A CORNERSTONE ALLOCATION FOR PENSION FUNDS SEEKING INCOME AND RETURN

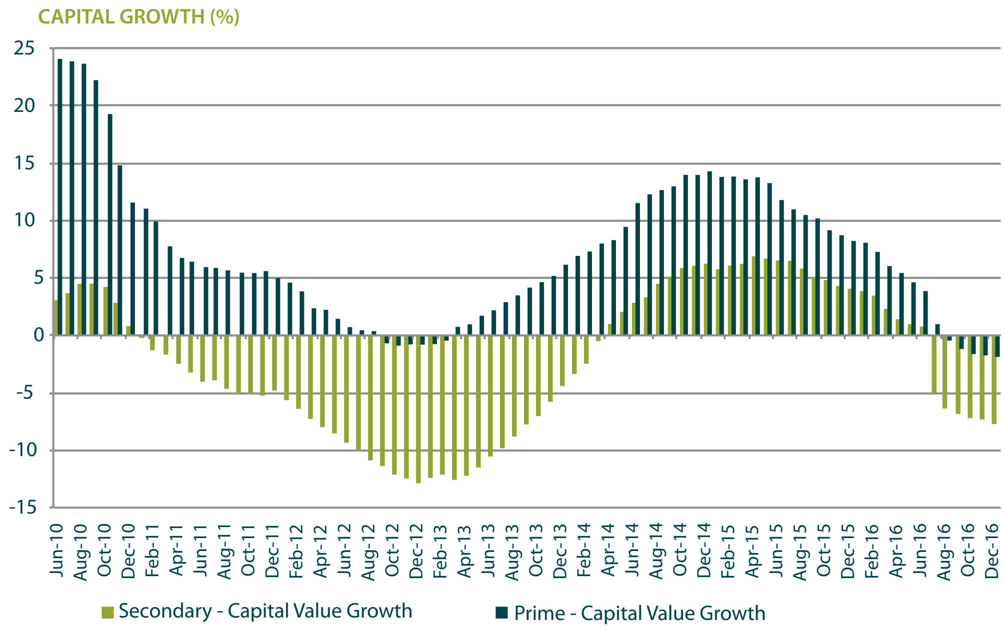
Tony Brown, *CIO*

With the Brexit referendum now months behind us, uncertainty looks set to shape the investment agenda for some time to come. But in the mature UK market, this sentiment is creating exciting opportunities for investors to enhance value by exploiting short-term market mispricing. And in the continental European market, investors are finding complementary opportunities to explore the potential of core to deliver the sustainable income streams they need, says Tony Brown, CIO at M&G Real Estate.

Few anticipated the final outcome of the Brexit referendum, and the capital markets were no exception, bearing the full brunt of the unexpected "Leave" decision by UK voters. Straight after the vote, sterling tumbled into free fall, losing more than 10% against the US dollar and hitting a 31-year low in the process. But while the initial impact to the markets was dramatic, it was also short-lived. The sharp, uncertainty-driven slowdown in the economy that many predicted has so far failed to materialise, with GDP growing at a healthy 0.5% pace in the third quarter of 2016. Sentiment also bounced back, with British consumers and businesses determined to return to business as usual in the wake of the vote.

In the real estate world, post-referendum fallout was felt most keenly in the UK, where non-core real estate assets shed 7.4% of their value in the 12 months to December 2016, reflecting investor risk aversion.

Non-core capital values experiencing greater volatility



Source: M&G Real Estate, CBRE (December 2016)

OCCUPIER FUNDAMENTALS REMAIN ROBUST

Uncertainty may have diluted institutional investors' appetite for risk, but underlying occupier fundamentals remain solid in many key markets. This is particularly true for high-quality, modern (or grade-A) space given the relative lack of development activity since the Global Financial Crisis.

