Aviva Investors Real Estate Conference 09

UK market - is the rollercoaster ride over?

Philip Nell

Philip Nell: Good morning. I'm Philip Nell, Head of UK Retail Funds at Aviva Investors, and I'm going to talk to you this morning about why I think the rollercoaster ride is over and, therefore, why I think it's time to focus on open-ended real estate funds today. I'm happy to take questions as we go along although I have left time at the end to cover anything you might want to look at. I'm going to focus on the Aviva Investors Property Trust, formerly known as the Norwich Property Trust, which is one of our two open-ended daily-priced retail schemes. It's a non-UCIT retail scheme launched in 1991, and it focuses on the UK commercial property market. It is highly liquid, having never suspended dealings in its 18-year life. It's highly diversified, being the largest fund in its sector by some margin, and it comprises a high quality portfolio managed by a skilled team.

So let's have a look at the rollercoaster. Well, as you can see from this slide, our cashflows over the last four years have been extreme. Between June 2005 and June 2007, the Fund saw around £2bn of net inflows, and between June 2007 and June 2009 the Fund saw around £1½bn of net outflows. Now those sort of cashflows are very difficult to manage, even for the most liquid of asset classes, but we must remember that real estate is traditionally a relatively illiquid asset class. Just to give you a sense of where our liquidity position was in June 2007, we had around £300m in cash and around £550m in listed securities.

At this point I think it would be useful also to cover pricing. Now the Fund moved from an offer price to a bid price on the 11th July 2007. Now that was the first time that happened in its history, and it didn't move back to an offer price until the 11th September this year. Now that demonstrates two things, firstly that the cashflows as shown by this slide have been enormous on an outflow basis and also the fact that we take price basis volatility very seriously; in other words, as managers, we weren't going to move the Fund back to an offer price until the risk of it moving back to bid had largely dissipated.

I thought it would be also useful to look at and compare our cashflows with capital returns for the market. Now, as you can see from the line on the graph now, the correlation isn't perfect. For example, in September 2008, when Lehmans' happened, we obviously saw significant down performance in terms of capital values, but there is a relationship between the two, and it looks like now that we're returning to both positive cashflow, we're also returning to positive performance.

We sold out of the listed market towards the end of 2007, and then over the two years between June/September 2007 and now we sold over 70 direct real estate assets for a total of almost £1bn. That amounts to sell almost every one to two weeks, which given the general illiquidity of the asset class anyway and the fact that we were experiencing

very, very low levels of transactional volumes, something like 10 to 25% of their normal, this demonstrates a very good access to market, we feel, and it was quite an achievement.

So what drove our sales strategy? Well, much like Michelangelo, we were starting with some strong fundamentals. We had a portfolio of 150 properties almost, which accounted for around 1½% of the IPD annual index at the time. We had assets in virtually every sector and sub-sector of the market. We had both growth stock and we had active management stock. So rather than just chipping away at the portfolio and not really having any sense of where we might end up, we decided to focus on a core portfolio of around a third of the size of the one we were starting with and build a strategy around that, decide what assets beyond that we were going to sell and when, and look at the macroeconomic cycles as well as the individual asset cycles to determine the best sell points for those assets.

First of all, we sold out of the City of London's office market in late 2007 off yields of between 5¼ and 4¾%. The slide here showing one of the buildings we sold at the time. Now those buildings today would probably be worth 25 to 30% less than we sold them. We then sold out of the regional office market, selling a building in Manchester, shown here on the right of the slide, at a price of 5¾%. Now that today would probably be valued at 6¾%. We sold some smaller assets where we felt performance attribution was weaker and where generally at the time lending was available. All through this process we did have an eye to liquidity and keeping the Fund open, but it was our bottom up strategy that really drove us towards that active management approach. That was the advantage really of starting with 145 assets in a £4.2bn fund. We could look at every sector, we could balance the portfolio as we saw fit, and we could create from these building blocks a portfolio for long-term sustained performance.

