Strutt & Parker / MSCI Business Parks Index

Strong rental growth a cause for optimism

Autumn 2016

struttandparker.com

Velocity, Brooklands, Weybridge
A new speculative development of two buildings totalling 106,400 sq ft by Rockspring Property Investment Managers Limited and Exton Estates.

Introduction

Welcome to our annual Business Parks Index which tracks the performance of select UK business parks to enable us to benchmark the performance of the best parks versus the wider MSCI universe, in order to understand the key drivers of return.

The Strutt & Parker Business Parks Index measures the performance of a select sample of business parks from within the wider MSCI sample. These parks have been identified to give investors an overview of how the best parks perform relative to the wider market. Typically they are characterised by the provision of good accessibility, amenities, car parking and site management. The sample for 2015 consists of 90 assets across 24 parks, valued at £1.36bn as at 31 December 2015.

Following the exceptional returns (21.8%) seen in 2014, 2015 was always likely to see some moderation, registering a total return of 14.1%, driven by capital growth of 7.8% and an income return of 5.9%. And no doubt 2016 and beyond will see a further moderation with income likely to be the primary driver. What bodes well, Brexit notwithstanding, is that 2015's capital growth was helped along by a 6% increase in rental values, the highest figure since 2000. Taking the view that sustainable returns are income plus long-term rental growth, the sector still appears to have the prospect of reasonable above-inflation returns, providing it can continue to remain relevant.

S&P Business Parks also outperformed the MSCI UK Annual All Property Index for the second year in succession, with the full index reporting a total return of 13.2%. However, the S&P sample of business parks was outperformed by MSCI Standard Offices*, which saw strong yield-driven capital growth over the year. MSCI's quarterly data to Q2 2016 does show, however, S&P Business Parks delivering a return of 3% on a half-year basis (6.1% annualised) versus 2.2% for the wider MSCI Business Parks sample and 2.7% for MSCI Standard Offices*.

Given the outcome of the EU Referendum and the ongoing uncertainty regarding the future nature of our relationship with the EU, it would be fair to say that a full-year total return of 6% should be regarded favourably. Particularly in light of the fact that, based on a half-year return of 2.5%, MSCI UK All Property is heading toward an annualised return of 5% for 2016. Clearly a straight-line continuation of H1 2016 is unlikely, and the third-quarter figures released shortly will give us a better idea.

On a more positive note, we need to give due attention when discussing nominal returns to current and expected inflation. Although the outlook for nominal returns in the next few years appears to be in the single-digits, inflation in the UK, and the rest of the developed world, is suppressed - well below central bank targets. At the same time UK 10-year Gilts are trading at sub-1% yields. Consequently on a 'real' inflation-adjusted basis the outlook for returns is not as poor as it first appears.

Indeed, we are seeing increasing discussion amongst major investment institutions around the globe regarding the need to invest in 'real assets' in order to counteract the mounting pension deficits stemming from quantitative easing's bearing down on gilt-edged returns. Although we should avoid marketing real estate as a bond-like investment – in the long-term it certainly isn't – it's clear that attention is set to increase. Those investors with the correct advice, focusing on customer (tenant) needs, and not seeing property as a buy-and-forget asset, will do well. Real returns of 4% or more should be viewed favourably. Welcome to the new normal.

I hope you find our research both informative and of genuine commercial use when considering this asset class, and would welcome your views on any of the subjects raised. If you would like to discuss the findings and their implications in further detail, our research team would be delighted to hear from you.

