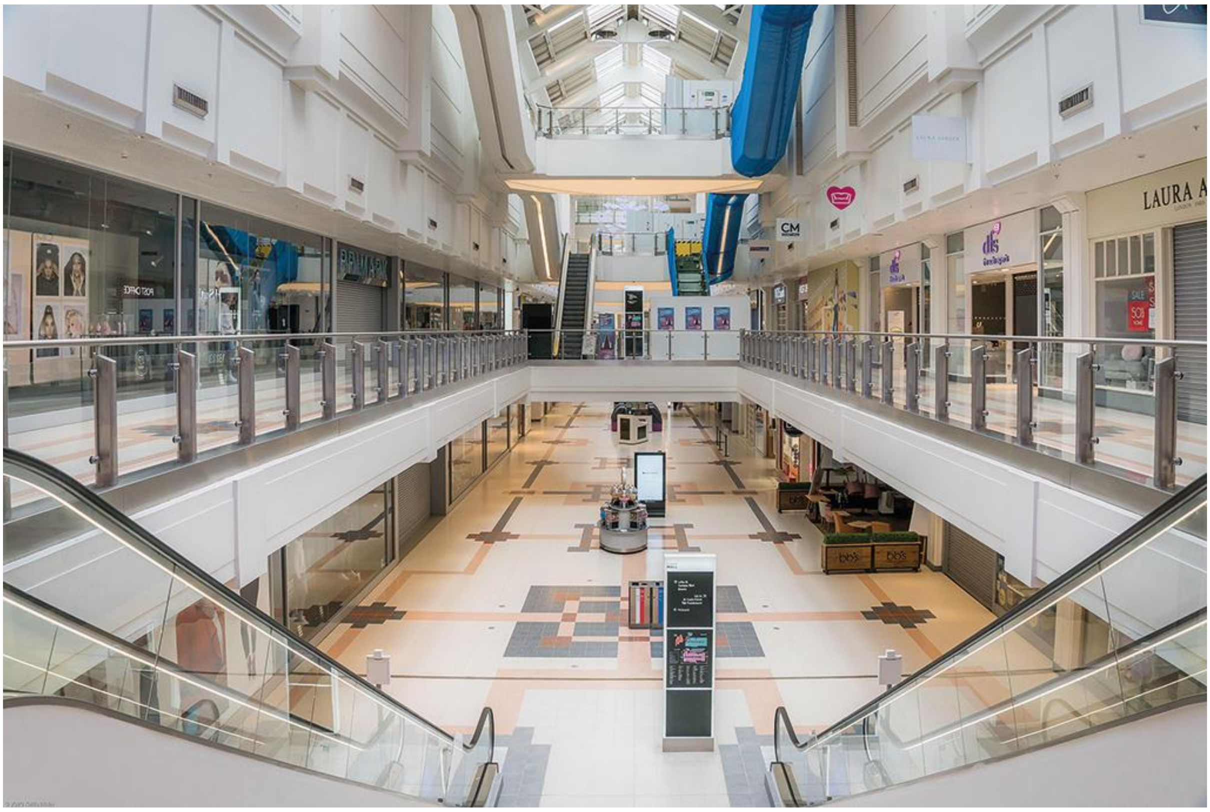
MoneyWeek

Where to find value in the property sector



SHOPPING CENTRES HAVE BEEN THE MAIN LOSERS FROM LOCKDOWNS

Commercial real estate – notably shopping centres and offices – has struggled due to Covid-19. But there are several promising trusts that look attractively priced, says Max King

The share prices of commercial-property companies collapsed in March 2020 along with the broader market as investors pondered the impact of lockdown on rents and valuations. Soon, though, investors started to see winners – notably logistics warehouses, supermarkets and medical property – as well as losers, primarily shopping centres. In time, investors realised that some properties, such as student accommodation, were only temporarily affected; that gloom about other sites, such as retail parks, was misplaced; and that the setback to offices had been discounted in share prices to an excessive degree.

