BUILDING ON STRONG FOUNDATIONS

Anyone reading this publication will already be aware of the strong capital value growth experienced across European real estate in recent years. That growth has been more pronounced in some markets and sectors than others, so now is an opportune time to review how much value remains on offer, where best to find it and what strategies to deploy in accessing it.

There seems little doubt that real estate continues to offer value relative to other asset classes, particularly fixed income. The spread between bonds and property remains comfortably above long term averages.

However, yields in some markets and sectors are now at historic lows, which – despite the evident relative value of the asset class as a whole – has prompted questions about how advanced we are in the current cycle and indeed whether pricing is sustainable. Prime central London offices are a particular subject of debate, with continued global appetite driving yields lower and lower.

At M&G Real Estate, we believe that the key determinant of returns over the longer term is, and should be, income. This seems particularly pertinent at a time when a significant part of the capital flowing into real estate is seeking to take advantage of its favourable income characteristics compared to bonds. Taking into account economic fundamentals and the consequent demand for space from occupiers, we believe that Europe, including the UK, continues to offer many opportunities for income-focused real estate investment strategies.

This is not to say real estate investment should solely be focused on acquiring existing assets with long leases. By analysing markets and their fundamental supply/demand characteristics, we can identify opportunities for income growth, and in some cases where under supply is – or is forecast to be – acute, there is the potential to develop new assets to lease and hold for long-term income. The latter strategy is already common in North America, and termed Build-to-Core.

By creating new, efficient, Grade A buildings, Build-to-Core investors can ensure that their assets best meet the latest occupier needs and create a portfolio of modern, future proof properties well-positioned to generate long-term, stable cash flows. In an environment where speculative development finance remains constrained, investors who are willing and able to fund new buildings can access attractive risk adjusted returns, suitably compensating them for the development and leasing risk.

Martin Towns, **Head of Capital Solutions, M&G Real Estate**

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We are currently employing the Build-to-Core strategy in both the UK residential and UK office sectors. With £6.7 billion under management in the UK office sector, and dedicated sector specialists in investment, asset management and development, M&G Real Estate is well-placed to assess occupier demand. Indeed, we have identified a clear shortage of Grade A office space in certain locations – particularly in improving areas of London outside of the prime centre (for example around the fringes of the traditional City core). We also see the same supply/demand imbalance in certain key cities outside London.

SUPPLY AND DEMAND

The UK economy is on track to post the fastest growth of the G7 group of major advanced economies for a second year in a row, unemployment is at historic lows, inflation is subdued and rising real wages are fuelling consumer spending.

As a result, businesses are increasingly confident about their prospects and happy to take on new office premises. At the same time, their oc-

CASE STUDY ONE:
FRUIT & WOOL EXCHANGE, LONDON

- Prime mixed-use development site immediately to the East of the City of London.
- Acquired by M&G Real Estate in January 2015
- Offices (290,000 sq ft) 100% pre-let on a 20-year lease to a top UK law firm during construction
- Completion scheduled for 2018, with end asset value estimated at c£300m.

CASE STUDY TWO:
1 FORBURY PLACE, READING

- 186,000 sq ft, eight storey grade A development
- Site acquired by M&G Real Estate in 2012
- Whole building leased in August 2015 to energy company SSE plc ahead of completion in what is believed to be the largest letting in Reading town centre in a quarter of a century

CASE STUDY THREE:
SPINNINGFIELDS, MANCHESTER

- Two prime, centrally-located office buildings, spanning 500,000 sq ft
- Acquired in June 2014 in a £320m joint venture between an existing M&G Real Estate client and a separate account investor
- Let to The Royal Bank of Scotland for 23.5 years with 3% per annum rental increases, payable 5 yearly.
- Strong growth in market value since acquisition

cupier requirements are changing. Companies are now much more interested in getting the right buildings, the right floor plates, the right mix of amenities and transport options for staff. That can often be more important than being in the place where their firm, or even industry, has traditionally been based.

For investors, such an environment creates fresh opportunities, but also places the emphasis on local knowledge in order to choose the buildings and locations that would be best placed to attract occupiers. We are seeing increased interest from European and global institutions for strategies capitalising on the shifting office occupier demands both through acquiring and building suitable assets.

M&G REAL ESTATE'S RESPONSE

Capitalising on extensive local market knowledge and contacts to boost returns for our investors, last year M&G Real Estate invested over £1 billion in offices across Greater London, the South East of England and in major regional cities such as Birmingham and Manchester – including a number of high profile developments.

Our current UK office development programme extends to an estimated gross development value (GDV) in excess of £1 billion. A substantial portion of the new space has been leased during construction; this has included significant corporate relocations and some of the largest lettings in local markets for many years. Once constructed and fully leased, we would typically recommend holding the Build-to-Core assets for a number of years to benefit from their modern, efficient design and income generating qualities.

As the London office market becomes more polycentric, the so-called fringes or emerging locations – such as the Southbank to the South, Kings Cross to the North, Paddington to the West and Shoreditch to the East – are increasingly attracting major domestic and global companies. Others are looking further afield to well-connected areas like Stratford, where rents are at roughly half the levels of the City of London, and where both the Financial Conduct Authority (FCA) and Transport for London (TFL) are establishing their new headquarters.

Attracted by improving connectivity and considerably lower rents, occupiers are also looking further afield, across the South East of England (including Reading and Maidenhead) as well as the major regional cities such as Manchester or Birmingham. Danish shipping company Maersk, for example, has recently agreed a 10-year lease on offices in Maidenhead, where it plans to move some of the functions from its City of London base.

ACCESSING THE OPPORTUNITY

Typically the assets in question represent relatively large lot sizes, say £75 million and upwards, so are suited to forming part of a fund or mandate, or to addressing a specific strategic allocation by larger investors. As many larger investors – be they pension funds, insurance companies or sovereign wealth funds – increasingly demand greater levels of customisation and control in their real estate allocations, this is a strategy which can suit a separate account, joint venture or co-investment approach.

Against a backdrop of historically low bond yields, real estate is set to remain a key source of income for institutional investors for the foreseeable future. There are many opportunities globally, but modern UK offices stand out as one of the more attractive sectors thanks to the strong economy, limited supply and growing occupier confidence.

To maximise returns, investors should consider looking beyond London and teaming up with expert local managers who can identify or even create the right assets in the right locations. For larger investors, the diversity of the UK market also presents an attractive opportunity to invest through tailored strategies, focusing on select joint ventures and separate accounts that are designed to best meet their specific needs.

M&G REAL ESTATE

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