ANDREW MCLAUGHLIN ASKS HOW LOW CAN PROPERTY YIELDS GO.

Stretched valuations

Commercial property is never far from the radar screen of UK treasurers. It is a vital asset in many company balance sheets and its importance has grown thanks to rising capital values and falling yields – a welcome cocktail for the property owner. The value of the total UK private sector property portfolio has increased by 31% over the last decade to a figure approaching £440bn.

There is hardly a company in the country left which has not been involved in a property finance transaction over the same period. Many have opted to release some of this value to fund core operations including some large-scale and lease-back transactions (equity release in the corporate world).

I know from regular trips around the country, however, that many finance directors are wondering how long the property boom can last. Are we in a bubble and therefore at risk from a major correction?

WHAT IS A BUBBLE? A bubble occurs when prices in a market become detached from underlying economic fundamentals. Prices may have started rising for a good reason but then spiral upwards to extraordinary levels of valuation. It is tempting to think that bubbles should not occur in an era when information about the returns from different assets is so readily available via the internet and wider media. But this is not the case. The dotcom stock market crash of 2000 was one of the largest ever.

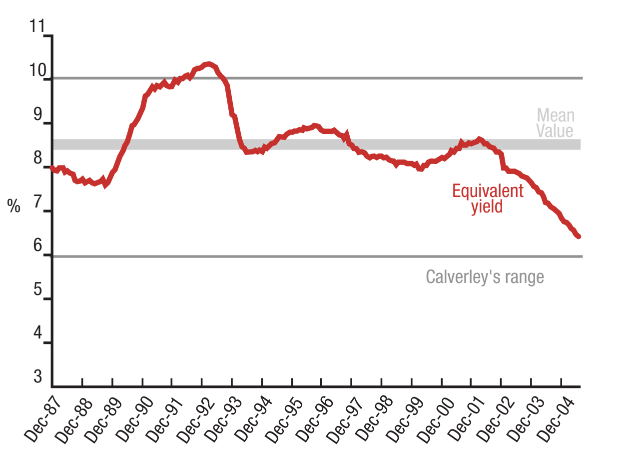
Executive summary

- The value of the total UK private sector property portfolio has increased by 31% in the last decade.
- The commercial property market has experienced a boom since 2002, driven by compression in valuation yields rather than significant growth in rental values.
- Any further compression in property yields would be a source of worry, especially as bond yields are finally starting to edge upwards.

BUBBLES IN THE PROPERTY MARKET Real estate is no stranger to the bubble phenomenon. Many readers will recall the wild ride in UK residential house prices in the late 1980s. This, though, was tame when compared with the collapse in the Japanese property market in the early 1990s. From the peak in 1991, land prices fell more than 90%, inflicting crippling losses on investors and Japanese banks and contributing hugely to Japan's economic stagnation.

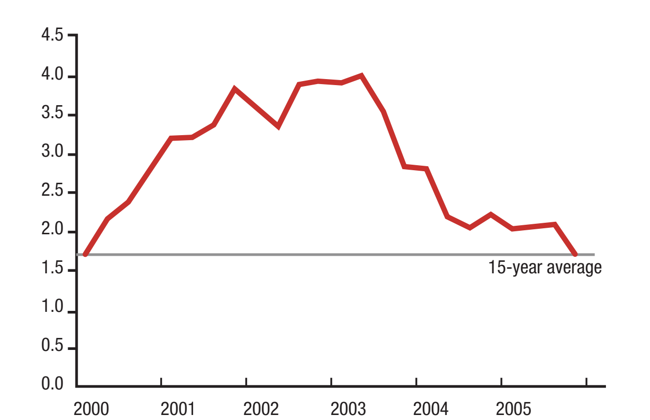
So what about the UK commercial property market in early 2006? The first basic task is to establish where property returns currently sit relative to their long-run average or mean. Most economic models are built on the principle of mean reversion. The mean value ought to capture the risks and returns associated with the asset class over a

Chart 1. All property equivalent yields



SOURCE: Investment Property Data (IPD)

Chart 2. Gap between property yields and the five-year gilt rate



SOURCE: Investment Property Data (IPD)

long period of time. In any single economic cycle (which typically last between six to eight years), actual values will fluctuate around the mean as investors respond to the ebb and flow of the business cycle. But when a market moves a long way from the mean, then for proponents of the mean reversion methodology it is moving away from fair value and is at risk of a crash.