So what metrics might you use to measure a property fund? Well, the first thing to remember is that property is a discrete asset; every property is different. This property will perform differently and hold different risks, both upside and downside, from the one next door or the one opposite. Understanding real estate takes time and effort. We appraise every property that we own from a macroeconomic perspective, looking at the core drivers of those returns, tenant demand, economic rents, catchment fundamentals, but the real driver behind our investment decision-making process is a bottom up approach. Get in amongst it, talk to the tenants, understand their space requirements, these are all keys to driving the returns for individual assets.

So what next? Well, it's all very well having a good portfolio, but you must remember that property is a direct asset. It's real, it has substance, and it takes time, effort and knowledge to manage. It's all very well identifying asset management opportunities but unless you've got the team to deliver those they come to nothing. The slide here shows some of the team involved with the Fund, not on a 100% basis but those dedicated of fund day-to-day on a 100% basis total six property professionals with around 70 years of combined experience in the property market. Beyond that there's a team managing around £15bn of UK commercial real estate. Now that gives us enormous relationships and leverage with tenants, allowing us to extract maximum value for our clients.

So you've got a strong portfolio managed by a skilled team. Is that enough? Well, like with all investment funds, scale is important. If you want high alpha, then a small fund with loads of specific risk is probably your best bet, and there are a few out there with good management teams that I can recommend. However, the Aviva Investors Property Trust is about long-term sustained performance. We're not here to shoot the lights out. We focus on core and core-plus risk return profiles. So, for us, big is beautiful. The Fund is highly diversified with only 4% of the rents coming from our largest tenant and our largest asset accounts for only 5% of our balance sheet. We're also invested in virtually every sector and sub-sector of the market, as I said before, which gives us enormous spread across the country. Now the counter to this is we must be, therefore, some sort of index tracking fund, finding it hard to outperform the benchmark. Well, I prefer to think of us as an index-picking fund, a fund big enough to be able to invest in any sector or sub-sector and move out of those sectors where we feel performance is going to be weakest.

Now this map behind me shows where we own across the country, but it's a consequence of our decision-making process, it's not a driver of it. Just because we don't own something in Stornoway, for example, we're not going to go out of our way to buy something there. We do have an eye to regional diversification, but it's our bottom up strategy that drives us towards specific stocks in specific towns. As you can see around the map, there are some examples of some of the buildings we own, and having focused on a core portfolio we've ended up with a very strong portfolio built around some core and, in some cases, landmark assets.

So what sectors do we own in? Well, 43% of our exposure is to the retail market. Now 24% of that is made up from High Street and shopping centres; that compares to 23% shown in brackets for the benchmark. We're pretty happy with that exposure. It's pretty much on benchmark. We'd look possibly at increasing that in the near term as we can see some rents bottoming out in some of the strongest sub-regional centres. The rest of our retail exposure is combined with the retail warehouse market.

Now that's a market that's focused on larger unit retail parks, generally on edge-of-town locations and usually with good road access, and we favour those sort of parks with unrestricted planning consents where you can attract any type of occupier and create tension between them and therefore, hopefully, rental growth. We sold recently quite a few parks that had more restrictive planning consents where we felt that rental growth would probably be weaker. This again I think demonstrates our ability to focus on those assets that we think are going to underperform and not simply to sell assets for the sake of raising cash.

Our office exposure is split between West End and the prime regional centres. We have 13% of our, bench, sorry, start again - pressed the wrong button.

Now 34% of our office holdings, start again.

Now 34% of our holdings are in the office sector, 13% of that is in the West End of

London and 20%+ is in the regions, mostly in the strong prime regional centres. We have no exposure to the City of London's market save a small holding to the west of Liverpool Street Station; this is really a ransom situation between two competing landowners. The benchmark, as you'll notice from that slide, has 5% of its exposure to the City of London's office market. Now that's a market in the near term that we think will continue to underperform. Rents are under huge pressure, and whilst there might be some rental growth in the medium to long-term, we feel over the short term that's a market to be out of.