The biggest risks are in Central London, where employment in financial services and related industries is under pressure and where there is 8 million square feet of supply coming on stream. But beyond London, lower levels of new supply in most markets present a much more positive outlook for rental levels. Overall vacancy rates for both offices and industrials are near record lows at 6.5%, with grade-A modern supply closer to 1% or 2% (according to JLL and Gerald Eve as at end Q4 2016).

Overall office take-up has been resilient and more or less remained in line with its five-year average, while industrial take-up reached a record high in 2016, driven by retailer and online expansion.

A WINDOW OF OPPORTUNITY

Now that the initial "noise" that followed the referendum result has subsided, the prospect of a UK recession has been replaced with more favourable forecasts for positive, albeit slower, growth over

ACTIVE MANAGEMENT IN ACTION: LONDON SQUARE, GUILDFORD

In uncertain times, investors tend to misprice income risk. However, by taking on appropriate income risk in established locations experienced investors may find attractive opportunities to create value through active asset management initiatives such as refurbishment and lease-up. These investors can position themselves for outperformance – not just by growing the capital value of the asset, but by generating an improved income stream at the end of the process. M&G Real Estate's London Square office development in Guildford demonstrated those principles in action.

We acquired London Square, a 30-year-old office campus totalling 120,000 sq ft at the edge of Guildford town centre, for £43.5 million in December 2014. This south-east town has limited supply due to the tight planning restrictions associated with a historic centre and the recent sale of several competing sites for residential development. With 60% of income set to expire three months post acquisition, we initiated a progressive £13m refurbishment programme almost immediately, including the creation of two new floors and a glazed atrium. The refurbished accommodation will command a new quoting benchmark rent of £35 per sq ft, up from £25 per sq ft.

Our acquisition of London Square went beyond physical repositioning alone. Reinforcing our credentials in responsible property investment, we focused closely on enhancing the asset from an environmental perspective too. We successfully improved the Energy Performance Certificate rating of 2 London Square from a D to a B, and are targeting BREEAM Very Good rating.

Nina Reid,
Director, Responsible Property Investment

BUILDING RESPONSIBLE PROPERTY INVESTING INTO DEVELOPMENT

At M&G Real Estate, we believe that the impact of the decisions we make when developing and refurbishing assets is far more than just financial. We believe that these decisions have a tangible impact on the environmental, social and economic performance of our assets in operation.

With more than £1 billion of new developments and refurbishments under way (as at end Q3 2016), spanning projects directly under our control, joint ventures and forward-funding projects, we use these critical stages in the asset lifecycle as opportunities to deliver high-quality assets with strong sustainability credentials.

In a clear illustration of this commitment, we completed our first BREEAM Outstanding development in 2016. Located in Leeds, Central Square's sustainability credentials were a key factor in PwC's decision to relocate there. The building features a range of sustainable technologies and approaches, such as:

- Hot water via combined heat and power technology (a wood chip boiler)
- LED lighting throughout, significantly reducing electricity consumption
- Charging points for 20 electric vehicles in the car park
- Storage facilities for bicycles (plus showers/lockers) to encourage commuters to cycle
- A public Winter Garden on the ground floor, plus 9th floor Sky Garden to facilitate interaction between tenants
- Enhanced monitoring for maximum energy efficiency and low service charges
- Water conservation measures including dual flush, sensor flow toilets, waterless urinals and low-flow showers.

"Central Square's environmental efficiency credentials were an important part of our decision to relocate to the building."
Christopher Richmond, Head of Real Estate, PwC

Within our residential portfolio, we are also forward-funding a range of developments that provide environmentally sustainable homes with a real sense of community. We believe that empowering residents to mix and form communities is an important part of what makes our developments more attractive to prospective tenants – a conviction borne out by the high occupation rates at our standing residential assets.

