Real Estate Insight

Thematic House View

Standard Life Investments

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Introduction

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When forecasting real estate performance, as well as making top-down allocation decisions, many asset managers consider two main factors - geography and asset type.

However, a number of additional, more thematic factors can differentiate returns and bring another important dimension to top-down allocation. In theory, thematic factors are infinite but they can include the dominance of the asset (size), lease length, covenant strength, asset quality (flexibility/specification/sustainability) and location. While defining these factors can divide opinion on the classification of an asset, what is clear is that at different points in the cycle they have a material impact on performance. In this paper, we use the UK commercial real estate market to assess how these factors can, if harnessed properly, help to deliver enhanced performance and improve decision making.

Background

Asset managers must tilt their real estate portfolio according to various characteristics in order to perform and keep pace with the wider market. Typically, a top-down asset allocation decision will form part of the process using a two-dimensional framework – geography and asset type – as these two factors help describe and can assist in attributing performance drivers. From a top-down macro view, geography clearly drives returns and has an impact on the relative attractiveness of entering or exiting a market. Meanwhile, asset type (retail, office, logistics, etc) also dictates performance based on where the sector is in the cycle and the relative attractiveness of each.

There is more, however, and a third dimension to top-down asset allocation looks to factor in asset quality. Categorising assets as prime and secondary is not new and currently forms the foundation of many investment strategies. However, the definition of these labels is not clear and can differ between markets. As a result, defining asset quality remains the subject of both industry and academic research; but it is not the purpose of this paper. Rather, what we can do is narrow down and define the factors, or inputs, from which the categories are derived. Forming a view on those components individually moves beyond subjective labels and allows us to examine each factor that drives quality.

With this in mind, Standard Life Investments has developed and run a thematic overlay to its longstanding Real Estate House View. We use additional components that can assist in tilting the portfolio correctly to capture growth in a tactical way.

These thematic factors include:

- income duration
- build quality (specification/flexibility/sustainability)
- asset size (dominance)
- income quality (covenant)
- location.

For example, should the House View determine a country/region and a sector that has growth potential, the manager may target short income (increased cashflow risk) but counteract that with a sustainable high-quality building (attractive to new tenants) in an excellent location (more attractive).

Clearly, if we are to rely on these thematic drivers then we must know where to tilt the risk profile. A starting point is therefore to determine which factors drove performance in previous market cycles in order to inform future decisions.

Recent UK market performance defined by quality and lease length

Table 1[1] shows the 2012 total return for the UK market at an aggregate, All Property headline level broken down by asset quality and lease length. Assets on the horizontal axis are grouped by lease duration, thus the right-hand quadrants detail the performance of longer-lease assets. The vertical axis details a proxy for quality by taking each UK market segment and ranking assets by estimated rental value per square foot. Assets in the upper quadrants are the better-quality buildings within their peer group. The end result is assets that are grouped in the top right are characterised by longer-than-average leases and better-than-average quality than their peers. The reverse is true for the bottom-left quadrant, which details the performance of shorter-than-average leases and poorer-quality assets.

Table 1 - UK market return (%) 2012

2012	
2.7	4.1
-5.2	3.6

Quality

Lease Length

Index: 2.7

Source: MCSCI/IPD UK Quarterly Index

In 2012, the market was embroiled in the Euro Crisis and a risk-off environment resulted in a total return of 2.7%, with negative capital growth and a positive income return. Looking at Table 1, there was clearly better performance among longer-lease assets, particularly those of better-quality, longer-lease assets, as investor sentiment tilted toward income duration and security. In essence, cashflow duration and security became the key performance driver during this period.