Our West End of London's holdings is positioned well for the recovery in three to five years' time, and our regional office holdings, we've held those where we felt that there was an active management potential. But as with Manchester that I showed up earlier we sold those assets where we felt the rents were under pressure. 13% of our holdings are in the industrial and distribution market. Now that's our most underweight position against the benchmark. Yields on that sector are now around 7% but rents very rarely demonstrate any strong rental growth fundamentals, and whilst you might be able to gain long leases in the distribution market, we feel at the moment an underweight position is right until yields return to a more meaningful level.

Finally, our last and probably largest overweight position is in the leisure sector. We hold probably double the amount of leisure that the benchmark holds. Now this is an area where we feel the investment fundamentals are strongest. Leisure schemes generally valued off pretty attractive yields at the moment, early to mid 8%, and they generally let on long leases. For example, our holding in Edinburgh has around 18 years average unexpired lease term. The rents were never pushed as hard as they were in some other sectors like retail warehousing, for example, and we are seeing rental growth. Again, on our Edinburgh holding, we're seeing rents growing of between 10 and 25%. Now that demonstrates very strong performance, and we think is not being reflected currently in the yields, so we're very happy with that overweight position.

At this point, I thought it would be useful to talk about a situation where we've really added value and also to show you that sometimes these things take quite a long time to deliver. This is a building that we own in Bracknell. We opened discussions with Cable & Wireless about a year ago to extend their lease. They'd just spent a large amount of money fitting out the building. Now those discussions were only concluded and completed about two months ago, so it took us the best part of the year to deliver it, but we extended that lease from a 10-year commitment to a 30-year commitment, so an enormous increase in length of lease and therefore value. We also introduced fixed uplifts into the rent, and we delivered all that for no capital outlay, and we offered the tenant and agreed with the tenant an 18 month rent-free period, and taking all that into account added around 17% or £2m to the value of that building.

So to sum up, well, it's been a pretty turbulent couple of years, but I think we've hung on in there, and we've done pretty well to add as much value in terms of quality to the portfolio. The key here is that unlike Mr Brown, for example, we haven't simply sold the nation's gold reserves to raise cash; we have kept the crown jewels. Open-ended property funds might be a bit of a strange structure for an asset class that is normally

relatively illiquid, but I think the industry as a whole has demonstrated over the last two years that it is possible to manage these funds, keep them open and also in some cases improve the quality of the portfolio within them.

So what are we going to do with our net cashflows going forward? Well, we're going to look at adding value to the existing portfolio. We have 74 assets, so we don't simply have to go out and buy new properties. It takes time to get under the skin of assets, and we feel we can deliver better value by focusing on our existing portfolio. We'll also look at the listed sector where we see value returning. There are some smaller stocks and specialist stocks where there's value now. Some of the larger capitalised companies are probably looking a bit expensive, but we will buy back in there. That sector does offer us obviously greater liquidity than the direct market.

Now, finally, our last sector is probably our most overweight sector. In the leisure market, we have about twice the weighting to the benchmark. But this is the sector where we feel the investment fundamentals are the strongest. Yields, for example, are relatively high, over 8% for prime stock. The rents are relatively low, having never really been pushed as hard as they were in some other sectors, and we're seeing rental growth in our holding in Edinburgh, for example, of around £2 to £4 a square foot which is very strong. Now they've also got generally long leases. Our Edinburgh holding, again, has 18 years average unexpired term.

So for all these reasons we feel that the yields currently reflected in this market don't represent the relative risks. One of the concerns amongst the market was that tenant default would be high here with consumer expenditure being put under pressure. Well, there hasn't been that tenant default over the last few years, and I think the tenants are trading pretty well, so we're very comfortable with our overweight position.

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