Andy Martin

Senior Partner

Andy Martin

*excluding Central & Inner London

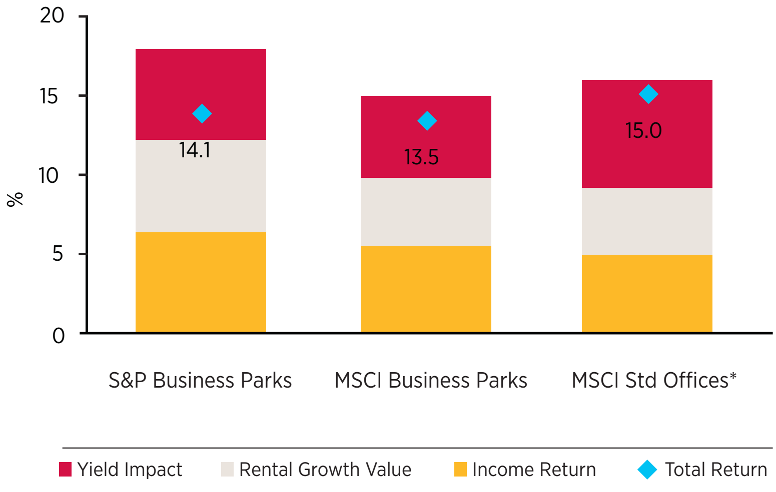
Summary data

	2014	2015	3 Years	5 Years	10 Years
Total Return, % per year					
S&P Business Parks	21.8	14.1	15.1	8.9	4.2
MSCI Business Parks	21.4	13.5	15.3	9.0	3.8
MSCI Std Offices*	19.6	15.0	14.9	9.0	4.0
Income Return % per year					
S&P Business Parks	7.0	5.9	7.1	7.3	6.9
MSCI Business Parks	6.7	5.4	6.6	7.0	6.7
MSCI Std Offices*	5.9	5.0	5.9	6.2	6.3
Capital Growth % per year					
S&P Business Parks	14.0	7.8	7.5	1.5	-2.6
MSCI Business Parks	13.8	7.7	8.2	1.9	-2.7
MSCI Std Offices*	12.9	9.5	8.6	2.6	-2.2
Rental Value Growth % per year					
S&P Business Parks	2.6	6.0	2.8	1.7	0.4
MSCI Business Parks	2.8	4.3	2.5	1.5	0.3
MSCI Std Offices*	3.5	4.3	3.1	1.7	0.4
Equivalent Yield Impact % per year					
S&P Business Parks	13.5	5.9	7.4	1.7	-2.0
MSCI Business Parks	12.1	5.3	7.3	1.7	-2.1
MSCI Std Offices*	12.0	6.8	7.4	2.4	-1.8
End Period Equivalent Yield %					
S&P Business Parks	7.6	7.1			
MSCI Business Parks	7.9	7.1			
MSCI Std Offices*	7.7	6.9			

* Excluding Central and Inner London

Headline performance

Figure 1 - Annual performance – 2015

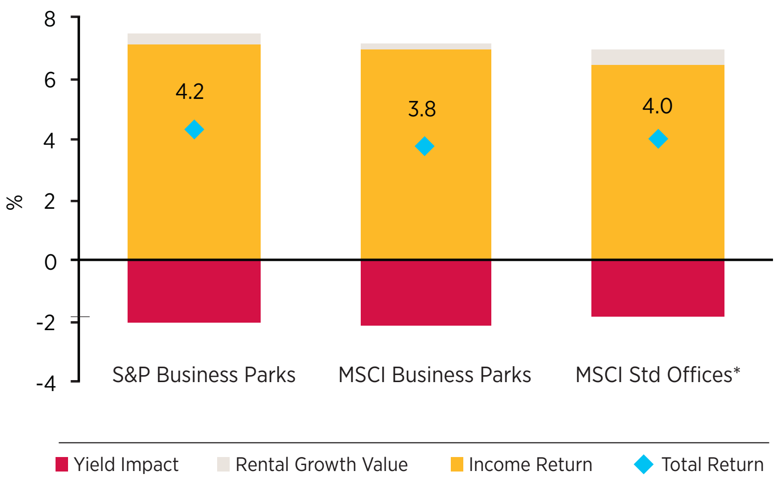


* Excluding Central and Inner London

S&P Business Parks registered total returns of 14.1% in 2015, outperforming the wider MSCI Business Parks sample but below the returns seen on MSCI Standard Offices*. Capital growth moderated to 7.8%, with rental growth of 6% and a yield impact of 5.9%, suggesting that the transmission of rental value growth to capital value growth was being inhibited by an element of over-renting and/or unusual lease terms in the sample. S&P Parks continued to record superior income returns to their peer group, with a 5.9% income return in 2015; compared to 5.4% for the wider business park sample and 5% for Standard Offices.

