

Legal & General Property

Recently, **Sbeila Hopkins**, senior editor and managing director – Europe with Institutional Real Estate, Inc, spoke with **Rob Martin** and **Charlie Walker** of Legal & General Property about successful investment strategies over the next five years and how to navigate through some of the biggest challenges. The following is an excerpt of their conversation.

We all know that the UK has become one of the more attractive investment markets in Europe, but what are the pitfalls? What's really happening in the market and where are the headwinds coming from?

Martin: The biggest challenge for any investor in the UK real estate market is generating growth in what is fundamentally a low-growth environment. Whilst the UK market compares very favourably to the rest of Europe, it is nonetheless affected by the same headwinds. For example, the austerity programmes are needed to support long-term economic sustainability, but they are depressing growth in the short term because governments are a major consumer in any economy. Anything that restricts Government demand is a depressing factor on UK GDP. The euro crisis is another factor depressing growth because the euro zone is the UK's biggest trading partner. Problems in that jurisdiction are negatively affecting export demand. In addition, we also have a continuing problem with the availability of credit. Both corporate and consumer credit conditions are still relatively tight.

Given these challenges, what types of strategies can investors use to find growth?

Walker: We see UK real estate opportunities falling into two distinct categories. The first is automated growth. These are strategies that take advantage of long-let situations that involve very strong covenants with fixed rent increases or those that are tied to inflation indices. These automatic increases provide income growth when the economy is struggling to deliver conditions for natural rental growth to occur. The second category is generated growth, where there are opportunities for investors to take advantage of mispricing caused by the banking environment, which is characterized by restrictions in the supply of debt and continued deleveraging. This provides an opportunity for investors to benefit from attractive entry prices. Coupled with that, equity investors have the ability to provide solutions to capital-hungry assets and generate growth through targeting value-add situations. The bottom line is that investors are going to need a deliberate strategy to realize growth in today's ex-growth market — it's not just going to happen by itself.

What if today's market is more than an ex-growth market? What should investors do to protect themselves in a market that seems to be structurally changing?

Walker: I would certainly recommend exploring alternative sectors. Looking at the structural changes occurring across the UK real estate



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market, I would single out sectors such as health care, student accommodation and leisure as being front runners in being able to hedge structural change within a portfolio.

Where do you see the risks, both in the strategies you've mentioned and in the market as a whole?

Walker: The new regulatory environment is creating risks, not only because of the uncertainty it is causing, but because of the need to obtain higher returns to cover the costs. Pushing for higher returns, almost by definition, increases risk. These regulations are currently affecting banks and insurance companies, and are moving towards European pension schemes. The higher returns will be available to those who can navigate themselves around those sorts of regulatory pressures.

Why does the UK continue to look attractive to European investors?

Martin: The UK has a stable operating environment, created by a number of favourable characteristics including the enforceable property rights, robust legal framework and a relatively liquid market. During the past few years when, from a UK-centric perspective, it felt like liquidity was relatively low, the UK — and London in particular — were by far and away the most traded markets in the European region. In addition, there is a high volume of market data available, so investors can gain a good deal of understanding and transparency before they actually invest. Maybe even more important, particularly in the current environment, is the fact that the UK has independent fiscal and monetary policy. This means that investors can confidently plan which currency their investment will be denominated in now and in the future. They simply can't allocate capital to markets where this isn't a given.

Which parts of the UK market offer the most compelling valuation story?

Martin: We are very aware that London prices are relatively high and consequently yields are low. We are, therefore, focusing on areas beyond London. The UK's southeast region shares many

of the same economic attributes as London, but is not as aggressively priced, so that's an interesting space to look in. There are also regional cities in other parts of the UK that have a particular sector mix or a particular entrepreneurial environment that is very conducive to generated growth, even against an otherwise challenged backdrop. We've got cities like Cambridge, which is very much focused on technology, and Aberdeen, which is connected to the oil industry. Both of those are outside of the South East, so one has to be a more sophisticated in one's regional allocation than just saying London or South East versus the rest.

