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Real estate income quality and investment performance

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Summary

Income is the principal foundation of real estate investment returns. For most markets and over the longer term, the vast majority of real estate return comes through income rather than capital appreciation. The income generating nature of real estate has become even more relevant given the recent global economic downturn and its aftermath, particularly for risk-averse investors. The high yields produced by commercial real estate have proved attractive relative to falling bond yields in the era of quantitative easing.

It is within this context that this short paper explores the relationship between real estate income quality and investment performance and risk, and more particularly how capital value is affected by the quality of income. The paper draws from research on four major markets, France, Germany, UK and the U.S., for which there is an increasing set of granular, asset-specific, income data that is available for analysis.

Although lease structures and valuation practices vary across these markets, the analysis clearly demonstrates the importance of two key drivers, the period remaining to lease expiry (WALT) and the quality of tenant credit rating, on investment performance. The paper also reveals important variations in the significance of income risk factors through the real estate cycle. The dynamic nature of these influences, coupled with their significance in driving investment performance, means income risk should be monitored and analysed on a range of dimensions including:

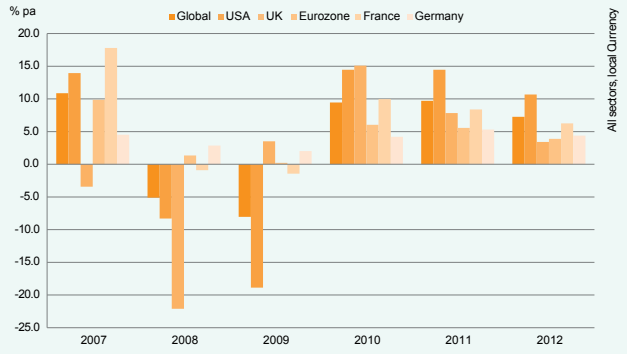
- Reversionary potential
- Weighted Average Lease Term (WALT)
- Tenant risk
- Tenant concentration

The relationship between real estate income quality and investment performance

The renewed focus on income

Through the economic downturn that followed the Global Financial Crisis, real estate markets went through a period of increased volatility, as shown in Figure 1. This period has highlighted the relationship between real estate income levels and performance, since income has been increasingly at risk from occupier default and vacancy in the harsh economic climate. On the one hand, investors have come to value real estate for its income generating features; but on the other, at a single asset level and across portfolios, that income has been put at increasing risk.

Figure 1: Real Estate total returns, U.S., UK, France & Germany, 2007-2012



Source: IPD

In the context of challenging economic conditions and more variable property cashflows, investors have increasingly demanded assets with secure income, leading to a pricing premium for such assets. Strong and stable income has thus not only contributed to the income return element of investment performance, but has also had a significant impact on capital values. This implies that income risks associated with each real estate asset are bound to play a key role in the level of performance produced by real estate portfolios.

The renewed focus on income and the weight of capital flowing towards income-producing real estate has led to a compression of cap rates, and income returns, since the trough of the global financial crisis. In most markets income returns now stand at, or close to, the lowest levels they have reached over the past decade or so (Figure 2). These low levels of income return raise concerns over the quality and duration of that return, particularly at a time of rising interest rates.

Figure 2: Income return ranges for main cities in the UK, France, Germany and U.S., 2005-2012

Source: IPD

The relationship between income and value theoretically depends on the level and length of cashflow, the risk of that cashflow being interrupted, and the likelihood of establishing a new cashflow once the existing one has terminated. These relationships vary between national markets due to differences in lease lengths and contract conditions.

Patterns of leasing risk and income security also vary through time, in particular as part of the real estate cycle. At times when occupier demand is weak and rents are falling, current and impending vacancy are likely to have a negative impact on future incomes and values; conversely, when demand is rising, vacancy will be a more positive influence as re-letting should be quicker and subsequent income higher.

Uncertain economic and financial market conditions have resulted in a greater emphasis on risk management in real estate investment. This has been reinforced by the effect of new regulations; in Europe the Alternative Investment Fund Managers Directive (AIFMD) in particular has bolstered the requirement for a systematic monitoring of risk in property funds. For real estate, there is now a strong awareness that income and capital risks are intertwined, and that these cannot be understood or managed independently.