"S&P Parks continued to record superior income returns to their peer group, with a 5.9% income return in 2015"

Figure 2 - Annual performance - 10 years to end – 2015



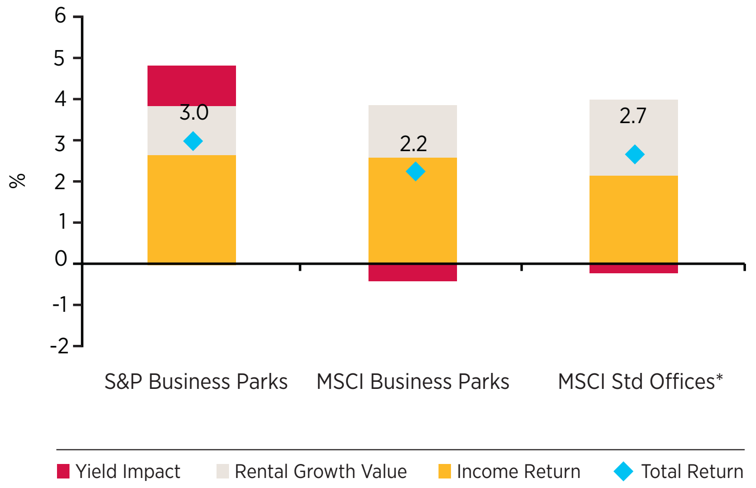
* Excluding Central and Inner London

In the 10 years to end-2015, S&P Business Parks have out-performed the wider MSCI Business Parks sample, and the Standard Offices sample, with total returns of 4.2% per annum – see Figure 2. This has been based on a superior income return of 6.9% per annum over the period, and broadly comparable declines in capital value. The performance against the wider MSCI real estate universe has been less favourable. MSCI UK Annual All Property delivered total returns of 5.8% per annum over the same period, the difference being mildly positive capital growth over the 10 years.

"S&P Business Parks have out- performed the wider MSCI Business Parks sample, and the Standard Offices sample"

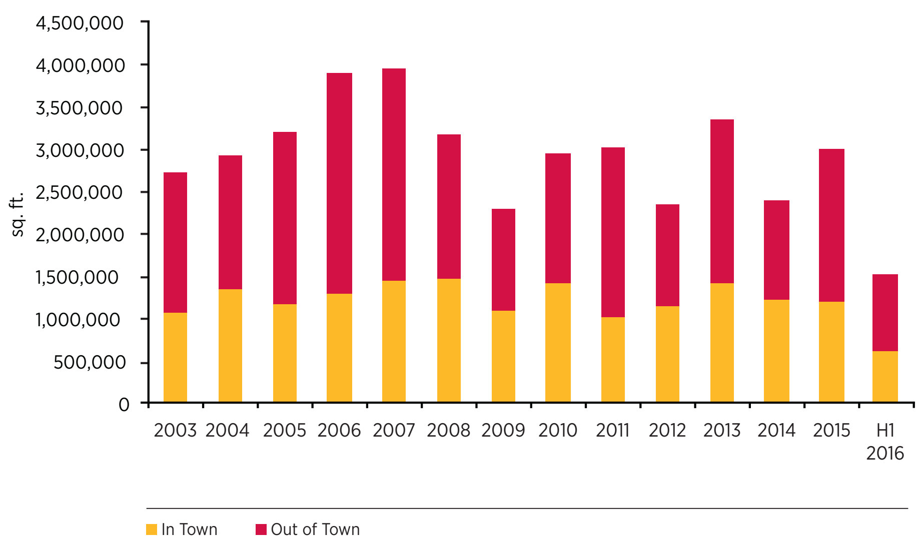
Early indicators in 2016

Figure 3 - Six-month performance to end-June 2016



* Excluding Central London

Figure 4 - Take-up, Thames Valley, North and South M25



Source: Strutt & Parker

This section provides performance data based on the MSCI quarterly sample of S&P Business Parks, which included assets valued at £1.3bn at end-June 2016.

