Solid foundations

Property companies need an IR approach of their own, as Adrian Holliday discovers

'Buy what you can see and touch. Speculate on properties not schemes. Property is tangible, a scheme is an idea.' This advice was scribbled down by a now little-known investor called Bob Caird before World War II. Caird scribbled a lot more financial advice besides, but the essence of his real estate wisdom has been taken up with gusto by many private and institutional UK and US investors, particularly in the last few years. Low interest rates have fuelled a massive rise in property values, while stock market returns, by contrast, have disappointed many. From pundits on glossy TV property makeover shows to the serious press, the prevailing advice is that bricks and mortar are a sure bet over the long term.

But as James Higgins from financial advisers Chamberlain de Broe in London points out, huge differences remain between investing in the commercial property sector – which in the UK soared 18 percent in 2004 – and private individuals buying property to rent out. 'It always amazes me when I'm walking around central London and I see all this commercial property empty,' Higgins notes. 'Many public companies would rather leave their property empty because their balance sheet and share price are a function of the portfolio. If you have a property valued on your books at £100 ($190) per square foot, with an overall value of £10 mn, and the value of that property drops to £5 mn, some investors would rather keep the shareholders happy and leave the building empty. It's something that won't hit the bottom line for a good few years yet.'

In other words, commercial property can be used as a financial instrument in a different way from a private residential owner hoping to cover mortgage payments from rental income. And it's just such differences that can distort the commercial property marketplace, adds Higgins. 'The value of commercial property doesn't have to be tested for years,' he explains. 'With residential property, you always have people buying and selling. The difference is down to liquidity: if you tried to sell a commercial building without a tenant, you might find the building almost worthless.'

Nevertheless, hoping to make the most of the recent commercial property boom, a rash of commercial property funds have arrived on the fledgling commercial property fund scene, including offerings from Foreign & Colonial (F&C) and Scottish Widows. Equity analyst Mitchell Todd from F&C acknowledges the days of heady double-digit commercial property returns are probably over. 'My outlook is that returns will be coming down to single digits, but much depends on what happens to bond levels, inflationary pressures and cost of funding,' he says. 'Although returns are declining, there are still some commercial property stocks that are reasonably valued.'

That means when Todd sees IROs, he's constantly looking forwards – and back. 'If they're showing us their past year results, I want to hear about trends in earnings, balance sheet and cash flow, as well as the wider market trends,' he says. 'Part forward-looking, part backwards; what are the companies' strategies? How are they using their capital, what are their returns on capital, and are they achievable? Often the most useful part is their wider appraisal of the market.'

But getting an accurate wider market appraisal is tough. Because interest in the commercial property sector has risen,

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capital values have also climbed. That means more pressure on rental yields, which can be slower to rise. Nick Anderson, head of equity research at Insight Investment, which invests in commercial property companies for its equity funds, says evaluation is no walk in the park. 'There are often so many separate assets to a commercial property business that you can't possibly be expected to visit them all,' he points out. 'There might be particular flagship projects you want to see. Some companies have a private finance initiative (PFI) arm and you might want to see that divisional head. You could spend months visiting each site without adding to your sum of knowledge.' But getting in the car to see a site can help give a sense of the physical magnitude of projects.

Digging for answers

Anderson says IR at many property companies starts from a pretty low base, often the poor end of average. 'Many public companies are run by entrepreneurs, almost as their own business, and the perception sometimes is still that shareholders are not their prime concern,' he explains. Anderson is too discreet to name names, but bigger property companies are predictably superior. 'There's been a big effort made to be more transparent to City investors,' Anderson continues. 'But within this profession there's IR and there's *IR*. Commercial property is not overly complicated, there are often not huge numbers of investors, and the investor base is often domestic rather than international, so you can do a large part of your job without calling on some senior IRO. But what is critical for me is someone who will tell me when he or she doesn't know the answer, and will go back and dig around for it.'

