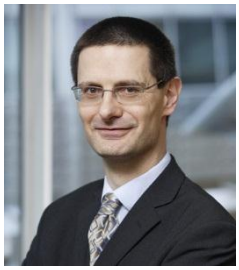
Schroder Property
How resilient is secondary property?



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Introduction

The last 12 months have seen total returns on secondary property start to rival those on prime property, marking an end to the prolonged underperformance which began during the financial crisis. There are three main reasons for this: secondary property offers a higher income return (6.4% at 2014 Q2) than prime property (5.1% at 2014 Q2)[1]; secondary properties are now starting to benefit from increasing tenant demand arising from the economic recovery in the UK and, finally, against this backdrop, investor appetite for properties carrying higher levels of risk is increasing.

Looking forward, our central view is that secondary property will probably outperform prime over the next few years as the deficit in rental growth narrows and as the gap in yields shrinks. That would broadly replicate the patterns seen during the long upswing from 1993 to 2006. This in turn assumes that the UK economy will continue to grow steadily and that long-dated gilt yields do not increase to more than 3.5-4.0%[2] over the next few years.

It is of course possible that our assumptions are wrong and that either the UK economy stalls unexpectedly, or that long gilt yields jump to 5%, or even higher, for various reasons: inflation might be higher than anticipated[3], or the unwinding of quantitative easing, which is unchartered territory for central banks, might destabilise bond markets. If we consider these alternative scenarios then which type of property would be more resilient – prime, or secondary?

[1]Source: IPD
[2]Please see the article "The Attractions of Property in a Rising Interest Rate Market", September 2014. www.schroders.com/property
[3]Annual UK consumer price inflation is forecast to run between 1.7%-2.0% in 2014-2015 and average 2.5% per year between 2016-2019. Source: Consensus Economics, August 2014.

Defining prime, secondary and tertiary property

IPD typically categorise properties according to their type and geography, but they can also further sub-divide the properties within each part of the market into quartiles, according to their equivalent yield. This further split is useful because the equivalent yield is a good indicator of the quality of each property and reflects both its physical condition (i.e. internal specification, location) and the security of its rental income (i.e. the financial strength of the tenant, length of the unexpired lease). Those properties in the lowest yield quartile will typically be relatively new and be let on long leases to strong tenants. The lowest yield quartile is a rough proxy for prime property[4]. By contrast, assets in the highest yield quartile are probably suffering from significant obsolescence and may also be let on short leases, or have weak tenants. The highest yield quartile is a proxy for tertiary property. Assets in the middle quartiles are secondary properties and form the mainstay of most institutional portfolios. Although they are of reasonable quality, they usually have the odd blemish such as a slightly dated specification (e.g.1980s office), or a fringe location, or a short unexpired lease, or a dubious tenant. This means that to generate attractive returns it is often necessary to adopt a more active management approach and invest capital: to ensure that the building continues to meet occupiers' requirements; or to extend the lease, or to negotiate a surrender and secure a new strong covenant.

Figure 1: Equivalent yields

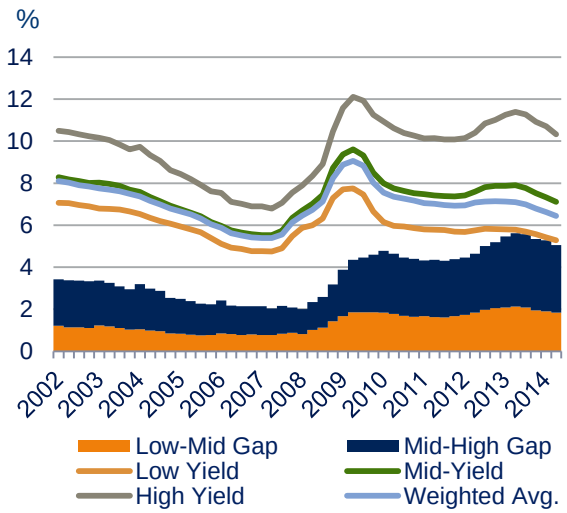
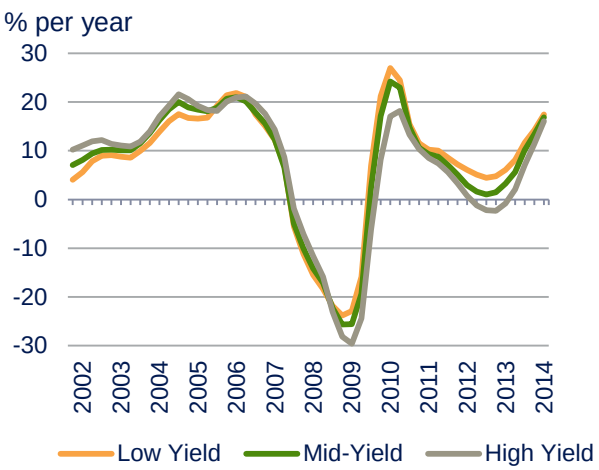


