Repurposing office real estate

Picton looks set to generate positive returns by repurposing some of its holdings...

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There can be a tendency among investors to see property investments as unchanging. A residential building today is going to be a residential building tomorrow. If that building falls in value, then there isn't much the owner can do about it.

Reality is more nuanced and real estate is regularly repurposed to meet occupier demands and increase investor returns. You only have to look at some of London's major commercial and residential hubs to see that's the case. As recently as the early 1980s, much of the London Docklands area contained just that – docklands, alongside some warehouses, and lower end residential properties.

Today it contains large office buildings, leisure and shopping facilities, as well as a mix of residential properties. Further west, Battersea Power Station has been changed from an industrial site into residential, retail, and leisure real estate.

Changes in working behaviour, notably the shift to working from home, mean even now there are questions about whether office blocks in places like Canary Wharf will shift once again into more in-demand residential properties.

The point is that real estate is not as static an asset class as it may seem at first glance. Moreover, properties can be repurposed in such a way that it proves accretive to long-term returns for investors. **Picton Property Income's (PCTN)** holdings provide some good examples of this.

PCTN is an internally managed REIT which invests in a diversified portfolio across UK commercial real estate. The fund currently has 49 holdings, with close to 60% invested in industrial assets and more of a skew, on a regional basis, towards London and the Southeast.

The managers do not try to quickly shift into whatever asset class in the sector is performing well. Instead, they will try to make their current holdings 'work' as much as possible, by maintaining high levels of tenant retention and generating long-term returns.

More recently that has meant repurposing holdings in the office sector, which is seeing lower demand, into alternative use properties. The most notable example of this is the REIT's holding in Angel Gate, an office asset in central London.

In October of last year, PCTN received full permission from local authorities to repurpose the asset into residential properties. The site was put up for sale in January, with PCTN now able to realise the maximum value from the asset.

It was a similar story with Longcross, an office building in Cardiff. PCTN has agreed to sell the property to a specialist student accommodation developer. The transaction is subject to planning permissions approval and the sale price will be based on how many rooms can be built under those terms. However, its sale will be accretive to PCTN's NAV, even if permissions are only given for the minimum number of rooms permitted.

Two other assets in the PCTN portfolio are at an earlier stage in a similar process. For example, the managers have submitted a planning application for Charlotte Terrace, a building in West London that's comprised of both office and retail space. The aim is to repurpose the asset into residential properties, fitting with a wider £1bn redevelopment that is happening in the area.

Outside of London but still in the South East, PCTN has received approval to amend an office building at Colchester Business Park for use by a healthcare provider.

As this all suggests, this means that real estate holdings can, within reason, be repurposed for a wide range of uses. The key point, from an investor's point of view, is to ensure such repurposing generates positive returns.

PCTN's success in repurposing its holdings is helped by the experience of the managers. As noted, PCTN is an internally managed REIT and CEO Michael Morris has over 25 years of experience in real estate investing.

Michael works alongside a team with extensive asset management, occupier services, and surveying experience, meaning the PCTN management have a solid understanding of planning policies, occupational demand, and how suitable a given building is for repurposing, all of which are vital to ensuring any changes to a property deliver returns for investors.

We think the proof is in the pudding in this regard given that the repurposing projects that have been completed or are in the process of undertaking look set to deliver strong investment returns for the REIT.

Despite these positives, PCTN was trading at a 34.4% discount as at 20/04/2024. Over 90% of PCTN's debt is fixed until 2031 and it has dividend coverage in excess of 100%. The REIT also has the potential to benefit from a significant uplift in income from its portfolio, driven by fixed rental uplifts, leasing vacant space and resetting rents to market levels.

We think PCTN sits at an interesting juncture as a result. The REIT enjoys rental growth potential, is not subject to a high level of refinancing risk, and already has excess dividend coverage. We think the wide discount and potential for rate cuts, alongside the positive returns generated from asset sales, could suggest a more positive outlook for the trust in the months ahead.

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