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BRICKS & MORTAR: ALTERNATIVE PROPERTY MARKETS

INVESTORS SEEKING REPRESENTATION IN THE COMMERCIAL PROPERTY SECTOR HAVE TRADITIONALLY FOCUSED ON ASSETS LIKE OFFICES, SHEDS AND SHOPS. BUT INTENSE COMPETITION FOR MAINSTREAM ASSETS HAS LED TO A BROADENING OF INVESTOR INTEREST INTO ALTERNATIVE PROPERTY MARKETS, A SCENARIO THAT MAY BE ACCELERATED BY THE LAUNCH OF REITS.

Richard Moir, specialist property partner at Gerald Eve, looks at the benefits and risks of investing in alternative assets and considers whether they may themselves become mainstream before long.

A few specialist investment funds have for many years focused on non-traditional or alternative asset classes. For example, Quercus (a joint venture between Morley and Quintain) has invested in care homes, Primary Health Properties in primary health facilities and Unite in student residential accommodation. While many funds have been wary of heading into 'unknown' areas, those that have taken the plunge will have benefited from exaggerated yield compression in recent years as their specialist markets have matured.

Indeed, the marketplace has become more crowded as funds with a substantial weight of money have sought increased exposure to commercial property as part of a balanced investment portfolio. Property assets have become increasingly significant to the valuation of asset-backed companies in a range of specialist areas.

LEVERAGING MAXIMUM VALUE

The pricing of traditional property investments has focused on a comparison of the passing rent with vacant possession market levels, lease terms and the financial/ covenant strength of the tenant. In alternative sectors, maximum value can be leveraged from property assets by focusing on their trading potential, an approach that works particularly well in a portfolio context.

A good early example of this was the acquisition in 2002 by the Royal Bank of Scotland, with Cinven, of the NCP car parking business, which has been adopted as the model for many similar transactions across a range of alternative markets, including pubs, hotels, care homes, hospitals and student residential accommodation.

Sectors in which the trading activity of the company is intrinsically linked with the property assets provide an opportunity to separate the operating company (opco) from the property company (propco). Value can be leveraged from the propco through internal debt funding arrangements, sale and leasebacks of the property assets, securitisation and, now possibly, REITs.

Many believe that, as the UK REIT market matures, it will follow the US model of sector specialist REITs, which may provide further stimulus to alternative property markets. Current speculation suggests that some pub companies may soon place their assets in specialist REITs although, in our view, there are hurdles to overcome.

A DIFFERENT APPROACH

The characteristics of alternative property investments often differ from traditional assets. In the absence of reliable market evidence of vacant possession rents, determination of initial rental levels has moved towards an assessment of 'affordability' of rental payment by the activity in occupation. Rents are increasingly determined as a proportion of the fair maintainable level of operating profit (EBITDA), with levels of between 60% and 80% having been achieved. A similar approach has been adopted to leverage value in more traditional sectors, such as supermarket assets.

Alternative investment opportunities are often 'purpose designed' at the point the propco is separated from the opco to maximise the attraction and value. Thus, in comparison with traditional investments, these opportunities often have:

- longer lease terms - trading activities often seek long-term use of the premises of in excess of 25 years whereas occupiers of office and industrial premises commonly seek flexibility with shorter term leases averaging seven years and five years respectively;
- tighter alienation provisions on the assignment or sub-letting of leases as tenant demand is often more limited and investors want to avoid covenant dilution;
- rents that are often the subject of fixed uplifts linked to RPI or other indexation, which offer financing opportunities for investors, as opposed to open market rent reviews.

Broadening of investor interest has led to a rapid maturing of alternative property sectors with prime yields at or below 5% now being achieved on some transactions, significantly reducing the previous yield margin with traditional investment classes.

Yield compression in many alternative sectors is encouraging larger property investors to purchase whole asset-backed companies in order to acquire the property investment. This approach is more sophisticated and carries greater risks than direct property investment but is expected to improve the return on property assets - provided investors and their advisers have a thorough understanding of the specialised business sectors in which they are working. For example, tenant demand is more focused so the ability to re-let property assets is of greater importance.

THE WIDER CONTEXT

Many alternative sectors are exposed to political influence such as the impact of the smoking ban on leisure facilities like pubs and bingo halls. Decisions about the future funding of healthcare in relation to a rapidly ageing population will impact positively or negatively on different areas of the healthcare sector, while decisions about the funding of higher education may influence the student residential market.

Specialised sectors are also subject to their own regulatory frameworks, which need to be considered in product selection. An ageing population does not make every care home a good investment! Location, design, condition, competition, barriers to entry and other factors determining trading potential and risks all need to be understood and built into pricing decisions.

Looking ahead, we believe that new markets will continue to emerge, as evidenced by recent acquisitions of garden centres. Education, and in particular the schools sector, holds considerable potential, and we would also expect infrastructure to continue to attract strong interest, whether social infrastructure (primary care, prisons, government buildings), utilities, transport or communications.

We are also likely to see markets mature further as more sophisticated investors are prepared to follow the lead of the hotel sector in seeking a greater risk/reward trade-off under owner/operator relationships, with sale and managebacks, rather than leasebacks, gaining ground. We have already seen some evidence of this in the healthcare sector and are confident that more will follow. ACQ

RISKS AND REWARDS OF ALTERNATIVE PROPERTY INVESTMENTS

REWARDS

- Portfolio diversification
- Potentially higher yields
- Growth sectors
- Often longer lease length and fixed rental uplifts

RISKS

- Alternative use limitations
- Political and regulatory influences
- Operational risks

details...

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