Figure 2: Total returns



Source: IPD, Schroders, August 2014

Scenario 1: An unexpected recession

If we consider the first alternative scenario of an unexpected recession in the UK then the likelihood is that prime property will prove to be the most defensive. That was the pattern through the downturn from mid-2007 to mid-2009 and again in 2012, when the sovereign debt crisis in southern Europe nearly tipped the UK economy back into recession. On both occasions prime properties outperformed, because they benefited from stronger tenant demand and suffered a more limited fall in rental values. On a cumulative basis prime rental values fell by 8% from peak to trough, whereas secondary and tertiary rental values declined by 12% and 20%, respectively (Source: IPD, Schroders, August 2014).

[4]For further background on how we define prime, secondary and tertiary property please see the article "Does Prime Property Always Outperform?", March 2010. www.schroders.com/property

While the range across prime, secondary and tertiary yields widened significantly between mid-2007 and mid-2009 in absolute terms (and again to a lesser extent in 2012), the proportionate increase in equivalent yields and hence the negative impacts on capital values were broadly similar[5].

Figure 3: Rental values, 2005-2014

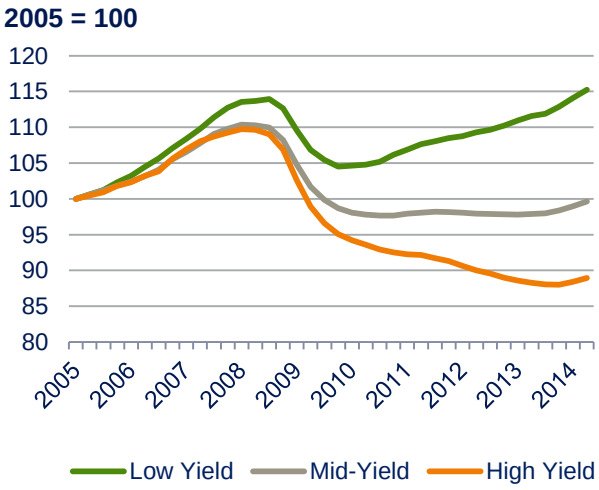
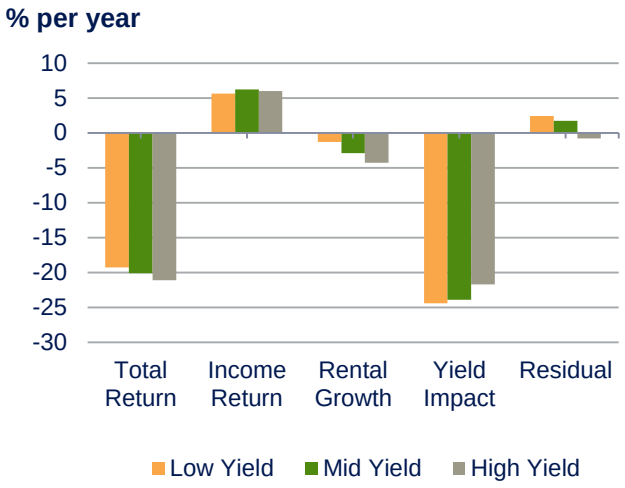


Figure 4: Property performance, June 2007-June 2009



Source: IPD, Schroders, August 2014

The one caveat to the above is that the UK recession of 2007-2009 was part of the global financial crisis. If, however, the UK went into recession by itself, then prime property might not be more defensive, because a relatively high proportion of prime London offices and regional shopping centres are owned by foreign investors[6]. In this scenario those foreign investors might look to exit the UK and if prime yields then rose faster than secondary yields, at least in proportionate terms that could offset the advantage of a shallower fall in prime rental values.

Scenario 2: A jump in long-dated gilt yields

If we then explore the second alternative scenario, in which the UK economy and rents continue to recover, but long-dated gilt yields rise to 5% or more, the outcome could be quite different. There are two reasons why prime property might underperform in this scenario. First, provided economic growth is sustained, then the lead in rental growth which prime property currently enjoys over secondary and tertiary property is likely to narrow, as tenants switch to poorer quality space, either because prime space tends to fill up first during an economic upswing and / or because tenants start to regard prime rents as too expensive. This catch-up in rental growth rates has already happened in the central London office market and there are early signs of it also in the regional office and industrial markets. Retail property might prove to be the exception, as the rapid growth in on-line sales is causing the sector to polarise and some secondary and tertiary shops and shopping centres appear to have fallen into the abyss.

