let as planned) the combined new rent will be at a 24% uplift to the current level.

The managers believe that Schroders' early-mover advantage in the 'green-to-brown' sphere creates the potential to capitalise on mispricing opportunities, particularly in the high-yielding office sector. It also positions the portfolio to pre-empt more stringent regulation likely to be introduced over the next decade and provides a source of differentiation from its peer group.

The trust is currently trading on a discount of c. 10% (as at 27/09/2024) which could provide a further kicker to returns if the discount narrows.

The trust's focus on sustainability has driven outperformance, with a net initial yield of 6.1% (compared to 5.1% for the MSCI benchmark) and an all-important reversionary yield (the anticipated yield when the property is fully let at local market values) of 8.5% relative to a 6.1% yield for the benchmark (as at 30/06/2024). Dividends are also typically fully covered by earnings.

Looking ahead, the structural drivers of constrained supply, strong rental value growth and an improving macroeconomic environment should continue to support the recovery in the UK real estate sector. Given declining yields from more defensive assets, the commercial property sector may be well-positioned to reap the rewards if investor appetite returns over the coming months.

Read our analysts' latest research on Schroder Real Estate

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