Market Polarisation

Opportunities in Secondary Markets

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

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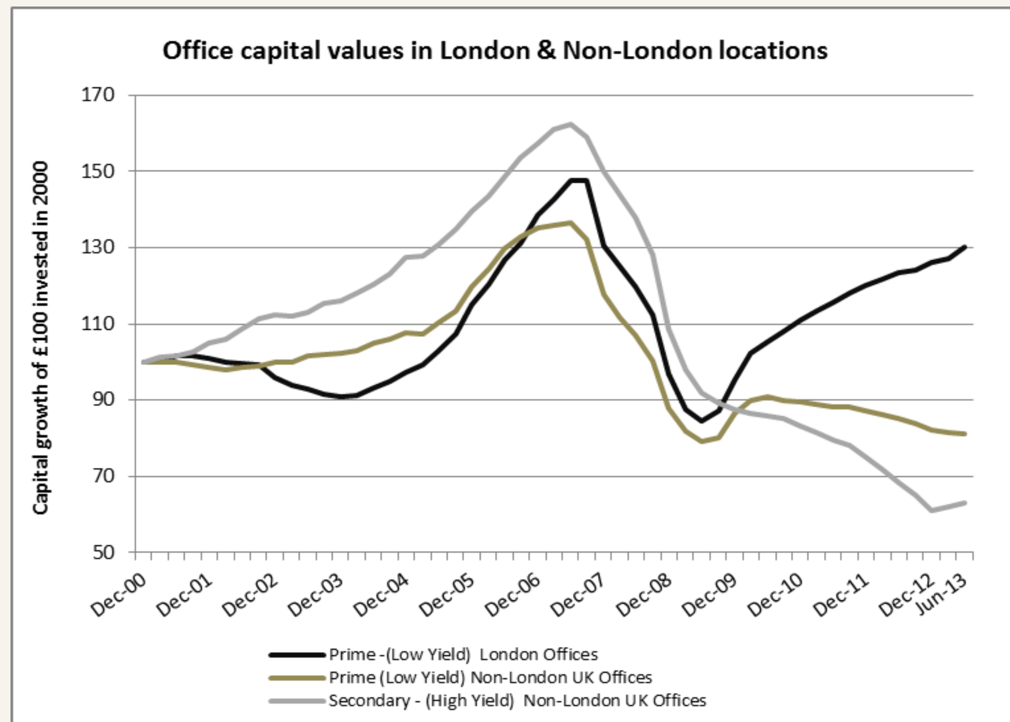
Opportunities in Secondary Markets

The fallout from the global economic crisis has had a material impact on the UK commercial property market. Due to the demand for investments with strong defensive characteristics, a large amount of capital has been invested into central London, the majority from abroad, and a two tier market has developed.

As we move into the last quarter of 2013, we believe that the large inflows of foreign capital are set to continue. Some concerns remain regarding UK GDP growth, and with investors still reluctant to take on risk, this capital is likely to persist in finding its way into the prime London market.

It can be seen from Fig. 1 that, whilst London capital values have rebounded and are approaching their 2007 peaks, property values outside of London, despite a slight recovery in the last quarter, are still significantly below their peak. Even some of the best non-London properties, classified by IPD as 'low yield' have struggled to recover.

Fig. 1



Source: IPD Quarterly Digest, June 2013

Over the next 12 months, the trend of investors staying away from non-prime property is set to continue, and secondary capital values will remain under pressure.

With investors looking for safe havens in core prime property, it has become evident to us that several opportunities in the secondary market have now begun to appear.

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In order to identify the opportunity we currently perceive, it is important to define what the terms “prime” and “secondary” refer to in a real estate context. Prime property is typically classed as property of the highest quality and specification, in the best location. Property that meets these criteria is expected to be fully let, often on long leases.

