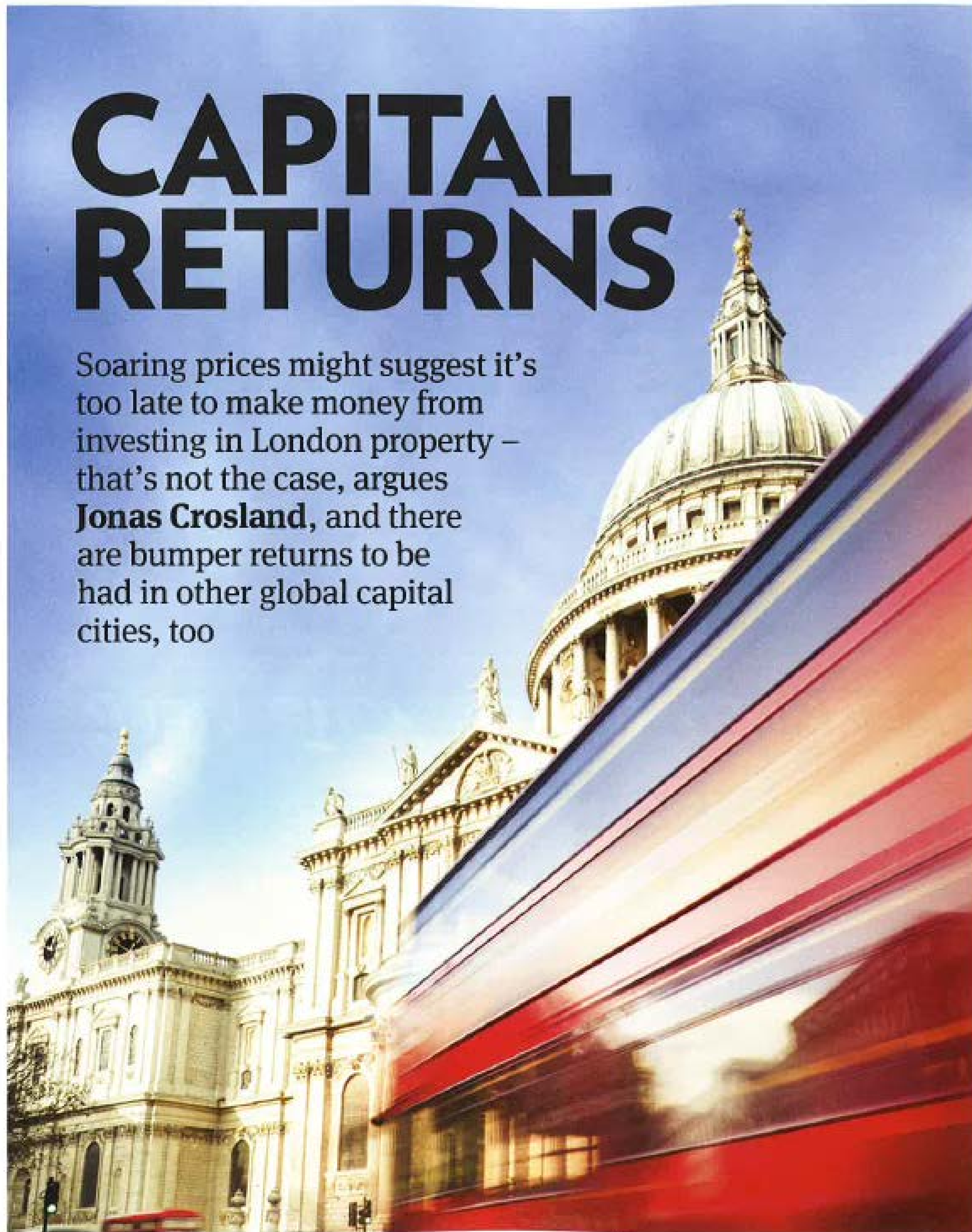
Buchanan

PRESS CUTTINGS

Publication: Investors Chronicle
Date: 17.07.2015
Client: GCP



CAPITAL RETURNS

Soaring prices might suggest it's too late to make money from investing in London property – that's not the case, argues **Jonas Crosland,** and there are bumper returns to be had in other global capital cities, too

Investing in London, or more specifically investing in London property, might now look like a case of missing the boat, given the meteoric rise in capital values over the past couple of years. So, is property in London approaching a peak in valuation terms? Never say never, but it is an axiom of the real-estate market that returns remain attractive as long as there is decent economic growth. In that case, given the recovering economy, there is probably more to come in the way of capital appreciation and rising rental income.

