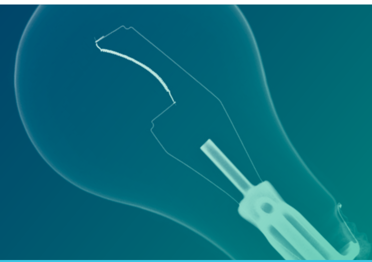
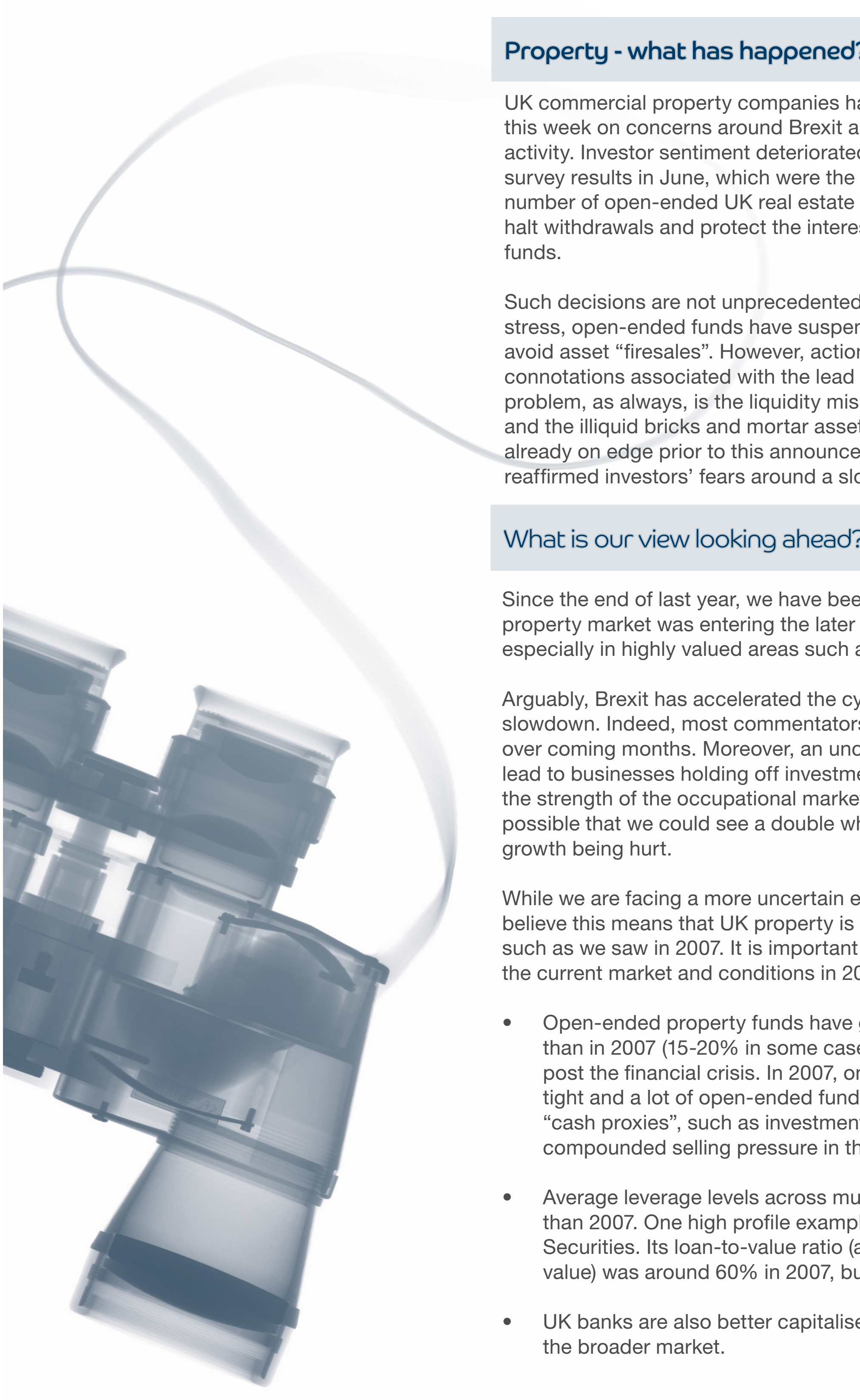
Heartwood
Investment Management



08 July 2016

Investment Insight

Weekly Insight



Property - what has happened?

