Think/UK Multi-let Industrials

Non-prime real estate has been facing pressure from softening capital values in most areas of the country outside of Central London. The re-rating of capital values after the credit crisis and ensuing recession is clearly over and non-prime values are likely to remain under pressure while the economy struggles its way through the deleveraging process. With volatile financial markets adding to uncertainty for much of last year, many investors have preferred to focus on prime, long-leased assets and have proved willing to pay keen prices for the privilege. Meanwhile, bank finance is difficult to obtain for riskier assets leaving the market polarised.

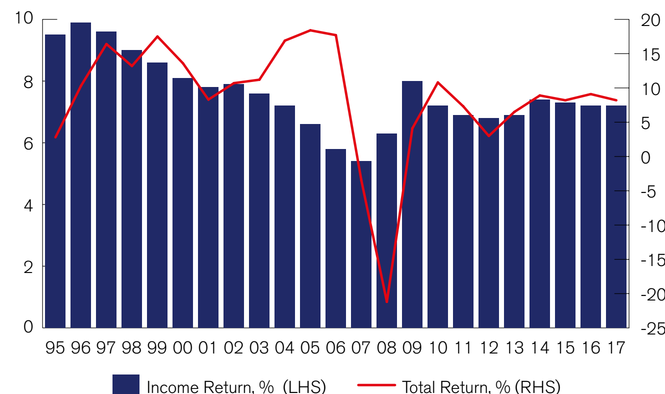
Although prime yields ought to remain defensive for some time, medium-term risks to values will become apparent in some segments of the market. Both long and short term interest rates are at historical lows and will inevitably move higher, even if not for a few years. In addition, the prime rental cycle in the highly favoured Central London office market will start to turn ex-growth at some point leaving yields susceptible to correction.

THE INDUSTRIAL SECTOR'S DOMINANT INCOME RETURN IS EXPECTED TO HELP IT OUTPERFORM THE WIDER PROPERTY MARKET OVER THE NEXT FIVE YEARS.

Income takes centre stage

As prospects for meaningful capital growth have been derailed for the foreseeable future, the focus of real estate performance will shift towards the sustainability of income. Industrial properties have typically produced attractive income yields in comparison with other asset types. The average annualised income return for standard industrials for the period 1995 to 2012 was 7.7% pa, as recorded by IPD, underpinning an average annualised total return of 8.4% pa. These compare with 6.5% pa and 8.1% pa respectively for the All Property benchmark. Henderson's internal forecasts suggest the standard industrial segment will continue to outperform with a projected five-year annualised income return of 7.3% pa between 2013 and 2017, helping to drive annualised total returns of 8.4% pa. Fig. 1 highlights how the income yield on standard industrial assets is projected to remain favourable compared with the All Property benchmark, despite the lower volatility of industrial returns since 1995.

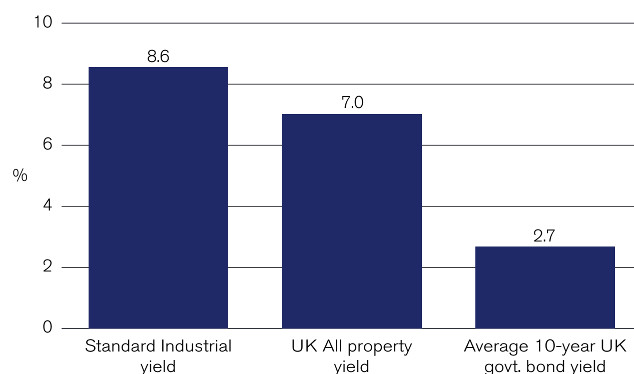
Fig. 1: Drivers of past industrial performance and forecasts for the future



Source: IPD UK Annual Digest for period 1995 to 2012, Henderson Global Investors for forecasted performance, 2013 to 2017.

Note: Past performance is not a guide to future performance and forecasts are not guaranteed.

Fig. 2: Comparative yields, average 2013 to 2017



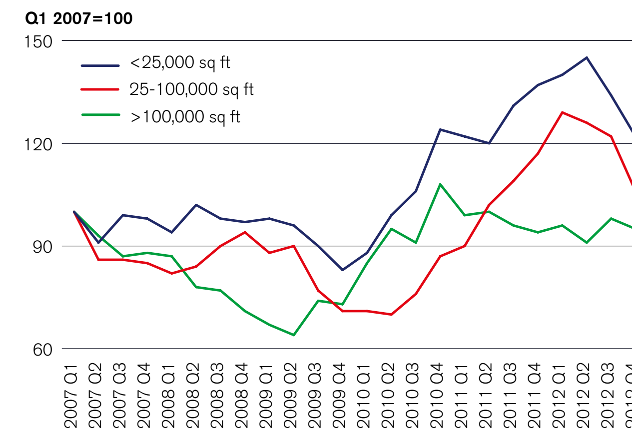
Source: Oxford Economics for forecast of UK government 10-year bond yield (based on period average quarterly yield, 2013 to 2017).

