april 2013

investment bulletin

Fletcher King

CHARTERED SURVEYORS

Institutional Investment in Property

In the first quarter of 2013 Moody's downgraded the UK's credit rating from AAA to AA1 citing subdued growth prospects, a high and rising debt burden and expectations that the period of sluggish growth would extend into the second half of the decade. The markets reacted by reducing the average yield on gilts from 2.7% to 2.4%.

Contrary to expectations, the snowfall and cold weather during Q1 2013 appears to have had a limited impact on GDP growth. April's preliminary estimate of GDP indicates that the UK economy avoided its first ever triple dip recession as output increased by 0.3% in Q1 2013 compared with Q4 2012. GDP has been broadly flat over the last 18 months and is still 2.6% below the peak in Q1 2008.

In March, the British Retail Consortium reported that UK retail sales values were 1.9% higher on a like-for-like basis compared with March 2012 when they were up 1.3% on the previous year. Online sales were up 6.6% compared with March 2012, when they had risen by 13.9%. March's figures were boosted by an early Easter. Snow and the prolonged unseasonal cold weather brought mixed fortunes for different categories. Food sales were boosted but demand was cool for new season clothing and footwear lines.

Without any encouragement from the macro-economic background the commercial property market endured its sixth consecutive quarter of decreasing prices. Capital values as measured by the IPD Monthly index fell by -0.6% in Q1 compared to a decline of -1.1% in Q4. Total returns increased to 1.1% in Q1 from 0.5% in Q4 2012 and total returns in the 12 months to March increased very slightly to 2.5% from 2.4% in the 12-months to December.

In Q4 institutions continued to put money into the commercial property market acquiring property assets worth £2.1 billion and recording sales of £1.5 billion. Net investment in Q4 of £654 million compared to net investment of £1.2 billion in Q3 representing the largest quarterly inflow into the asset class since Q1 2010 when net investment amounted to £1.8 billion. In the 12 months to December, net investment by institutions amounted to £1.7 billion compared with net investment of £1.8 billion in the 12 months to September.

In the third quarter, pension funds invested a further £458 million and have been net investors for the last twenty three quarters. Total investment by pension funds in the 12 months to December amounted to £1.8 billion compared to £1.7 billion in the 12 months to September and £1.3 billion in the year to December 2011. Life companies continued to be sellers and net disinvestment in Q4 amounted to £115 million. Total disinvestment in the 12 months to the end of December amounted to £1 billion compared to disinvestment of £705 million in the 12 months ending September and a net disinvestment of £366 million in the year to December 2011. Property Unit Trusts were net investors for the thirteenth consecutive quarter and invested £87 million in Q4. Net investment in the 12 months to the end of December amounted to £283 million compared with net investment of £387 million in the 12 months ending September and £640 million in the year to December 2011.

Total institutional investment shrunk by 20% to £20 billion in Q4 from £25 billion in Q3. Institutions made net investments in Q4 of £12.9 billion in overseas equities, £1.8 billion in UK equities, £1.3 billion in cash and other short term instruments, £1.2 billion in UK gilts and £654 million in UK Property as noted above.

The north v south divide

Britain is a deeply divided country. Inner London is the richest part of the entire European Union, while Cornwall and Wales benefit from the regional aid dispensed by Brussels. There is full employment in the better-off towns and cities of the Home Counties, while in Knowsley on Merseyside the true level of joblessness is well over 15%.

The divide between the northern and southern regions of the UK goes back a long way. The Economist in a recent article headed Divided Kingdom quoted John Hobson, an economist, who in 1900 described a southern "Consumers England" of leisurely suburbs and a northern "Producers England" of mills and mines.

In the 1930s, the centre of gravity of the British economy shifted towards the south-east, which is where many of the new light engineering firms were established. During the second half of the last century the split widened. Successive governments sought to compensate for the decline of the coal, cotton and shipbuilding industries that had supported Britain's mid-Victorian economic dominance. Regional policy in the 1960s and 1970s aimed to relocate jobs to the northern regions. For example, the Royal Mint was relocated to Llantrisant and the Girobank was set up in Bootle.

In the 1980s, the monetarist policies associated with Mrs Thatcher's first administration were accompanied by high unemployment, particularly in northern cities. The defeat of National Union of Mineworkers, accelerated the decline of the coal industry. Many former mining towns in Yorkshire and Lancashire struggle to attract new jobs to this day. The privatisation of the steel industry had a similar effect in places like Teesside. Meanwhile, London and the South East benefitted from the wealth created by a deregulated financial-services

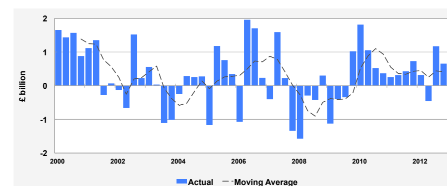
Investment in UK Property

Q1 2013 (£m)

	Pension Funds	Insurance Companies	Unit Trusts[1]	Total
Purchases	614	1,237	263	2,114
Sales	156	1,130	174	1,460
Net Investment	458	107	89	654

