RESEARCH

Knight Frank

SPECIALIST PROPERTY
THE CORE MARKETS

2015

OVERVIEW | INVESTOR SURVEY | OUTLOOK

UK SPECIALIST PROPERTY INVESTMENT TO HIT £10BN

The weight of money moving into property has done more than simply drive down yields; the difficulty of securing "traditional" investments and the drive for diversification has pushed the spotlight onto specialist sectors. Automotive Property, Healthcare, Hotels and Student Property have now become critical components of investors' core portfolios, argues Darren Yates.

"Based on our in-house forecasts, Knight Frank estimates that investment in the core specialist property sectors will break through the £10bn barrier in 2015."

DARREN YATES
Partner, Commercial Research

While retail, offices and industrial property still dominate in terms of their share of investment portfolios, accounting for around 90% of the IPD Index in 2014, recent years have seen a significant shift towards specialist property sectors.

In this report we confirm the scale of this shift, and also the outlook for investment in these sectors. On pages four and five we reveal the results of the first detailed "Specialist Property Investment Survey" which takes the views of leading investors and developers, and on pages six and seven we analyse in detail the micro-market opportunities within each of the sectors recognised as making up the specialist grouping.

In terms of definition, specialist property continues to evolve as a segment in its own right, led by fixed income sectors such as hotels, healthcare and retirement accommodation, but also encompassing automotive, student property and even private rented sector (PRS) residential accommodation. However, it is important to recognise that fixed income transactions account for only a relatively small proportion of the total specialist market.

The key reasons for the growth in demand for specialist property relate to changing market requirements. Put simply, twenty years ago the demand for purpose-built facilities for the elderly or students was so much smaller than today. Strong growth in the ageing population and expansion in student numbers – combined with generally poor quality existing provision – has stimulated occupier demand for such assets which, in turn, has led to increased investor appetite.

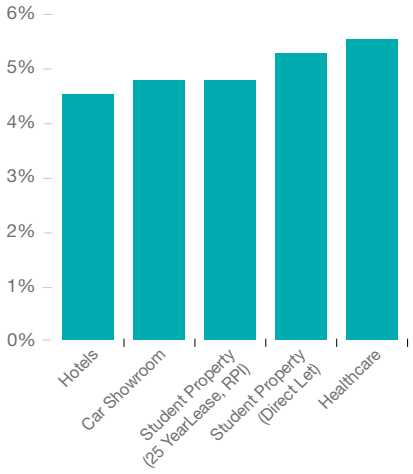
Another major reason for increased investor interest in specialist property has been the drive for diversification, particularly following the initial credit crunch of 2007/8 and subsequent recession.

Market conditions have improved significantly over the past five years, led by London and increasingly around the country. However, until recently much of the traditional market has been challenging in terms of performance and the ability to source good investment opportunities.

As demand and competition for investment product has risen, yields across the traditional sectors have been squeezed to such an extent that investors have sought alternative ways of protecting and enhancing their wealth. As a result, they have become more predisposed to looking outside the traditional property universe. Assets such as petrol stations, service areas, data centres and waste management facilities are therefore now playing an increasing role in property investment portfolios.

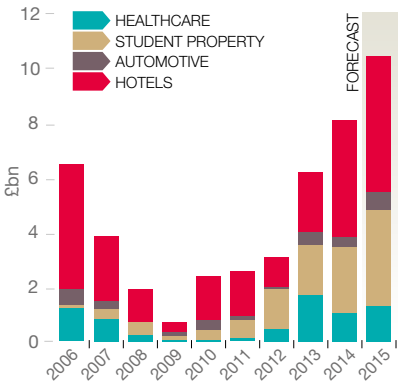
Now that the economic recovery is accelerating and indeed broadening out around the country, investors' appetite for specialist property is growing ever stronger. This is supported by a combination of improving occupier demand, easier access to finance, a broader understanding of operators' businesses and a willingness to accept greater risk. Indeed, it seems inevitable that investors will move further up the risk curve in search of returns, increasing their operational exposure to these markets through turnover-related leases, direct let and management contracts.

Prime yields



Source: Knight Frank

Specialist property investment volumes*



Source: Propertydata, Knight Frank
* excludes PRS

What makes specialist property "specialist"?

There are three key differences that tend to point to differences between specialist and traditional assets: lease duration, risk profile, and the structure of rental uplifts.