Table 2 - UK market return (%) 2013-2015

2013	
10.2	13.6
6.1	11.0

Quality

Lease Length

Index: 11.0

2014	
18.8	19.0
19.6	18.5

Quality

Lease Length

Index: 19.5

2015	
15.2	12.6
13.5	13.2

Quality

Lease Length

Index: 13.9

Source: Standard Life Investments using MSCI/IPD Asset Management Benchmarking and IPD Monthly Index Dec 2015

As the years progressed, the cycle matured and the Euro Crisis moved out of mind, resulting in an increasingly risk-on market environment. In 2013, returns for the UK market were above average. As Table 2[2] outlines, returns for all four quadrants improved as the market recovered. The best returns remained in the top-right quadrant, with lower-quality, shorter-lease length assets remaining out of favour in the bottom left. Here, the market was still favouring quality and duration as a key component. However, the top-left quadrant, those better quality assets on shorter leases, performed close to longer-lease assets given the market was becoming more comfortable with the recovery and thus comfortable taking on shorter duration leases.

As with previous cycles, the switch to a risk-on environment was rapid. In 2014, we saw the bottom-left quadrant become the strongest performer; as investors sought performance from shorter income in poorer-quality assets. In 2015, investors then started to drift back towards better-quality assets but still focused on shorter leases to capture expected rental growth as yield compression abated. Long-lease assets lagged as a result, as they cannot capture income growth as easily in what was an environment of increasing rental values.

[1] MSCI/IPD UK Quarterly Launch February 2013, UK Quarterly Index Dec 2012

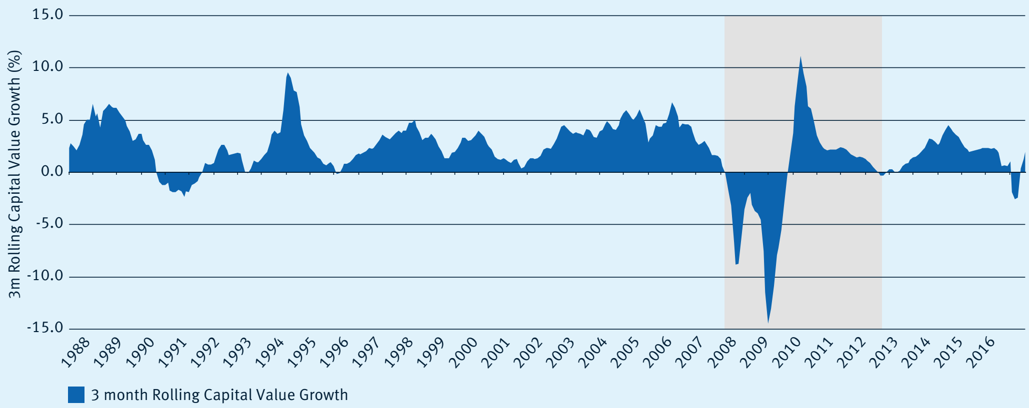
[2] 2013-2015 quadrants calculated by Standard Life Investments using MSCI/IPD Asset Management Benchmarking (using IPD Monthly Index) end Dec 2015

These examples are at the headline level but even here it is evident that correctly identifying and capturing these factors would have yielded positive results, such as moving towards shorter income duration in early 2013.

The global financial crisis and subsequent recovery

The period around the global financial crisis provides another example of how looking at previous cycles can aid future decision making. In early 2007, the UK real estate market was cooling and there were looming problems elsewhere. March 2007 proved a turning point and although several months away from negative capital growth, the trajectory was clear (see Chart 1[3]). After a very turbulent 18 months or so, the market then bottomed out in December 2008. From there, we saw a very sharp re-pricing only to see things cool down again, with below-average performance until the Euro Crisis. This allows us to examine an almost five-year period of essentially bust to boom to flat lining (March 2007 – December 2011).

Chart 1 - 3-month rolling capital value growth



Source: IPD Monthly Index, as at December 2016

What themes permeated through the data over this period? Using a relatively blunt metric of equivalent yield broken into quartiles, we can get a proxy for prime and secondary (see Table 3[4]). This shows that for every market sector except one, the highest equivalent yield (secondary) underperformed the lowest equivalent yield (prime). Moreover, the delta between prime and secondary is substantial. In many cases, there was a total return difference close to or above 20%, with retail warehousing the only exception.

