

It's been deep in the doldrums for five years but...

By **Helen Kirrane**

Is commercial property back on the UP?

NO ASSET class has taken a bigger battering in recent years than commercial property, undermining its traditional role as a portfolio diversifier and an important generator of regular income.

Impacted adversely by the Brexit vote in 2016, the lockdowns of 2020 and 2021 and turmoil in financial markets, commercial property has proved an underwhelming investment.

For example, over the past five years, the average fund investing directly in UK commercial property has generated a return of just under two per cent. Over the same period, the UK stock market – as measured by the FTSE All-Share Index – has risen by 16 per cent.

Yet this only tells half the story. In some instances, big property funds have had to suspend dealings as a result of a deluge of investors wanting out – and the funds not having sufficient liquidity (cash) to meet these withdrawals. This has led many investors to vow never to touch a property fund again.

Although the last year has also been painful – the average UK direct property fund recorded a loss of 9 per cent – some financial experts believe the proverbial worm has turned. They argue the doom and gloom has been overdone and that the sell-off has created buying opportunities for brave investors.

Commercial property embraces everything from office blocks through to shopping centres (in and out of town), industrial units and distribution centres run by the likes of Amazon. It can be in the UK or based overseas.

The financial mechanics of commercial property are relatively straightforward for investors to grasp. By investing in a fund run by a professional manager, investors get exposure to a diversified portfolio of bricks and mortar. These properties generate a rental stream, most of which (not all) ends up in the hands of investors by way of dividends. If the fund's properties increase in value, or are sold at a profit, investors see their holdings rise in value.

Most big investment companies including Abrdn, L&G, M&G and Scottish Widows run commercial property funds. Most are UK focused although a number invest overseas in Europe or the Far East.

Some invest in specific areas such as logistics (distribution centres and warehouses) and social housing, while others avoid direct property altogether, investing only in property shares.

It is also important to know that commercial property vehicles are set up in two ways. First, as investment funds where money flows in and out from investors with the managers trying to ensure that at all times there is sufficient cash to meet heavy withdrawals.

Sometimes, as happened in the wake of the Brexit vote, they fail to do this, resulting in the fund being closed until sufficient assets (properties) have been sold to meet all redemption requests.

The second way is as a stock market-listed investment company or trust where investors can always buy and sell shares. The only drawback is that the share price may not fully reflect the value of the trust's



investors who have invested in property in challenging markets have been rewarded over the long term.' She adds: 'Some property investment companies have dividends which are linked to inflation, which is reassuring for investors.'

They include LXI Real Estate, Supermarket Income Real Estate, Value and Indexed Property Income, Triple Point Social Housing, Tritax Big Box and Impact Healthcare.

Stock market-listed commercial property funds are currently producing investor income equivalent to 7 per cent a year, in big part a reflection of their subdued share prices. The average share price discount for the UK commercial property trust sector is 26 per cent, compared to 6 per cent at the end of 2021.

Analysts at Winterflood say: 'Discounts on a number of UK property trusts remain extremely wide, which we think offers value for long-term investors.'

Thirty per cent discounts exist on trusts such as Abrdn Property Income, Balanced Commercial Property and UK Commercial Property Real Estate.

SO WHAT FUNDS SHOULD YOU BUY?

WE ASKED Ben Yearsley, investment director at Plymouth-based Shore Financial Planning, to identify the best commercial property buys. This is what he came up with:

1. TR PROPERTY: 'Stock market-listed, this is the Big Daddy of the commercial property sector. It invests in a broad spread of property shares, providing a decent income and a good spread of investments.'

2. SUPERMARKET INCOME REAL ESTATE: 'This owns the freeholds of many UK supermarkets, focusing on sites that have multi-purpose use. For example, a traditional supermarket that also has the capability to act as a fulfilment centre for online orders.'

3. TRITAX BIG BOX REAL ESTATE: 'This was the investor's property darling during Covid. It owns large out-of-town online fulfilment centres. A recent

update showed 100 per cent rental collection, an average loan-to-value on the properties it owns of 30 per cent and an average debt cost of just 2.6 per cent.'

'The shares look reasonably priced.'

4. TARGET HEALTHCARE REAL ESTATE: 'It invests in modern, purpose-built care homes. Its shares trade on a big discount, but it offers investors good long-term prospects.'

property assets, resulting in the shares trading at a discount.

How does the land lie now in the sector?

THE pandemic and the shift to working from home was not good news for UK commercial property investors. And they have not had an easy time since as property values and rents have come under pressure from a stressed economy and company failures. This has resulted in investor losses. But

while challenges remain, analysts think things cannot get worse – and could get better. Specifically, with regards to property funds listed on the UK stock market, the wide discounts they trade at offer value for long-term investors – if the discounts close and positive sentiment returns to the asset class. Analysts at equity specialist LWinterflood believe the fall in UK commercial property values is bottoming out. In the last quarter of 2022, capital values fell by a dramatic 14.6 per cent, but in the three months to the end of March, they reduced by just

0.3 per cent. Winterflood says: 'We do not expect to see any further material declines in UK real estate valuations over the remainder of the year.'

Yet rising interest rates present dark clouds, helping push down the capital values of commercial buildings while making the income property funds relatively less attractive than more secure income alternatives such as UK Government bonds (gilts).

Annabel Brodie-Smith, a director of the Association of Investment Companies, says: 'In the past, brave

How can you invest in commercial property?

MORE than 100 funds are available to investors. There are 13 set up as funds investing in direct property and 79 investing either in the shares of property companies or overseas. More than 20 are set up as stock market-listed investments, most of which invest in UK commercial property.

Given property's illiquid nature, stock market-listed funds are most suitable. Brodie-Smith says: 'Investment trusts provide an investment manager with a permanent pool of capital which allows them to take a long-term view of their portfolio – and means they are not forced sellers of holdings when shareholders want their money back.'

'Of course, share prices can fall dramatically in a downturn as we saw during the pandemic, but in the past they have bounced back quickly when sentiment improves.'

Commercial property has proven itself a volatile investment and therefore those who choose to invest should usually only do so as a small component of a diversified portfolio, designed to be held over the long term.

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Financial STARTS ON
MAIL ON SUNDAY PAGE 85