Henderson Global Investors

Henderson Horizon Pan European Property Equities Fund

European Property Equities – The Facts

Despite recent underperformance and negative press, Patrick Sumner, Head of Property Equities at Henderson Global Investors, still believes there is plenty of life left within property equities.

Recent falls within certain property equity markets has seen some market analysts predicting that the party is over. At the beginning of April, the performance of property equities started to diverge from that of the general equity indices. Since then the FTSEurofirst Index has returned 6.5% and the Henderson Horizon Pan European Property Equities Fund has fallen 3.3%. Of course this has to be seen in the context of previous performance. In the past four years, to the end of 2006, the Henderson Horizon Pan European Property Equities Fund had delivered a return of 37% per annum and the FTSEurofirst 18%. Certainly not time to press the panic button just yet.

It seems that this year the general investor, who accounts for the majority of the liquidity and pricing in the property equities sector, has moved on to other sectors. This is because they believe that the valuation shift - in both the underlying property market and the listed stocks - has run its course.

It is futile to argue whether this view is right or wrong, but it is important to understand the state of property markets at present, where possible misconceptions are coming from, and to explain the underlying reasons behind recent underperformance.

Property markets still showing signs of strength

The two most important property markets in the listed sector are the pan-European shopping centre sector and the major office markets of London and Paris. Income growth in the retail sector is traditionally stable, rising in line with inflation and protected against downturns by the scarcity of prime retail locations. Office markets are more volatile, but London and Paris are experiencing strong rental growth that is expected to continue for at least two years before supply can meet demand.

Henderson's forecast total return from (unleveraged) pan-European commercial property in 2007 is 13%. Offices are expected to do better than retail, with London predicted to give a total return in the region of 20%. Property yields have fallen everywhere in the world, reflecting growing investor demand as well as lower expectations of returns from other assets. We do not believe that they are likely to fall further - on average. However, we do believe that they will fall further for prime assets with the best growth prospects, while they will rise for some secondary properties.

Commercial property misconceptions

Investors often make the mistake of assuming that residential and commercial property markets are equally affected by inflation and rising interest rates. House prices are directly affected by changes in interest rates, especially if the majority of loans are at floating rates. Commercial property is, by contrast, less highly leveraged and is financed at rates fixed for longer durations - typically five years. In addition, commercial rents are often explicitly linked to inflation, and even if they are not, typically show a strong correlation. There is therefore good reason to compare property yields not with standard bond yields, but with those of index-linked bonds.

Property stock valuations

There are some glaring disparities between valuations in the UK and those in other European countries. The UK index is currently trading at a weighted average discount of 5% to its net asset value (NAV), and the five largest stocks (all REITs and accounting for 63% of the sector by market cap) trade at a 13% discount. By contrast, French stocks are trading at an average 30% premium to net asset value, while Dutch and Swedish stocks are trading at a premium of 20%. Granted, the NAVs are probably an understatement of real market value, but this does not explain the discount in the UK, where the market outlook, supported by the strong London office market, is positive.
(Source: Merrill Lynch, Henderson Global Investors, May 2007)

We had expected that the UK general investor might be replaced by specialist funds from overseas, especially from the US, where institutions have been allocating substantial sums to global REIT funds. This has not had a noticeable effect on the UK, partly because it is the biggest and most liquid market in Europe and it takes a lot of money to make an impact, but more significantly because the exchange rate currently deters dollar investors.

Market mispricing

We believe that we are going through one of those periods when investors have lost sight of the fundamentals. Four years of strong outperformance, some unexpected inflation in the UK, a bursting of the Spanish bubble, plus an assumption that rising interest rates will seriously damage returns, have combined to send general investors looking for profits elsewhere.

It is clear from market and media reaction to results and statements from property companies that they are not prepared to take notice of any positive indicators. A "slow-down in NAV growth" (CEO of Land Securities) is interpreted as "price falls". When the CEO of Great Portland referred to the risk of an oversupply of office space in the City of London office market in 2010, this, rather than the positive outlook for the West End market, was the headline of The Times' report.

While UK stocks are down 10% this year, the rest of Europe is up 4%. In the longer run performance has been similar (34% and 33% p.a. respectively 2003-06). There is a perception among direct investors that Continental Europe offers better investment opportunities than the UK, and in some cases this means better returns. However, to a great extent it means that the UK is a seller's market, whereas buyers have greater chances in Europe. Asian property stocks are up strongly this year, suggesting that US investors are bypassing Europe in favour of markets with currencies more closely aligned, or relatively weak compared to the dollar.

In short, we are optimistic about future growth in several key markets in the developed economies of Europe, while at the same time there will continue to be a variety of opportunities in the emerging economies of Eastern and Central Europe - including Germany.

Portfolio positioning

Fund managers learn to ignore the market average, because it tells you very little about the performance of the individual property companies it includes. Our job is to pick the best, because each company will buy and sell, develop and manage to a variety of standards. In terms of portfolio positioning, we continue to find good investment opportunities, especially in smaller companies, so the underperformance of the big UK stocks has been offset by very strong returns from minnows such as Nanette (+32% since March), Dolphin Capital and Michaniki (both up 29%), Sjælsø (+17%) and Icade (+16%). As a result, the fund is down only 1.8% this quarter, while its benchmark index is down 4%.

Henderson Global Investors

Henderson Horizon Pan European Property Equities Fund

Portfolio positioning (continued)

The fund remains overweight in the UK stocks, especially in those exposed to London offices. Of the top ten stocks, three are London office specialists and another three have very significant London office exposure. Of these six, only one (Minerva) has made a positive contribution to performance since March. The biggest bet (against the benchmark) is in London office specialist Great Portland Estates, which makes up 4.7% of the fund and which this week reported NAV up 35% in the year to 31st March. We are forecasting a further NAV growth in the region of 20% for the current year, yet the share price is down 9% this quarter.

Market View

It is a persistent feature of investor behaviour that people buy markets that are rising and sell markets that are falling. This would work if markets were rational and information perfect. Since this is not the case, the opposite behaviour is often the most rewarding. We do not know how or when the market will reprice, but it may well happen as a result of a bid for a major UK company.

Our firm view is that this is a necessary cold shower for property equities. Interest rates are rising in order to curb inflation and prevent economies and markets from overheating. This inevitably causes corrections in share prices, but if we focus on the fundamentals rather than get distracted by short-term volatility - the equity market "noise" - markets will sooner or later revert to sensible pricing.

Patrick Sumner, 25 May 2007

Note: The Henderson Horizon Pan European Property Equities Fund is available for sale in Singapore, Hong Kong and Taiwan. The Singapore authorised Henderson European Property Securities Fund is established as a feeder fund, investing directly into the Henderson Horizon Pan European Property Equities Fund.