The risk of unexpected loss of income

The existence of a lease contract guarantees a stable income from real estate over an agreed period. The most significant risk to the security of this cashflow during the lease period is from tenant default, when financial difficulties make it impossible for the occupier to pay the rent due – although property rent is generally high up the payment hierarchy in case of bankruptcy or administration.

The scale of this risk is small but significant. In France, for example, 3.4% of properties suffered a serious loss of income due to tenant default over the period 2008-2012, with an average loss of income per property of €91,000. Provision for such losses can be made across a portfolio based on this average, but may be refined and targeted through the use of credit risk scores. In the French example, 68% of defaulting tenants were in the 'high risk' category of Dun & Bradstreet tenant ratings in the previous year, compared to a 24% level of 'high risk' tenants for the market as a whole.

Figure 3: Properties with unpaid rents by tenant risk group, France offices 2009-2012

Number and cashflows end of assets for which rent was unpaid, by tenant risk of prior year

	Assets		Cashflow	
	Number	Share (%)	Amount (millions)	Share (%)
Low risk	163	32%	€10,3	22%
High risk	344	68%	€35,9	78%

Source: IPD

Note: High risk assets are those in which some of the contracted rent passing through the property in the next 12 months is from tenants with relatively high credit risk

The potential for using credit ratings as a means of predicting defaults was consistently strong in the French market for each of the four years between 2009 and 2012, and indeed particularly in 2010, one of the weakest years for the French economy, when 80% of properties for which the rent was unpaid were in the high risk category by credit rating the previous year.

Similar analyses for properties held within portfolios will show considerable variation in default risks, given the higher weighting of each asset and tenancy. The level of such risks may be managed over the longer term through letting and investment strategies.

Vacancy, letting and capital growth

IPD data confirm the anecdotal understanding that capital growth is generally stronger for properties with newly-let space than for those with newly-vacant space. Over the period 2004-2012 this was consistently the case for the UK, U.S. and French markets, confirming the message that effective letting strategies at a portfolio level benefit not just income returns but also capital growth.

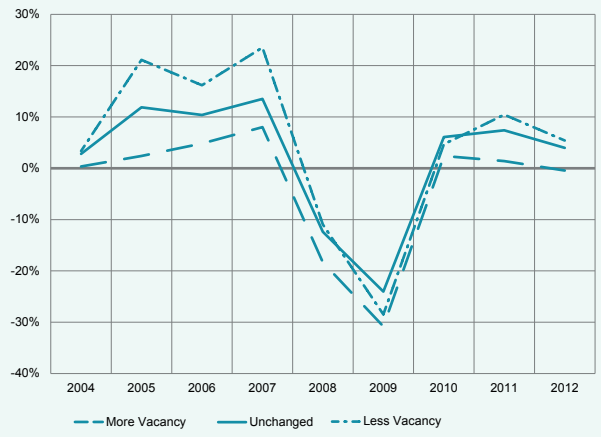
The risk associated with letting properties – both in terms of the potential loss of income from vacancy and the uncertainty of the level of income that will be achieved once the property is let – is thus reflected in the valuation process. The capital value premium for assets with new letting over those with new vacancy is clearly seen in the case of the U.S. market, but it is also evident that the difference in capital growth varies significantly through time, as shown in Figure 4.

The effect seems to have been strongest during the buoyant investment market of 2005-2007. This may reflect the fact that although the capital market was strong the rental market was more subdued, and the uncertainty of achieving the rental assumed in the appraisal was substantial, both in terms of the level and of timing of the eventual letting of vacant space.

During the period of declining capital values in 2008 and 2009, the premium for new letting over new vacancy in the U.S. was reduced, though still present. The Global Financial Crisis affected capital markets much more directly than rental markets, since capital flows were cut to a trickle compared to their previous levels; in terms of investment performance, the immediate impact was to capitalisation rates rather than occupational markets, and hit all assets across the market, irrespective of fundamental strength or weakness[1].

