Buy City offices for steady income

Wednesday, 6th October 2010

Pick your property fund carefully for great rental yields

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CONFIDENCE in UK property has plummeted over recent months. The recent commercial property confidence survey conducted by Lloyds showed that almost half of property professionals now think that property prices will stay flat over the next six months (up from 36 per cent in May). So is now the time to ditch commercial property and sit tight?

The overall news does not look good. Of those expecting price movements in the Lloyds survey, most now expect falls rather than rises. Tellingly, despite anticipating a general fall, a larger percentage surveyed think that their own portfolios will rise. This should be a warning signal: fund managers can often be overly optimistic about their own picks.

Even so, there are clearly some good opportunities for investment in certain segments of the market, especially for those hunting income. But Frogmore managing director Paul White says that investors must remember to be picky: "There are two commercial property markets in the UK: central London and the rest of the country. Outside London, the market has still not found a consistent level and there remains a considerable overhang of properties to come out of the banks." White expects more distressed stock to come to market in the coming months, depressing prices.

But while the next few quarters are unlikely to see good capital growth, for the right property, funds can expect good rental yields to deliver a steady stream of income. Caisson Investment Managers' David Carter says that prime yields now range between 5 per cent and 10 per cent, with prime retail at the bottom of this range and City offices at the top: "There is a dearth of space in the City. At current take-up rates, there's only one year's worth of grade-A office space left, which is why rents are being driven up so quickly. People know that supply is shrinking and so they're willing to pay the higher rates to get hold of space. And banks wants to avoid lending on speculation, so the majority of new stuff coming onto the market is pre-let."

Even at the lower end of this yield range, commercial property far outperforms bond yields (see chart) and is on level pegging with many dividend-generating shares. As a result, Carter says that many cash-rich pension funds are diving into the market, pointing to Scottish Widows' recent purchase of 75 King William Street for around £60bn as an example.

Due to the unusually wide spread between bond and property yields, however, Chesterton Humberts urges caution in its October commercial property report. It expects property yields to drop closer to their average distance from bond yields, predicting a yield close to 4.85 per cent by 2014. But the firm expects this decline to be balanced by an increase in capital growth: "Stable growth and serious deficit reduction should decrease the risk premium on UK commercial property," its analysts write, "narrowing the spread to its long run average." In other words, there is a greater likelihood of capital growth than is being priced in by yields at the moment. So even if yields fall, values should go up. While this might not hold for properties in the north, many of which are let by the government, it should hold for the south.

Either way, investors looking for income in the short-term could do far worse than to put money into prime commercial property. The key is to stick to areas with high demand such as central London and to make sure you are targeting income – there is no point pricing an empty building out of the rental market just to keep its headline capital value high, as some pension funds are reportedly doing. But if a property fund can offer steady income, it is a solid option in uncertain times.

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