

# Schroders

## Does prime property always outperform?

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Although prime, secondary and tertiary are terms which are widely used by investors to grade the quality of individual properties, they are highly subjective and lack precision. One investor's prime property is another investor's secondary. This paper uses a framework of six specific risks to create a set of working definitions for prime, secondary and tertiary. We estimate that only around 10% of properties in investment portfolios are prime and the majority are secondary, or tertiary. The paper then considers how the relative performance of prime and secondary property is likely to change over the course of the property cycle, as rental incomes move at different speeds and as the gap between prime and secondary yields fluctuates, according to investors' appetite for risk. Our key conclusion is that prime property is unlikely to consistently outperform and that investors should periodically rebalance their portfolios between prime and secondary property in much the same way that they switch allocations across different sectors of the market.

### Definitions

If we start from the premise that a prime property is one where the future rental income stream is relatively secure, then it is possible to create a set of working definitions. If we ignore general market fluctuations in open market rents caused by the economy and by development activity, then the future rental income on an individual property will depend upon six main variables. The first three depend upon the current tenant, the current lease and the change in open market rental values since the start of the lease, or the last rent review. The fourth, fifth and sixth variables relate to the physical attributes of the property and its ability to attract and retain tenants in the future, once the current lease has expired.

- Covenant strength. Is the tenant likely to become insolvent and default on the rent?
- Lease length. How long is the unexpired term on the current lease and does the lease include a break clause?
- Over renting. Is the current rent above the open market rental value (i.e. over rented), equal to the open market rental value (i.e. rack rented), or below the open market rental value (i.e. reversionary)? If the lease is over rented then the landlord is likely to suffer a fall in rent when the current lease expires and either the lease is renewed, or the unit is relet.



- Location. Is the location highly sought after by occupiers, or is it on the fringes of the main commercial area? Is there a large stock of vacant or under utilised space? Are there strict planning controls limiting new development, or is the planning regime relatively loose?
- Specification. Does the building meet occupiers' latest requirements in terms of its external appearance, internal layout, energy efficiency, waste and water recycling, connectivity, etc, or it is an old building which is suffering from obsolescence?
- Sustainability. Sustainability is a distinct criterion, although it is heavily influenced by a building's specification and by its location and proximity to public transport.

Using this checklist we can define a prime office as a new, energy efficient building in a central location with good public transport which is let to a financially strong tenant on a long, rack rented lease. The definitions of prime retail and prime industrial are slightly different, reflecting the overriding importance of location in the retail sector (e.g. old shops in cathedral cities) and good road access in the industrial sector. While investors in prime properties are still exposed to general market movements in open market rental values (i.e. systematic risk), the risk that the rent will fall due to factors which are building specific should be relatively low.

At the other end of the scale we can define a tertiary property as one that fails on all counts, or almost all and where both the building's physical attributes and the income are compromised. An extreme example would be a derelict building with a negative site value.

That leaves a large spectrum of secondary properties in the middle. We can split secondary properties into two broad types. First, secondary properties which have a strong tenant on a long lease, but either the building's specification, or its location are defective. A typical example would be a 1970s office let to a government department with a long, unexpired lease term. We will call these properties secondary grade B. Second, good buildings in decent locations, but either the unexpired term on the lease is relatively short, or the covenant is weak. A typical example would be a modern, well positioned retail unit let to a good retailer, but with only three years left on the lease. We will call these properties secondary grade A. (These two types of secondary property are roughly analogous to hardware and software faults on computers).

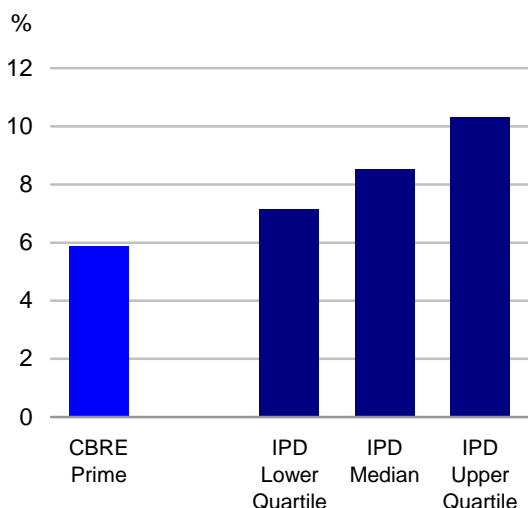
Yet, while this typology provides some good rules of thumb, it is not truly scientific in the sense that it eliminates all ambiguity and leads to a precise definition of prime. For example, one short coming is that there is no objective rule about how long is a safe unexpired term. When the economy is strong then most investors would probably regard a lease with 5-7 years until expiry as acceptable, but when the economy is weak and tenant demand is sporadic then most investors would probably only feel comfortable with a lease with at least 10-12 years to run.