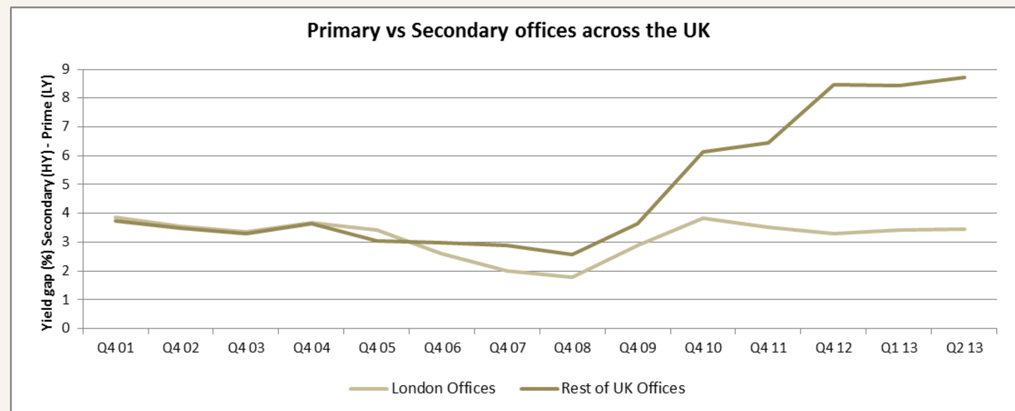
Defining secondary property is more difficult. In its simplest form, it is defined as any property that doesn’t meet prime criteria. However, we believe that secondary property requires further definition, and as such we have divided secondary into two broad categories.

Firstly, “good secondary” property can be defined as property that has some, but not all of the characteristics of prime property. For example, at Riverside Capital we have recently been successful in purchasing property that is let on long leases to Grade A tenants, thus reflecting two characteristics of what would normally be defined as prime property. Nevertheless, the locations of these assets are currently classed as non-prime, albeit they are in good locations from a historical perspective.

Secondly, “poor secondary” properties are in bad locations, may have short leases and often face obsolescence when the existing tenancy expires.

Outside of London, there continues to be a significant yield spread between prime and secondary assets due to the fall in capital values of the highest yielding properties. This is in stark contrast to London, where the spread has returned to the “pre-crisis” average (see Fig. 2).

Fig. 2



Source: IPD Quarterly Digest, June 2013

It is our house view at Riverside Capital that good secondary property is likely to perform well over the medium to long term.

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In selecting good secondary opportunities, the key is to pick those assets that have long lease lengths and good tenants, as we perceive that income will be the main driver of returns above capital appreciation.

Over the last 32 years, 72% of total property returns have come from income. The number becomes even more significant over a 10 year period with income accounting for over 93% of total returns. Given the anaemic levels of growth we are currently seeing, this trend is likely to continue for the foreseeable future.

The pipeline supply of stock due to the amount of outstanding bank debt looks strong. According to the De Montfort survey, 62% of outstanding bank debt in the UK (£128bn) is secured against secondary property (much of it at high loan to value ratios). It is expected that banks will start to release some of this stock as they get on top of the non-performing loans issues.

Whilst the difference between prime and secondary yields (see Fig. 3), as well as prices, is expected to remain wide (in the short term at least), now is the right time for investors to look to the “good” secondary sector in order to take advantage of the disparity between values.

Fig. 3

Equivalent Yields % - June 2013			
	Prime	**Good Secondary**	**Poor Secondary**
London Offices	4.24	5.83	7.69
Rest of UK Offices	7.39	10.79	16.10
Retail Shops	4.97	6.89	10.24
Retail Warehouses	5.86	7.06	9.07
Shopping centres	5.92	9.04	15.15
Industrials	6.78	9.16	13.11

Prime refers to well-located rented property, let to a financially strong tenants on a lease with a minimum of 15 years unexpired.

Following an extremely difficult period over the last five years and, although we will continue to see periods of dislocation, there is now a marked increase in optimism surrounding the economy. Secondary properties (both “good” & “poor”) often outperform when the economy starts to pick up as the risks of tenant failure start to recede, therefore producing a high and relatively more secure income yield.

With the recovery seemingly underway and the outlook for both 2013 and 2014 being revised upwards we see this as an opportune moment to begin building portfolios to take advantage of the next cycle in the economy.

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