In the six months to end-June, S&P Business Parks delivered a total return of 3.0%, or 6.0% on an annualised basis, based on an income return of 2.7% and capital growth of 0.3%. It should be noted, however, that capital growth went negative in the second quarter, down 0.3% - owing to a similarly negative yield impact. The wider MSCI business park and office samples delivered slightly weaker returns of 2.2% and 2.7% respectively, mainly as a result of negative yield impact. Weaker rental growth (1.2%) on the S&P Parks sample – versus 1.3% for MSCI Business Parks and 1.9% on MSCI Standard Offices* - is a surprise given the strong performance seen on the annual sample, and something to look out for in the latter half of this year.

"In the six months to end-June, S&P Business Parks delivered a total return of 3.0%, or 6.0% on an annualised basis"

Take-up in the South East office market was strong in the first half of 2016, just over half of the total seen in 2015, and 19% above the H1 2015 figure. Out of Town leasing accounted for 60% of take-up in H1 2016, broadly in line with the trend of the last decade or so. We may see this proportion decline slightly in the coming years as significant in-town development comes online in places like Reading. The majority of workers in the South East still travel to work by car, and occupiers, cognisant of this fact, remain focused on offices with multi-modal transport capabilities; ergo car-parking ratios, even in-town, remain fundamental to attractiveness.

Looking at tenant sector breakdown, the Technology and Telecoms sector took 407,000 sq ft. in H1 2016, the largest proportion, followed by Construction, Manufacturing and Logistics with 392,000 sq ft. and in third-place Financial & Business Services, with 353,000 sq ft.

It is worth noting that we continue to see 'mature' technology occupiers base themselves in the Thames Valley area in particular, and we have recently seen Becton Dickinson, a listed global medical technology firm, take 44,000 sq ft. of new space at Winnersh Triangle.

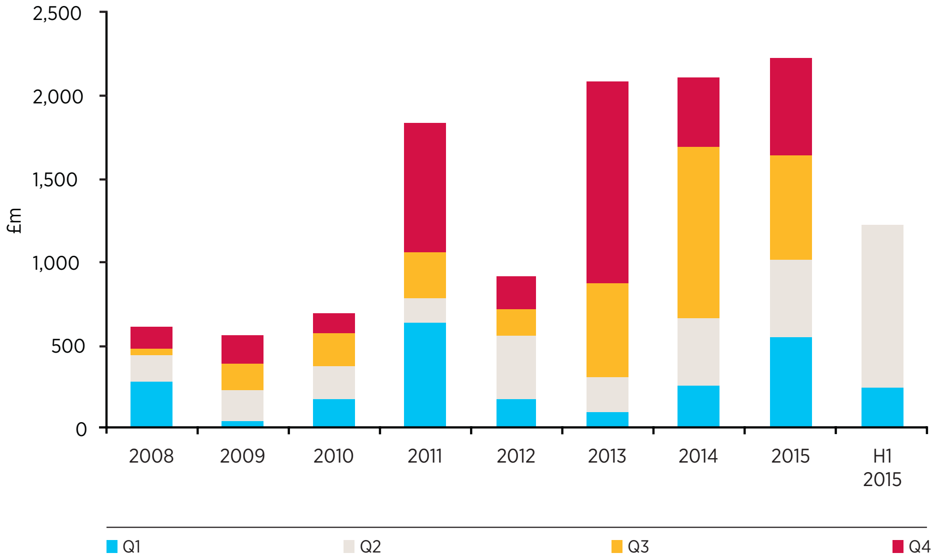
Capital markets trends

Business parks continue to be a significant sector within the overall property investment universe. Figure 5 shows trends in investment volumes of business parks since the bottom of the market in 2008. Despite the uncertainty hanging over the market pre-Referendum, we saw H1 2016 volumes eclipse both the levels set in the same period in 2015 and those seen in 2007, but with the Q2 figure being distorted by the acquisition of Green Park Business Park, Reading to Singapore-based Mapletree investments.