Another limitation is that the specification of a prime building gradually morphs over time as companies adopt new technology and working practices and as regulations on health, safety and environmental issues develop. In addition, changes in building materials and in aesthetic values means that the appearance of buildings gradually becomes dated. Furthermore, prime locations can some times lose their status as competing new developments, or new transport infrastructure increase the attraction of fringe locations and in the office sector, the importance of a prestigious address appears to have gradually declined over the last 20-30 years, as companies have put more emphasis on building specification and on having all their employees "under one roof".

### What percentages of properties are prime?

Given the lack of precise definitions, it is difficult to say exactly how the stock of UK investment property breaks down between prime, secondary and tertiary property. However, it is possible to arrive at some ball park numbers, if we assume that the IPD databank is broadly representative of investment property in the UK.

**Figure 1: Property Yields, end 2009**



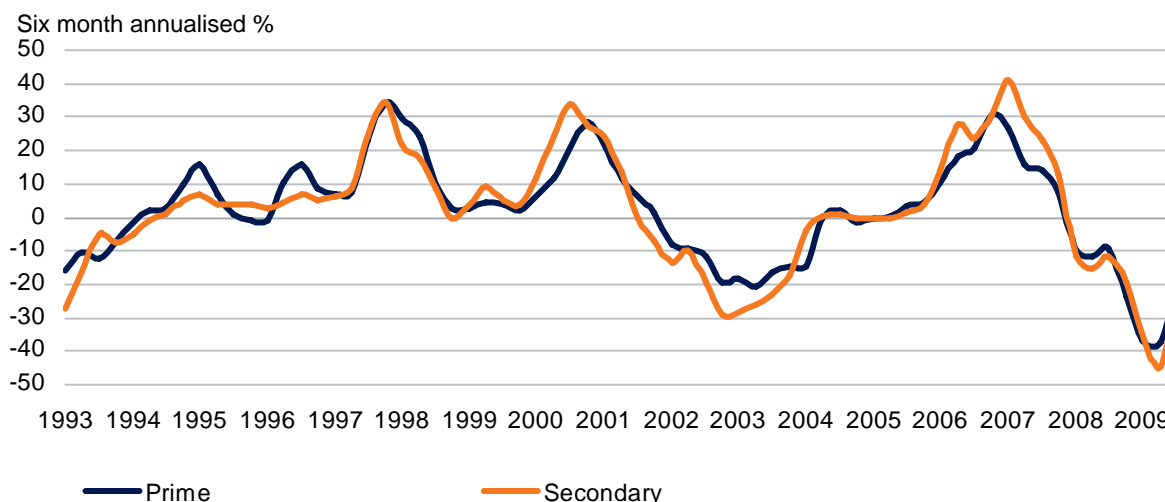
Source: CBRE, IPD. February 2010

Figure 1 compares CBRE’s prime yield with the lower quartile, median and upper quartile of equivalent yields in the IPD at the end of 2009. (In theory prime properties are rack rented so the initial and equivalent yields are identical. 25% of properties in the IPD sample had an equivalent yield above the upper quartile and 25% of properties had an equivalent yield below the lower quartile). Given that CBRE’s prime yield is below the lower quartile, it is clear that less than 25% of investment properties by number are prime. If we then assume that the range in yields is normally distributed, we can estimate that only around 10% of investment properties by number are prime. Note that this could be an over estimate, if the IPD sample is biased towards prime properties. Please also note that prime properties’ share of the total value of investment property in the UK will be much higher, given that they have the highest capital values per square foot and that they also tend to be relatively large buildings.