Historically, one of the key attractions of UK property for investors was the prevalence of long term (25 year) leases. While the average lease length across the traditional sectors has now declined to around six years on an equally weighted basis (according to IPD), many companies which trade from hotels or care homes for example often prefer to sign much longer leases. Equally, in the automotive sector, leases of 25 years plus are commonplace. Clearly, the nature of such leases offers a greater degree of income security for landlords.

Some specialist sectors offer a relatively lower risk profile, compared with some of the more established sectors. Arguably, student accommodation falls into this category, given the multi-tenanted nature of most student properties. It is also often the case that rental agreements with students are supported by a parental guarantee. Car parks might also be considered low risk, relative to other parts of the property market.

While rents on traditional retail, office or industrial assets are usually linked to open market rent reviews, it is common for rents on alternative assets to be linked to inflation or similar index, frequently with attractive caps and collars. This allows the tenant to fix some of their costs in advance, while giving the investor protection against inflation.

Rental evidence on alternative sectors has improved over time but, as with any emerging sector, it is often limited compared with the more traditional property sectors. Initial rents for alternative assets have therefore usually been based on the tenant's ability to pay or a a percentage of a sustainable EBITDA. This approach has been common in the hotel and care homes sectors. Typically, initial rents have been set at 60-80% of EBITDA, although levels can vary widely by operator and location. Conversely, in the vehicle dealership market, rents are often set by reference to a cost-recovery exercise, given the significant capital expenditure required to develop a bespoke facility.

On the downside, alternative investments often comprise properties which have limited change of use potential e.g. service areas, waste management or indeed a limited range of other potential occupiers. This of course heightens the risk, should a tenant leave or encounter financial difficulties. For some assets – including car parks – it is extremely difficult to add value through asset management and the emerging nature of some sectors means that there is a lack of data to assess historic and future performance. In contrast, some of the asset classes such as hotels have strong underlying fundamentals and potential alternative uses in the future.

To-date, a large proportion of alternative investment deals have been based around the "opco-propco" structure in order to maximise value. Indeed, some of the features discussed above – including long term leases with fixed uplifts – are a direct result of the "opco-propco" structure.

As with all emerging property sectors over the years, yields on alternative assets were high initially, but have hardened as investor interest has increased and some sectors have become more mainstream. As a result of the growth in capital values, many early entrants to the market have reaped significant rewards.

SPECIALIST PROPERTY CHARACTERISTICS

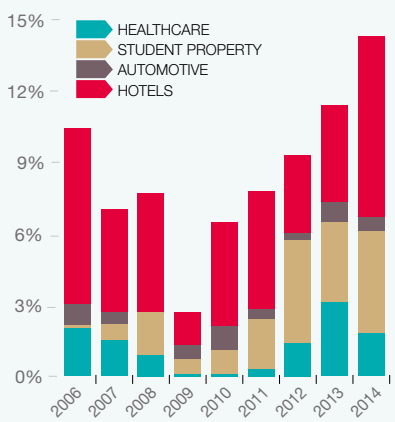
Opportunities

- Under-supply of good quality stock offers development opportunities
- Driven by structural rather than cyclical change, for example changing demographics
- Relatively high-yielding with potential for future yield compression
- The value of specialist property assets is closely aligned with occupational performance
- Sale & leasebacks with strong covenants/long term occupiers (albeit not in student accommodation)
- Value directly linked to the performance of incumbent businesses and therefore tenants often invest heavily in their sites to maintain customer appeal
- Anti-competition legislation, as in evidence in the vehicle dealership and motorway service area markets

Risks

- The multi-tenanted and operational nature of some specialist properties requires an intensive management structure
- Specialist nature of many properties means limited scope to add value/ change use
- Lack of market data weakens the potential for performance benchmarking
- Limited investor (and, in some cases, advisor) knowledge of specialist property
- Legislative changes can impact on the market, for example the potential for rent caps and mandatory fixed tenancy terms being discussed for the private rental sector, or the removal of spacing restrictions on the development of service areas

Specialist share of commercial property investment



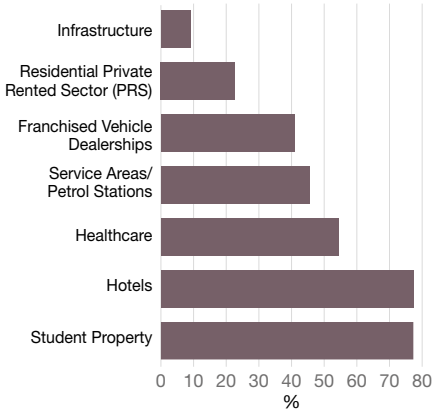
Source: Propertydata, Knight Frank

KNIGHT FRANK SPECIALIST PROPERTY SURVEY

In January 2015, we undertook a detailed survey of 69 leading investors, developers and lenders, with the aim of understanding their attitudes towards specialist investments.

