Heartwood
Investment Management

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Investment Insight

Weekly Insight

Where next for UK commercial property?

UK commercial real estate has seen strong investment volumes over the last few years, totalling £71 million at the end of 2015. Inevitably, we are now at the later stage of the market cycle and growth in total transaction volumes is likely to level off, although market participants continue to expect volumes to stay around 2015 levels for this year.

Nonetheless, investors should reasonably expect lower yields, increased dependence on rental growth to drive returns, marginally increasing supply (in particular areas and/or sectors) and diminishing asset class relative value going forward. It seems a rather dull summation of a sector that has seen very strong growth in the last few years, but nevertheless it should not preclude investors like us from finding opportunities. However, we will need to be more targeted in our exposure.

Where are we targeting exposure?

We continue to prefer prime offices and industrials, though have less conviction in the retail sector, which continues to suffer around concerns of "death of the high street". This has been a long held view, but we are now expecting investors in the UK market to shift their geographic tilt.

Over the last few years, our portfolios have had a strong focus on developers in London and the south east. We still consider that the central London office sector remains a robust market with demand outstripping supply, and these conditions should underpin rental growth, albeit at a slower pace than seen in recent years. However, we are also seeing more investment opportunities in other UK cities, which remain at an earlier stage of the recovery cycle, thus leaving room for both capital growth and higher rental yields.

Increasing investor confidence outside of London

One important driver for UK commercial property in the last few years has been foreign investment flows, where we are now observing shifting trends. Foreign investment has long been a key driver of London/prime real estate markets, hitting a plateau of around 70% of the central London market in 2014/15. While this is not expected to drop off materially over 2016, the global hunt for yield is encouraging international investors into cities like Manchester, Birmingham, Bristol and Leeds.

In 2015, around 35% of transactions outside of London involved foreign buyers compared with the historical average around 15%-20%. Here again, though, selectivity is key as there is broad dispersion. For example, the take-up of offices in Aberdeen was down 50% relative to 2014, due to the city's dependence on the oil sector.

Property remains a core holding

More generally, UK commercial property continues to be attractively priced relative to other asset classes and we still believe it should represent a core part of a multi-asset class portfolio. Both prime and secondary property yield spreads remain elevated relative to ten-year UK conventional Gilts and UK corporate bonds versus their historical averages.

Understandably, there are concerns about the UK economic outlook and the impact this may have for the UK property market. Export activity has languished in response to global factors and business investment has slowed, which is not being helped by Brexit concerns. These are all headwinds, but they should be countered by reasonably firm levels of private consumption. We continue to believe that UK economic fundamentals are sound, which in turn should support occupier demand.

How are we positioning portfolios?

UK commercial property remains a core allocation within our portfolios. However, following strong performance in recent years, we are looking to reduce some of our allocation to more volatile, equity-like instruments, such as developers, which have a higher exposure to retail, as well as London and the south east. Our preference is to have a more targeted exposure to those sectors that we believe are best positioned for growth – prime offices, industrials and select opportunities in regional UK cities.

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Risk Warnings:

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