By extension, we can estimate that 90% of investment properties by number are either secondary, or tertiary. Unfortunately, there are no obvious markers to fix the boundary between the two, but if we assume that any property with an equivalent yield over 10% in today’s market is tertiary, then we can estimate in very round terms that approximately 60% of investment properties are secondary and 30% are tertiary.

## Headline rents

**Figure 2: City of London Headline Office Rents**



Source: CBRE, November 2009

Figure 2 compares the changes in prime and secondary headline office rents in the City of London since 1993. (CBRE does not compile a rent series for tertiary properties). The data are headline rents which exclude rent free periods and other tenant incentives. In broad terms prime and secondary offices in the City have followed the same rental cycle over the past sixteen years, suggesting that they are heavily influenced by the same overall demand and supply forces. However, it is possible to identify some minor variations:

- Prime offices have tended to lead the initial recovery in rents, but then be over taken by secondary offices in the later stages of upswings.
- The starts of the downswing in prime and secondary rents have been almost simultaneous. There is no evidence that prime rents initially hold up better than secondary, or vice versa.
- Secondary office rents have tended to be slightly more volatile than prime office rents.
- Over the long term prime office rental growth in the City has exceeded secondary office rental growth by between 1.25 and 1.5% per year. The gap reflects the impact of obsolescence on older buildings and is a crude indication of the rate of depreciation<sup>1</sup>.

These subtle differences in the timing and volatility of prime and secondary headline rents presumably reflect the fact that prime offices initially capture most of the demand as the economy recovers. However, the stock of prime buildings is limited and if the upturn in the economy is sustained tenants then have to accept space in secondary grade B properties where either the building's specification, or its location is suboptimal. That spill over of demand leads to a sharp percentage increase in rents at the secondary end of the market, albeit from relatively low levels.

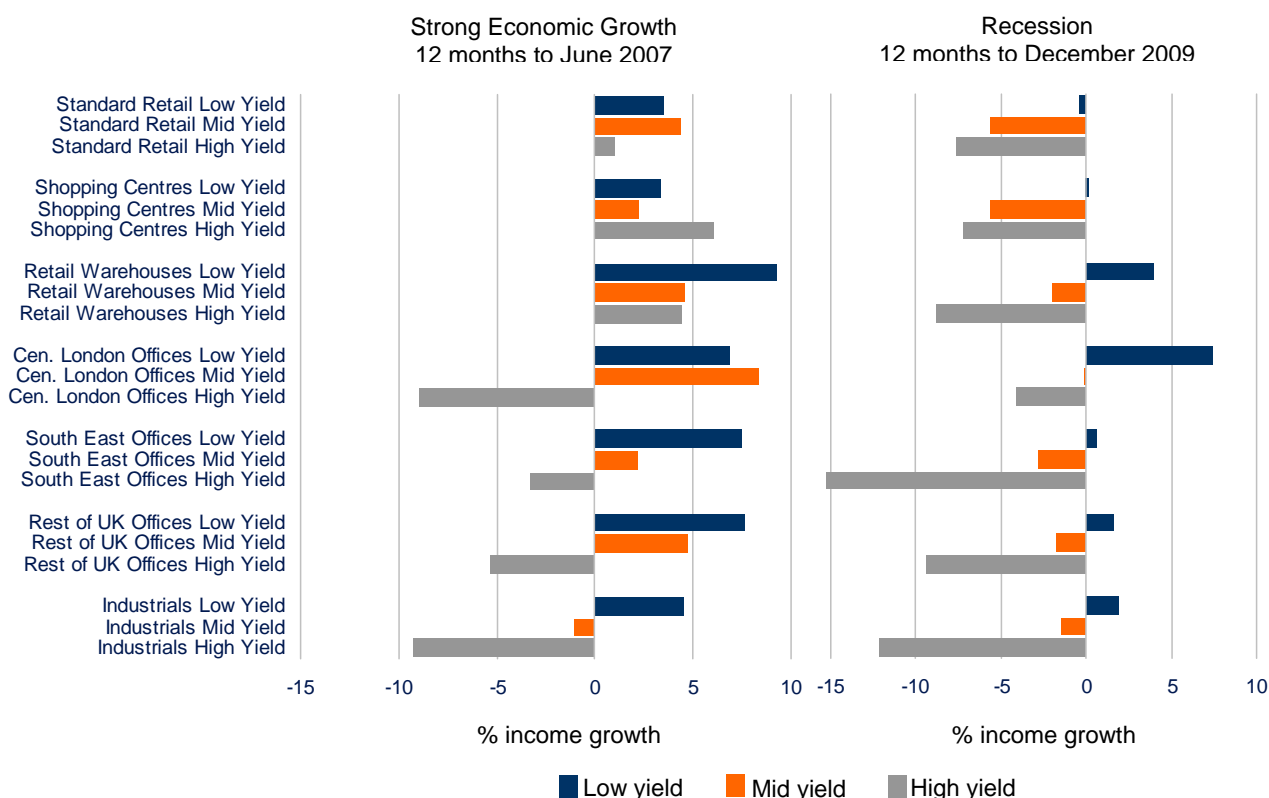
Conversely, in a downswing when there is a lot of vacant space, tenants generally opt for prime buildings and prime headline rents fall slightly less than secondary headline rents, even though affordability has become a key issue. (By the third quarter of 2009 prime office rents in the City had fallen by 35% from their peak at the end of 2007, whereas secondary office rents had fallen by 39%. CBRE's data show a similar pattern in the West End).