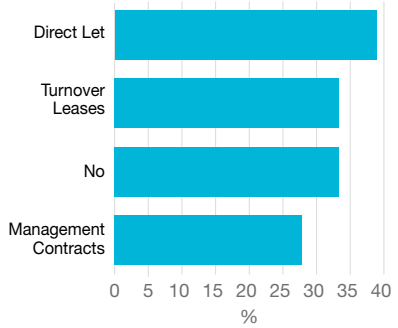
Our respondents have exposure to a diverse range of specialist sub-sectors, with almost 90% invested across multiple sectors. The wide exposure of our sample is shown in the graph below – all the specialist sectors are represented, albeit with a slight bias towards student accommodation and hotels.

Which (if any) of the following specialist property sectors are you currently exposed to?



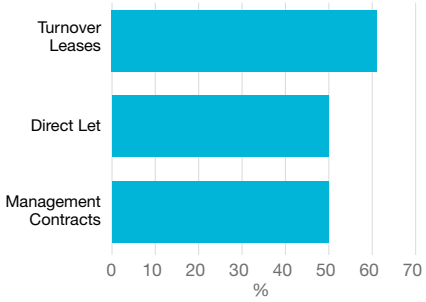
Some 38.9% of those who responded said they have exposure to direct let specialist property, while a third has exposure to turnover leases and just over a fifth are exposed to management contracts. However, a third of the sample has no exposure to variable trading income.

Do you own specialist property with trading (i.e. variable) income?



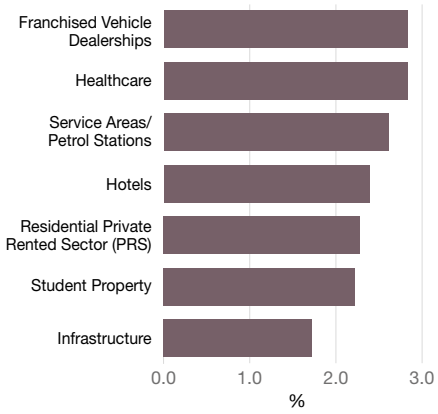
For those who do not own property with trading exposure, over 60% would consider property with turnover leases, while 50% said they would look at direct let and management contracts.

If you do not own specialist property with trading exposure, please state if you would consider any of the following?



Investors' perception of risk did not vary significantly across the various specialist sectors. The main exception was that infrastructure was perceived as being generally low risk (83.3% said low or very low risk).

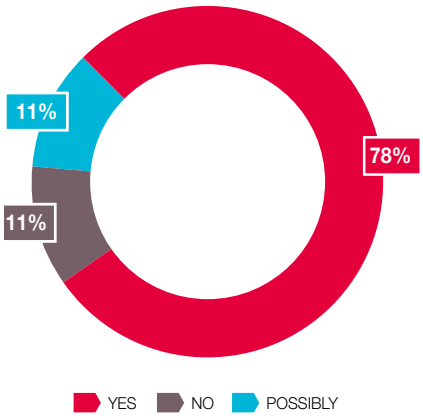
Perception of risk of investing in specialist property sectors (weighted average scores – higher number equals higher risk)



Over 20% said they thought healthcare, hotels, student property and PRS are all very low risk. However, healthcare also emerged at the higher end of the risk spectrum, with 5.6% perceiving it to be very high risk, which increased its overall perceived risk score. Franchised vehicle dealerships were also labelled very high risk by 5.6% of respondents.

The specialist property sector is set to grow strongly, with an overwhelming percentage of respondents (77.8%) saying they would be increasing their exposure to it in the next 1-2 years. Of those who will not be increasing their allocation to specialist property, all the respondents cited the fact that the sector does not match their risk/ return requirements.

Will you be increasing your allocation to specialist property investment in the next 1-2 years?



