Building a long-term real estate strategy

By Will Fulton, Lead Manager, UK Commercial Property REIT

- Industrial is on the rise
- Retail demands selectivity
- Alternatives going mainstream

In an ultra low-interest rate environment, commercial real estate in the UK continues to stand out as an asset class with the potential to deliver a strong, sustainable and rising income return and long-term capital appreciation.

However, at a time of deep structural change for the UK property market – driven by massive shifts in how we live, shop and work – choosing where to and in what to invest has never been more critical.

Here I want to look at the factors that have been shaping our long-term strategy for the UK Commercial Property Real Estate Investment Trust and the near term prospects for the UK commercial real estate market.

Industrial is on the rise

One of the major drivers shaping the UK commercial property market in recent years has been the consumer shift from shopping on the high street to shopping on the internet.

This has, naturally, had an impact on the value of bricks and mortar retail property. But it has also put the industrial property sector in the ascendant. In the south east of England, the need for 'last mile' logistics space, for example, has helped increase industrial rents by twice as much as the rest of the UK over the past five years[1]. In 2018, industrial property in the UK returned 16.4% according to the MSCI IPD Quarterly Index – its highest annual return yet - and its seventh successive year of outperforming the wider property market.

Given that logistics real estate such as distribution centres and warehousing are critical to e-commerce, we've chosen to make industrial property a core focus of our strategy and it now accounts for 50% of our portfolio. But it's vital to be aware that not all industrial real estate is a sure bet. In the wake of the sector's powerful recent performance, investors are becoming more discerning and the pricing of some riskier assets or locations with less demand is showing signs of softening.

Our strategy has been to balance a strong but lower-yielding south-east portfolio with a higher-yielding regional portfolio. The latter has included the purchase of a £85.4m portfolio of distribution warehouses close to the logistics 'Golden Triangle' in the Midlands (the area from which 90% of the population of England and Wales are in a four-and-a-half hour drive).

Meanwhile in London, a prime distribution warehouse – Wembly180 – has been pre-let to an international occupier on a 10-year index-linked lease with no breaks. Completed in October 2019, this major transaction should deliver significant value as well as a long-term income that's assured to keep pace with inflation.

Retail demands selectivity

Although a large proportion of retail activity has moved online, the value of physical stores shouldn't be completely discounted. Certain locations continue to perform well for retailers and offer robust income for discerning investors.

In the UK Commercial Property REIT, retail now accounts for just 23% of our portfolio. By focusing on assets in key locations, and which often also hold value for their alternative use potential, this portion of our portfolio continues to enjoy a 93% occupancy rate.

Alternatives going mainstream

Traditionally, the UK commercial property market has been dominated by three sectors: retail, office and industrial. But a range of economic, technological, demographic and societal drivers, as well as investor appetite for diversified but sustainable income streams, are supporting the rise of other property types.

In April 2019 our shareholders approved an amendment to the UK Commercial Property REIT's investment policy, giving it flexibility to invest across a wider spectrum of commercial property, including healthcare, student housing, hotels, data centres and the commercially-managed private residential rental sector.

Our interest in these sectors partly lies in their potential to tap into major social and demographic trends, such as an ageing population, urbanisation and technological change. They also allow us to introduce assets with a wider range of risk/return profiles to the portfolio.

Asset managers need full flexibility to respond to society's property needs, whatever form or location they take and our broader investment policy gives us the scope to respond to the ongoing evolution of the UK property market.

Outlook for the UK real estate market

So what can we expect from the UK commercial property market in the near term? The UK economy continues to be affected by political uncertainty which is likely to hold back growth. Nonetheless, occupier appetite for space is holding up relatively well overall.

Office demand is supported by the rapid expansion of flexible office providers and, in the regions, by corporate and public sector consolidation. The twin engines of urbanisation and the rise of e-commerce should continue to drive demand in the industrial sector.

Even so, many investors are adopting a more cautious approach, and investment volumes in the first half of 2019 are down nearly 40% compared with the same period in 2018[2]. But this also means there is considerable capital available for deployment, ready to be attracted by UK real estate's income yield and – the retail sector aside – strong occupier demand.

UK Commercial Property REIT

The UK Commercial Property Real Estate Investment Trust is well placed to help investors take full advantage of the fundamental strength of the UK real estate market, while navigating the UK economy's near-term economic and political risks.

As one of the largest diversified REITs on the market with a portfolio worth over £1.4 billion[3], it has the scale and profile to access and invest in real estate opportunities of almost any size, supported by its strong balance sheet and low levels of debt.

Its portfolio of prime assets and a strong, diversified tenant base is positioned with the aim to deliver secure, long-term income to investors, regardless of prevailing economic conditions. Plus the REIT's broadened investment remit – mentioned above – gives it flexibility to tilt towards whichever UK real estate sectors are expected to perform well, be that in terms of rental income or capital appreciation.

Finally, as a FTSE™ 250 company, the UK Commercial Property Real Estate Investment Trust also offers deep liquidity, giving investors the reassurance that they can sell their holding at any time, should they wish to.

UK commercial real estate has continued to generate positive returns in 2019. The UK Commercial Property Real Estate Investment Trust offers a risk-aware, dynamic and income-focused approach that may appeal to investors wanting to access this compelling and multi-faceted asset class.

[1] Source: MSCI Monthly Index – Dec 13 to Dec 18
[2] Source: Property Data, Jun 19
[3] Source: Aberdeen Standard Investments as at end-June 2019

Important information
Risk factors you should consider prior to investing:

- The value of investments and the income from them can fall and investors may get back less than the amount invested.
- Past performance is not a guide to future results.
- Investment trusts are specialised investments and may not be appropriate for all investors.
- There is no guarantee that the market price of a Trust's shares will fully reflect its underlying Net Asset Value.
- As with all stock exchange investments the value of the Trust shares purchased will immediately fall by the difference between the buying and selling prices, the bid-offer spread. If trading volumes fall, the bid-offer spread can widen.
- Investment trusts can borrow money in order to enhance investment returns. This is known as 'gearing' or 'leverage'. However, the use of gearing can result in share prices being more volatile and subject to sudden or large falls in value. Where permitted an investment trust may invest in other investment trusts that utilise gearing which will exaggerate market movements, both up and down.
- The value of tax benefits depends on individual circumstances and the favourable tax treatment for ISAs may not be maintained. If you are a basic rate tax payer and you do not anticipate any liability to Capital Gains Tax, you should consider if the advantages of an ISA investment justify the additional management cost/charges incurred.
- Property values are a matter of the independent valuers' opinions and can go up and down. There is no guarantee that property values, or rental income from them, will increase so you may not get back the full amount invested. Property investments can take significantly longer to buy and sell than other investments, such as bonds and company shares. If properties have to be sold quickly this could result in lower prices being obtained for them.
- Specialist funds which invest in small markets or sectors of industry are likely to be more volatile than more diversified trusts.

Other important information:
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