Table 3: Cumulative total return (%) using equivalent yield quartiles (March 07 - Dec 11)

	Central London Office	Rest of SE Office	Rest of UK Office	Shopping Centres	Retail Warehouse	All Std Retail	All Industrial
Low Equiv Yield (Prime Proxy)	8.9	-7.2	-12.2	-2.3	-7.5	5.1	-0.5
Mid Equiv Yield (Average Proxy)	7.6	-15.9	-18.0	-23.3	-2.8	-3.9	-5.7
High Equiv Yield (Secondary Proxy)	4.7	-28.8	-35.7	-29.7	-4.0	-13.6	-18.7
Segment Average	7.5	-13.5	-18.3	-15.6	-5.1	-2.5	-5.5

Source: MSCI/IPD UK Quarterly Index

[3] MSCI/IPD UK Monthly Index, December 2016
[4] MSCI/IPD UK Quarterly Index, June 2016

Taking a closer look

Equivalent yields are a relatively blunt metric to examine quality given all the moving parts that are included. Equivalent yield is an output and thus a function of a number of inputs[5], e.g. many of the factors touched on previously. Therefore, we must examine the performance in Table 3 in further detail. A low-yielding property could be a function of an excellent location, fully flexible, sustainable, high-speculation building on a short lease. It could also be an asset in a weaker location, of average build but on a very long lease to an excellent covenant. In some instances, the result in terms of the equivalent yield will be the same but the individual inputs will be different. Given the myriad of permutations to arrive at a similar yield, we must look beyond this into the various factors behind what is creating this yield and thus dig deeper into Table 3.

Examining lease length

Lease length, as highlighted previously, is one of the factors we know has had an impact on headline market performance through various cycles. Looking at roughly the same period[6] as Table 3, we can isolate various market segments and group them by income duration (see Table 4[7]). Unsurprisingly, the risk-off environment resulted in assets with longer leases outperforming those with shorter leases. In some sectors, there was a cumulative difference of over 40%.

Table 4: Cumulative total return (%) using lease length quartiles (Dec 07 - Dec 11)

	Central London Office	Rest of SE Office	Rest of UK Office	Shopping Centres	Retail Warehouse	All Std Retail	All Industrial
Longest Lease Length	4.2	-2.2	-3.8	-3.8	3.5	6.8	4.2
Average Lease Length	-3.9	-20.0	-22.4	-22.4	-5.9	-3.5	-6.9
Short Lease Length	-18.4	-38.5	-38.9	-38.9	-14.7	-15.5	-27.3
Segment Average	-2.6	-16.3	-20.1	-16.9	-5.5	0.9	-8.0

Source: MSCI/IPD UK Quarterly Index

[5] Malcolm Frodsham, Defining Asset Quality, IPF 2016
[6] Due to data constraints the data starts at December 2007
[7] MSCI/IPD UK Quarterly Index, June 2016

Examining asset quality

We can also assess how sectors performed in terms of their quality (see Table 5[8]). Here, the proxy is expected rental value (ERV) per square foot (sq ft), whereby the higher the expected ERV per sq ft, the better the quality. Again, it paints a compelling story around holding better-quality buildings over the period. Secondary London office assets outperformed the market average but prime assets remained top. Retail warehousing looked to have bucked the market trend, with average quality just ahead of prime. However, it falls back into trend when looking at performance of secondary assets.

Table 5: Cumulative total return (%) using ERV/sq ft quartiles (Dec 07 - Dec 11)

	Central London Office	Rest of SE Office	Rest of UK Office	Shopping Centres	Retail Warehouse	All Std Retail	All Industrial
High ERV/sq ft (Prime Proxy)	1.4	-13.5	-17.5	-6.6	-4.3	4.3	-3.6
Mid ERV/sq ft (Average Proxy)	-5.8	-22.3	-21.1	-22.1	-4.1	-7.1	-7.4
Low ERV/sq ft (Secondary Proxy)	0.2	-21.1	-21.5	-23.3	-7.6	-16.5	-19.7
Segment Average	-2.6	-16.3	-20.1	-16.9	-5.5	0.9	-8.0

Source: MSCI/IPD UK Quarterly Index

This highlights an important aspect of thematic drivers. Forming a view and making a judgement on these should not be about uniform application, but rather in conjunction with the two-dimensional, top-down allocation framework. For example, being aware and, crucially, understanding that Central London and retail warehousing are historically more volatile sectors and therefore do not react the same way as other segments is important. Clearly, we must factor this in when trying to overlay a thematic view.