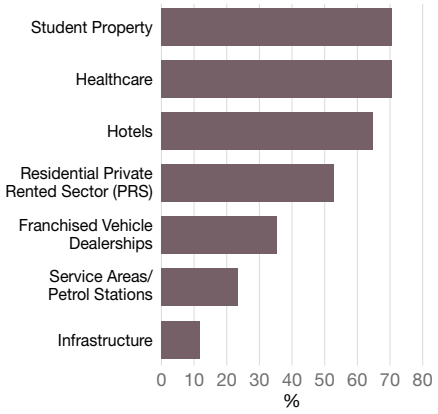
Investors are targeting a broad range of markets around the UK, albeit with a bias towards London and the South East. Interestingly, 23.5% said they would be targeting Continental Europe, indicating the growing internationalisation of the specialist property sector.

Source for all charts: Knight Frank Research

If you plan to increase your exposure to specialist property, which geographical area(s) will you be targeting?

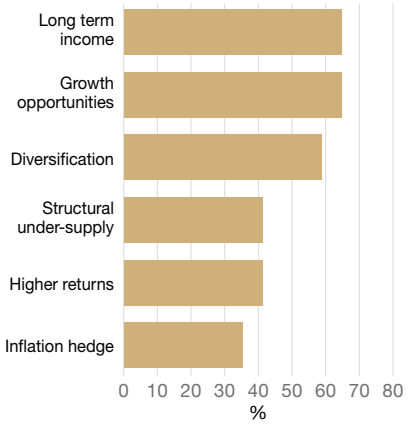
In terms of target sectors, student property and healthcare were the clear leaders, with over 70% of respondents saying they will be targeting these two areas. Hotels was the third choice among our sample, with 64.7% targeting this sector, while 52.9% said they would be looking at PRS. Some 35.3% and 23.5% said they would be targeting franchised vehicle dealerships and service areas/ petrol stations respectively.

If you are planning to increase your exposure to specialist property, which sector(s) will you be targeting?



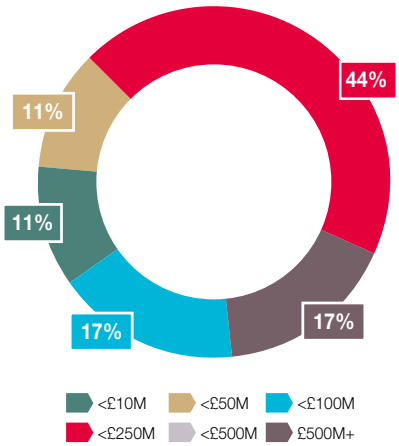
According to our survey, growth opportunities and long term income are the main attractions of investing in specialist property, with 64.7% of respondents citing these two factors. The opportunity for diversification was also popular, with 53.8% listing this as a main attraction of specialist property.

What are the main attractions of investing in specialist property sectors?



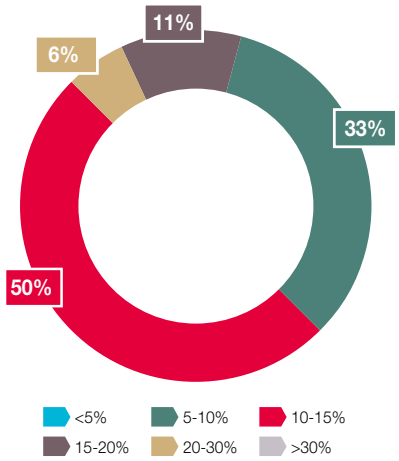
Based on the results of our survey, we expect investment activity in specialist property to increase steadily, with 44.4% saying they will invest between £100-250m, while 16.7% of our sample said they would be investing over £500m.

How much will you invest in specialist property in the next 1-2 years (total debt plus equity)?



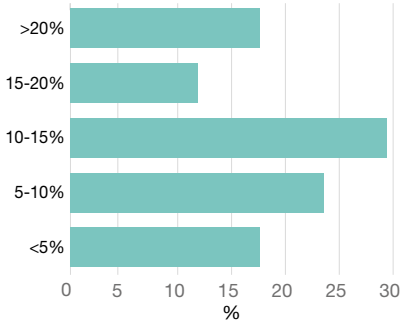
Without gearing, the vast majority (83.3%) are targeting returns of 5-10%, a standard range for property investment. Gearing clearly enhances the ability to generate higher returns, with 50% saying they will target returns of 10-15% and 11.1% saying they will target returns of 15-20%. Some 5.6% of the sample said they are targeting geared returns of 20-30%.

