Cap-ex tends to boost performance in most markets, although there are significant variations by property type and country

- Cap-ex has a greater impact in the UK and the USA than in Germany and the Netherlands
- Higher levels of cap-ex have a more significant positive impact on performance
- Offices benefit from cap-ex in Germany and the Netherlands, but do not in the UK and the USA

Capital expenditure (cap-ex) has been an important dimension of real estate investment management, and there is increasing interest in better understanding the relationship between expenditure and investment performance. Real estate managers undertake a significant outlay on improvements each year, representing 0.5% - 2.5% of total capital value across most markets. Annually €30 billion is spent in the four countries in this report and €75 billion globally.

> ‘There are profound variations that have practical implications for portfolio construction and asset management’

There are significant variations in levels of capital expenditure across markets and over time, with highest levels in the USA at 200bps and lowest in Germany and the Netherlands at 50bps. Cap-ex as a percentage of value is relatively stable over time in all of the markets but in the UK and the USA there is a slight increase during the financial crisis, implying that levels of cap-ex did not fall as significantly as overall values.

The nature of capital expenditure means returns are negatively impacted in the year improvements are carried out due to the costs incurred and disruption to the income stream. For Germany, the UK and the USA there is a boost to subsequent performance that tails off, most immediately in Germany. As the level of cap-ex becomes more substantial the initial hit to performance increases but so does the subsequent outperformance, certainly in Germany and the UK.

Important insights into the relationship between capital growth and income return are most clearly demonstrated in the UK and the Netherlands. For the UK, assets receiving higher levels of capital expenditure, of at least 5%, experienced a significant boost to capital growth. Although this relative improvement in values might have been associated with rental growth, the greater influence was yield shift, as evidenced by the lower levels of income

The case of Germany, the Netherlands, the UK and the USA

returns for assets receiving cap-ex than for the market. Even if cap-ex contributed to income growth, this was less significant than the boost to capital values such that the income returns for refurbished assets tended to be lower than the market. Conversely, in the Netherlands, the negative impact of cap-ex on asset values meant that there was improvement in the relative level of income return. The implication is that with values declining the income return tended to increase.

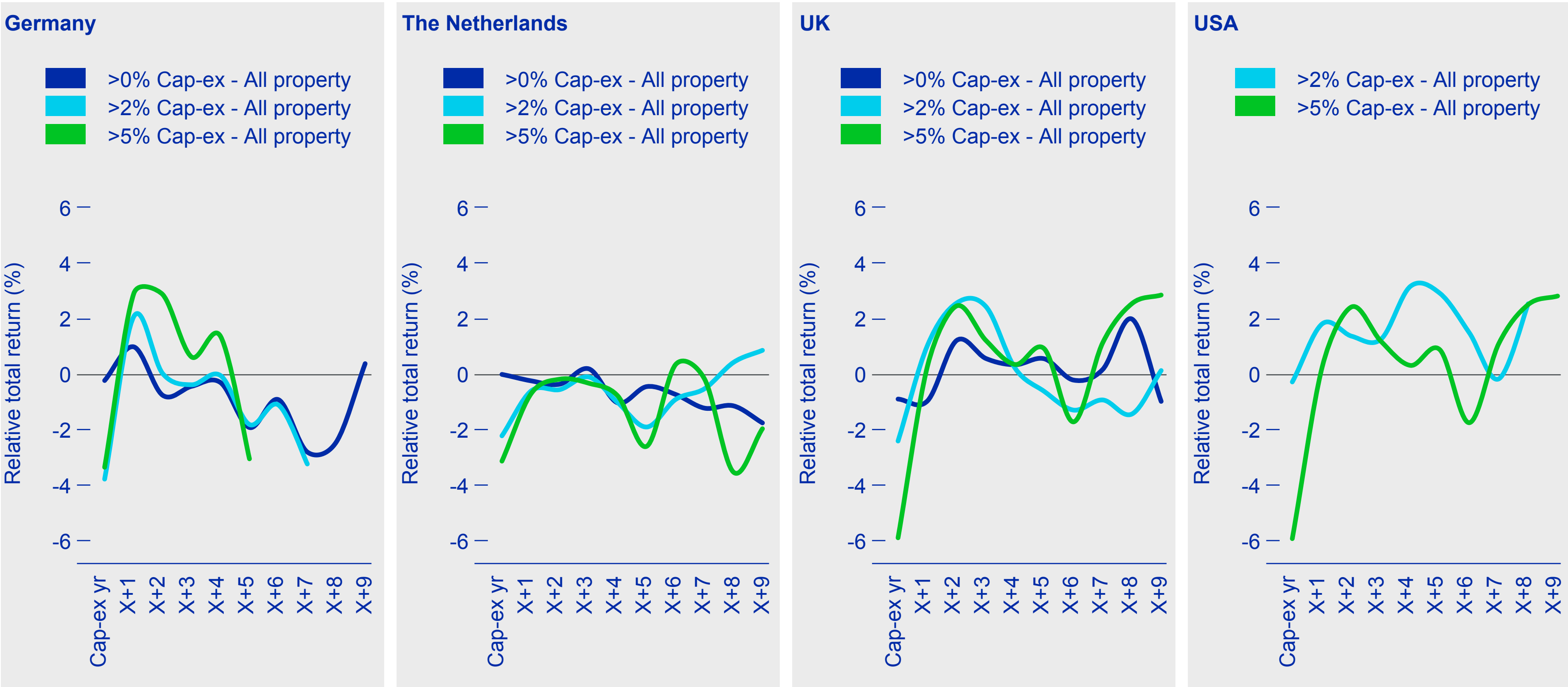
The research revealed important differences in the impact of cap-ex by property types across countries. This is most marked for offices where there is a tendency for cap-ex to destroy value in the UK and the USA, while in Germany and the Netherlands it tends to boost performance. Industrial also tends to benefit from cap-ex in all countries except for the Netherlands. Cap-ex tends to have the weakest impact on performance for retail properties, tending to represent a negative impact for Germany, the Netherlands and the UK, and only a marginally positive impact for the USA.

For portfolio managers there are a series of strategic implications based on the significant variations across countries and property types, in terms of levels of spending and impact on future performance. It seems there is persistence in the differential levels of capital expenditure and their impact on investment performance. At a national level, it seems that cap-ex has a more significant impact in the UK and the USA, than in Germany and the Netherlands.

For further details contact research@inrev.org

The full report is available to members at inrev.org/library/publications

Figure 1: Relative performance by level of capital expenditure



The data used in this research study is sourced from MSCI