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MONEY

'I manage £230m of UK property – offices are cheap but investors are twitchy'

Fund Of The Week: AEW UK Reit manager on the new 'ugly duckling' of the market

By **Danielle Levy**

Investing in Britain's commercial property market has required nerves of steel over the past five years. In the wake of the uncertainty created by the pandemic, interest rate rises increased the cost of debt and sparked the indiscriminate selling of real estate investment trusts (Reits) in 2022.

Despite these challenges, AEW UK Reit has been a standout performer. While many rivals cut or suspended their dividends during the pandemic, AEW has delivered an annual payout of 8p per share for close to nine consecutive years. Its share price is up 54pc over the past five years, which compares to a 16pc loss by rivals.

Henry Butt, assistant fund manager who works on the trust with lead manager Laura Elkin, believes the retail sector is through the eye of the storm and is no longer the "ugly duckling" of Britain's commercial property market. This title now belongs to the office sector, where he is spotting bargains.

The trust currently yields 8pc and trades at a 5pc discount to its assets.

How do you invest?

We look to buy properties which have a high income and then we actively manage them by refurbishing to improve rental income. When we buy properties, we look at the "vacant possession value" (the value of the property if it was vacant and available for a new tenant), as well as the "alternative use value". That means that if plan A as an office, retail unit or industrial fails and that property becomes vacant, we have the ability to move to an alternative use, like residential.

We typically buy properties with yields from 8pc upwards – that is important to us because we pay out a dividend of 2p per quarter.

What do interest rate cuts mean for the commercial property market?

We can see the light at the end of the tunnel, but we also can't ignore gilt yields reaching a 16-year high recently. This reflects inflation creeping back into the economy, with businesses paying higher taxes and therefore having to raise their prices. Naturally, that could have an impact because tenants may choose to downsize or have less appetite for new space.

Having said that, there has been a perception over the past year that we are at the bottom of the cycle and things will improve. I would expect there will be some exciting buying opportunities over the next six months, which bodes well for us. We recently sold the largest asset in our portfolio in December, the bulk of a retail park in Coventry, for £26.25m. We are looking to recycle that capital into new opportunities.

How will the Budget affect commercial property?

I think the obvious one is National Insurance, which is an increased cost for businesses. It will most likely have an impact on the casual dining restaurant sector, where margins are smaller, and potentially on the high street, which is a concern.

What do you think the future holds for retail?

I think the transition from the high street to online is embedded now. Having said that, I think people appreciate going back to the shops. Retail warehouses have fared well recently because of trends like click and collect, halfway between online and physical retail.

I think we have gone through the storm and retail is in a more solid place than it has been for the past 10 to 15 years, during which time it was seen as the ugly duckling. That is very much the office sector now, where there is most uncertainty because of working patterns. By comparison, I think we have pretty much figured out retail patterns.

Where are you seeing investment opportunities?

We are looking across all sectors. In leisure, there's a lot of yield to go after. The properties sit on larger sites, which bodes well if you want to convert them to an alternative use. We like chunks of retail in good towns and city centres. There is good income there and the potential to move these properties from retail to an alternative use, especially with the relaxing of the planning system.

Over the past 18 months we have been selling out of lower yielding industrial investments, crystallising strong profits and recycling them into higher yielding retail and leisure assets. Investors feel excited about the prospects for rental growth in the industrial market.

Meanwhile, entrepreneurial investors are entering the office market again. I think chief executives of large companies realise that if they want to retain staff and for their businesses to function as best as possible, having people in the office developing personal relationships is important. But in general, investors are very twitchy about the sector.

I think offices potentially could be an exciting prospect going forward. The caveat is they have to be in the best locations, the right buildings, and have good environmental, social and governance (ESG) credentials – that is what larger corporates want.

Have you bought any offices recently?

We are able to pick up investments that are being sold purely because investors are trying to move out of the office sector altogether. For example, we previously bought two mixed-use blocks in Bath in the wake of Liz Truss's mini-Budget in 2022 for a fantastic price.

What has been your best investment?

Eastpoint Business Park in Oxford, which we sold in 2022, stands out. We bought it for £8.2m in 2015. It was yielding 9.4pc at the time. The out-of-town office market with three to five-year standard office lettings wasn't the way forward, so we changed its use to life sciences. We let it out to a life sciences tenant on a 25-year lease with rent reviews linked to the retail prices index (RPI). It was sold for £29m, in excess of a 250pc premium to its purchase price.

What has been your worst investment?

We had an office in Glasgow where the location probably wasn't the best. We knew the way to maximise the exit value was to sell it to a developer for student accommodation. It was a poor performer because naturally when you are selling to developers, you have to run down the asset to a high level of vacancy. We had to take a short to medium-term hit while the income dropped off as tenants vacated. We bought the property for £12.2m in 2015 and sold it for £9.3m in 2022.