

How robust is property as an investment vehicle for charities in the current economic climate?

Over the last decade, nothing short of a transformation has occurred in the European commercial property investment market. Commercial property has matured as an asset class, with growing investor recognition of its attractive risk-return characteristics and the diversification benefits of holding commercial property in a multi-asset portfolio. The risk of investment in commercial property has been re-rated downward across Europe as liquidity and transparency has improved, helped by the exponential growth in vehicles to gain both direct and indirect exposure to commercial property. The relatively low cost of debt in recent years and a reduction in real estate risk premia created a strong growth in demand for real estate assets; according to figures from DTZ, €215.8bn of European commercial property was purchased in 2007, over six times more than the €34.2bn transacted in 1998. This weight of money chasing real estate assets bid prices up and yields downwards, delivering strong capital appreciation and excellent returns to investors particularly since 2004.

However the macro-economic and capital market environment has substantially changed over the last twelve months and many of the positive headwinds for commercial property investment seemed to have eased or even reversed. The listed sector has taken a mauling over the last twelve months, with share prices of the UK majors down more than 50% from their peak in early 2007. Negative headlines predominate for the asset class due to two critical drivers: capital market conditions and fear of weakness in occupational markets. Property investment is highly sensitive to the cost of debt and debt has become both more difficult to access and certainly more expensive as banks absorb the fall-out from the dislocation in the credit markets. This is resulting in a negative impact on pricing as liquidity and transaction volumes have dried up in 2008. Further to this, an economic slowdown is likely to reduce net occupier demand for space, easing the upward pressure we have seen on rents in most European markets.

Given this background, can we possibly believe that commercial property is a robust investment vehicle? Well yes we can, given an understanding of its fundamental attributes as an asset class ... but with some important caveats. Commercial property – through rental income - delivers a stable coupon and through active asset management and market rental growth, offers the opportunity for equity like capital appreciation. Investors in commercial property tend to have medium to long-term investment horizons where steady income return outweighs any shorter-term cyclical volatility in pricing. In the UK, it is typical to see assets trading with leases with 15 or 20 years to expiry. Furthermore through indexation and/or rent reviews, property is good inflation hedge which is a particularly important attribute given current economic conditions. For well-let buildings, the major downside risk is an investor being forced into a sale and having to accept a price beneath long-term fair value. This is much more likely if an investor has taken an aggressive leverage position or has a short-term investment horizon neither of which is typical for charity investors.

Commercial property is heterogeneous which allows for good diversification of risk on a portfolio level by exposure to different tenants, sectors and geographical markets. Each building has its own drivers of value and despite the current economic climate, investors with the right understanding of market dynamics can secure good value. Charities typically purchase commercial property for income yield with low or zero leverage. Current market conditions are favourable to those who are not sensitive to the cost of debt. In the UK where there has been a sharp adjustment in pricing in recent months, yields are now typically 125+bps (depending on sector and location) above June 2007, presenting opportunities to secure assets with good long term growth prospects, particularly for charities and pension funds who benefit from tax-exempt status. Whilst charities cannot access international property directly, the proliferation in pooled vehicles allows charity investors exposure to the asset class across Europe providing access to markets with attractive income returns and attendant diversification benefits.

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Nevertheless we should not be too sanguine about the risks. Current economic conditions mean that occupier for demand is likely to be weaker over the next 18 months, particularly in the more volatile office markets such as the City of London. In countries such as the UK and Spain, with higher levels of household debt and household balance sheets exposed to changes in residential pricing, consumer spending, and therefore demand for retail space may be more vulnerable. It is likely that over the short-term, this uncertainty will feed into pricing. The relative illiquidity of real estate – whilst sometimes overstated – is apparent in the current market, perhaps most obviously amongst UK charities for those with holdings in PUTS.

However we would caution against a short-term approach to property investment. At this point in the cycle, the most important decisions are in stock selection: choosing markets and sectors carefully by understanding local supply and demand characteristics. From a pan-European perspective, there is significant divergence in current and forecast performance at a local market level. Some markets have intrinsic weakness; some are in good shape with attractive income yields relative to risk. There are markets which offer strong structural growth prospects, through planned infrastructure and associated projects. Investors should focus on growing income through active asset management rather than looking at property as a pure capital appreciation play and ensure tenant and market risk is fully priced in. Despite current cyclical uncertainty commercial property will continue to be an attractive asset class for many investor types and the current market offers excellent opportunities for charities with long-term perspective to acquire UK commercial property at attractive yields or invest in pooled vehicles for European exposure, investments which should deliver steady returns through the course of this economic cycle.

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