TIME INVESTMENTS

What next for UK property investors?

A conversation with Nigel Ashfield and Roger Skeldon

As we come out of a period of suspensions and turbulence for UK direct property funds, many investors will be asking themselves, what is the best way to continue to access the attractive attributes of this asset class? We hear from Fund Managers Nigel Ashfield (N) and Roger Skeldon (R) on their view of the matter.

Nigel Ashfield

Fund Manager and Partner

Roger Skeldon

Fund Manager

1 Are you expecting investors in traditional UK direct property funds to look elsewhere for real estate exposure due to the extended period of suspensions?

R: In some cases, yes, there will be investors that have become frustrated with direct property funds and suspensions. That said, most investors understand the liquidity profile of investing in direct property and appreciate that during times of market stress or liquidity pressure that suspending is in the best interest of the investors.

I also expect to see investors looking to move away from allocating to traditional commercial property (i.e office and high-street retail which are experiencing structural change) and continue to move into alternative real estate sectors. Investors will likely look elsewhere to areas that have grown in prevalence over the last few years, such as social real estate, or increase their exposure within logistics and operational real estate.

N: This has already been seen with an exodus of investors leaving some of the more traditional property funds, however, I don't believe this is down to a change of heart towards direct real estate but down to the challenges within certain sectors, as Roger just mentioned.

Since we reopened our commercial long income property fund, after an initial fortnight of pent-up redemptions venting, the fund has experienced a month of net inflows as a result of a loyal investor base who understand the underlying sector exposure and the benefits of long income property.

Because of the nature of long income property, our funds are typically less volatile during times of uncertainty. As such, our investors don't need to react in the same way as those invested in traditional commercial property. With the share prices typically being less volatile, we have seen fewer redemptions during uncertain times, evidenced during the run-up to and aftermath of the Brexit vote.

2 If investors were to look elsewhere for property allocation, what options do they have?

N: For investors still looking to allocate to property, some investors may have opted for REITs over the past 12 months as investor sentiment towards direct property has shifted.

By investing in REITs, investors will have gained access to underlying property exposure, but with an equity-style return. That said, over the COVID-19 period REIT investors will have suffered significant volatility and underperformed on many occasions against the direct property market. This volatility is often highlighted by the disconnect between underlying property values (and the associated Net Asset Value (NAV) of a REIT) and the REIT's share price, with some trading at significant discounts and premiums.

I have had many conversations with investors, who appreciate direct real estate for what it is and treat it as an illiquid asset class, investing for the long term. Therefore, periods of suspension have impacted those investors less, as they seek smoother returns and less volatility at the potential expense of liquidity.

R: The other option for investors could be to move away from the more traditional direct property funds. At TIME we are experts at investing in long income property; real estate let on long-dated leases from which a long income stream is derived. The lease length is driven by the tenant, down to the simple fact they want to remain in the property for an extended period of time. This will be a result of a number of factors, for example, a supermarket chain may wish to be within a certain town to access that population, but planning might be quite restrictive or there might be limited availability of appropriate sites, so being in that specific property is essential.

Long leases and the rent being paid are commonly reflective of the underlying business activity and how that is expected to change over time. Typically, this leads to rent reviews being linked to RPI or CPI to further reflect the growth in revenue from the business activity in that property. Traditional commercial property is typically leased on shorter terms with rent reviews based on Open Market Values (OMV), negotiated at a point in time.

3 What trends are you seeing in the wider real estate investment market?

R: Over the last 12 months, I have seen two main trends within the real estate market, the first being a flight to safety by investors searching for lower-risk investments, very much a natural reaction to increased volatility and stress within the market.

But also, on a sector level, I have seen growing investor appetite towards operational real estate, including healthcare, social housing and logistics that have picked up on the wider long-term themes throughout the UK.

N: This is evidenced in the institutional market, with the weight in capital towards property and specifically the sectors Roger mentions continuing to increase both pre and post COVID-19. As we remain in an environment of low interest rates, paired with concerns around bond returns, many investors are looking to alternatives to deliver reliable returns. We've seen this first-hand with defined benefit pension scheme clients continuing to invest in long income property over the last year looking for it to provide consistent income over the long term and provide some protection against inflation. With concerns around increased levels of inflation, long income property, where rent reviews are typically linked to an inflation index or contain fixed uplifts, offers investors an attractive option.

