Food for Thought

By: Peter Bill (September 2022)

Picking gold pieces in London puzzle

Let's puzzle the investment case for the London office market by starting with a quote from leading London investment agent Chris Brett, quoted in the Financial Times in May. Chris warned, that aside from the upper reaches, what's coming is "the biggest truck hitting the office market you can imagine". Warning that the shift to hybrid working, rising interest rates, inflation and tighter energy regulations are building into a terrible accident waiting to happen.

The bear case

The often-quoted 'flight to quality' is underway. Sure. Not often quoted is the fact that for every 70 sq ft of new space leased tenants tend to vacate 100 sq ft of old space. The wind under the wings of this flight are Energy Performance Certificate (EPC) regulations, which rate buildings like fridges. From E to A, from worst to best. New leases cannot be signed after 2027 unless the rating is C: By 2030 the rating has to be B.

Estates Gazette predicts 24 million square feet of London office space has yet to meet these mandatory ratings, which become operative next April with the need to prove the property meets the minimum 'E' rating before any new lease is signed. 'Hope value' is also dimming. Counting on getting planning to double or treble the floor space is getting harder. Pressure from conservationists to refurbish rather than rebuild is growing.

Final growl

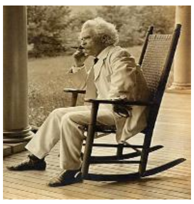
Manhattan vacancy rates have doubled since 2019 and now stand at 21%. In San Francisco almost a quarter of office space is vacant. The Central London leasing market 'remained buoyant in Q2 2022, with 2.6 million sq ft let.' Says JLL. Indeed. This is the 'flight to quality' in operation. What is not highlighted is the fact that leasing buoyancy is not shrinking vacancy rates, which remain stable at 7.8%.

The bull case

London offices remain over 90% occupied. Listen to a contrarian investor. Prestbury Holdings chief executive Nick Leslau, 63, who has built up a £400 million fortune investing in real estate over 40 years. He told website Bisnow last month, 'I once read that the time to sell is when there is nothing but bright light at the end of the tunnel and the time to buy is when there is nothing but darkness there. That has worked OK for me.'

'As to when is that time to buy, the answer is when others are running scared and until you have a strong sense of the recovery prospects of a particular asset.'

The good news is of course anyone who is anyone in the London investment market is aware of the bad news. Little of what I have said isn't being said across a thousand lunch tables. Which means bad news is being priced in. In late September, Schroders' said the rise of the key five-year Swap Rate to 3.6% from 2.45% in a year suggests values will fall 15% by December 2023. A perfectly reasonable forecast given the current circumstances.

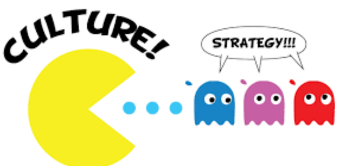


Mark Twain

Which can also be read as good news, if you are a disciple of fund manager, Howard Marks, who quotes Mark Twain in his September newsletter: 'It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.' The 76-year-old American founder of Oaktree Capital, which holds $159 billion of assets under management is not keen on forecasters: 'self-interest causes them to act in a certain way, and self-justification enables them to stick with it in the face of evidence to the contrary.' I would not presume to give advice on what or where to buy. But the central London market is as varied as it is large. Office stock stands at 283 million square feet, aged from zero to 100 years old, parcelled in sizes and lease lengths of infinite variety, up to 90% producing decent returns. If someone you trust comes along with a deal that works for you, tune out the noise. The next 12 months could be a time to move in while others move out.

ESG – Easy to Sound Good

Easy to Sound Good? Attempts by the genuinely good to promote ESG property investment are being undermined by irresponsible funds re-badging products to promote or sell with their wares, property included. A reminder: E for Environment – don't pollute the planet. The S is for Social – play nice with your own people. G is for Governance – be ethical, charitable, restrained. That is supposed to be the strategy. But as management consultant Peter Drucker once said, 'culture eats strategy for breakfast'.



The practice of 'greenwashing' - dipping existing funds in a mild solution of ESG - is now the subject of an inquiry by the Securities and Exchange Commission. The US regulator is mulling a rule that will require money managers who label funds 'socially responsible' 'sustainable' or 'green' must have invested 80% of said assets in ways consistent with a provable, pre-set strategy. 'You should know that all ESG funds are not the same,' was the frankly limp warning to the market from the SEC last month.

Because who can prove what is quite another matter. Bloomberg estimate world-wide ESG-labelled funds will contain $53 trillion of assets by 2025, about one-third of total Assets Under Management. Is all this money being tended by cultured, sharing tree-huggers? Of course not. 'Many ESG funds are doing very little of anything in fact, as they are quasi-index funds with minor tilts and with no engagement/stewardship capabilities,' says Harvard business school professor, George Serafeim in his new book: *Purpose and Profit.*

The idea that the 'S' and the 'G' can be regulated and policed is frankly fanciful. It is the 'E' that surely matters. Should not ALL funds be discouraged from investing in environmentally damaging assets? Why badge a few? As George Serafeim concludes, 'In my opinion, eventually, there should not be any ESG funds. ESG analysis should simply be part of good corporate and investment management.'