Hot property

Are the stars aligning for a revival in the fortunes of the REIT sector?

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Interest cuts seem to be having a positive effect on the share prices of REITs and other property trusts. This raises the questions whether there are signs that investors are beginning to pay attention again, and if the prices on offer are still attractive.

At a recent meeting with **TR Property's (TRY)** manager Marcus Phayre-Mudge, he noted that TRY's gearing, c. 15%, was as high as it generally gets. He is aware there are still some issues to work through but overall he thinks that many leading property companies in the UK and Europe are in good shape, and share prices are undervaluing this. He noted that the bond market in Europe has reopened for property companies, and this is one more piece in the puzzle, as it's not just falling interest rates that can reduce the cost of borrowing, but more competition among lenders. If property companies can play the banks off against the bond market, it should result in lower borrowing costs, and in the end, we think it's the cost of borrowing and its impact on property valuations that has been playing on investors' minds for the last two or three years. TRY's NAV and share price have risen in recent weeks as a result, although the share price has slightly lagged the NAV. We also recently met with **M&G Credit Income (MGCI)**, who provide some confirmation of this point about the bond market, having profitably exited some European REIT bonds bought in 2022 when spreads were much wider. The same trust is finding other debt funding opportunities in property in the UK, where private debt is yet to move pricing as quickly as the bond market.

Meanwhile at another very recent meeting Dean Orrico at **Middlefield Canadian Income (MCT)** provides us with a glimpse into the Canadian property market. MCT itself is not a REIT but it has long held a large position in the domestic REIT sector, in the belief that it is significantly undervalued and also subject to some long-term tailwinds in terms of supply and demand. While Canada is a vast country by area, most of the population lives in a small number of cities and there is significant demand for sites to build new residential and logistics hubs, as well as more specialist needs, such as senior living. Dean sees the same dynamic playing out, with borrowing costs coming down. He also anticipates that investors who have opted for higher interest rates on cash in the last couple of years could return to investing in equities, including REITs, which are starting to offer yields that compete with cash, while at the same time giving the potential for income growth. Dean has seen some significant price moves on Canadian REITs in recent months, as other investors begin to reach the same conclusion as Dean, and MCT's performance has exceeded its benchmark this year by a comfortable margin. Like Marcus, Dean has increased gearing to near the top of his range as a reflection of his confidence in the portfolio.

So, we have two very different investors in REITs sharing a very similar experience, with prices starting to show that the stock market is coming around to property as rates begin to fall. Among others, two very recent meetings with equity fund managers tell a bit of a story. Both **BlackRock Greater Europe's (BRGE)** and **Henderson European's (HET)** managers have taken positions in real estate this year in anticipation of interest rate tailwinds, which appear to be playing out.

Meanwhile, there has been a fierce pace of corporate activity in the UK REIT space, with a mixture of mergers with other REITs and portfolio sales to private equity. While mergers help to show that investors aren't fundamentally unhappy with owning REITs, which we need if we want those discounts to narrow, sales of whole portfolios help to give us a picture of the difference between discounts and real-world values of property. They also remove supply from the stock market, which should ultimately help those remaining to achieve a better rating. Two examples from September 2024 are the portfolio sales agreed by **Balanced Commercial Property (BCPT)** and abrdn Property Income (API). BCPT's sale is agreed at an 8.7% discount to the

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NAV at 30/06/2024, while API's transaction is at a 12.7% discount. On the face of it one might see this as a bit disappointing, but share prices of both were significantly below these levels: BCPT's transaction is at a c. 22% premium to the 'undisturbed' share price, API's at c. 20%. This brings us back to a conclusion we've reached before, which is that the stock market got it right when prices of REITs fell rapidly in 2022 in response to interest rates, reaching low points long before the property market caught up. But now property values have fallen by 20% or more these transactions help to give us a sense of how far the market has overshot.

Of course, REIT fund managers haven't just stood still during this period, so it's worth briefly considering how some of them have responded. Macro-factors like interest rates aren't the only thing investors have been worried about. Take the office sector, where profound changes in the way people work were accelerated by the 2020 pandemic. Given that offices are a highly visible asset class that many of us interact with regularly, it's not hard to see how these changes have weighed on investor sentiment. A REIT such as **Picton Property Income (PCTN)** hasn't stood still during this period and has had some notable successes in gaining permitted development on some of its largest office assets, allowing changes of use for residential and student accommodation. Not every building is suitable for this, and doggedness to deal with the planning system in the UK is required, but PCTN recently sold its largest asset, an office building in London with permissions in place for residential redevelopment, at a premium to its carrying value. REIT managers, in contrast to equity fund managers, are asset owners who can directly influence the assets they own.

Schroder Real Estate (SREI) has chosen a slightly different, although equally valid, hands-on approach. This REIT has now adopted sustainability as one of its core objectives, and evidence is already showing that a little bit of extra investment in its buildings in terms of energy efficiency and such things as solar power generation can make a building more desirable and attract higher rents. And to help answer the question we posed above, SREI provides us with an interesting number. The net initial yield on the property portfolio is now 6.1%, while UK 10 Year gilts are yielding c. 3.9%, which is a very attractive yield premium in our view. Factor in the c. 16% discount and is the yield rises to over 7%. While SREI's stablemate, **Schroder European Real Estate (SERE)** has not formally adopted the same sustainability objectives, manager Jeff O'Dwyer is very much in agreement that sustainability in property is mainstream, with good buildings likely to attract good tenants in a virtuous circle. Jeff also saw rents grow through the higher inflation period, using the explicit inflation indexation that is common in Europe and that covers most of his portfolio to increase rents in line with inflation, even at its peak. This is a good indication of the strength of the tenants that his portfolio has attracted.

Conclusion

In conclusion, the stock market, which is starting to drive prices higher, could very well be correct that this is the right time to 'lean in' to property as an asset class again . Positive earnings growth through the last two years has not been rewarded until very recently, and with the UK and EU central banks cutting rates and bond yields falling, the valuation of property looks more attractive, as does the cost of borrowing, which should have positive consequences for earnings. But what we also know is that it doesn't have to be perfect straight away , as yields are now reaching levels where one can say with more confidence that property is good value purely on an income basis. And, of course, interest rate cutting cycles aren't necessarily always a smooth path to a soft economic landing, so it won't be any surprise if there's a bumpy ride in store. But yields are attractive, and that's the fundamental long-term reason to invest in property.

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