FROM UNCERTAINTY EMERGES THE VALUE-ADD OPPORTUNITY

Paul Crosbie
Fund Manager, M&G Real Estate

2017 saw investment volumes in the UK commercial property market rise by over 10% on the previous year.[1] Much of this was helped by overseas buyers and a weak Sterling, which remained 10% on average below pre-referendum levels. Whilst an improvement on a subdued 2016, the year of the EU referendum, transaction activity was notably still nearly 30% down versus its 2015 peak, reflecting Brexit-related macro uncertainty. Underneath the 2017 headline figures, non-currency driven activity was also relatively quiet.

As well as impacting investment volumes, macro uncertainty has been a key driver of pricing in the UK real estate market. Investor preference for 'safer' assets has created a clear divergence in pricing between 'core' (prime) property and non-core (secondary) assets with perceived risk attached. Since the referendum, core asset capital values have climbed 5%, while non-core asset prices have fallen 8%,[2] creating an interesting pricing dislocation. In addition, the definition of what is considered a core asset has narrowed over the last 18 months as investors have become more cautious, preferring the highest quality assets with the securest income profiles. As a result, the net initial yield spread between core and non-core assets has increased by 70 basis points (bps) since March 2016 to stand at 320bps in February 2018.[3] We believe this dislocation of pricing presents experienced investors, who are willing to take on risk in a considered manner, with an exciting "value-add" investment opportunity in locations with favourable supply and demand dynamics.

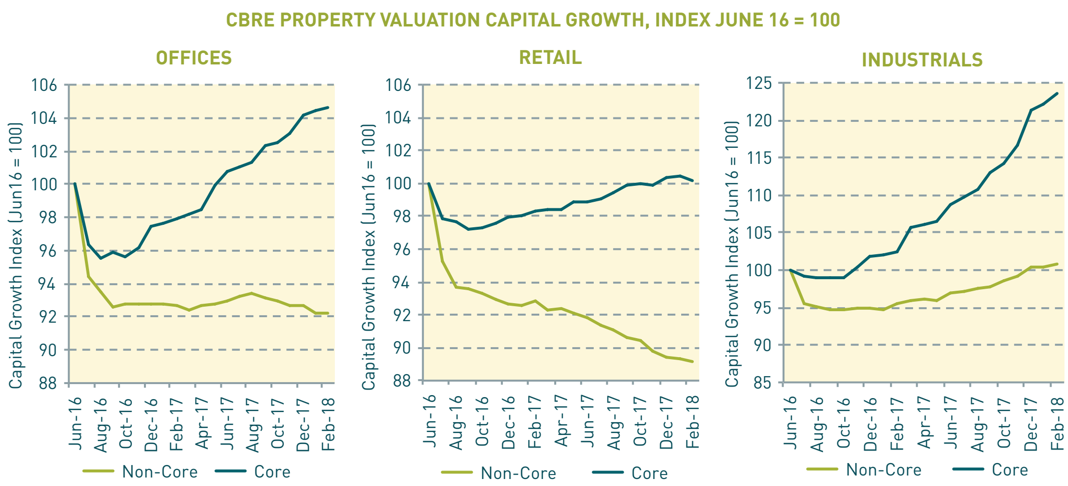
Despite macro uncertainties, there are several reasons to be optimistic about the UK's outlook. So far, the latest agreement on a 21-month transitionary period post March 2019 has allayed fears of a "cliff-edge" scenario regarding trade tariffs. Moreover, some of the concern around the risks of financial services relocating from central London has been mitigated, with estimates around the loss of staff downgraded to 5,000 jobs, representing just 0.1% of the Capital's overall workforce. Office take-up in 2017 remained in line with its long-term average, helped by a mix of both domestic and international occupiers attracted by London's highly skilled labour and the quality of space on offer. Looking at the Core 8 markets[4] outside of Central London, take-up volumes reached 8.1 million sq ft in 2017, the highest level since 2000.

Investor confidence in UK real estate should be underscored by the current strength of the underlying occupational market. Construction levels across all sectors of the UK property market have still not fully recovered from the Global Financial Crisis and the combination of muted levels of new supply coming to market and robust occupier demand for space is underpinning rental growth in some markets. Vacancy rates across the UK industrial and regional office sectors remain at record lows, with prime vacancy in many markets now less than 2% of available stock. The shortage of quality accommodation and robust demand supports taking risk, such as leasing or capex, on the right assets in the best locations, which can be actively managed to enhance returns.

Strength in occupational demand is set to continue for regional office markets, where take-up is more domestic focused and therefore more Brexit-resilient. Increased transport infrastructure development will further improve the connectivity of the regions, whilst greater affordability and additional spending by local government has positioned regional cities as highly desirable locations to live and work. This contrasts with the less benign outlook for Central London offices. The rising levels of supply and the challenging

NON-CORE CAPITAL VALUES HAVE FALLEN SINCE EU REFERENDUM

Mispricing creates unique value-add opportunity



Source: M&G Real Estate, CBRE (data to Dec' 2017)

BUILDING IN WELLNESS

Nina Reid
Director, Responsible Property Investment, M&G Real Estate

Delivering investment returns from property is about more than just financial factors. The integration of environmental, social and governance principles into the design and build of assets can also help enhance the performance of property portfolios. Active asset management initiatives extend beyond the more visible activities of increasing building condition through refurbishment, but also to those aimed at rental reversion potential.

Considering health, wellbeing and experiential factors in how we design and manage buildings enables our occupiers to have happy productive employees, our retail destinations to attract customers and our homes to be places where people want to live. If people enjoy being in our buildings, investment performance will follow through in lower vacancy rates and higher rents. The long-term success of our properties and our development projects is also supported by our focus on the creation of strong relationships with the local community and visitors to our buildings.