1. For further analysis please see "IPF Research Report: Depreciation in Commercial Property Markets", July 2005

### Net rental income

However, one major caveat to the preceding analysis is that it only covers headline rents and does not also take into account concessions to tenants, defaults, over renting and vacancies. While there are no published figures on exactly how these factors vary between prime, secondary and tertiary property, it is possible to gauge their impact by looking at IPD data on changes in net rental income. Figure 3 shows net income growth in each of the main property segments, split between properties with equivalent yields in the lowest quartile, properties in the middle 50% of the yield range and properties with equivalent yields in the highest quartile. We estimate that the lowest quartile is split roughly equally between prime and secondary properties, the middle 50% consists mainly of secondary properties and the highest quartile is tertiary properties. The left hand chart covers the twelve months to June 2007 when the economy was growing rapidly and the right hand chart covers 2009 when the economy was in recession.

**Figure 3: Property Net Rental Income Growth**



Source: IPD Quarterly Index, February 2010

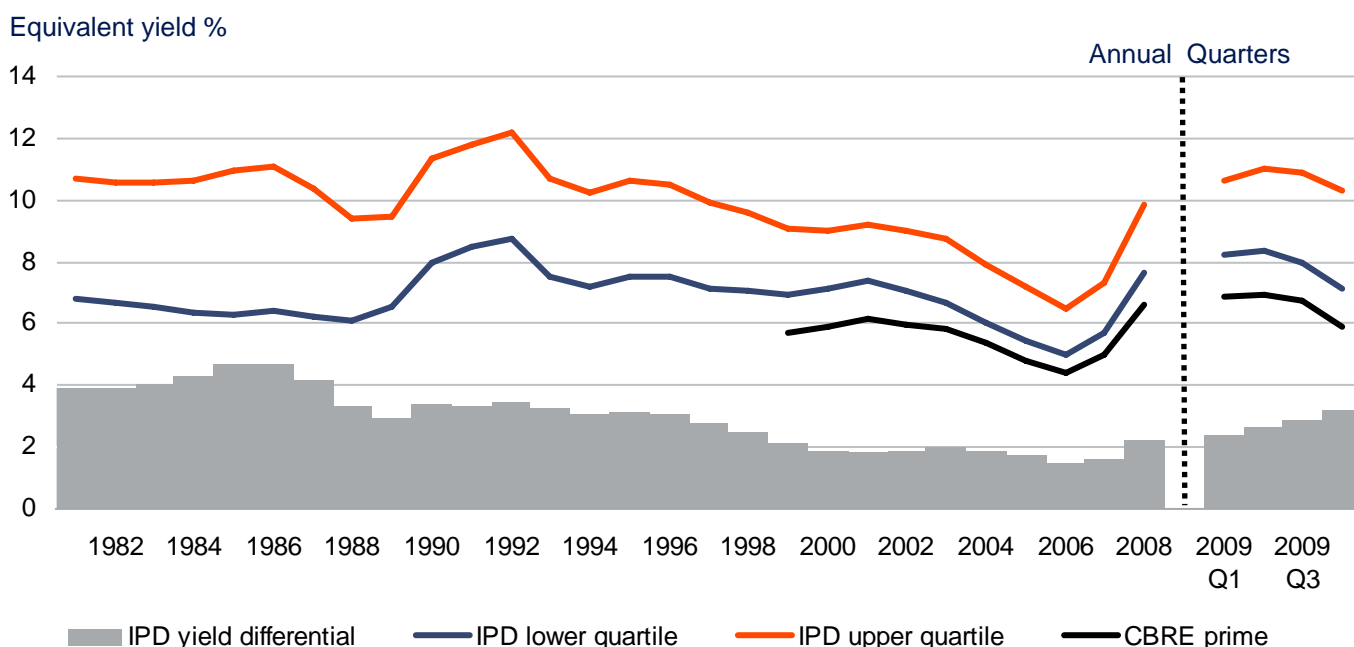
Although the IPD data on net rental income growth are slightly erratic, they highlight the fact that headline rents only tell a part of the story. While headline rental growth on secondary property may exceed that on prime in the later stages of an economic upswing, income growth is unlikely to be stronger and may lag behind (see left hand chart above). This might be because secondary property is initially more over rented than prime, so that faster headline rental growth does not feed through to larger increases at rent review, or it might reflect the fact that landlords of secondary grade B properties have to give bigger incentives (e.g. rent free periods) in order to win tenants. The relatively strong income growth on tertiary shopping centres between June 2006 and June 2007 was probably due to intensive property management cutting vacancies.

