Property: reasons to be cheerful

There are a number of reasons to be optimistic about property returns in 2013 and beyond says Rob Martin

UK commercial property prices fell in 2012. But, there are a now a number of factors that make Legal & General Property (LGP) more optimistic about returns in 2013 and beyond. The key drivers are:

1. Improved economic growth forecasts
2. An easing in commercial real estate credit conditions
3. The persuasive valuation case for UK commercial property

The Legal & General Investment Management economics team have raised their expectations for global and UK economic performance in 2013. For property investors, a gradual improvement in economic growth should translate into greater confidence from occupiers to bear the cost of moving into modern, well-located buildings. There are now also increasing signs of easing in commercial real estate credit conditions. Recent months have seen improved loan availability from UK banks. Furthermore, US and emerging market banks, insurance companies and debt funds acting as conduits for pension funds/private wealth are scaling up their UK property lending activities. That said, LGP holds a strong view that a sustainable recovery in property prices must depend more on equity than debt-financed investment. The valuation case for the asset is therefore critical – and that is our third driver for greater optimism. We monitor a number of different valuation metrics, with the results as of the start of 2013 illustrated in the chart. Each valuation indicator has been normalised; the more extreme the current value is, the larger will be the normalised value. Out of 12 indicators, all but two measures suggest property offers better than average value.

Taking these positive factors together, the LGP view now is that in the absence of economic or political shocks, prices for the market as a whole will be broadly stable in the next 12 months. Total returns are therefore likely to be dominated by income return, currently at 6%. Given the attractive level of yield, whilst sentiment is likely to remain relatively volatile, we see upside risk to medium-term total returns from a positive repricing of property. But the market will continue to polarise between best and worst. A number of subsectors which have been shunned in a risk-averse environment are now priced to deliver above-average returns. We favour the higher-yielding sections of the office and industrial markets, primarily outside of London. Within London, opportunities to drive strong returns will be linked to transport infrastructure improvements and occupier hotspots more than has been the case in recent years. By contrast, we view the prospects for many retail property sub-sectors as below average. One of the key barometers of success will be ensuring that rents are priced at levels that allow retailers to trade profitably.

We also see opportunities to invest in real estate assets, beyond the traditional ‘core’ property types of shops, offices and industrial buildings. These would include student accommodation and health and social care facilities such as care homes.

Among the advantages to these sectors is the availability of long, index-linked rental contracts. The increased cost of derisking arising from low fixed income yields creates a particular challenge for institutional investors seeking to match future liabilities. Our view is that the potential for real estate to act as a matching asset will see greater allocations to the asset class as part of ALM strategies.

The bottom line

The improving economic backdrop and signs of easing in the credit markets are taking pressure off commercial property values. We believe that the persuasive valuation case will tempt equity investors to allocate more to the asset class. But in an economy that remains sluggish by historic standards, performance differences between sectors and locations will remain wide. Strategic positioning and stock selection will add substantial value over pure market return.

Rob Martin is Director of Research at Legal & General Property.