[1]As described in the IPD Research, "Private real estate: From asset class to asset" published in November 2013

Figure 4: Capital growth for properties with increased and reduced vacancy, U.S. offices 2004-2012



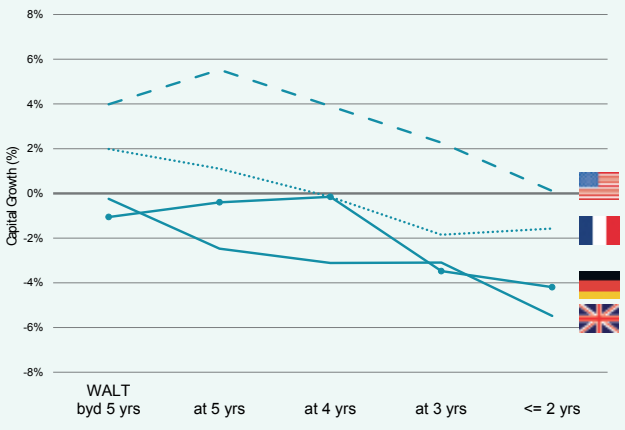
Source: IPD

Note: This chart shows the historical capital growth from 2004 to 2012 for three categories of offices: those with increased vacancy, reduced vacancy and those for which the situation remains unchanged.

Capital growth impacts during lease period

The risks associated with letting assets not only affect their value at the event of lease termination or break, but also through the course of the prior lease period as the event approaches. It has been possible to test this by comparing the value change for segments of the market with different WALTs (Weighted Average unexpired Lease Terms), as shown in Figure 5. This relationship is particularly strong (0.9) for the UK and France but it also exists in the U.S. (0.7) and Germany (above 0.5).

Figure 5: Capital growth by WALT for offices in the U.S., France, UK and Germany in 2012



Source: IPD

Note: Due to differences in the typical lease profile across markets, for this graph categories of WALT have been gathered for long and short leases. French and German results are based on properties with a standard erosion of their WALT.

The magnitude of this relationship is significant with, for instance, U.S. leases with a WALT at 5 years seeing capital growth of about 6% in 2012, a full 600bp higher than the 0% for those with a WALT within two years.

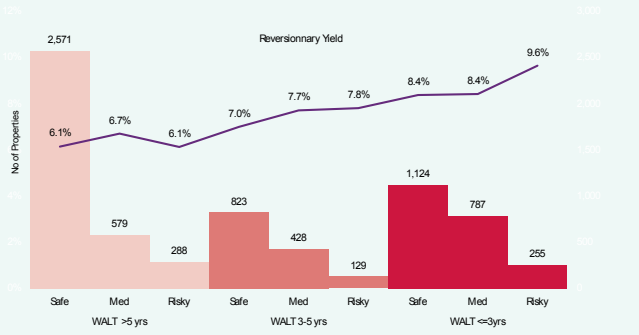
This pattern of an increasingly negative impact on capital values of the approaching lease end or break is evident internationally, with similar effects also seen in France. The impact in France is however less pronounced, perhaps because occupiers are less inclined to vacate at the end of a lease. Both in France and Germany, a capital growth premium is obtained for assets with leases where five years or more remain on contracts; this reflects the shorter standard leases in these countries.

Figure 6: Capital growth by WALT through the cycle, UK offices 2007-2012

Source: IPD

These relationships do however change over time through the market cycle. For example, in the UK in 2007, with market conditions still relatively buoyant, properties with predominantly shorter leases outperformed those with longer periods remaining to expiry, as shown in figure 6. However in 2008, when turmoil hit the capital markets, this picture rapidly turned around, with those assets facing imminent lease expiry written down most dramatically. This underlines the observation that short leases are more attractive in the upswing and less attractive in the downturn, and provides a quantification of the impact through the cycle.

Figure 7: Reversionary yield hierarchy by WALT and tenant credit rating, UK commercial properties 2012



Source: IPD

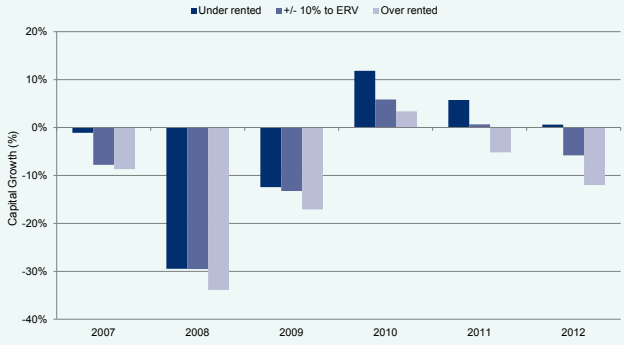
Although lease length (WALT) has an impact on performance, it is also clear, from Figure 7, that tenant quality is an important factor in differential pricing and performance. This chart compares the reversionary yield of properties with different WALTs and tenant quality. The tenant quality is based on the credit risk scores calculated by Dun & Bradstreet. The "Safe" category refers to properties with a Weighted Risk Score greater than 75, whereas "Risky" ones have a WRS less than 35. Unsurprisingly, those assets with WALT at three years or less registered the highest reversionary yields in 2012, whatever the credit risk of their tenants. Meanwhile those assets with WALT exceeding five years saw the lowest yields, irrespective of tenant covenant risk. On the basis of these three divisions of UK lease lengths, both WALT and risk scores are significant in explaining yields and therefore performance.