There are two key factors to consider. The first is that the London property market has been distorted to some extent by a prolonged period of low interest rates. These will rise at some point, but no-one is looking for a meaningful increase for at least a year or two. And even when they do, property as an investment asset will continue to have its attractions, particularly as real estate investment trusts (Reits) build up their revenue stream from rents and distribute it through attractive dividends. What's attractive? Shifting through the list of Reits, you can find yields of up to 6 per cent – that's attractive.

The second key point is that real estate companies have taken on board some tough lessons from the financial turmoil that started in 2007. There were two principal areas of heartache; debt and development. Given that few were lucky enough to spot the downturn, companies were left with highly leveraged development schemes that suddenly became hard – if not impossible – to let. Valuations started to fall, and banking covenants on the loans started to creak. This time, not only are banks reluctant to lend on speculative developments that are not pre-let, but companies have adopted a much more cautious stance to gearing, even though it is tempting to push the debt pile higher because the loan-to-value ratio is kept to acceptable levels as capital values rise.

There is another reason why interest rates are important. Low rates increase the attraction of real estate as investors steer away from fixed-interest investments in search of a decent return. Global developments have also provided a steady stream of overseas investors keen to escape localised political volatility, the occasional war and financial constraints. A high-quality asset in London has now become close to a reserve currency.

Residential

In the residential property market, there are currently 30 potential buyers for every property on the market priced at over £2m in Kensington and Chelsea, according to boutique estate agency Patterson Bowe. Potential buyers and completed sales are two very different animals, but it seems that buyers will remain in play as a result of the general election, which effectively ruled out any mansion tax. In 2014, flats in central London rose by nearly 20 per cent, but since then the picture has become more clouded, with prices in the first quarter of 2015 falling by nearly 16 per cent. And it remains to be seen how much of this will be recouped now that the election is out of the way. According to online estate agent eMoov, demand (not prices) in prime central London fell by 3 per cent in May, although some areas still showed an increase.

In the rarefied atmosphere of Chelsea and Kensington, the economic effects of what happens in the real world are that much less pronounced than elsewhere. Apart from the fact that these two boroughs attract interest from the seriously well heeled, demand is underpinned by the chronic lack of new construction. And even gaining planning consent for a major refurbishment is not easy. The second factor is demand, notably from overseas buyers. Nearly all of these are cash buyers, so lending restrictions imposed on lenders become academic. Cyclical trends will see capital values vary, but in the long term these two boroughs are as near to being as safe as houses as you can get.

Even outside these areas, but still within walking distance of central London, the gentrification of such previously avoided places as Bethnal Green Road, and, further out, Hackney and Stratford are now seeing developers such as **Telford Homes (TEF)** selling apartments off-plan, years before anyone can move in or rent out. And for those operating on a buy-to-let basis, rising capital values may have compressed yields, but rental income remains strong. Rents in Greater London rose 10.7 per cent (on new lettings) in the year to May, and jumped 2.4 per cent in May from April. At an average of £1,500 per month, London rents are currently double what they are in the rest of the UK.

So why is there a queue of potential renters willing to pay such high prices? Part of this is explained by changes in social trends, such as the Manhattan effect, where people are more relaxed about living near to where they work. Leisure time increases, while blood pressure, in the absence of being humiliated by having to commute on Britain's decrepit and expensive rail network, stays at acceptable levels. However, there is some argument warning against the risks of superdensity. This is designated as having over 350 dwellings per hectare generated by building tower blocks. The worry is that pushing people into the clouds and away from the vibrancy of the social 'buzz' generated at street level will weaken the attractions of working close to town. Time will tell, but the first residential schemes in Canary Wharf have found no shortage of interest.