Within our retail portfolio, refurbishment also gives us significant opportunities to make environmental improvements. In late 2015, we took the decision to close Compass One, a 25,000sqm shopping mall in Singapore, for a comprehensive refurbishment. As an integral part of the refurbishment, we were keen to target the Building and Construction Authority (BCA) Green Mark certification as an integral part of the refurbishment, and Compass One underwent an energy efficiency assessment of its operating systems to identify risks and opportunities as part of this process. We implemented the findings of the assessment to ensure the environmental efficiency, sustainable operation of the asset, and good-quality indoor environment. As a result, the shopping centre was awarded the BCA Green Mark Gold certification in September 2016, when it reopened for business. The refurbishment has been extremely successful; the new-look mall reopened already 97% let and valued 23.5% higher than pre-refurbishment. It also came in significantly under budget, and was completed two months ahead of schedule with a zero incident rate. Alongside this, Compass One has already been revalued significantly higher as retailers have queued up to take up space. We are confident the refurbishment of Compass One – its first since the retail centre opened 14 years ago – will secure the future of the mall and maintain its competitive edge.

the next few years. The positive macro drivers that underpin the UK real estate market also remain in place. Online retailing continues to extend its reach, increasing the pressure on retailers' supply chains and boosting demand for logistics space. Meanwhile, the trend towards urbanisation continues, alongside a growing and ageing population, while the supply of available land and buildings continues to diminish. In addition, central Government continues to pursue a "pro-growth" strategy, spearheading major public infrastructure projects to open up regional centres with greater connectivity.

POSITIONING PROPERTY PORTFOLIOS FOR THE MARKET UPTURN

On balance, the UK property market appears to be in a much better position than many were expecting in the summer, shortly after the EU referendum. We now look to be entering spring 2017 from a position of relative strength and with a modicum of optimism. But with the UK government soon to push the Article 50 button, political uncertainty will be on the cards for some time to come.

For investors in UK real estate, the short-term focus will be on limiting risk by maintaining a portfolio that is balanced and well-diversified in terms of both geography and market segment. And for those investors looking to allocate to UK property for the first time, or expanding their existing UK footprint, the focus is on looking beyond the current period of uncertainty and buying good-quality assets that can generate enhanced value - and attractive income returns - in the years ahead.

SOLID PROSPECTS FOR CORE EUROPEAN REAL ESTATE

Moving beyond the boundaries of the mature UK market, institutional investors have not missed the fact that continental European real estate currently offers strong value in the developed world, supported by an increasingly positive economic outlook. This growing market offers investors the scope to tap into a wide opportunity set, capitalise on the region's economic recovery and reap the benefits of diversification, while keeping risk down to levels consistent with core, income-driven investments.

Occupier demand is on the rise across the region, and we expect that rents will broadly grow over the short to medium term, delivering an improving income stream for investors. Total European volumes for 2016 hit a record high of €190.3bn, representing a 4% increase compared to 2015, and a 7% increase compared to the previous peak in 2007. And with attractive spreads above bonds, the political outlook across Europe is clearly not deterring investors from allocating capital to real estate.

Strong occupier markets in German and Spanish cities, as well as Stockholm, look set to offer the greatest office rental growth prospects. We also expect the long-term prospects of key logistics markets to continue to be boosted by structural, ecommerce and reshoring trends. Coupled with the weight of capital driving down yields, we expect continued strong return performance into 2017.

The Continental European real estate market is less advanced in the cycle than most other global core markets, and is therefore attracting strong interest from investors seeking to enter this market at a good point in the cycle. The fundamentals are showing positive improvement in many major markets, against a backdrop of constrained supply.

Additionally, for investors seeking long term stable returns coupled with broad diversification, a core pan-European strategy offers excellent risk diversification. This powerful combination of market cycle timing and long term attractive risk-adjusted returns is driving strong investor interest in the region.

By looking beyond the current period of uncertainty, we presently believe that investors such as pension funds can access good-quality assets in Europe and the UK that should generate stable income returns now and in the years ahead. In our view, investors will look back at 2017 to 2019 as a period of opportunity despite the backdrop of political uncertainty.

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