[5]The positive residuals show that both prime and secondary capital values were cushioned to some extent from the full force of the fall in open market rental values between mid-2007 and mid-2009 by the fact that the rental income on existing leases remained fairly stable. However, tertiary capital values did not enjoy the same protection, probably because they had much higher vacancy and fewer existing leases. That would also explain why the income return on tertiary properties was slightly lower than that on secondary assets.

[6]According to IPF research, foreign investors own 59% of City offices and 34% of West End offices. "The Size and Structure of the UK Property Market 2013: A Decade of Change". Investment Property Forum, March 2014. Data compiled by Real Capital Analytics for Schroders reveals that since 2010 the average initial yield on London offices bought by foreign investors has consistently been 0.75-1.00% lower than the average initial yield on London offices bought by UK investors, suggesting a heavy bias towards prime property.

Second, consistent with the relative improvement in secondary and tertiary rental growth, this year has seen yields on secondary and tertiary properties start to fall faster than prime yields. While a sudden jump in gilt yields to 5% would halt this trend and push up all property yields, there is no reason why secondary and tertiary properties should then rise faster than prime yields, if the economy is improving and there is a broad base of tenants looking for space. The last major jump in gilt yields and indeed in developed market bond yields generally was in 1994, when the Federal Reserve began to tighten monetary policy in order to head off a potential acceleration in US inflation as the economy recovered. The limited data available[7] for City of London offices suggest that prime and secondary yields rose in parallel by 0.4 to 0.5% through 1995-1996, but the impact on prime office capital values was more damaging, because the increase was from a lower base. Partly as a result, prime City offices underperformed secondary City offices over the five years to end-1999.

Figure 5: City of London office and 10 year gilt yields

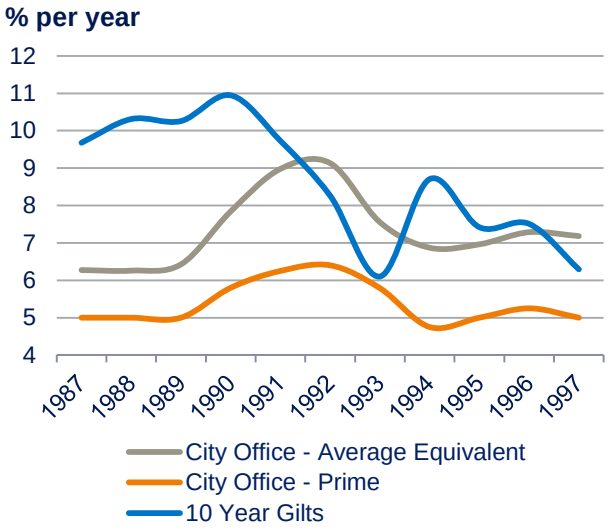
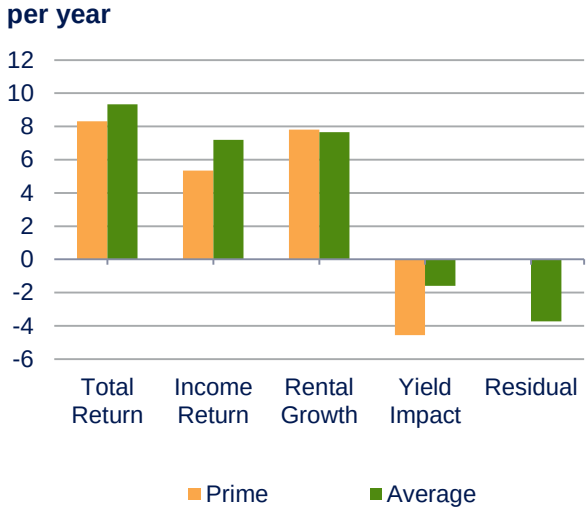


Figure 6: City of London office performance 1994-1999



Source: Healey & Baker, IPD, Schroders, August 2014

Conclusion

We expect that secondary property will now start to outperform prime, at least in the office and industrial sectors. In addition to a higher income return, secondary property should benefit from a partial catch-up in rental growth relative to prime and from a narrowing in the yield spread. Our key assumption is that the UK economy and rental growth will continue to grow. If that is correct, then secondary property should still outperform prime, even if gilt yields confound expectations and jump to 5% or higher. However, if there is an unexpected recession, then prime property would probably again start to outperform secondary property, unless the recession was confined to the UK.

[7] IPD's analysis measuring property performance according to equivalent yield quartile starts in 2001. We have therefore focused on the City of London office market where there is relatively good historical data on prime and average yields. It is not possible to calculate a residual for prime offices using agents' data because prime properties are always assumed to be rack-rented and their capital values and total returns are therefore not affected by over-renting on existing leases.

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