Offices

It comes as little surprise that the London office market has also operated very differently to the rest of the country. And even within London there are two distinct markets; the West End and everywhere else. In general, demand for office space is again a product of economic wellbeing. And it's not unnatural to see workers moving towards those areas that offer the highest paid jobs. This trend seems unlikely to change any time soon. In fact, the regeneration of such areas as Docklands and Tower Hamlets, and the construction of residential towers in Southwark and Lambeth will only go some way towards accommodating a ▶

'A high-quality asset in London has now become close to a reserve currency'

10.7%

YEARLY INCREASE IN GREATER LONDON RENTS ON NEW LETTINGS

Buchanan

▶ rising London population. It's interesting to note that London's population peaked at 8.6m in 1939. After the war, industrial-related jobs declined and people moved out to the new towns. But this trend has been reversed, and in February this year that 1939 peak was surpassed for the first time. Estimates suggest that from 8.6m, the population in London will grow to 11m by 2050. That's a lot of jobs to find and a lot more offices.

Office demand is driven by a recent 3.6 per cent rise in employment in London, and this rising trend is expected to continue at a rate of 2.2 per cent for the next five years. In a normal world, this would see office development accelerate to meet the demand, but the residual effects of the financial crash have constrained the availability of development finance. And while the take-up in office space last year was significantly above trend at 15m square feet, there will remain an acute supply/demand imbalance for some time yet. Crucially, many of the real-estate operators in London, such as **British Land (BLND)**, have largely completed a string of developments started in 2010, and speculative development is now further down the pecking order. Plenty of construction is still under way, but a good part of this is either pre-let or residential.

The other way of boosting rental income is through refurbishment of existing buildings. This is virtually de rigueur in the West End, where a bulk of the office stock is housed in buildings with some form of listed status. Financing such developments can be helped along by capital recycling. One chief executive told me that he would rarely hesitate to sell a building that he considered was too expensive to buy. But while the shortage of space remains an issue, rental values will rise. Office rents in May rose by 1 per cent in the City of London and by 1.7 per cent in the West End. That means that, over the past year, a weighted average of City and West End rental values rose by 13 per cent. However, after adjusting for inflation, all-property rental values are still 7 per cent below their pre-recession highs, which suggests that there is plenty of room for further increases.

Inevitably, as transport links show belated signs of starting to improve, so it has been possible to provide office space a little further out; Canary Wharf is a prime example. Songbird Estates, recently acquired by its majority shareholders, has an 11m development pipeline, half of which is adjacent to the existing offices, and this will include a large chunk of office space. Property developers have also kept a keen eye on properties ideally placed to take advantage of new transport links such as Crossrail. **Derwent London (DLN)** recently bought a site in Farringdon Road, just along from where the new Crossrail station will be sited.

Commercial

Investment in central London commercial property is on target to reach record levels, with volume in the first half of 2015 reaching £9.4bn. That figure has only been topped twice before – in 2004 and 2007 – and the first half comfortably exceeds the £6.1bn invested in the first half of 2013, in what went on to be a record-breaking year. Investment so far include Taiwanese Cathay Life Insurance's acquisition of the Walbrook building near the Bank of England for £575m, the biggest single property purchase so far this year.

As well as an array of international investors looking to put funds to work, demand for space in and around London brings together an array of potential buyers looking for office space and residential sites. But there is also a growing demand for commercial space, underpinned by a steady increase in the number of small and medium-sized enterprises. Small companies employing a handful of people need decent office space without all the hassle involved with buying outright. Companies such as **Workspace (WKP)** endeavour to provide an all-inclusive working environment for small start-ups. It may sound obvious, but providing such facilities as meeting rooms, social areas, catering, safe cycle storage and the latest in communications are fairly recent innovations, and a long way from the non-bespoke offerings under railway arches. Its progress in recent years has been impressive; in the year to March 2014, the group's net asset value jumped by a huge 43 per cent, followed up by a further 42 per cent jump in the year to 2015. Acquisition of new sites is usually followed by complete refurbishment after achieving total vacancy. Ideally, tenancies are kept fairly short, thus allowing the group to crystallise reversionary values on a fairly regular basis – in other words, put the rent up to keep pace with rising market rates.

> 'Investment in central London commercial property is on target to reach record levels, with volume in the first half of 2015 reaching £9.4bn'

The added attraction of acquiring new sites comes from the demand for residential use. This demand can be accommodated through striking up a deal with a housebuilder. In a typical agreement, Workspace secures planning consent, after which the housebuilder pays for the redevelopment and construction of new houses at no cost or risk to Workspace. In return, it secures a purpose-built office complex built by the housebuilder on part of the redeveloped site.

