



# UK PROPERTY MARKET

## THE CHANGING NATURE OF UK PROPERTY

**We are observing significant and rapid change in the nature of commercial property as an investment class in the UK, leading some to question what form the market will ultimately take. In this brief note, we attempt to set the current observable changes occurring in the UK commercial property in context with the longer term evolution of property as an investment asset class in the UK. In this way, we can begin to see the current changes as part of a logical and secular trend which, in turn, might help us think how the UK property market might evolve.**

At least four major trends have influenced the nature of the modern UK property market. The first has been the transformation of landownership and property from a "social" to an "economic" relationship. Since at least the 17th and 18th century, the occupation and use of land and property have moved inexorably from being a "social" relationship – with common ownerships and mutually interdependent responsibilities between the classes of society – to a more economically-based landlord-tenant relationship, governed by fixed-term leases rather than by immemorial rights.

The second trend was the growth of urbanism and the resultant 'fracturing' of landownership. In land market terms, urbanisation led to the absorption and subsequent parcelling up of large areas of previously, often traditionally held, land through building leases, ground rents and the like. As the small towns and cities grew into the metropolises we know today, they constantly reconfigured themselves to accommodate growth. This led to the fragmentation of land ownership into smaller land parcels, typically bought and owned in Victorian times through the use of mortgages, either for owner occupation or onward renting.

This fracturing of ownership and the move to a more recognisable form of lease helped to create the investable and transferable set of rights which forms the basis of today's commodified form of property investment. These new assets were commodities of moderate lot size that could be traded reasonably widely, unencumbered by the social relationships that had governed land and property in earlier times.

The third trend, and here we are talking primarily about commercial property, came later, and was mainly a 20th century phenomenon in the UK. This was the move from owner occupation to specialised landlordism and renting.

Competitive capitalism creates "specialisation" and concepts of "core business" for commercial enterprises. In the UK, this has been at the root of a century or more of "sale and leaseback" activity where owner occupiers have sold their property assets to raise capital to reinvest

back into core businesses in the belief that this will generate higher returns than remaining as amateur landlords. Retailers led this trend in the inter-war period and UK property companies and institutions were at the forefront of buying such assets.

The final trend in the modern era of property is the increasing "equitisation" of property. It is a commonplace to talk of UK property as an "equity-bond" hybrid. However, it is easy to forget just how dramatically UK property has moved from being a "bond-like" asset to an (albeit illiquid) equity asset.

In feudal times, tithes were often fixed nominally in perpetuity – a right to occupy for ever. In modern times, as the table below shows, leases were initially extremely long in duration with fixed levels of rents. Even by the mid 1950s, the average rent review period was still typically 50 years and leases often 999 years in length.

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Inflationary pressures in post-war Britain and the rental growth dynamic of the post-war UK property market soon led UK landlords to want to capture uplifts in rental value while staving off the debilitating impacts of inflation on fixed income based, long leases and, as the table below also shows, rent review periods (and leases lengths) fell dramatically.



### Shortening Rent Review Periods

Date	Rent Review Period (yrs)
1955	50
1960	21
1965	14
1970	7
1975	5
1978-1993	5

Source: Peter Scott (1996)

Hence, by the early 1970s we see a UK commercial property market with lot sizes capable of being bought and sold as unencumbered commodities by "professional investors". We had 25-year leases, with 5-yearly upwards only rent review patterns, and we had property as an emerging "third" investment asset class for investing institutions to diversify into. At this time, the main forms of exposure to commercial property risks and returns were through direct equity ownership, through commercial mortgages and, indirectly, through property company shares.

### Not quite a "modern asset"

Property has come a long way from its feudal roots but still, comparative illiquidity makes it relatively problematic to transact. It remains lumpy and heterogeneous which frustrates universal ownership, excludes investors from the market and makes risk control more difficult than for other asset classes.

Property is a hybrid equity-bond which helps provide diversification benefits but it also makes it something of a "mongrel" asset for investors wanting pure bond or pure equity exposures.

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In short, property in the 1970s was a tradable and commodified asset but was neither a "modern" asset for the professional investor nor investable by the retail investor. As such, much of the change we witness today is the result of pressure to make property more accessible and more modern.

In direct property, the "equitisation" trend continues, as lease lengths fall steadily with terms of trade gradually shifting towards greater choice and a less adversarial relationship between landlord and tenant. Shortening leases provide even more equity-like forms of direct property than historically. However, there are also other more bond-like (often inflation proofed) forms of indexed leases to interest pure bond investors. Sale and leasebacks continue to increase the investable universe.

### Private to Public: Four Quadrants

	Equity	Debt
Private	Direct Property	Commercial Mortgages
	↓	↓
Public	Property Company shares REITs	CMBS

Source: PRUJIM

Clearly, securitised property, in the form of property company shares, has been around in the UK for a very long time. However, after years of trying, and many false starts to find appropriate tax efficient forms, it appears that, with REITs, a long journey towards the atomisation of property to improve access and commodification is nearing completion.

At the same time, we are seeing the long-awaited emergence of securitised debt in the form of Commercial Mortgage Backed Securities (CMBS) which is helping drive the cost of property-related borrowing down.

More recently, in emulation of other asset types, we have seen the ultimate passive diversifier – property index-based derivatives – evolve to allow investors to buy and sell the performance not of individual assets but whole markets without bothering with actual properties at all.

### Conclusion

Without doubt, profound changes are occurring in the UK commercial property market. However, these developments need to be seen in context with a much longer secular trend towards making property more commodified, more liquid, more universally accessible, more homogenised and, recently, more tax efficient, more "modern" and more like other investable assets. ■

## — ABOUT PRUPIM —

PRUPIM is one of the leading real estate investment managers in the United Kingdom. We form part of the M&G Group of Companies which is the asset management arm of Prudential plc in the UK and Europe. We manage around US\$37 billion of real estate assets, of which US\$6 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with approximately 6,000 property occupiers. We manage real estate investments for a wide variety of clients, providing core services and expertise in fund management, asset management and property management. These services are offered individually, or on a fully integrated basis.

Our major activities are driven by powerful research, managed by the Global Property Research Team. Our considerable scale and diversified activities allow us to draw on our own multi-dimensional inputs which give us an unrivalled information advantage. We evaluate the macro-economic environment working as part of the global research capability of Prudential. We receive detailed property related data generated by our on-the-ground surveyors. This is fed into proprietary modelling systems which form the basis of our analysis. The 10-strong Global Property Research Team was formed in 1987 and is comprised of property economists and performance measurement analysts who work together to provide leading property analysis and commentary on the UK and international property markets.

## — PROPERTY RESEARCH TEAM —



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