ING INVESTMENT MANAGEMENT

for financial advisers only

building returns

October 2009

Nigel Pickup reflects on why he believes the UK commercial property market now offers some compelling investment opportunities.

At ING, we have said for some time that property fundamentals, with secure and stable income, provide the building blocks for successful investment. The income return has always been the differentiator of commercial property as an asset class and the most important component of total return, a factor overlooked as values rose sharply in the middle of the decade and fell dramatically along with other asset markets as the financial crisis took hold. Falls in value on UK commercial property have been substantial, with the IPD (Investment Property Databank) reporting a 44% reduction in prices from the peak of the market in June 2007 to July 2009. So where does the market go from here? The best way of illustrating the prospects for commercial property returns is to go back to basics.

The key to forecasting long-term returns is establishing the risk premium for the market, ie the return required above the risk free rate on UK government bonds. The property risk premium can be defined as the current income yield, plus income growth, minus the yield on a government bond. Over the long term, this risk premium has been between c.2%-3%. However, following the collapse of Lehman Brothers in September 2008 investors worldwide rushed to the security of government bonds, forcing down yields which subsequently rose across virtually all other asset classes due to extreme risk aversion.

In such circumstances it was hardly surprising that property values fell swiftly. This has resulted in the current risk premium for UK property reaching a historic high, approaching 5%, well beyond any long-term measure. As a result the income return has reached its highest point for over a decade, well above other assets classes (see figure 1).

The excess premium will disappear if the income generating value of the market is re-valued. As capital markets have stabilised throughout the year and an appetite for risk has returned this phenomenon has been experienced by other markets with equity indices up sharply throughout the world and corporate bond yields down as investors move out of cash holdings.

renewed interest

The attraction of a strong income return from UK commercial property, backed by long leases with upwards only rent reviews, appears to be becoming accepted once more, creating renewed interest in the sector. There are signs of a recovery in pricing and performance. The IPD Monthly Index for August reported the first rise in capital values since June 2007 and was the second month of rising total returns, which are firmly in positive territory, driven by the strength of income. The question is becoming not whether this change in direction in capital values proves to be long-lived but how strong a recovery will be. This brings us to assessing the current prospects for the property market.

With income the key component of returns a frequently asked question is: where are the tenants and are the lights still on? Property is a real asset and investment into the right properties will ensure that value is retained given the potential of the asset to generate a future income. Income across the bulk of the UK property market remains defensive, even during times of economic weakness (see figure 2). Real income on UK property, allowing for the effects of inflation, has proved to be resilient and growing over time.

risk controls

Vacancy levels have risen and owning a portfolio of Woolworth's stores at the start of the year may not have been the best strategy as the business headed into administration and those lights were turned off. Within a diversified portfolio, however, such specific risks can be mitigated and managed by appropriate strategies, individual stock selection and other risk controls. In any event, recent evidence from CBRE shows that close to 60% of Woolworth's 800 stores have now been re-let or are under offer by landlords.

Occupier demand remains limited and rental levels are falling but the pace of decline is not even and the sensible strategy is to avoid those sectors of the market most exposed to the demand/supply imbalance. At ING our portfolios are based upon clearly defined strategies and sector allocations across property markets to minimise these risks. Within the Skandia Property Fund we reduced our allocation substantially in early 2008 to central London offices, traditionally the most volatile sector in the UK commercial market, to avoid such an impact.

exploiting opportunities

The bottom line is that relative to gilts and equities the implied risk premium on offer from UK commercial property is too high to be justified by investment fundamentals. The market is entering a recovery phase and astute investors who have the ability and cash resources to exploit opportunities will be best placed to create longer-term performance. With substantial cash available on the Skandia Property Fund we have been taking advantage of market conditions and have been acquiring assets. A modern office property leased for 10 years was recently purchased at an attractive initial yield of 7.5%. A range of investors from the UK and overseas, benefiting from the fall in sterling, are now seeking to increase their exposure and enter the market.

This is not to say that there are no risks ahead. The UK's recovery from recession, anticipated to be a slow and uneven process, will continue to place occupier conditions under pressure and rental values are not expected to recover for some time to come. A sharp rise in government bond yields would erode relative value in commercial property. However, yields would have to rise significantly to get anywhere near eroding the historically wide premium currently in favour of commercial property.

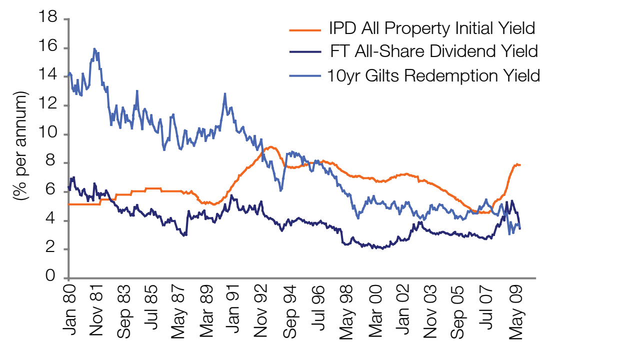
> "The opportunity is one of building returns at the bottom of the market rather than chasing performance at the top."

We are confident that the gap between the current risk premium of 5% and the long-term premium will be closed. This will generate improved performance. Looking forward, commercial property has a strong foundation and this is becoming appreciated again by investors as overall financial conditions improve. Investors need to make sure that the vehicle they choose is well diversified and has a strategy to meet the economic challenges. The opportunity is then one of building returns at the bottom of the market rather than chasing performance at the top.

Nigel Pickup is Director of ING Real Estate Investment Management and manager of the Skandia Property Fund.

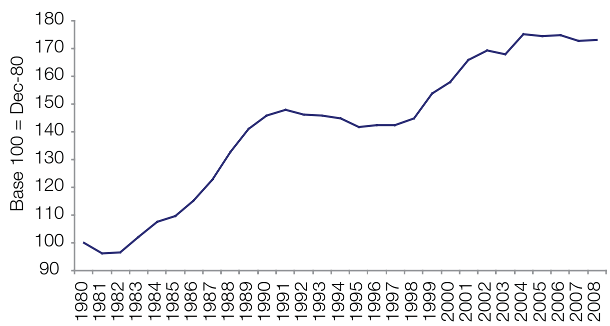
The linked life assurance fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

figure 1 – UK yield levels



Source: Datastream   Past performance is not a guide to future performance.

figure 2 – UK all-property real income growth



Source: IPD/ING

The Skandia Property Fund is available through the Skandia Investment Solutions platform and Skandia's Life and Pensions fund ranges.