Health, wellbeing and occupier experience is one of the four key impact areas of M&G Real Estate's Responsible Property Investment strategy. Our target is to reach 10 million people with our health, wellbeing and inclusivity programmes by 2025. We are also investigating ways to improve, measure and communicate the health and wellbeing performance of our buildings.

This year, we have designed our first asset using the WELL Building Standard®, and have registered the asset with the scheme, targeting WELL Gold. It is the first property in Scotland to be registered, and we believe that this accreditation will help us attract corporate occupiers. Over the next year, we intend to investigate the applicability of other standards such as Fitwell and RESET.

Health and wellbeing measures implemented across our portfolio include:

➤ **biophilic design** – the incorporation of nature and natural features, has been shown to have a positive impact on occupiers. We have integrated green walls and planted terraces in communal space at a number of recent office developments.

environment have pushed landlords into offering higher incentives to occupiers, which are depressing net effective rents.

Out of the main property sectors, the industrial sector has experienced the most acute demand and supply imbalance. This is due to rapid e-commerce growth and competition from other land uses, which is driving up values across the board. The UK has the highest online retail penetration globally.[5] This has driven occupational demand for industrial space, particularly for multi-let estates and sites close to major conurbations and/or arterial road networks. Investors should therefore feel confident about taking on development risk in such supply-constrained markets, given the strong demand dynamics underpinned by this long-term trend.

The rental growth in industrials and regional offices evidences the importance of supply and demand fundamentals to investment returns. At an asset level, strong location and building fundamentals, or the actual structure of the asset, should not be compromised on. Whereas other asset risks can be actively managed to drive up potential property returns. Building condition can be upgraded through refurbishment to enhance an asset's value and income profile by improving the rental reversion potential. The net operating income of an asset can be increased through the lease-up of vacant space, tackling near-term income expiries and reducing operating expenses. Asset repositioning can lead to a capital re-rating, for example through the conversion of urban industrial parks to higher value alternatives. An asset can also be refurbished to become mixed-use, such as, by converting the upper floors in retail schemes to residential in order to extract latent value. Office accommodation can be enhanced through intensification of use or the addition of floors. Retail warehouse parks starved of capex within an urban location can be repositioned, by adding click and collect or leisure options, and income enhanced through optimising the tenant mix.

Improvement in macro fundamentals is the key driver behind the crystallisation of value-add returns. Performance is realised by selling the enhanced assets into better market conditions. Over the next two years, we expect ongoing Brexit-related uncertainty to continue to weigh on both investor sentiment and GDP growth, before a recovery starts to take hold in the UK. This macro uncertainty creates a compelling window of opportunity to acquire properties which we believe have strong underlying fundamentals, but which are discounted due to current sentiment. By targeting well-located assets that could benefit from asset management initiatives, investors have the opportunity to increase a property's value and income profile. Once the EU exit process has completed, we anticipate that the UK economy and real estate markets will recover, leading to positive conditions to sell such assets into a more favourable market, thus crystallising gains for investors.

Given the yield compression we have seen in real estate markets across the globe, including the UK, we believe that a higher proportion of future returns will be attributable to income growth underpinned by rental growth. The onus is therefore upon asset managers to drive rental growth through effective asset management initiatives to maximise returns. Post-Brexit, rental growth should accelerate as the occupational market strengthens on the back of an improving economy, further aided by the undersupply of high quality space across all sectors. Given the expectation that confidence will return, we anticipate the spread in risk premiums between non-core and core real estate assets will narrow, as both occupier and investor risk aversion diminishes. Delivering the best risk-adjusted returns from the property market requires expert delivery of active asset management initiatives to maximise returns by investing in attractive supply-constrained submarkets. Managers with access to the capital markets, significant experience of the UK market and the asset management resources will be able to capture the opportunity and ultimately deliver better returns for investors.

FOOTNOTES
1 CBRE Q4 2017
2 CBRE December 2017
3 CBRE
4 Source: JLL Western Corridor, Manchester, Edinburgh, Leeds, Birmingham, Glasgow, Cardiff and Bristol
5 Source: Global Data Autumn 2017

ACTIVE MANAGEMENT IN ACTION: 2 COLLEGE SQUARE, BRISTOL

In September 2012, we acquired a 51,900 sq ft multi-let office building in Bristol city centre with just below 50% vacant, equating to 25,300 sq ft of unused space. The asset was fully let by December 2015. The size and flexibility of the floor plates were a key attraction of the asset, as there was a lack of quality large buildings in Bristol's CBD, alongside strengthening occupational demand and diminishing 'Grade A' prime supply. The asset was bought for £13m and sold for £22.8m in January 2016, representing a profit on cost of 65%.

➤ **fitness facilities** – facilitating an active lifestyle. We have helped integrate fitness into office life by providing bike racks, foldaway bikes and heated lockers at properties. Our residential developments feature amenities and services designed to encourage tenants to live an active lifestyle, such as indoor and outdoor gyms, extensive cycle parking and even exercise groups.

➤ **circadian lighting** – this mimics natural daylight by adjusting the colour and brightness of the artificial lighting. It is believed to offer a number of benefits to occupiers of a building, including boosting alertness and promoting better sleep. This ultimately benefits the company's 'bottom line' by enhancing productivity and reducing absence rates in staff. We installed our first project at an office last year.

Such innovation is being driven by demand from occupiers across the globe, as indicated by an increasing number of studies. For example, one of our Fintech occupiers in Germany has several wellness initiatives in place including wellness rooms, a games room as well as high quality breakout areas for their employees. It is important we understand the needs of our occupiers and incorporate this into the design of our properties. Ultimately this enables us to future-proof the performance of our assets by increasing their quality and long-term appeal, which could translate into higher capital values as well as rental growth.