4 As Managers of two commercial long income funds, why do you prefer this strategy over traditional property funds?

R: The type of returns achievable from long income property tends to be smoother, less volatile, and more predictable in nature, and this is the type of return we want to deliver to our investors.

Traditional commercial property funds can benefit from not having long leases in place and being able to more actively manage their real estate and take advantage of rental growth through OMV rent reviews. Yet, the negative can come when markets turn the other way, such as the shift away from high-street retail over the last decade and consequently increased vacancies and a fall in rental levels and valuations.

N: A long income property strategy essentially swaps away some of the volatility found in traditional property funds, in return for greater visibility of income and certainty in rental growth through higher Weighted Average Lease Terms (WALT) and structured rent reviews.

5 Why have your funds performed so resiliently compared to traditional commercial property funds?

R: The resilience of our funds is supported by the nature of the long leases on the assets where tenants wish to have access to the property for a long period of time. Furthermore, we look to invest only in sectors that meet our desired characteristics, including strong underlying trends of growth, long-term operational sustainability, high quality and profitable tenants, provision of essential services and favourable market dynamics to name a few.

We have never had exposure to high-street retail which has continued to decline in demand over the past decade. Furthermore over the past 12 months, we've seen these changes accelerate due to the pandemic. Similarly, we currently have no exposure to office spaces understanding that the new world of working is hugely uncertain with many businesses expected to cut back on the space they require and move to more flexible working.

6 You mention sector exposure being a key factor in your outperformance, which sectors, in particular have performed positively during the last 12 months and why?

R: There is no doubt that one of the real winners of the pandemic are sectors that are benefiting from the structural change that is being seen within the retail market.

The logistics sector has benefitted significantly, as online retailers have continued to pick up the lost revenue from the high street over the last 12 months. We've seen these trends for the last few years and have ourselves acquired a DPD Last Mile delivery unit in the Midlands into our commercial long income property fund to increase our logistics exposure. The asset is an essential part of the logistics chain, helping a package land on the customer's doorstep quickly and efficiently within that locality.

Sectors that are less cyclical, where demand is less influenced by the economy, have also been key to our performance. These sectors include healthcare, social housing and educational assets which have all continued to operate throughout the pandemic as the services and care provided at these properties are essential. Such sectors are indicating long-term trends highlighting increased demand in the future and are also heavily undersupplied in terms of quality real estate available. This is echoed in our social real estate fund which has collected all its rent throughout the past 12 months with all tenants remaining in occupation as the services they provide are key to those that require them.

7 Which sectors have been the most challenging during the last 12 months?

R: Overall, our funds have been resilient over the period having low or no exposure to sectors hit the hardest.

That said, within our commercial long income fund we have exposure to the hotel and leisure sectors, which have suffered as a result of being closed for much of the last year. Despite this, we believe that long-term demand remains for these sectors and expect trading to pick back up as lockdown restrictions are eased, and the economy continues to open up further. We anticipate these sectors to experience a recovery over the medium to long term.

8 What does the outlook look like for the funds over the next 12 months?

N: The outlook is excellent for our long income property funds based on the nature of long leases and our choice of underlying sector exposure. It would be remiss of us not to mention the ongoing FCA consultation into open-ended property funds and the proposed longer redemption notice periods for illiquid property funds. We are pleased the FCA has recognised in its recent May 2021 feedback statement, the challenges placed on firms and investors by the implementation of notice periods and we welcome their stance that if such notice periods are made mandatory, they will allow a suitable implementation period (not before 2023) before the rules come into force, if at all.

However, direct property should in most cases be classified as a long-term investment based on the way property is bought and sold and the associated costs that come with it. For investors that treat it as such, they can benefit from the security and visibility that the asset class offers. There are significant concerns that we might see increased levels of inflation, our funds are well positioned and our commercial long income property fund has approximately 94% of its portfolio rent reviews linked to an inflation index or containing a fixed uplift, rather than being subject to open-market rent review negotiations which is more typical in traditional property funds.

We believe direct property remains an attractive asset class with unique features that can benefit most investment portfolios.

020 7391 4747
questions@time-investments.com
time-investments.com

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