The overall return from commercial property in 2020, says the Investment Property Forum (IPF), was only negative by 1%, comprising a -5% capital return, but 4% of income. The capital value of shopping centres fell by 23%, but industrial properties appreciated by 4% and offices declined by just 2%, despite being largely empty for most of the year. The IPF consensus forecast expects a modest pick-up in 2021, with the industrial subsector continuing to do well, but retail poorly, before a broader pick-up in 2022. In that case, there is still plenty of good value in the sector.

"OFFICES WON'T DIE – THEY ARE JUST TOO IMPORTANT FOR CREATIVITY AND SOCIAL INTERACTION"

Charlie Ellingworth, a partner at Property Vision, a property-investment adviser, says "this is no time to leave your capital on furlough. Though the dynamics of the sector are changing, commercial property remains an attractive asset class with yields averaging 5.2%, while interest rates are negligible". Retail, he points out, still accounts for a third of the sector, but has been in decline for over a decade. As a result of overexpansion in the 1990s and 2000s, the sector is "over spaced by 40%", according to Savills. Since the trend towards online shopping is not going to reverse, a lot of surplus space needs to be "repurposed".

REMODELLING DISUSED SHOPS

"Recent changes to planning laws permit a much more fluid interchange of commercial uses," says Ellingworth, allowing disused shops to be turned into leisure facilities and flats. Clearly, this applies to the high street rather than shopping centres, on which Ellingworth's advice to investors is "to run for the hills". The share price of Hammerson, once a FTSE-100 constituent, has fallen by more than 99% since mid-2017; the group unwisely decided to focus on shopping centres several years ago.

For supermarkets with ample parking, the move to online shopping may allow for additional rentable buildings on surplus land. John Cahill of brokers Stifel describes the **Supermarket Income Real Estate Investment Trust**, or Reit **(LSE: SUPR)** as "one of the most mispriced shares in the sector, with the benefit of a portfolio of largely index-linked, long-dated leases to the major UK supermarkets". Yet the shares yield a generous 5.4%.

This far exceeds the 3.4% yield of Tritax Big Box Reit (LSE: BBOX), a stockmarket darling. Its portfolio of large distribution centres next to major roads has proved indispensable to major online retailers scrambling to sign long-term leases with inflation-linked rents to facilitate the rapid delivery of goods. An 8% uplift in net asset value (NAV) to 172p-175p was announced in January, but Stifel targets a share price of only 160p against a current 186p.

Investors have, perhaps, become overenthusiastic about this corner of the industrial sector, which Ellingworth describes as "the ugly duckling of the market that has turned into a swan". This is certainly true of Segro (LSE: SGRO), the £11.5bn giant of the property sector, once called Slough Estates. Now with an international spread of industrial property, its shares yield 2.2% and trade at a 26% premium to NAV. Its prospects certainly look good, but not good enough to justify the share price.

WHAT NEXT FOR THE WORKPLACE?

The move to working from home should be a negative development for office property, but there are mitigating factors. Demand has been deferred, not shelved, according to brokers Numis, while the development pipeline is slim. "Offices won't die," says Ellingworth. "They're simply too important for social interaction, collaboration and creativity." Occupational density is likely to fall, thinks Numis, while occupational requirements means earlier obsolescence. According to Ellingworth, smaller offices with their own front doors in the West End will become more attractive than Canary Wharf's large spaces and trading floors.

Supply is further constrained by the conversion since 2017 of at least 830,000 square metres of office space in London into 16,000 homes, a trend that could accelerate due to new legislation. There are reports of new rentals in central London that are 40% lower than in early 2020, but that is reflected in asset values and there should be a sharp rebound. Marcus Phayre-Mudge, manager of the TR Property Investment Trust favours firms "with firepower that can withstand any correction in prices and have the potential to improve their portfolios", such as London-focused **Great Portland Estates (LSE: GPOR)** and **Derwent London (LSE: DLN)** on discounts to NAV of 18% and 19%.

"These shares could rerate quite sharply on a return to the office," says Justin Bell of Numis Securities. The same applies to the providers of purpose-built student accommodation, such as **Unite Group (LSE: UTG)**, **Empiric Student Property (LSE: ESP)** and **GCP Student Living (LSE: DIGS)**. The stocks have already recovered, but are paying minimal, if any, dividends until the students return. UTG, as a developer rather than just an owner/manager, trades at a 16% premium to NAV. ESP, largely dependent on foreign students and with a history of mishaps, is on a 30% discount; DIGS on 7%.