The weight of UK investment is heavily focused on longer leases with safe credit ratings, with this category representing a third of the properties analysed.

As also seen in the French example discussed earlier, the incidence of high-risk occupiers in institutionally-owned real estate is relatively small; but the impact on loss of income may be significant, particularly in the case of smaller portfolios. UK valuers, for example, appear to be quite sensitive to these covenant risks.

The values of properties which are approaching lease termination are also affected by their level of estimated market rent compared to the current rent. If the property has potential for an increase in rent on expiry – with market rent higher than current rent - this is likely to be reflected in stronger capital growth performance. Conversely those properties which are over-rented, with current rent higher than market rent, would be expected to perform less well. This pattern is seen in data drawn from the UK office market between 2007 and 2012.

Figure 8: Capital growth for properties with WALT 1-3 years by state of reversion, UK offices 2007-2012



Source: IPD

Figure 8 shows that this pattern existed for each year between 2007 and 2012, but that the range of impacts on capital growth varied depending on market conditions and the position in the real estate cycle. In 2008 and 2009, with the market in free-fall, the difference in returns for under-rented and over-rented assets on the approach to lease expiry was at its smallest. This was partly because the stalling capital market affected all properties equally, but may also have reflected a perceived increase in vacancy risk for all of these assets, whatever their reversionary state.

Conclusion

This research outlines the relationships between real estate income and investment returns across the major investment markets of France, Germany, UK and U.S. Although lease structures and valuation practices vary across these markets, the analysis clearly demonstrates the importance of two key drivers, the period remaining to lease expiry (WALT) and the quality of tenant credit rating, on investment performance. The analysis also helps to quantify the impact of different WALTs and tenant quality on investment performance and, as such, can provide some actionable insights to help reposition investment portfolios. The analysis also shows that these impacts vary through the cycle, so the strategy towards tenant quality and WALT should, potentially, be adjusted through the cycle.

It should be recognised that the impact of different WALTs and tenant quality on investment performance was somewhat muted through the recent financial crisis. This reflected the strong correlation of negative pricing movements across all assets and asset classes at this time; occupational market fundamentals exerted less influence on capital values.

Despite this, the overwhelming conclusion of the results in the paper is that real estate investors need an accurate view of their income security in order to gain a full understanding of the financial risks they face, not just from the viewpoint of potential fluctuations to cashflows, but also in relation to the likely impact of these changes on asset values. This can only be established through detailed analysis of tenant income risks at the portfolio level; the varied patterns of performance illustrated at the market level in this paper are likely to be heightened for most portfolios, given their smaller number of assets and the greater weight of each individual tenancy.

The paper points to four specific areas where the monitoring of real estate cashflows could help in driving stronger performance and reducing risks:

1. Reversionary analysis: during periods of both growth and downturn, reversionary analysis can help investors to anticipate future negotiations with current tenants or new tenants to maximise the cashflow of the asset in the context of market conditions and the position in the real estate cycle.
2. Weighted Average Lease Term (WALT) analysis: there is a clear relationship between lease length and capital growth; more specifically, properties with short leases experience significantly weaker capital growth than those with longer leases. The monitoring and management of WALT through time can provide valuable insights for strengthening performance and help insulate portfolios against weak capital growth.
3. Tenant risk analysis: risk score analysis should be run in parallel to WALT analysis to anticipate potential losses to cashflows. These losses could come from tenant defaults but also from medium and risky tenants that might be keen to reduce costs and therefore inclined to leave the property when permitted by the lease.
4. Tenant concentration analysis: a portfolio-wide analysis of tenant quality and concentration would help investors monitor real estate portfolio cashflows and risks.

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