In summary the market for core to core-plus business park investments has remained buoyant for the first part of the year but our prediction is the second half of 2016 is likely to see a noticeable slowdown in trading volumes. In the aftermath of the vote to leave the EU, purchasers have become more cautious in their investment strategies and more opportunistic in their pricing, but the much publicised issues with open-ended property funds have blown over somewhat and their remains significant capital targeting the sector from a range of investors. In fact one of the key issues now impacting the sector is lack of available opportunities with vendors under little pressure to sell, in contrast to 2008/09.

The reality is that Brexit-induced uncertainty is going to be with us for some time. But the issue should be seen as the changing degree of long-term growth, depending on your side of the argument, as opposed to an acute breakdown in the market. There remains significant demand from buyers for quality business parks with the fundamentals favoured by investors, in particular generous car-parking ratios (ratios which now cannot be achieved under current planning policy), the presence of amenity facilities (or the ability to create these if they are currently not in place), good environmental credentials for single building acquisitions, and in the case of larger business park acquisitions, contiguous plot ownerships which enable the implementation of a coordinated asset management strategy.

Figure 5 - Business Parks Investment

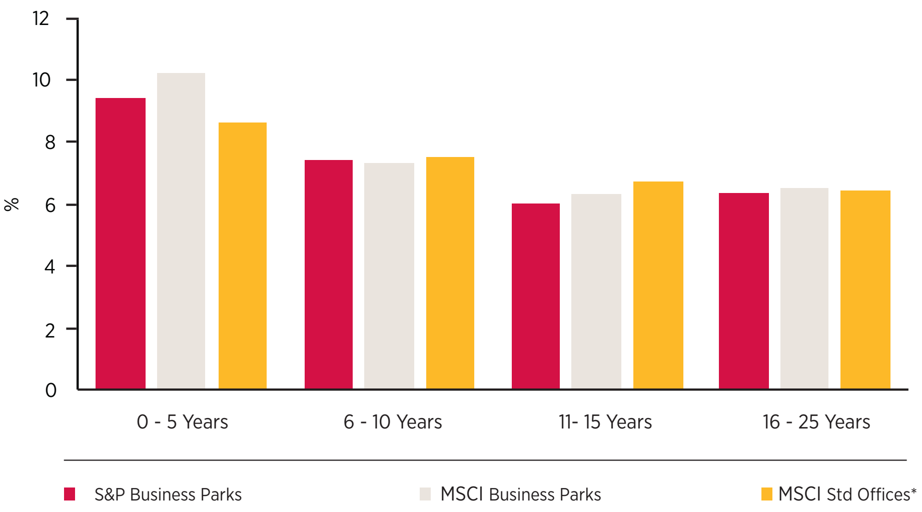


Source: Property Data Ltd, Strutt & Parker

“There remains significant demand from buyers for quality business parks with the fundamentals favoured by investors, in particular generous car- parking ratios (ratios which now cannot be achieved under current planning policy)”