By unpicking the components that make up the labels of prime, secondary, core, etc., we can look to construct a more suitable portfolio that complements top-down allocation. Essentially, we can start to isolate and form a view on individual components. These factors will of course differ by market but once you have chosen your target market, they can affect both risk and performance.

[8] MSCI/IPD UK Quarterly Index, June 2016

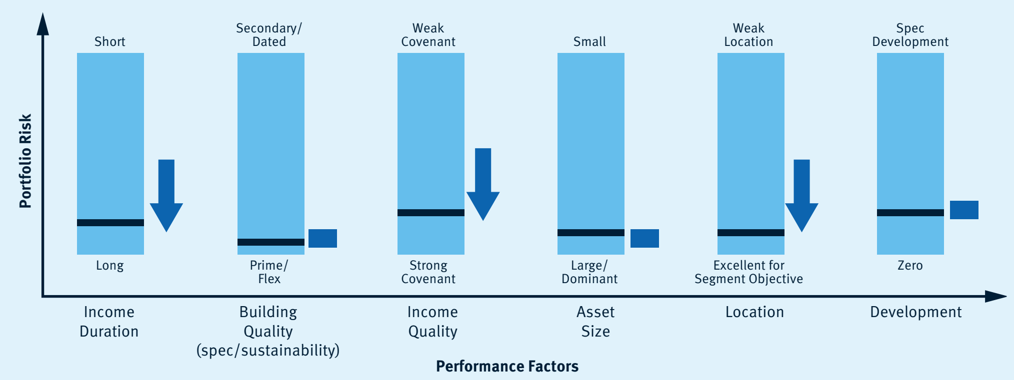
Creating a blueprint

Chart 2 is a high-level blueprint of how we can start to calibrate the various risks from a top-down allocation view. It is crucial to point out that this has to be relative to the market you are operating in or looking to access. Different markets will obviously have different parameters, a long lease in one market may not be considered long in another. What is important, however, is where we feel the risk makes most sense when looking forward within the target market. These calibrations are not for the here and now but rather where a target location, growth and demand will materialise in the future.

Taking income duration as an example, is the market expected to move in favour of shorter duration (risk on) or retrench to longer duration (risk off)? Building quality is another example. Where is the cycle currently and is the market expanding or contracting as a result? Therefore, is there merit in taking on some risk in terms of older stock with repositioning potential? The same logic can apply across all the factors.

In Chart 2, the vertical axis shows increasing perceived risk; therefore the higher up the axis you move, the more risk (shorter leases, poorer-quality assets, weaker locations) you are willing to take. When we enter a risk-off period, we would likely dial the risks right down to some extent. In extreme conditions, we would see a move towards the longest duration leases, exceptional building specification, robust covenant and dominant assets in excellent locations with zero development risk – essentially battening down the hatches.

Chart 2 - Thematic drivers - adjusting for portfoio risk



Source: Standard Life Investments

Our approach

At Standard Life Investments, we aim to identify these turning points, where one would look to move the risk dial or dials, through our *Focus on Change* investment philosophy. Our real estate research team lists the triggers of change for the asset class, which provides a crucial overlay and indication of a risk-on or risk-off environment.

In Chart 2, a number of factors are trending down, with many already towards the bottom of the risk profile. The blue squares represent a static metric for several quarters. There looks to be some risk appetite for shorter leases, indicating that shorter income had a place for the right assets. Alongside this, however, some other factors have trended down, therefore indicating a reduction of risk. This forms a guide regarding where a portfolio should look to tilt. The market is moderating, a risk-off appetite is approaching and a relatively low risk portfolio looks to be the optimal position.