UK commercial property companies have been hit by renewed selling pressure this week on concerns around Brexit and its impact on underlying investment activity. Investor sentiment deteriorated in response to the UK construction outlook survey results in June, which were the weakest since 2009. This was followed by a number of open-ended UK real estate funds suspending trading, in an attempt to halt withdrawals and protect the interests of remaining investors in their respective funds.

Such decisions are not unprecedented. During periods of uncertainty or market stress, open-ended funds have suspended redemptions to protect investors and avoid asset “firesales”. However, actions taken over the last week do have negative connotations associated with the lead up to the last property crash in 2007. The problem, as always, is the liquidity mismatch between liquid investment vehicles and the illiquid bricks and mortar assets into which they invest. The market was already on edge prior to this announcement, and it seems that this event has reaffirmed investors’ fears around a slowdown in UK property.

What is our view looking ahead?

Since the end of last year, we have been consistent in our view that the UK property market was entering the later stage of its post-2008 recovery cycle, especially in highly valued areas such as London and the South East.

Arguably, Brexit has accelerated the cycle further towards the tipping point of a slowdown. Indeed, most commentators are expecting a slowdown in capital values over coming months. Moreover, an uncertain economic environment is likely to lead to businesses holding off investment decisions, which raises questions for the strength of the occupational market and rental demand going forward. It is possible that we could see a double whammy of both capital values and rental growth being hurt.

While we are facing a more uncertain environment in the near term, we do not believe this means that UK property is entering a protracted and deep slowdown such as we saw in 2007. It is important to highlight some key differences between the current market and conditions in 2007:

- Open-ended property funds have greater levels of cash in portfolios today than in 2007 (15-20% in some cases), partly due to regulatory pressure post the financial crisis. In 2007, on the other hand, cash levels were very tight and a lot of open-ended funds were holding what they deemed to be “cash proxies”, such as investment trusts and shares in developers which compounded selling pressure in the sector as a whole.

- Average leverage levels across much of the marketplace are far lower than 2007. One high profile example is the London-based developer Land Securities. Its loan-to-value ratio (a measurement of leverage versus portfolio value) was around 60% in 2007, but is now down at 19%.

- UK banks are also better capitalised which will reduce fears of contagion into the broader market.

Clear Thinking

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Overall, therefore, property funds are generally better capitalised today, with healthier balance sheets, and should be in a stronger position to withstand today's selling pressure compared with 8 years ago.

What about valuations?

Inevitably, valuations of UK commercial property are becoming more compelling. Several listed investment trusts are trading at discounts anywhere between 20-30% and with yields of between 5-6%. However, there are significant caveats: namely the political uncertainty and downside risks to UK economic growth in the near term. Until the political impasse is resolved, until we see the UK's economic adjustment making further progress and until we see hard evidence of transactional activity post the referendum result, there is little visibility in the short term around the extent to which capital values could fall further and their subsequent impact on rental growth.

Of course, given the degree of the discounts and shape of the market compared with 2007, this does not preclude us from actively looking at opportunities, especially when it is so hard to find reasonable yields in today's low interest rate/low growth/low yield world. Indeed, some risks could be mitigated by the 'lower for longer' interest rate environment, given that the Bank of England is expected to ease policy this summer. On a longer term view, sterling's significant devaluation could also attract international buyers into the UK market, as global investors search for higher yielding investments. It should be remembered that despite current political difficulties, the UK's open, transparent and consistent legal framework stands out compared with other developed economies.

Are we doing anything?

We have been gradually reducing property through the year, though not just in response to Brexit but also to reflect a maturing UK property cycle. We hold select exposure to areas of the marketplace that we expect to benefit from rising rental income due to supply constraints and low vacancy rates, such as regional offices and industrials, and have broadened our exposure outside of London to other key UK cities.

In our view, it is still too early to assess the impact of Brexit on property prices, particularly as we have yet to see the impact on transaction activity following the referendum result. The market is trying to evaluate a fair price but until we see actual property deals being done, nothing is certain. We remain cautious on UK property given recent developments, but also recognise that we are reaching more attractive levels that could present opportunities further out.

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