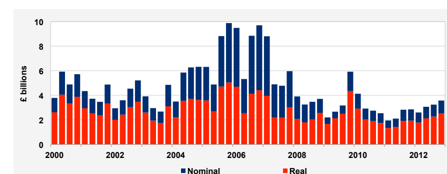
[1] Includes Investment Trusts

Net Institutional Investment in Property



Source: National Statistics

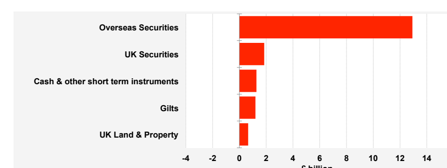
Property Market Liquidity



Source: National Statistics & Fletcher King

Net Institutional Investment

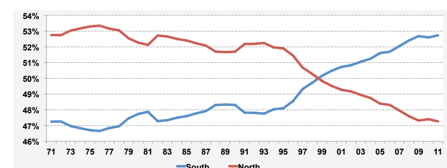
By Asset Type Q4 2012



Source: National Statistics

Regional Economic Output

The proportion of economic output provide by the South has risen while that provided by the North has shrunk...



Source: National Statistics

industry. This part of the country, historically less dependent on heavy industry, has higher levels of private-sector employment, particularly in Britain's successful service and knowledge industries.

From 1997-2010 the Labour government sought to compensate for the slower economic growth of the north by increasing public spending in the regions. Gradually, the state accounted, directly and indirectly, for a larger share of jobs created there. As part of its deficit reduction programme, the current coalition government now has plans to cut public-sector jobs further widening the regional divide.

The rest of this piece will now explore to what extent, this north-south divide is reflected in the UK's commercial property market; and a quick analysis suggests that is certainly the case. London and the South East together make up 35% of the UK's economy. Approximately 60% of the property monitored by IPD is located in London and the South East. In 2010 and 2011 inward investment into Central London commercial property accounted for approximately 50% of all UK-wide commercial property investment. In 2012 that figure rose to 65%.

Looking a little deeper at total returns and net investment in the UK market recorded by the IPD annual index since 1980 provides some further interesting insights into the north-south divide in the property market. To reflect the longer time horizons of property investors, the full thirty two year history of the IPD index has been divided into twenty eight rolling five year periods. The analysis reveals firstly that economic drivers have an important role to play differentiating the returns offered by Central London, South East and Rest of UK property.

Across all three sectors, South East shops, offices and industrials were the dominant performers in the 1980's. The recession of 1991 ushered in a five year period of falling rental values and Rest of UK property characterised by a higher income return profile dominated performance between 1991 and 1997. Central London shops and London industrials have been the strongest performers in their respective segments since 1997. Central London offices also dominated for a period after 1997 but lost their top performing slot following the dot.com crash and recession in the USA in 2001. However, Central London offices have now been the top performing office segment in each of the last six rolling five year periods.

The second observation to be drawn from this analysis is that while Central London and the South East have consistently produced stronger returns that out-performance has not in all cases encouraged increased investment.

Central London shops have been one of the top performing segments of the market in recent years with an annualised average total return of 17.4% in the three years to 2012 compared to the All Property average of 8.7%. Central London has been the top performing shop segment in the last six rolling five year periods and in nineteen of the twenty eight rolling five year periods. However, IPD funds have been net sellers for the last ten rolling five year periods. The destination of choice for investors in high street shops was the Rest of UK sector in seventeen out of the twenty eight rolling five year periods.

Similarly, looking at the industrial sector, Rest of UK industrials have been the segment of choice in sixteen out of the twenty eight rolling five year periods. Central London industrials generated an annualised average total return of 8.5% in the three years to 2012 and 1.5% in the five years ending 2012 compared with an all industrial average over these time frames of 7.0% and 0.1% respectively. However, IPD funds have been net disinvestors in five out of the last six years. Only last year in 2012 was London the destination of choice for investors in UK industrials.

It is the office sector that partly conforms to expectations. Central London and South East offices have seen either the highest levels of investment or at least the lowest levels of disinvestment in eighteen of the twenty eight rolling five year periods. Central London offices generated an annualised average total return of 14.6% in the three years to 2012 and 3.2% in the five years ending 2012 compared with an all office average over these time frames of 9.7% and 0.7% respectively.

Against expectations, IPD funds have been net sellers of Central London offices in each of the last four rolling five year periods. The most likely explanation is that IPD's predominantly UK based funds have not been willing to bid competitively against the overseas investors who have targeted the London market over the last three years. At the prices being achieved domestic investors are sellers rather than buyers.

London and the South East together make up 35% of the UK's economy but approximately 60% of the property monitored by IPD is located in London and the South East. Shop, office and industrial property located in Central London and the South East has consistently outperformed. But IPD funds have sought to diversify their asset allocation away from these hot spots and have perhaps been unwilling to follow the naïve strategy of allocating further resources to last year's top performing sectors.

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