By contrast, during a recession while the income on prime properties holds firm, the income on secondary and tertiary properties falls (see right hand chart). For the most part this is because secondary and tertiary properties generally have shorter leases, so that there is more opportunity for tenants to leave when their lease expires, resulting in higher vacancy. It also seems likely that secondary grade A properties and tertiary properties with weak tenants suffer more insolvencies.

**Investor sentiment and yields**

Of course, one of the key attractions of secondary and tertiary property for investors is that the future risks to the income stream are offset to a greater or lesser extent by a high income return today. The income return on a property, which is akin to the dividend yield on an equity, is largely a function of the equivalent yield, although it is also affected by concessions to tenants and vacancies. Figure 4 shows the lower and upper quartiles of the range in equivalent yields in the IPD sample. Since 1981, the inter quartile range in equivalent yields covering the middle 50% of the distribution has averaged 290 basis points.

**Figure 4: Range in Property Equivalent Yields**



Source: CBRE, IPD Annual Index 1981-2008, IPD Quarterly Index 2009, March 2010

In addition to the income return, the third key influence on the relative performance of prime, secondary and tertiary property are changes in the yield differential, as investor appetite for risk shifts over the cycle. The differential started to narrow in the second half of the 1990s and between 1999 (the start of CBRE’s data) and 2006 the gap between prime yields and the upper quartile of the IPD range (a rough proxy for tertiary property), compressed by 130 basis points. In the process, this favourable rerating added approximately 1% per year to the capital growth and total returns on tertiary property relative to prime property over the seven years to 2006.

Surprisingly, perhaps the inter quartile range barely changed in the first phase of the financial crisis in late 2007 and in proportionate terms, prime property yields actually rose by slightly more than secondary and tertiary property yields. One explanation for this apparent anomaly is that prime properties remained relatively liquid and valuers therefore had more market evidence of rising yields at the prime end of the market than in either the secondary, or tertiary tiers.

However, as the recession intensified through 2008 and the first half of 2009 the inter quartile range in yields widened rapidly as investors became increasingly risk averse. Likewise, the revival in investor demand since mid-2009 has been focused on prime and secondary grade B properties with secure income streams and whereas prime yields fell by 125 basis points in the second half of 2009, yields at the tertiary end of the market fell by 70 basis points. This rerating deducted around 3% per year from total returns on tertiary property relative to prime property between the end of 2007 and the end of 2009.

Some commentators have suggested that the sharper correction in secondary and tertiary yields since 2008 marks a return to normality and that the narrowing in the yield range between 1996 and 2006 was an aberration, caused by over exuberance among investors and lax lending by banks. However, what the IPD history reveals is that a similar phenomenon occurred during the late 1980s boom, but was then reversed in the early 1990s recession. Looked at from this perspective the period from 1996 to 2006 appears to have been just part of the normal ebb and flow of investor appetite for risk and it seems probable that at some point in the future the range in yields will narrow again, boosting the relative performance of secondary and tertiary property.