Ideally the IRO should come back not just with the answer but with a view on the sector as a whole. Jamie Stewart, head of institutional marketing and research at Eden Group, a trading, stockbroking and independent research intermediary, doesn't often see IROs giving that bigger picture. It's not their fault, however, he says – IROs are hired to project and extend information about their company. 'By definition IROs see their company not in isolation but in far bigger font than other competing companies or an industry as a whole,' Stewart says. 'Even if done innocently they won't have an impartial comparative view, which is what investors hanker after.'

Given its recent bull market spurt, Stewart is now cautious on commercial property. Pinpointing exactly where the sector is demands *very* close fact sifting, he says. 'One gets so much information, counter-information and disinformation,' he observes. 'Commercial property is particularly vulnerable because there are so many ways of making money from it – an almost infinite range of views and valuations.'

Given the rage for commercial property – much of it coming from retail investors rather than institutional investors who piled in early – where does Stewart turn for possible signs the market is close to peaking? Not to real estate or investment journalists, that's for sure. 'It's impossible to reach for a reliable pulse,' he says. 'There's a lot of supply coming into the market, but the marketplace is very variable in working out the net contraction and expansion. Look out to the City of London: it extends from the Square Mile and out to Canary Wharf. Certain branches like M&A and credit derivatives are doing well, but there's a lot of pressure in equity trading. So people get brought in by certain doors and pushed back out again through others. And there are few journalists thoughtful enough to look at all the figures and say, *Around 7,000 people got fired last month and 5,000 people got hired*. That sort of information is often not obtainable. Plus, a lot of new hires

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Commercial property: still a rising star?

The best-known weather vane of UK commercial real estate value is the Investment Property Databank (IPD) monthly index, measuring total returns for all commercial, retail, office and industrial property. For the twelve months to March 2005, the IPD index soared 18 percent, outperforming the FTSE All Share by nearly 20 percent, and trouncing gilts, which rose just 5.1 percent in the same period.

But worries about inflation and interest rates, as well as fear about future profits, could all help undermine the commercial property market in the US and the UK. Slow structural changes to the way commercial space is used, thanks to the growth of electronic transactions, mean a steadily diminishing use of administration back-office space.

are yesterday's refirings, which might not affect commercial property anyway.'

Changing environments

The nature of how and where people work, especially in often densely populated commercial centers, is also changing, warns Stewart. But the pace of change appears so slow that it's difficult to realize what's happening. Happening it is, however. 'Technology, like automation 120 years ago, is eating away at manpower, with a lot of functions now being given over to electronic alternatives, and that has to affect demand,' Stewart notes.

Commercial property is also affected by the offshore outsourcing trend, which of course affects office space demand. Closer to home, however, there is real retail anxiety. Too few people are going shopping, at least in the numbers they were twelve months ago, according to recent retail figures, so mall and shopping complex occupancy rates could look vulnerable. Interest rate rises and a rash of energy price hikes is slowing consumer spending and, in the UK, inflation and unemployment both appear to be on the increase.

This isn't the healthiest news for the commercial property sector, but it's a very mixed picture, says Robert Hannington, chairman of corporate finance at real estate specialist Knight Frank, who is upbeat about future prospects. 'You're looking in the low teens for income and capital growth,' he comments. 'The chief opportunities are around warehousing and the distribution of retail products, plus you have very tight planning control around the London arteries, so you have very static supply, causing rents to rise.'

If Hannington's right, most investors would be delighted with a return of around 12 percent. But others aren't seeing buy signals right now, particularly in the long term. 'IROs are probably aware their own company might pay big rents for property,' says one commercial property specialist recently back from a trip to New York. But this specialist is not sure how long rental yields can continue to rise, due in part, he increasingly thinks, to the tremendous online domestic shopping boom in the US. 'Purchasing transactions literally go straight from the warehouse to a DHL or a UPS, completely bypassing the retailer, the supermarkets and other storage outlets,' he points out. 'In terms of cubic meters of space, that is going to have a big impact. At the moment, though, it's still very much under the surface of things and not really being talked about.' ■

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