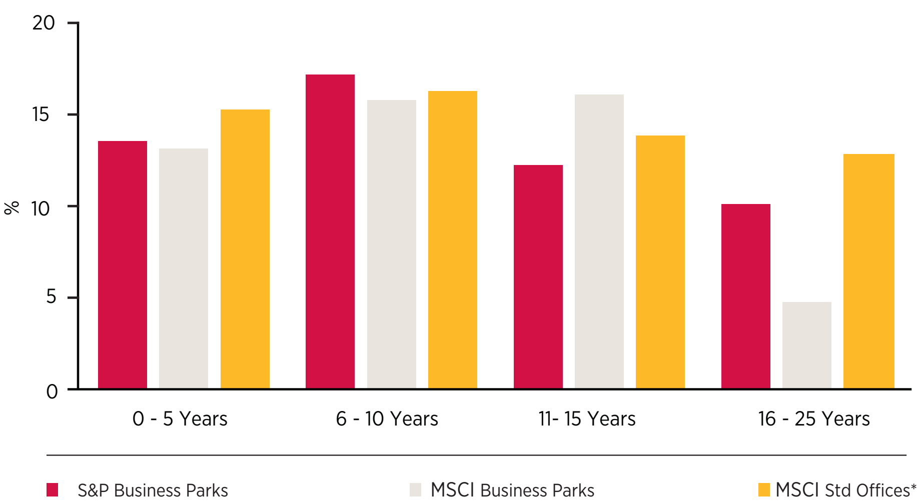
Lease length and performance

Figure 6 - Equivalent yield at end – 2015, by term to expiry



* Excluding Central and Inner London

Figure 7 - Annual performance by term to expiry – 2015



* Excluding Central and Inner London

Figure 6 displays the yield profile, by term to expiry, across the S&P Business Parks compared with the two comparator samples. The chart highlights the extent to which lease length is dominating the pricing of real estate assets, with the yield differential between the segments still marginal within any particular lease length banding.

On the shorter-let (0-5 years) sample we can see that S&P Parks do trade at a slight premium to the wider business park sample, suggesting more sensitivity to quality when we get to the business end of the lease term. Whilst we can see that the MSCI Standard Offices* sample trades at a further premium, suggesting more investor confidence in in-town reletting prospects. For those confident in prospects for business parks with strong fundamentals, this would suggest there is some value to be captured at the asset selection level.

In 2014 we saw a 'levelling out' of returns across the different term to expiry bands, as investors bid down yields on the shorter-let assets, owing to strong economic confidence at the time. Looking at Figure 7, it is clear that 2015 saw a broad continuation of this trend, with strong yield compression, and capital growth, notable on shorter-let assets. With strong confidence over letting prospects emerging, it is not a surprise that investors looked to shorter-let, asset management driven opportunities. Although we do not have detailed data for 2016, yet, it would be realistic to say that we are likely to see a rebalancing of this trend, with risk-averse investors refocusing on security of income, and opportunistic buyers waiting for yields on riskier assets to widen, something we have only seen a little of so far, post-Referendum.

> *"Although we do not have detailed data for 2016, yet, it would be realistic to say that we are likely to see a rebalancing of this trend, with risk-averse investors refocusing on security of income."*

Rents and yields in context

S&P Business Parks saw rental growth of 6.0% in 2015, whilst the MSCI Business Parks sample saw an increase of 4.3%. Although these are high figures, they should be viewed in a longer-term context. Rents on S&P Parks remained 5% below their 2001 peak at end-2015, and 30% in real (CPI-adjusted) terms.

Compared to the other costs businesses face, offices look relatively cheap. The issue, then, for business park rental prospects is one of supply, and, more pertinently, of the sort of space that occupiers want. On the supply-side the market is in a better position than in 2008 and certainly better than the post-2000 period. The challenge will be to continue investing in the amenities, transport and internet connectivity necessary to continue attracting the best occupiers.

Looking at Figure 9 we can see that S&P Business Parks had seen yields compress to an equivalent of 5.8% by end-2006, before peaking at 9.6% in 2012. As at end-2015 yields had fallen to 7.1%, compared to 5.6% for both the All Property and All Office annual samples from MSCI. For those backing themselves to pick good assets on parks with strong fundamentals, the pricing looks attractive; the high yield reflects continuing negative sentiment toward the sector by many investors, and a focus on 'urban' assets.