Investing based on just one thematic factor is not possible. We cannot unpick one of the metrics within an asset and ignore the others. We cannot simply acquire a short lease length or an excellent location and not take everything else that comes with it. However, when you monitor these factors individually and blend a portfolio together then these themes do arise and respective tilts come to the fore. Some factors in this example are flexed more frequently while other metrics do not move as much and are more consistent.

Each market will be different but monitoring and evaluating these themes in isolation and then building those up to a portfolio level can build a dynamic and tactical overlay to allocation that complements the existing two-dimensional framework. While every real estate investor thinks about these within their own market, taking action in a structured way is difficult as these themes are not prescriptive and cannot be individually targeted. However, they are themes that drive real estate returns. Questions investors need to ask include what themes should play out across their target market and is their portfolio positioned to capture these themes? More importantly, are they set to capture them in the best risk-adjusted way?

Where next for the UK?

When we look back, it is clear that thematic factors have manifested themselves into asset returns in a number of ways. But where next for the UK real estate market?

Table 6[9] details nine discrete years of returns for the UK market, with different performance drivers each year. At the top of the cycle in 2014, we can see that shorter leases and weaker-quality assets were the top performers. This started to abate in 2015 and then clearly shifted in 2016, which was a year of two halves following the EU referendum of June that year. As a result, we saw a clear shift to a risk-off environment and investors seeking shelter in terms of income duration. The UK real estate market was already late cycle given the strong returns through 2013-2015 and the uncertainty following the referendum decision meant this moved the risk dial immediately. Given ongoing political uncertainty, we would expect the right-hand side of the quadrant to remain in favour until there is more clarity, at which time some more risk will likely come into the market.

That said, this is only two factors and many others will drive asset, and ultimately portfolio, performance as the UK market cycle moves forward. There will be a time and place to shift focus and when that comes we would expect the top-left quadrant to be the first to outperform.

Table 6 - UK market return 2008-2016

Quality ↑ / Lease Length →

2008	-23.9	-20.6	-25.3	-20.2	Index: -22.1
2009	-5.1	14.1	-12.0	8.7	Index: 3.4
2010	13.0	17.2	5.0	13.5	Index: 15.2
2011	6.9	8.7	1.8	7.6	Index: 7.8
2012	2.7	4.1	-5.2	3.6	Index: 2.7
2013	10.2	13.6	6.1	11.0	Index: 11.0
2014	18.8	19.0	19.6	18.5	Index: 19.5
2015	15.2	12.6	13.5	13.2	Index: 13.9
2016	1.6	2.6	1.0	2.5	Index: 2.6

Source: MCSCI/IPD UK Quarterly Index, Standard Life Investments using MSCI/IPD Asset Management Benchmarking and IPD Monthly Index Dec 2016

Conclusion

Monitoring and applying thematic tilts to portfolios can lead to outperformance through cycles. Crucially, it allows managers to follow a framework in which the approach can be consistent across markets. While each market will have different drivers, the relevant tilts should be dynamic and able to react beforehand to market triggers that indicate a risk-on or risk-off environment. However, these thematic overlays are not mutually exclusive. In order to tilt portfolios accurately in line with these thematic factors, investors need data at an asset level to score quality bandings and then form a view at a portfolio level. Building up asset level descriptions of these thematic factors offers investors powerful tools to tilt portfolios in the future across a range of dimensions relative to the market they are operating in or looking to enter or exit. As a result, they can actively manage investments according to macro conditions by adopting a uniform approach and taking appropriate tactical risk positions.

[9] MSCI/IPD UK Quarterly Launch February 2012 for figures 2008-2012 using UK Qtly Index. 2013-2016 calculated by Standard Life Investments using MSCI/IPD Asset Management Benchmarking (using IPD Monthly Index) Dec 2016

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