### Active management

The other key attraction of secondary and tertiary property for investors is the potential to add value through various forms of active management. In the case of secondary grade A properties this will be limited to negotiating lease extensions, cutting vacancies and replacing weak tenants with strong tenants. By definition, tertiary properties are much more challenging and typically they will also require refurbishment, or even redevelopment. In general these initiatives work best during periods of strong economic growth when there is healthy tenant demand, although many schemes have also succeeded through periods of weak economic growth. A strong economy is not therefore a prerequisite. The opportunity to redevelop and refurbish buildings will usually depend upon planning laws (e.g. listed buildings). The one immutable feature which investors cannot improve is a building's location.

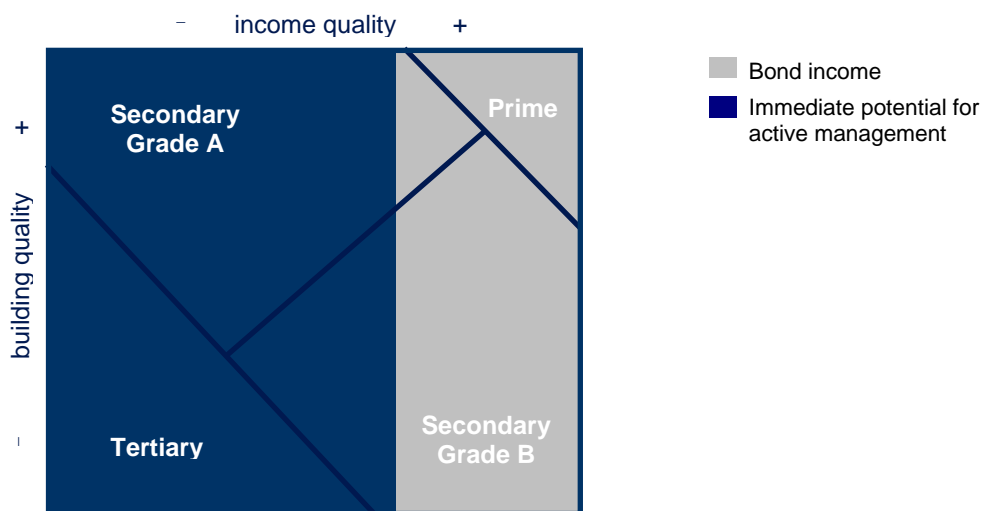
By comparison, prime properties are relatively passive, or "dry" assets and their investment performance is largely dictated by market movements in rents and yields (albeit with a prime bias), which are outside the control of individual investors.

### Investment performance

Figure 5 attempts to provide an idea of the relative size of the prime, secondary and tertiary tiers of the property market and their investment characteristics, in the style of Mondrian. The vertical axis of the box refers to the quality of the building, while the horizontal axis refers to the security of income on the current lease. Over time properties will slip down the box and drift from right to left as obsolescence increases and the unexpired term on the lease gets shorter. However, it is possible to reverse this migration either fully, or partially through active management.

- Prime buildings offer the best of both worlds, delivering solid income growth during upswings in the occupier market and secure bond like income during downturns.
- Secondary grade B properties with long leases and strong covenants offer secure bond like incomes during downturns. Their lower specification, or less attractive location, means that income growth is likely to be weaker than on prime properties during market upswings and they are likely to require refurbishment when the current lease expires.

