COMMERCIAL PROPERTY » Weak demand means investors need to hold their position until the property market recovers

London property is safe haven

Towers of strength: investors need to hold their positions

main points

» In the commercial property sector occupational demand for space has been weak since the credit crunch began

» The value of commercial property has risen since the depths of the credit crunch but values are, on the whole, still a long way below their peak of 2007

» Yields on prime commercial investment property in the West End are sometimes as low as 3.5 per cent

» By contrast, yields on secondary commercial investment properties – a broadening class of properties – are significantly greater

» London offers little upside from present levels. Yields are unlikely to compress further and, in view of income returns from these properties being so low, rental income cannot be relied on to generate returns

» Secondary property let on long leases, to good covenants and subject to low rents per square foot can currently be bought at yields of 6.5-7 per cent or more, nearly twice the yield available on prime London property

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Generally speaking, the UK is a less than ideal location for investments at the moment. Although interest rates are expected to remain low, consumers are stretched, bank balance sheets are weak and bank lending remains constrained.

Basel III and other regulatory changes will further impact liquidity and markets. Coupled with the Coalition government's austerity measures, the UK's economy is likely to remain in the doldrums for many years. The very nature of the UK economy is recessionary.

In the commercial property sector, occupational demand for space has been weak since the credit crunch began, with the notable exception of certain pockets of central London.

The value of commercial property has risen since the depths of the credit crunch in late 2008 and early 2009 but values are, on the whole, still a long way below their peak of 2007.

Against this backdrop of weak occupational demand and financing markets, it is remarkable that prime property in the West End and the City of London has recovered so sharply in value. Foreigners, in search of safe havens, appear to be the principal drivers of the market. Yields on prime commercial investment property in the West End are now, on occasion, as low as 3.5 per cent, lower than they were in 2007.

By contrast, yields on secondary commercial investment properties – an ever broadening class of properties, as just about everything other than central London fails to attract large investor interest – are significantly greater. Indeed, the gap in yields between prime and secondary commercial properties is at an all time high.

So which market offers better value? Prime property in London or shunned secondary property across the rest of the UK?

By any sensible yardstick central London offers little upside from present levels. Yields are unlikely to compress further and, in view of the fact that the income return from these properties is so low, rental income cannot be relied on to generate returns.

So, is the desire to invest in prime London property similar to the motivation to invest in gold: There may not be a decent income to be had but at least the capital is safe?

Capital can only be preserved if yields stay at these very low levels. To keep yields at these levels it is not enough for just the buyer of such a property to hold the view that these low yields are an acceptable price to pay for security; the market must also hold this view.

It would appear that this seems to be the case at the moment. There is apparently some £36bn chasing some £10bn of commercial investment property for sale in central London.

However, the tide will change dramatically when (not if) interest rates rise. This may be some years away, but interest rates can only go up and go up they will. Even small increases in yields from these low levels will result in significant capital value destruction.

The other potential fly in the ointment of the London investment market is occupational demand. This has held up well, all things considered, but the global economy is entering a period of weakness and London is closely linked to the global economy.

Today, you often hear that London is special and insulated from the turmoil in the rest of the UK; it is an international city of choice for all; that it is no longer the London of the early 1990s which experienced massive reductions in property prices during the 1991-92 recession. These views are symptomatic of a bubble.

No city in the world is immune from what is the biggest credit crunch in living memory. The effects have so far been dulled by low interest rates and government policy but these tonics will soon wear off. The London market is in a bubble. Yields will rise and values will fall. All that remains to be determined is the timing of the fall.

Secondary risks

Even though investing in the secondary commercial property market may present risks, the risks have been well flagged. In many cases rents have been reduced to lower levels and, most importantly, secondary property offers a respectable income yield. The key is to identify those properties within the secondary market where the income is sustainable. This can be done.

The term "secondary" property has been somewhat stigmatised, but within this categorisation there is a spectrum of different kinds of properties, many of which are risky but some of which do offer high sustainable income streams.

Secondary property let on long leases, to good covenants and subject to low rents per square foot can be bought at yields of 6.5 per cent to 7 per cent or more, nearly twice the yield available on prime London property.

Towering returns no more: London offers little opportunity for commercial property investors

It is worth reflecting on some statistics. According to data collated by Investment Property Databank (IPD) over the past 30 years, City offices have yielded an annualised return of 7.8 per cent, with a standard deviation of 13.4 per cent, and West End offices have yielded an annualised return of 9.7 per cent, with a standard deviation of 14.6 per cent.

The annualised return of the entire of commercial properties has been 9.2 per cent, with a standard deviation of 10.3, over the same period. The long term returns available from secondary property are better and more stable than those available from prime London property.

According to IPD, 86 per cent and 81 per cent of total property returns in the past 10 and 20 years respectively have resulted from the rent receivable from commercial properties, with only 13 per cent and 18 per cent resulting from capital value increases. In the long term, the main driver for returns is income, not capital gain. Income is not available from prime London property, where yields are so low.

Illiquid costs

Commercial property is an illiquid asset class and the cost of dealing in it is large, at some 5.8 per cent of the value of the property. This trading cost means that, all things being equal, it would take roughly 18 months to recover purchase costs from the income generated on a prime London property. An increase in value of the property would assist in shortening this period but forecasting the direction of capital value movements is difficult and cannot be relied on.

The only definite way to defray trading costs over a shorter period is to ensure the yield being generated is high and sustainable.

It is also sensible to have a long term approach to property. It is all very well to have a short term business plan for driving returns but if the market moves against you, as it did in 2008-09, survival turns on having a sufficiently high and robust income stream. You have to be able to hold your position until markets recover.

All of the above points away from investing in prime property in London. The safer proposition is to invest in good secondary property.

Ben Habib is chief executive officer of First Property Group