Henderson Global Investors for forecast of Standard Industrial and UK All property equivalent yield (based on end-period estimates).

Note: Forecasts are not guaranteed.

The struggling domestic economy has hardly been conducive to rental growth and rental values have been under pressure in recent years, particularly outside London and the South East. Rental values are, however, arguably close to the bottom of their cycle and occupier fundamentals have not looked at all that bad. Fig. 3 illustrates industrial take up trends by size of unit, as recorded by PMA. These reveal a reasonably healthy picture, particularly for units below 25,000 sq ft for which take up is around 20% higher than its level in 2007, arguably the peak of the economic cycle prior to the onset of the credit crunch and recession. Take up is also currently higher for mid-sized deals and both size-bands enjoyed a very healthy surge in take up through 2010 and 2011, before moderating last year. Only bigger lettings in excess of 100,000 sq ft are currently below their 2007 levels.

Fig. 3: Take up by unit size



Source: PMA, April 2013.

MANAGING INCOME RISK IS PARTLY DOWN TO UNDERSTANDING PROBABILITIES. INVESTORS SHOULD SEEK OUT MANAGERS THAT OFFER A PROVEN TRACK RECORD IN MITIGATING AND MANAGING RISK.

Henderson Research

May 2013

Think/UK Multi-let Industrials

Measuring and managing income risk

Focusing on UK multi-let industrial estates, we can draw on results from Gerald Eve's annual study in order to gauge a clearer understanding of income risk and the drivers of outperformance. The study, last published in mid-2012, examines the performance of 1,119 estates in 2011 and incorporates 12,680 units. The findings are invaluable for those seeking to benchmark and control income risk across their portfolio.

Tenant churn

Churn is partly a function of the economic backdrop, since tenants are less likely to move in periods of greater uncertainty and more likely when the business outlook is believed to improve sustainably. Small units <5,000 sq ft tend to have higher rates of churn because they are often let on shorter leases, while big units of >50,000 sq ft tend to experience lower rates. Across the sample, churn affected 16% of units in 2011 with three-quarters of units remaining fully occupied and 8% remaining vacant. Of those units that experienced churn, more than two-thirds attracted a new tenant by the year end, or a previously vacant unit was let. Only a third of units affected were left without a tenant by the end of the year, representing 5% of the total number of units.

Breaks and expiries

The study also helps us to understand the risk associated with tenant breaks and lease expiries. For instance, 73% of breaks out of a total of 599 possible, were not exercised in 2011. Of the 27% of breaks that were exercised, two-thirds of units remained vacant at the end of the year while the remainder were re-let. This broadly equates to a 1 in 5 chance of a unit staying vacant until at least the end of the year following a break, although interruption to the income stream occurred on 18% of occasions. Some 1,348 units in the sample faced lease expiry in 2011 of which 60% of tenants renewed and 40% vacated. Of the units vacated, 42% were re-let within the year and 23% remained vacant at year end.

Voids

The overall void rate, expressed as a proportion of open market rental value, improved in 2011 to 12.4%, from 14.7% in the previous year. However, there were significant differences with the void rate of small units <5,000 sq ft at 19.4%, compared with 5.3% for units >50,000 sq ft. Regional differences were also apparent with London, the South East and Eastern areas experiencing void rates below the sample average and many of the northern regions of England experiencing above-average rates.

Lease lengths

Lease lengths averaged 10 years across the entire sample, although they were significantly longer for bigger units than smaller ones. The remaining term to expiry, however, was much less attractive, averaging just 3.8 years across all units. There has also been a trend for shortening lease terms in recent years; the average length of leases signed in 2011 was 4.3 years, compared with 4.6 years in 2010 and 5.0 years in 2008.

Identifying outperformance

Gerald Eve's findings confirm regional geography to be the most important factor in terms of outperformance. London, the South East and Eastern regions all benefit from a high exposure to wholesale businesses, as well as a high proportion of transport and communications firms. Other regions have mixed exposures to both high and low value-add manufacturing businesses. The tenant mix of an estate also has a bearing on performance. Business clusters enhance returns and local economic conditions vary considerably from the national picture which in turn affects the relative strength of local occupier demand, the net absorption of available space, covenant strength and default risk.

ACTIVE MANAGEMENT TO LIMIT CHURN AND REDUCE VOIDS WILL BE CRITICAL TO OUTPERFORMANCE.

Stock quality is also shown to be a key performance driver, particularly of late, as investors have bid up capital values on prime assets in the risk-averse environment. The size of the estate also matters because smaller estates tend to be easier to manage and therefore experience lower void rates. Mid-sized estates between 100,000 and 200,000 sq ft, with bigger units of over 50,000 sq ft experience the lowest void rates and should therefore be targeted by those on the acquisition hunt.

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