**Figure 5: Investment Characteristics of Prime, Secondary and Tertiary Property**



Source: Schroders, March 2010

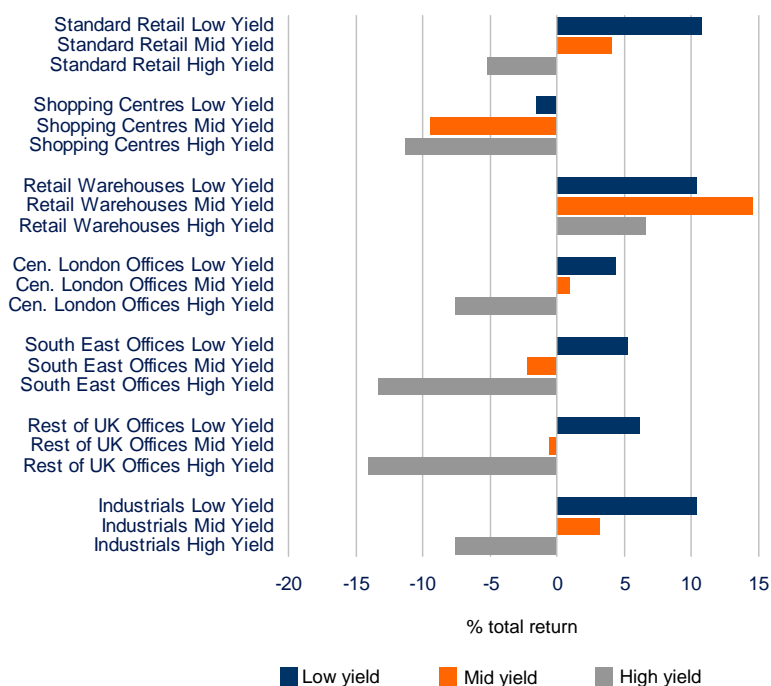
- Secondary grade A properties offer less income protection in a downturn. If either the tenant defaults, or the lease expires during a downturn then they are likely to be relet at a lower rent. By contrast, secondary grade A properties may achieve similar income growth to prime properties during an upswing, if the leases and tenants are actively managed.
- Tertiary properties offer the worst of both worlds. They are most likely to suffer vacancies in a downturn and are unlikely to achieve income growth in an upswing without both refurbishment and active management of leases and tenants.
- Inevitably, competition among investors for prime properties means that equivalent yields are lowest in the top right hand corner of the box and highest in the bottom left hand corner. The income return will generally follow the same gradient, although in a downturn the high level of vacancies in tertiary properties could mean that their income return falls below that on secondary properties.

While we cannot pin point the performance of prime property, the available evidence suggests that it outperformed the rest of the property market by a wide margin in 2009. Figure 6 uses IPD data to show how total returns within each part of the market varied in 2009 according to equivalent yield quartiles. We estimate that the lowest quartile is split roughly equally between prime and secondary properties, the middle 50% consists mainly of secondary properties and the highest quartile is tertiary properties. The strong performance of prime property last year was partly because their rental incomes proved to be relatively stable through the recession (Figure 3) and partly because given their defensive nature, prime properties saw the biggest favourable fall in yields through the second half of 2009 (Figure 4). The exception was retail warehouses where bulky goods retail parks gained from a bigger fall in yields than prime fashion parks.

However, looking forward, we believe that the relative performance of prime and secondary property will be more finely balanced. On the one hand prime property is likely to continue to benefit from stronger occupier demand, as the fall in rents and increase in incentives over the last 18 months have made good quality space more affordable. For example, JLL reported that the amount of vacant grade A office space in central London fell in the final quarter of 2009, but the amount of vacant grade B increased.

The income on prime properties is therefore likely to remain fairly stable, while the income on secondary grade A and tertiary properties may continue to fall.

**Figure 6: Total Returns in 2009 by Market Segment and Yield Level**



Source: IPD Quarterly Index, February 2010.

On the other hand, it seems likely that the favourable rerating of prime and secondary grade B property relative to secondary grade A and tertiary property has now largely run its course. Clearly, a lot will depend upon whether the UK economy gains momentum over the next six months in keeping with current forecasts, or whether the UK slips back into recession. By the end of 2009 the inter quartile range in equivalent yields covering the middle 50% of properties in the IPD had expanded to 320 basis points, its widest since 1992. While we cannot rule out a further increase in the range in 2010, we believe that if the economy does recover, then investors will become less fixated on prime and secondary grade B properties with bond like incomes and their interest will broaden to secondary grade A properties which can be easily relet when the lease expires, or in the event that the tenant defaults. (Tertiary properties are likely to remain taboo). While secondary grade A properties do not provide the same income security, they offer a higher income return than prime properties and they may deliver similar income growth to prime properties over the long term, if leases and tenants are actively managed. As a result, once the gap between prime and secondary yields has stabilised, we believe that the returns on secondary grade A properties could match, or even exceed those on prime properties.

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