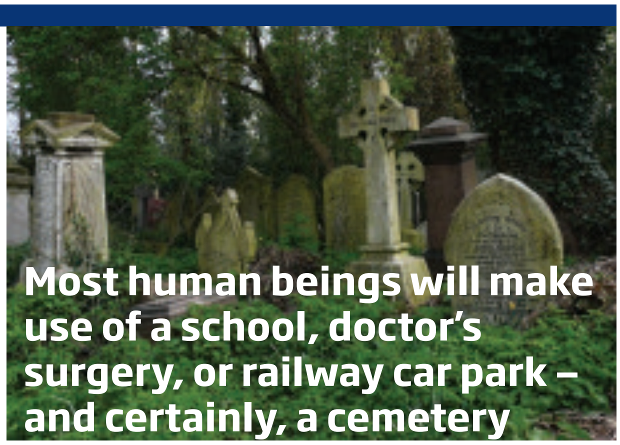
CITY VIEW Hugo Llewelyn

Cradle-to-grave property is a core business



"Alternative" real estate, which is gaining in popularity among UK institutional property investors, is alternative by name, but not by nature.

Alternative assets are labelled so, only because they are not retail, industrial, leisure or office investments. These asset classes include: accommodation (market, social, student and elderly housing); social infrastructure (the assets facilitating the provision of healthcare, education, transport, energy and waste management); storage (domestic and commercial, energy related, vehicle and boat); government property (law courts, prisons, army barracks); and assets linked to death (cemeteries, funeral parlours).

These alternative assets loosely make up the real estate that society needs to function physically at a most basic level and are, therefore, anything but alternative. I consider them to be the "new core" asset classes, rather than "alternatives", and believe that they will more and more become part of the mainstream universe – perhaps more so than, say, high street retail or shopping centres, as the services provided from them are increasingly delivered through the internet "virtual estate" and other physical needs-driven uses take their place.

It is far more likely that most human beings will make use of a school, doctor's surgery, or railway car park – and certainly, practically speaking, a cemetery or graveyard – than they will enter a multi-let industrial estate or distribution shed. The latter are core to the workings of society, too – it is just that the former are not really alternative (other than alternative to offices, industrial and retail, which now seems a rather outdated way of expressing them).

In defining "core" here, we do not mean this in terms of risk (as in core, value-added and opportunistic investment), but that such assets are core to society's continuing physical needs. These assets' risk profiles are not always core or low risk. It is possible to take on high, medium or low risk with these asset classes. For example, speculative care home development is high risk. Unleveraged investment in doctors' surgeries is generally low risk. Gearing, of course, changes all risk profiles, however secure the income stream is considered to be.

Researching and investing in these sectors has led us to examine two critical aspects of this new core investment class: the understanding that the owner/investor must have of the actual operation or service taking place at that property and the physical infrastructure in place to allow them to use it.

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In traditional asset investing, the key criteria for analysis have been along the lines of: functionality for other users at the market rent (homogeneity), obsolescence, tenant covenant and lease length. While these all remain important in the new core sectors, a further level of analysis is required. This is because in the case, for example, of leased student housing and care homes, the investor is just one step away (at lease end, bankruptcy or prepack administration of the tenant) from becoming the operator itself. If the tenant goes unexpectedly, the investor will still have to deal with the end users in the property who are likely to remain in occupation, unlike in the case, for example, of high street shops. Consequently, the investor needs to have a detailed understanding of the dynamics of the operation and the tenant's business plan; to have controls to take back the management of the business operation if rent cover drops (as a result, say, of tenant under-investment and falling profitability); and, of course, to be comfortable with affordable rent levels and uplift mechanisms in place at the outset of a sale and leaseback, if the covenant is anything short of governmental.

Second, investing in these areas has made us think much more carefully about the relationship that end users have with the property investments that we own – again looking past the leases – and the importance of understanding their ongoing requirement for such property, before making an investment. If they stop wanting to use our assets en masse, the investment is in trouble, however strong the tenant covenant.

Property ubiquity

Looked at from the other end of the telescope, most people do not give a second thought to the land on which they are treading and the buildings that they are using, although they will cease to use such land and buildings if they become surplus, virtually available or where there are more important demands on their time.

In fact, from the moment they step from their house, drive to the railway station, park, get on the train, pop into the doctors, arrive at the office, shop or factory where they work, go home via the gym, pick up the children from school, get home, all this time they are utilising either private investments or public sector ownerships, each with a capital structure in place set up to benefit economically from the interaction between that person's use and the cost levied for using it.

Our conclusion has been, therefore, that it makes sense to invest in assets where we understand why the users are using the asset. This is perhaps intuitively easier when we ourselves have been users – students at university, relatives of those in care homes, patients at the doctor's surgery.

It is our view, though, that one generally takes more operational risk in property than intended, whatever the sector in today's market; that property investment is for the most part more akin to taking equity than bond risk; and that, as a consequence, applying some "alternative" thinking will help the 21st-century property investor navigate the markets, whether alternative, new core or traditional.

Hugo Llewelyn is managing director of Newcore Capital Management