Changes in consumer spending habits have provided another growth area in commercial property, as the high-street names look to centralise their distribution depots. The rise of click and collect, next-day home delivery and internet sales have prompted a root and branch reorganisation of the way that major retailers organise their distribution networks. Establishing these close to London is even more vital, given the number of people living inside the M25 motorway ring. That change in consumer habits can be seen in the way that, over the past eight years, internet sales as a percentage of all retail sales have risen from less than 3 per cent to more than 12 per cent.

But the explosive rise in capital values brings its own challenges, or disposal dilemmas. The temptation to recycle assets and lock in a significant premium over the initial cost has to be limited, simply

because replacing those assets is becoming more difficult, or specifically more expensive. However, opportunities still exist, and **LondonMetric (LMP)** is achieving the ideal blend of high occupancy levels and long leases. The risk element is kept low enough to allow the directors to sleep at night, with contracted developments largely pre-let, and the overall business model benefits from continued yield compression, growth in rental income and profits on asset disposals. Supply remains tight. New-build is still falling from its 2006 peak, as is the supply of already constructed properties.

Retail/leisure

Any company with a foothold in the prime tourist areas in London should be on to a good thing. As well as being the largest city in Europe, London generates nearly a third of the UK's GDP, attracting around 200m visits a year; that's more than any other city in the western world.

Companies such as **Shaftesbury (SHB)**, which owns a string of retail-focused sites – as well as a smattering of office and residential sites – are benefiting from the fact that space around London's tourist hotspots, including Carnaby Street, Chinatown, Covent Garden and Soho, is very limited and the ability to expand comes almost exclusively from redevelopment and refurbishment.

> 'Investment in central London commercial property is on target to reach record levels, with volume in the first half of 2015 reaching £9.4bn'

Some idea of the strong demand can be seen in the case of Shaftesbury. Its portfolio reversion – or the rental income if all properties were let at the current market rate – now stands at 29 per cent above current rental income. Demand is broad based, and the group's portfolio stretches across shops, restaurants, cafes and pubs. Redeveloped sites don't stay vacant for very long, and most are pre-let. The key tourist and visitor sites are already buzzing, but numbers will increase with the opening of Crossrail and, before that, plans to run tube trains all through the night. Rising capital values have led to pronounced yield compression, with acquisitions made in the six months to March 2015 producing an average net initial yield of 2 per cent. Existing property owners are also becoming more reluctant to sell their properties, given the strong rise in capital values. However, by refurbishing the properties acquired, Shaftesbury can benefit from charging much higher rents. Oiling the wheels of the planning process comes from supporting local council plans to upgrade streetscapes, and developments usually include an element of street improvements, such as pavements and lighting.

Student

Another side of the London property market that is sometimes overlooked is student accommodation. In the 2014-15 academic year the student intake for the country as a whole was over 500,000. And the cap has now been removed on overseas students, so the next academic year is expected to see a significant increase in student numbers, with some estimates suggesting an increase of 100,000. For the UK as a whole, investment in student housing passed £3.8bn in the first six months, and is set to reach a record £5.75bn by the year-end.

Savvy investors have already recognised the investment potential here. **GCP Student Living (DIGS)**, a real-estate investment trust (Reit) that invests in modern purpose-built student accommodation primarily in and around London, recently raised £120m through a placing and open offer that was substantially oversubscribed, despite the sum raised doubling the group's market capitalisation. The funds will be used to finance the purchase of three additional sites to cater for the upswing in demand expected next year.

In broad terms, the companies involved are showing financial discipline, avoiding the temptation to adopt high leverage rates. What that implies is that the business model should be much more resilient to shocks.

Space around London's tourist hotspots, including Carnaby Street, Chinatown, Covent Garden and Soho, is very limited

Is it still worth investing in the companies that invest in the London real estate market, or are the publicly quoted shares now looking too expensive? The answer to both those questions should correlate tightly with your take on the general health of London's economy. There will always be knocks that instil a note of uncertainty, although, oddly enough, some of the global worries that occur outside the UK can, in many cases, encourage overseas investors to invest in London property, whether as a safe place to park funds or simply to benefit from capital growth and rental income. At some point, interest rates will start to rise, although from such a low base the initial effects will be minimal. At some point, fixed-income investments may regain some of their attraction, which could lead to the more cautious investor taking money out of the property sector. This is likely to be some way off however, and as long as the economic drive supports demand for more housing, more offices and more commercial space, which, at the same time, outstrips supply, then the London property market has some way to go.