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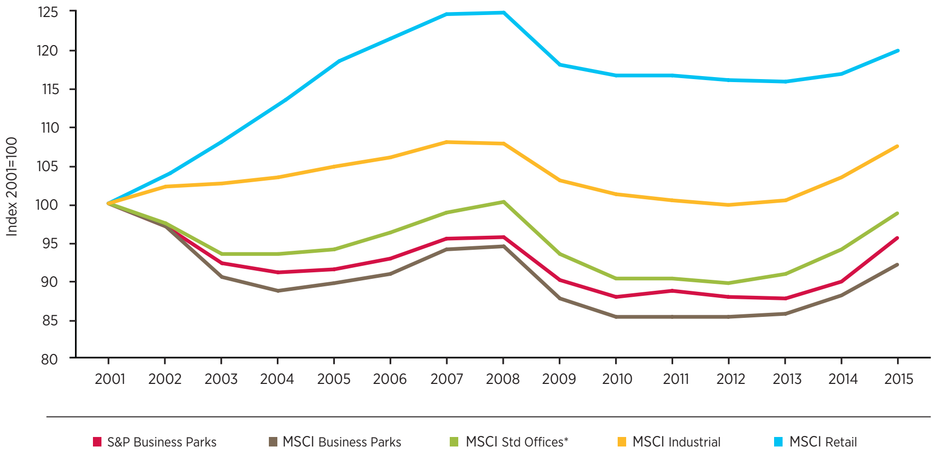
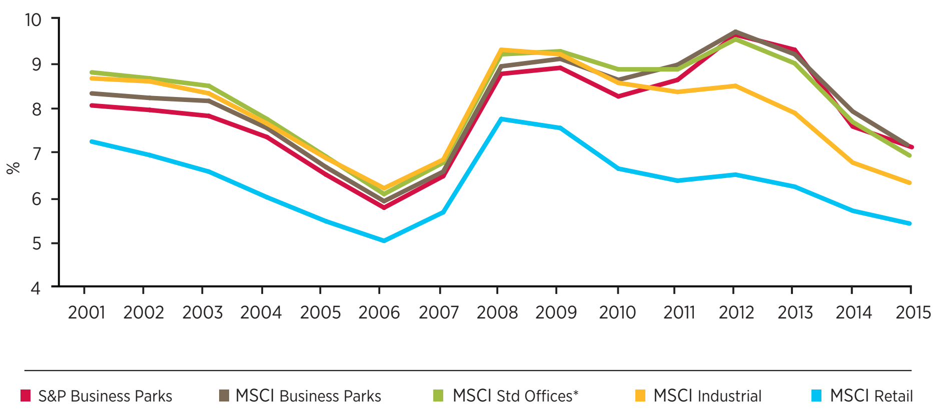
Figure 8 - Rental values - 2001 to 2015



* Excluding Central and Inner London

Figure 9 - Equivalent yield at end-year



* Excluding Central and Inner London

Looking forward

S&P Business Parks and the main MSCI Business Parks sample have both outperformed the wider All Property universe for the second year in succession. A combination of strong income returns, and rental value and yield compression-fuelled capital growth – the wider sample having seen this earlier in the cycle.

This is, however, the end of double-digit returns for now. Property yields across the UK are predominantly flat, or seeing some softening in the aftermath of the Brexit vote, and the occupational market is likely to weaken and drag on rental value growth. Since 1980 property has generally yielded total returns in the order of 9-10% per annum, with the old Retail Price Index growing at 4% per year and the newer Consumer Price Index (CPI) 3% per year. Giving 'real' growth between 5% and 7% depending on the measures used. With CPI in the year to August of just 0.6%, and limited upward pressure expected in the short to medium term, realistic returns should certainly be sub-10%. UK 10-year gilts were also sub-1% at the time of writing, so even with Brexit-induced uncertainty, there is little room for yields to rise.

Looking specifically at S&P Parks, an equivalent yield of around 7% looks very attractive if it can be maintained. Based on what we know of the current occupational market, this represents what we might call a binary risk. Occupiers are focused more than ever on staff retention, and offices' role in that. Those parks with a strong transport and amenity offer will continue to attract tenants, but those that don't will struggle. It is hard to compete purely on a rent discount basis when there are far greater costs that occupiers face than real estate. Employment costs being foremost among them. We are seeing some parks roll out more ambitious food and drink offerings, with street food vans also being utilised in some parks to widen the offer and limit the capital expenditure being required of landlords. Our Office Futures research surveyed 1,000 London offices workers on their office and locational preferences earlier this year. From a location perspective, transport connectivity and the food and drink offer were far and away the most important factors for staff. Although this is a London-specific survey, the lessons should be the same.