"THE LONG-OVERDUE OPENING OF CROSSRAIL IN 2022 WILL FACILITATE ACCESS TO CENTRAL LONDON"

The healthcare sector has not had any problems with rents. The rent paid by doctors to **Primary Health Properties (LSE: PHP)** and **Assura (LSE: AGR)** for their surgeries is guaranteed by the NHS, so they represent the lowest-risk companies in the sector. Their yields of around 4% rising at least in line with inflation compare well with anything the bond market has to offer. Care-home providers **Impact Healthcare (LSE: IHR)** and **Target Healthcare (LSE: THRL)** yield 5.5% and 5.8% respectively, which implies higher risk, though they have both withstood the pandemic well. The social-housing trusts, such as **Civitas (LSE: CSH)**, **Home Reit (LSE: HOME)** and **Triple Point (LSE: SOHO)**, come somewhere in the middle in terms of risk and yield (a little below 5%). Like the care-home providers, they trade a little above NAV.

BETS ON MULTIPLE SUBSECTORS

Many property companies, including British Land and Land Securities, span the sector and thus contain a mixture of assets that are doing well and others that are struggling. Investors have started to focus more on the good news than the bad, to the benefit of **UK Commercial Property Reit (LSE: UKCM)**. Its shares trade on an 18% discount to NAV and yield 3.3%, but 78% of its assets are in outperforming areas, including 58% in the sought-after industrials and logistics subsector. Will Fulton, UKCM's lead manager, foresees continued good performance driven by e-commerce and "near-shoring" of supply chains.

"We have a renewed sense of optimism… but there are short-term risks," he says. "The UK will remain a safe haven for global money," helping offices that meet rising quality thresholds. About 83% of UKCM's rents were received last year and more has been recovered since the year end. There is even progress in the 17% of the portfolio in retail, two thirds of which is in retail parks and half the remainder in supermarkets.

Secure Income Reit (LSE: SIR), headed by renowned property entrepreneur Nick Leslau, has also made good progress, though it still yields nearly 5% and trades on a discount of 21% to last June's NAV. That was down by 10% over six months. Travelodge accounted for 25% of its pre-Covid-19 rents, Merlin Entertainments (which operates Alton Towers, Chessington and Legoland) for 32% and other leisure properties (notably the Manchester Arena) for 10%.

But all rental income is expected to return to pre-Covid-19 levels by the start of 2022. The healthcare properties (private hospitals), accounting for 33% of historic rents but 39% of the portfolio's valuation, are worth a 35% premium to net assets, Stifel believes. Around 98% of the portfolio has at least 17 years left on the lease, without break clauses, so both post-Covid-19 recovery and long-term prospects look assured.

Numis remains negative on **Shaftesbury (LSE: SHB)** and **Capital & Counties (LSE: CAPC)** owing to their exposure to retail, leisure and residential property in central London. The disappearance of tourism, both international and domestic, has hit their tenants hard, but the gloom will prove overdone if the visitors return. Their shops are less exposed to online competition and could easily be converted into leisure and residential properties. The opening of Crossrail, now expected in early 2022, will facilitate access to central London and the current post-Brexit obstacles to cross-Channel internet shopping could encourage shopping trips to the capital. CAPC's redevelopment of Earls Court for housing could appeal to those fleeing Hong Kong and it should help SHB's Chinatown estate.

CAPC trades on a 30% discount to mid-2020 NAV and SHB on a 17% discount to NAV at the end of September, but both valuations were down 17% year on year. CAPC bought a 25% stake in SHB last year at an average share price well below the current price of 620p, making a tie-up a possibility. Long-term investors should be tempted to buy either. These apart, the property sector offers plenty of choice to investors seeking income, recovery potential or value, but little for growth investors. For those looking for a one-stop trust, the **TR Property Investment Trust (LSE: TRY)** trades on a 9% discount, yields 3.8% and has a consistent record of outperformance. Only a third of assets are in the UK (two-thirds are in Europe), but that could quickly change.