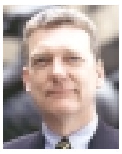
POTENTIAL IN PROPERTY PORTFOLIOS



COMPANIES LOOKING TO RAISE NEW CAPITAL MAY FIND SOME UNEXPECTED OPPORTUNITIES IN THEIR PROPERTY PORTFOLIOS, SAYS **IAN WHITTOCK** OF ING REAL ESTATE INVESTMENT MANAGEMENT.

Businesses are under increasing pressure to maximise the use of their existing capital assets. At the same time, it is difficult to raise additional capital by issuing new stock, and with corporate debt levels already high many companies find that raising capital from unsecured debt is not an option. A company's property portfolio, whether held freehold or leasehold, may offer a solution.

In recent years, falling stockmarkets have highlighted the attraction of investing in other assets. Consequently, institutional ownership (insurance companies and pension funds) and non-institutional ownership (property companies and private individuals) have been raising their investment in commercial property. Last year an estimated £2bn was invested in the sector, while bank lending to fund the purchase of property investments was at a record high.

MAKING COMMERCIAL SENSE. Impressive though these figures are, the biggest owners of UK commercial real estate are companies with property assets. These assets hold a value of roughly £250bn, about 65% of the total commercial property market, and no less than 34% of total UK business assets. Given the appetite for income-producing property from the investment community and the fact the corporate world owns much of the product, there is an opportunity for corporate occupiers to raise capital through sale and leaseback deals.

Demand from investors is centred on mainstream commercial buildings, offices, shops, warehouses and leisure outlets. Though they are increasingly prepared to consider more unusual buildings such as car parks, hotels, supermarkets and car showrooms, provided rental values are transparent. This is usually overcome by fixing increases in rents to the retail price index (RPI), a factor that provides a degree of certainty as to future rent levels to both parties.

The main attraction of commercial property at the moment is the relatively high yield available (initial yield of about 7%) relative to other asset classes such as gilts (a ten-year gilt offers 4.2%) and equities (offering a dividend yield of about 4%). Given the current climate, investors want as great a degree of certainty as they can get. In this context, this means long-term leases, preferably of ten years or more, backed by a strong covenant. There is a significant premium for certainty at the moment. In both instances, the longer the lease and the stronger the covenant, the higher the capital value investors are willing to pay.

For example, if we take two identical office buildings next to one another, one building, which has a lease with an unexpired term of, say, 12 years at a rent of £100,000 a year, might be valued at around 6% to produce a value of roughly £1.6m. Meanwhile, its next door neighbour, where the unexpired term on the lease is only three years, would produce a value based on, say, 7% to give a capital value of about £1.4m. Therefore, companies intent on raising capital through sale and leaseback deals should evaluate the effect on capital value of the length of the lease commitment and the covenant strength.

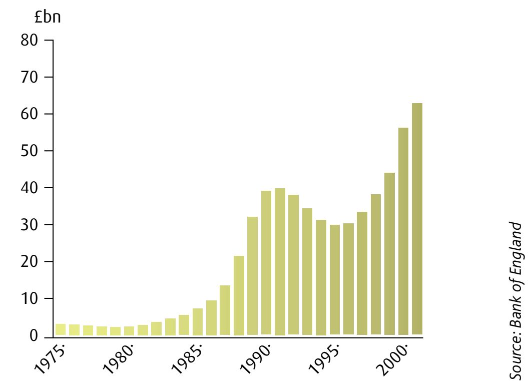
AN ASSESSMENT OF THE ASSETS. If a company wants to retain direct control over its property assets, it could consider releasing capital by mortgaging property. This is an attractive option at the moment, as the cost of borrowing is invariably lower than the valuation yield applied to most properties. This means that for any given amount of capital raised it is cheaper to pay the interest on the loan rather than rent. The disadvantage is that it is not possible to raise the same amount of capital as would be the case from a freehold sale.

It is also possible to raise capital from a company's property portfolio, even though operational properties are not held on a freehold or long leasehold basis. While the investment market remains strong, the occupational market has been weakening – a factor that many tenants may be able to exploit. The key to maximising the potential of the situation is to understand how important the tenant and the terms of the tenancy are in determining the ultimate value of the investment.

Most commercial property markets in the UK suffer from an oversupply of floor space. The tenant therefore has a strong negotiating position. This is likely to remain the case for at least the next two years and probably longer.

As the outstanding term on a lease on a premises gets shorter then, in the absence of any growth in rental values the capital value of the building will decline. This fall in value becomes acute in the last two or three years of the lease term.

FIGURE 1
LOANS OUTSTANDING ON PROPERTY.



At this stage, it is in the interests of the landlord to encourage the tenants to extend the term of the lease because by doing so the value of the building rises. A tenant willing to extend the existing term on the lease should therefore be able to negotiate some financial incentive for doing so. It should be noted that tenants' negotiating position under these circumstances varies from one market to another, but generally the value derived from extending a short unexpired term is greatest on office buildings.

Another variation on this theme is for the tenant to buy the property on the basis of a depressed value (due to a short unexpired lease term) and then undertake a sale and leaseback with a longer occupational lease in place.

TABLE 1
VALUATION RATE SENSITIVITY: PRIME OFFICES.

Covenant	15-year lease with 5-year indexed rent reviews	10-year lease with 5-year upward rent reviews	5-year lease with no rent reviews
Excellent	6.75%	7.50%	8.25%
Average	7.00%	7.75%	8.50%
Weak	7.75%	8.00%	8.75%

Whatever the composition of a tenant's occupational property portfolio – whether freehold, leasehold or a mix of both – it is worth spending time to assess the potential for raising capital, since the tenant currently commands a powerful position in the property investment market. Drawing up a list of freeholds and premises with short unexpired terms would be the first place to start.

Ian Whittock is Director of Investment Research and Forecasting at ING Real Estate Investment Management.
ian.whittock@ing-realestate.co.uk
www.ingrealestate.com