Chart 1 shows the trend in nominal rental yields for all UK commercial property versus the mean value, and an upper and lower range (more of which soon). Actual yields have moved well below the mean value since 2002 and were 32% lower by the end of 2005. Yield compression during this period was driven by rising capital values. On our first basic test therefore, property yields have travelled far from their mean, and look stretched.

Investors have a choice of assets in which to invest. So it is also important to have some feel for what level of return investors should expect for holding one asset over another. In his book, *Bubbles And How To Survive Them*, John Calverley calculates "reasonable value" ranges for the yield in each asset class. These are set out in *Table 1*. Calverley reasons that property should be priced somewhere between bonds and stocks. His work focuses on residential property but the range is broad enough to incorporate commercial property.

Chart 1 illustrates that yields are currently toward the bottom end of Calverley's range. In fact, property yields have only been outside the range between March 1992 and August 1993. This was in the aftermath of an economy-wide recession when yields rose above 10% as investors demanded a significant risk premium for holding property assets. The market very quickly mean-reverted in the mid-1990s and stayed there until 2002.

Calverley's work provides more latitude than a simple mean. On this measure, property is expensive but not unreasonably so. Further yield compression from here, however, would make even the most optimistic economist twitchy.

ARE LOWER YIELDS JUSTIFIED BY A MORE STABLE MACRO ECONOMY? Investors tend to make their biggest errors when they believe that the world has changed in some important way – a view that is later revised, having been based on incomplete evidence. Such errors are most often made when investors are trying to justify a huge increase in asset values. One need only think back to the various attempts to justify the dotcom bubble at the time. It is with some trepidation therefore that I now ponder whether higher property values since 2002 have some fundamental justification that allows a step-change away from the mean value.

In the past two decades, central banks and governments have waged a successful war against general inflation. That has been hugely beneficial for the commercial property sector. The introduction of an inflation-targeting regime and fiscal rules in the UK has created a more transparent environment for investors. The ultimate prize has been more stable economic growth across the economy. In the UK, this has produced 54 quarters of consecutive

Table 1. 'REASONABLE' YIELDS BY ASSET CLASS

Asset Class	Reasonable Valuation Range (Yield)
Index-linked bonds	2-3%
Conventional bonds	4-6%
Corporate bonds	5.5-7.5%
Stocks	10-20 price/earnings ratio*
Property	6-10% (gross yield)

Source: Calverley (2004)
*Assumes a 50% total payout. Consistent with a 2.5-5% dividend yield (including buybacks)

growth and a healthy demand for property. The reduction in the economic risk premium has also contributed to more stable tenant covenants for landlords as the incidence of corporate defaults has remained at an all-time low. Perhaps most significantly of all, the reduction in the inflation risk premium has allowed long-term interest rates to come down, evidenced by a flat, and more recently, inverted yield curve.

It makes sense to look at the relative changes in returns across asset classes as well as the long-run average within each asset class. The gap between the risk-free gilt rate and the property yield should be a positive one, reflecting the greater risk associated with property assets. On Calverley's estimate this yield gap could be between 2% and 4%. In the last 15 years it has averaged 1.73% as macro stability has become entrenched.

As *Chart 2* illustrates, a much larger gap opened up after 2000. The gap emerged initially due to a fall in gilt rates. Since then the gap has been closing as property yields have steadily fallen. By the end of 2005, the gap was back in line with the 15-year average.

Much of the yield compression observed recently could therefore reflect the property market re-establishing a more typical relationship with the risk-free rate. Once again, though, the evidence is that this adjustment is now complete and any further compression in property yields would be a source of worry, especially as bond yields are starting to edge upwards.

STRUCTURAL CHANGE The commercial property market has experienced a boom since 2002, driven by compression in valuation yields rather than significant growth in rental values. The market seems to have been adjusting to a more stable economic environment and a lower risk-free rate. Some of these gains may prove permanent provided we do not return to a period of higher and more volatile inflation in the UK economy. This is what economists call a structural change. The risk in any period of adjustment is that the market overshoots as it tries to find a new equilibrium. Our analysis indicates that valuations currently look stretched but to nothing like the extent suggested by a basic mean-reversion analysis. There are good reasons why yields have compressed to close to 6%. There are few good reasons why they should compress much further.

Andrew McLaughlin will be speaking on 'Inflation: How worried should we be?' at The Treasurers' Conference 2006.

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INVESTORS TEND TO MAKE THEIR BIGGEST ERRORS WHEN THEY BELIEVE THAT THE WORLD HAS CHANGED IN SOME IMPORTANT WAY AND ARE TRYING TO JUSTIFY A HUGE INCREASE IN ASSET VALUES.