Seeking Value Away from Prime

Getting the Most from Secondary Assets

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

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With intense competition for a limited supply of property in Central London driving prices to record highs, Riverside Capital has been focussed on areas outside of the prime London market.

With this is mind, the key question is how can quality secondary property assets be turned into core investments? We examine how returns can be maximised in real estate investments through the use of active asset management.

Opportunities in Secondary Property

Secondary property has long been considered riskier than its prime counterparts. Whilst we have started to see growth in occupational markets and an improvement in debt secured against such assets, it is likely that investors will continue to view secondary assets as risky. However secondary property is also a great source of opportunity, and with an understanding of the intricacies surrounding secondary assets, their intrinsic challenges can be managed to achieve significant income.

What is Secondary Property?

In our paper released last year; “Market Polarisation: Opportunities in Secondary Markets”, we explored the definitions of “prime” and “secondary” property. Prime property is typically classed as property of the highest quality and specification, in the best location. Property that meets these criteria is expected to be fully let, often on long leases.

Defining secondary property is more difficult. In its simplest form, it is defined as any property that doesn’t meet prime criteria. It would seem that commercial property outside of central London is often classed as secondary. However, in our opinion it is impossible to classify it as one category.

For example, at Riverside Capital we have purchased property that is let on long leases to Grade A tenants, thus reflecting two characteristics of what would normally be defined as prime property. Nevertheless, the locations of these assets are currently classed as non-prime, albeit they are in good locations from a historical perspective.

With the sometimes blurred lines between “prime” & “secondary” property and the large and diverse range of assets secondary property covers, it can often be hard to define secondary property exactly. However, what cannot be contested is that – owing to its failure to achieve the recovery in values enjoyed by the prime market over the last two years and the large amount of debt still secured against such assets – a level of risk with regard to investment in secondary property prevails.

The Future for Secondary Assets

Whilst excessive investor demand has led the yield gap between prime and secondary assets to somewhat narrow as investors' appetites for higher risk secondary assets has improved, prime holdings (typically characterised by good locations and long, secure covenants) have continued to command higher premiums, buoyed by their limited supply.

In a recent report, DTZ property services noted that secondary property is expected to outperform prime on a total return basis from 2014 onwards. This echoes the views of Morningstar OBSR, who expect the rest of the South East and other regions to catch up with central London as the high yields available in the provinces attract further attention, even from overseas investors who, until recently, bid primarily on trophy assets in central London.

Whilst London continues to outperform, there is a rapidly increasing interest in near-prime property, as well as good secondary property, and yields have adjusted accordingly. The strong demand from overseas investors only serves to compound this. Potential income has started to look significantly more interesting to investors as it has become clearer that the economy is recovering and the likelihood of tenants defaulting on rent has lessened.

The current yield gap represents a significant pricing opportunity due to the upside that secondary property offers through both capital and income growth over the coming years.

How can Asset management help Secondary Assets Achieve Prime Expectations?

It would be easy for investors to assume that Prime assets are without risk, particularly over the last two years where one has only had to buy a property and watch the yield come in.

However, when considering the potential fallout in pricing as we eventually return to more traditional market conditions, some prime assets could now represent a greater risk than good secondary assets.

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It would also be foolish to discount the possibility of another period of risk aversion where properties bought at a premium would be hit the hardest.

The pricing of prime stock over the past two years provides a strong argument for the investment into alternative assets. There is no doubt that good secondary property can be managed successfully and can head towards the potentials of prime if an appropriate asset management plan is implemented.

Compared to other asset classes, secondary commercial property can be a safe bet providing you have an understanding of the fundamentals of property and how to develop value in your portfolio.

Asset managers today cannot sit back and rely upon yield compression in the absence of rental growth in order to make money. Times have changed, and now it is time to manage and work the assets hard.

If the property is held over a long period of time the cycle will move up and down and any enhancement of capital or income must be active not passive.

So can good returns be made from secondary property? The simple answer is yes, providing some simple rules are followed:

- A sensible approach to borrowing is adopted. In last month's report, "The Renaissance of Commercial Lending", we talked about the rapid improvement in debt markets and addressed concerns of a new credit bubble. Borrowing on an interest only basis and waiting for growth and yield compression is a thing of the past, and now debt must be serviced more conservatively. The upside of this is, as experienced investors we are able to source the best financing terms and now, can also use gearing as part of an effective long-term strategy.

- Once an investment in a good secondary location with strong covenants is secured, a specific, time-bound and measurable asset management plan should be applied. A well-coordinated and deliverable asset management plan would allow sensible debt servicing and good time to work with your tenants to ascertain their needs, business function and commitments over a planned period; the objective being a consistent income over the investment term from a satisfied tenant.

- Management of stock in-house. Internal control over asset management initiatives allows for a far deeper understanding of the secondary asset and tenants, keeping senior debt providers happy, safe in the knowledge that the stock they are lending on is in safe hands.

- Monitoring the area around the commercial property is extremely important. This not only relates to planning policies that may have an effect on the property itself but also what is happening to buildings around the property.

  Fundamental changes occurring in the vicinity of the property such as a shift in occupier types or residential conversions can have a significant impact on values and needs to be monitored in order to maximise value.

Summary: Where do we go from Here?

Investor appetite for commercial real estate is at its strongest in the post-crash era due to the continued large inflows of overseas money and the normalisation of the lending markets. Last month saw investment volumes approaching those of December last year.

Occupier sentiment and demand for commercial property is also generally improving and take-up is growing across the regions.

With property fundamentals starting to drive returns in the regions, investors should look to take advantage of the current pricing gap and the longer, more secure leases attached to secondary investments. Whilst prices continue to rise, we at Riverside Capital believe that there is a long way to go in the current cycle.

We continue to see a great number of opportunities in the secondary market and believe – through the use of active asset management – we can greatly enhance investor returns.

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