Besides geographical regions, what sectors or strategies have a compelling story?

Martin: The thoughtful acquisition of income risk offers some higher total returns. This could involve buying shorter leases versus longer leases or buying more challenged covenants or credits versus something that the market would perceive as very safe. Much investor demand is focused on the most straightforward propositions, so focusing on assets that require a more thoughtful approach and intense due diligence thins out the competition on the buy side. In our view, assets outside London with a higher risk profile are likely to offer some of the most exciting returns on a five-year horizon, and that we're finding most attractive to European investors.

Walker: I would add that, in certain cases, superficially high income yields reflect poor asset fundamentals. Investors have to carefully appraise the letting prospects, capital expenditure requirements and sustainability prospects for value-add investment stock to assess prospective return levels.

What are the main areas that you'd avoid?

Martin: Real estate investors need to look beyond the short term and start to plan for an environment where growth will be stronger and risk-free rates — and hence performance targets — will be higher. In that environment, the stock I would really worry about is low-yield and ex-growth assets. These assets have been regarded by many as safe havens because they offer long-term income streams often tied to reasonable covenants. In an environment where interest rates and growth are higher, those assets simply don't have the credentials to perform. That's a part of the market that we feel will be challenging in the medium term.

In addition, the bubble and the crisis have somewhat masked the fact that there are certain parts of the real estate market that are disadvantaged on a more fundamental level. In the retail space, in particular, there are certain locations that have lost their relevance. Those locations are not equipped to benefit from growth when it does return. And having a very strong handle on where they are and not being investors in those locations is key.

What are some of the important considerations in developing defensive portfolios?

Walker: Most investors consider the obvious income and covenant-strength risks and will seek to diversify against them. They are also beginning to recognize that an inflation risk is ever present and needs to be diversified away, to the extent that it can be. This is an area where alternative

investments will play a role. Furthermore, there are still many investors who will not have fully appreciated the underlying risk that's presented by failing to meet a new sustainability threshold. There will be an increasing legislative emphasis around the grade that buildings must achieve in order to be let and transacted. Furthermore, occupiers will demand much improved sustainability credentials for the space they occupy, impacting lettable and rental growth. There will be no hiding place for those assets that don't meet the requirements.

Martin: Building a defensive portfolio is about much more than holding assets in different locations and sectors; diversification is about a spread of risk exposures, which need to include lease expiry profile, covenant strength and income growth potential. As Charlie has said, inflation-hedging capability and the sustainability profile of assets are key considerations in modern real estate risk management.

Is this the type of thing you're discussing with your clients?

Martin: Very much so. The underlying rationale for many of the strategies that we've been discussing is to not only target areas of growth, but to create defensiveness within portfolios.

What else do you and your clients discuss?

Walker: European investors rightly remain focused on alignment, so we need to make sure that we're making the right co-investment and that there is a robust governance and incentive structure in place. We are continually working with investors to raise the bar around the governance of co-mingled funds. Having the transparency and the communication to go alongside that is a critical part of the whole investment strategy for investors, as well as picking the right strategy to meet their needs.

What will you be focusing on during the next couple of years?

Walker: We will be maintaining a focus on the opportunities presented by the economic and banking austerity, as well as selectively moving up the risk curve. I also believe that the alternative sectors, such as leisure and healthcare, will have an increasingly important role to play in portfolio construction. ❖

CORPORATE OVERVIEW

Legal & General Property (LGP) is a wholly-owned subsidiary of Legal & General Investment Management (LGIM), one of Europe's largest institutional asset managers and a major global investor. LGIM manages approximately £381 billion of assets on behalf of more than 3,300 clients (30 June 2012) and provides products and solutions spanning all asset classes. LGP is the third-largest institutional property fund manager in the UK, managing or co-managing 16 separate funds or vehicles and two segregated mandates with an aggregate asset value of £10.4 billion as of 30 June 2012.

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