What are your return requirements from specialist property investments (geared)?



There was a range of responses on intended allocations, although the largest percentage said they would allocate 10-15% to specialist property. However, the importance of specialist property to investors is clear in that 17.7% said they would allocate over 20% of their property portfolio to the specialist sector.

Considering your entire property investment portfolio, what percentage are you aiming to allocate to specialist property investments?



KEY FINDINGS

Deal volumes to increase across all sectors

Further capital growth through yield compression

London to perform strongly, albeit with a continuing regional recovery

Quality of stock will continue to improve

Planning remains a key area of risk

SPECIALIST PROPERTY INVESTMENT – OUTLOOK FOR 2015

As our survey notes, appetite is increasing for investment exposure across all the specialist sectors. The risk for investors is that they will approach these sectors in an overly generic way, missing the opportunity to seek value from careful analysis of micro-market trends.

In this section we have pulled together the insight from our specialist teams to provide a guide to what to watch for in 2015.

HEALTHCARE

Best performing sector

Due to a structural undersupply of future proof assets and annuity grade covenants, the care home sector will likely be the strongest performing healthcare segment on the back of increasing demand.

New trends

New healthcare housing models in urban settings which bridge the gap between care villages and new operators will enter the sector, both domestically and from abroad. We also anticipate increasing brand awareness and new entrants to the sector

Top risks and opportunities

Specialist sectors, in particular mental health and learning disabilities, are sectors which are undervalued and offer potential gains through yield compression.

HOTELS

Best performing sector

In London, space efficient, funky hotel formats will continue to outperform the wider budget sector. Shoreditch will outstrip the West End in terms of operational growth.

In the regions, the conference market will return, while the Aberdeen hotel market will see the impact of lower oil prices, which may boost Edinburgh's prospects.

New trends

Asian hotel groups will continue their expansion in London, while the general market will see an influx of lifestyle hotel brands. The refurbished Lanesborough hotel in the capital may set a new record for Average Room Rate (ARR).

Top risks and opportunities

The demand for London trophy assets will be such that it may be difficult to justify some sale prices on a commercial basis. Elsewhere in the capital, emerging

hotel markets, including East London and Nine Elms, will continue to thrive. The weight of available money and the recovery in trading performance meanwhile will lead to resurgent demand for secondary locations across the country.

STUDENT PROPERTY

Best performing sector

The best performing student property segment in 2015 is expected to be the direct let market in London. Universities in the capital are performing very strongly, with increased student numbers, notably from abroad. Values in London already seem to be rising through yield compression and the prospects for rental growth are excellent.

New trends

One of the key trends emerging in 2015 is likely to be the strong growth in deal volumes, with at least £3 billion of student accommodation assets within established portfolios expected to change hands.

Top risks and opportunities

Major risks for the sector include the possibility of an increase in adverse planning decisions on student accommodation through the use of section 106, the Community Infrastructure Levy and social affordable housing requirements. High alternative use values may also restrict development in some areas.

AUTOMOTIVE PROPERTY

Best performing sector

Pricing for premium brand purpose-built dealership investments let to manufacturer covenants is at a record high, with strong demand driven by high profile trophy assets let on 25 year+ leases incorporating RPI uplifts. For the very best stock, yields are expected to harden further in 2015. Investors now fully appreciate that stringent manufacturer corporate identity standards require continual, and often substantial, tenant investment in their properties, resulting in rental and capital growth.

New trends

Due to a much improved understanding of sector dynamics, automotive opportunities are now very much on the radar for the vast majority of institutional funds; 2015 will witness the largest ever volume of automotive investment transactions in the UK.

Top risks and opportunities

Investors are expected to benefit from covenant windfalls on the back of consolidation among regional dealer groups trading with sought-after franchises, as a result of acquisition by UK majors, quoted companies and foreign dealer groups. In 2014, new car registrations reached a ten-year high and, in response, manufacturers are reviving long-standing site requirements. This will present attractive forward funding and sale and leaseback opportunities on bespoke assets, while it should also improve the overall quality of the UK dealership network.

"With its anticipated growth in market share, specialist property is expected to account for 20% of the overall commercial market within the next five years."

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