2016 so far tells us that the strong rental growth seen on S&P Parks in 2015 has slowed, with six-month growth of 1.2% to Q2 2016. This is not a surprise given the uncertainty leading up to the EU Referendum, and the occupational market has not improved in the aftermath. Nor, however, is it in freefall. In addition much of the excess stock that acted as a drag on the market from the early noughties has been absorbed or converted. In summary, rental growth will probably be quite flat, but the steep declines of the post-2000 and 2007 periods appear very unlikely.

To conclude, it has remained the case for some time that there is little to choose between the performance of office assets on business parks in the Strutt & Parker, high quality, sample, and those on parks that sit outside it. Although the data shows some price premium for S&P Parks, and stronger rental value growth in 2015, it is quite small and lease length remains the primary driver of value. Although the current uncertainty is likely to focus investors' minds on income security, it remains our view that wider park quality in the long-run will prove itself more significant. Tenant demands are incrementally shifting towards greater leasing flexibility, and technological advances - especially in terms of mobile work equipment – are making it cheaper and easier to move office. For weaker buildings and business parks, a longer lease is often only delaying the inevitable. Conversely, a short lease on an attractive building, in a quality park, need not be seen as a certain risk to income. Real estate as a whole is getting used to the idea that most of the asset class is quite different to a bond, and understanding tenants' business needs is now fundamental to success. There is no reason for business parks to be any different.

Appendix: definition of key terms

Business park
According to Strutt & Parker, a business park is a large scale development conceived from a master plan and developed through the control of single entity. Among its attributes are low density developments in a highly landscaped environment with sufficient car parking to meet occupational needs. Further, an overall management structure applies across the development to maintain standards and be administered by a central body. In distinguishing the property within this index, Strutt & Parker considered a number of factors. No single factor was sufficient to characterise a development.

Total Return
The annual compounded rate of monthly capital appreciation, net of capital expenditure, plus monthly net income received expressed as a percentage of monthly capital employed. Note that annual capital growth plus annual income return may not sum perfectly to annual total return due to the cross product that occurs when capital and income returns are combined within compounded total returns.

Income Return
The annual compounded rate of net income receivable per month expressed as a percentage of the capital employed over the month.

Capital Growth
The annual compounded increase in monthly values, net of capital expenditure, expressed as a percentage of the capital employed each month.

Capital Values
Are those supplied by the Fund's external or internal valuers, in accordance with the RICS definition of Open Market Value, net of purchasers' costs.

Equivalent Yield
MSCI estimation of the discount rate which equates the future income flows to the current capital value. MSCI projected cash flows are estimated from records of current tenant rents, ground rents, open market rental values, rent review and lease expiry dates, and tenant options to break, assuming upward only rent reviews to expiry of the lease and that options to break are exercised when the tenant rent exceeds the market rent. Vacant or void units are assumed to be let over a period of eighteen months. Changes in the End-Year yield reflect changes in the composition of the portfolio covered by the MSCI, resulting from the effects of trading and development activity.

Yield Impact
An indicator of the change in capital values due to changes in the Equivalent Yield on standing investments through the year. Calculated as the Yield Shift expressed as a percentage of yield at the end of the year, with the sign reversed to show the impact on values.

ERV Growth or Rental Value Growth
The annual compounded increase in monthly estimated rental values expressed as a percentage of the rental value at the beginning of each month.

Estimated Rental Value (ERV)
The rent the valuer estimates could be charged if the unit were let in the open market on the valuation date.

Residual
That part of the annual change in capital values not explained by movements in rental values and yields and attributable to lags between changes in rental values and income due to rent reviews, or non-linear impacts of yield movements over the valuation cash flow produced by over-renting.

Notes

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80,000 sq ft owned by Legal and General Assurance Society Limited.

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