september 2013

investment bulletin

Fletcher King

CHARTERED SURVEYORS

Institutional Investment in Property

All recessions come to an end eventually. The economy increased by 0.7% in Q2 2013 and economic growth in the 12 months to the end of June amounted to 1.4% compared to growth of 0.4% in the 12 months to the end of March. The peak to trough fall of the economic downturn in 2008/09 is now estimated to be 7.2% and by the end of the second quarter GDP remains 3.3% lower than the pre-financial crisis peak in Q1 2008. The remaining question is whether the upturn in Britain was unnecessarily delayed by VAT increases, cuts in capital spending and the unfortunate comparison of the UK with Greece.

The good economic news continues to be supported by evidence from surveys.

In September, the British Retail Consortium reported that UK retail sales values were 0.7% higher on a like-for-like basis compared with September 2012. Online sales grew by 13.4% compared with September 2012. The BRC commented that, "while total retail sales have continued to grow this month, it has been the weakest growth so far this year. The continued improvement in the UK housing market was reflected by a strong performance in home accessories."

The Nationwide House Price Index indicated that prices rose by 2.2% in Q3 2013 and were up 4.3% compared with the same quarter of 2012. House price growth accelerated in London to reach 10%. Prices in London are now 8% above their 2007 peak. Amongst the English regions, the South of England and the Midlands continued to outperform the North.

As the UK economy enjoyed its strongest quarter of growth since the second quarter of 2010 and the start of "austerity" the commercial property market enjoyed its second consecutive quarter of increasing prices. Capital values as measured by the IPD Monthly index rose by 1.2% in Q3 compared to 0.2% in Q2. Total returns increased to 2.9% in Q3 from 1.9% in Q2 and total returns in the 12 months to September increased to 6.5% from 4.1% in the 12-months to June and could reach 9% or more for the whole of 2013.

Given the macro-economic and market background, it seems curious that in Q2 institutions disinvested from the commercial property market acquiring property assets worth £1.6 billion but recording sales of £2.1 billion. Net disinvestment in Q2 of £445 million compared to net investment of £162 million in Q1. This is only the second quarter since the start of the market recovery in Q4 2009 that institutions have been net sellers of commercial property. In the 12 months to June, net investment by institutions amounted to £1.57 billion compared with net investment of £1.58 billion in the 12 months to March.

In the second quarter, pension funds invested a further £158 million and have been net investors for the last twenty five quarters. Total investment by pension funds in the 12 months to March amounted to £1.57 billion compared to £1.65 billion in the 12 months to March and £1.37 billion in the year to June 2012. Life companies continued to be sellers as net disinvestment in Q2 grew to £1.07 billion from just £38 million in Q2. Total disinvestment in the 12 months to the end of June amounted to £1.22 billion compared to disinvestment of £945 million in the 12 months ending March and a net disinvestment of £897 million in the year to June 2012. Property Unit Trusts were net investors for the fifteenth consecutive quarter and invested £265 million in Q2. Net investment in the 12 months to the end of June amounted to £560 million compared with net investment of £352 million in the 12 months ending March and £352 million in the year to June 2012.

Total institutional investment grew by 66% to £35 billion in Q2 from £21 billion in Q1. Institutions made net investments in Q1 of £10.9 billion in overseas equities, £10.2 billion in UK gilts, £6.2 billion in cash and other short term instruments and £1.8 billion in UK equities, but were net sellers £445 million in UK Property as noted above.

Is the recovery sustainable?

After a lacklustre eighteen months the UK's commercial property market finally looks to be staging something of a recovery or at least a return to normality as investors exude more confidence..

After a 44% fall in values between June 2007 and August 2009 a short lived recovery followed before values started to fall again in November 2011. This period of falling values owed more to sentiment than it did to fundamentals. In November 2011 property yields were already at near record levels compared to gilts; and although rents were falling the annualised rate of decline at the All Property level was less than 0.5%. In the worst performing regions outside London, the situation was bleaker but these segments make up less than 20% of the monthly index.

Investors risk aversion was heightened by news headlines that focused on the likelihood of a triple dip recession at home, the imminent collapse of the Eurozone and the fiscal cliff in the USA. Any money going into property targeted long let prime assets and Central London offices and retail. As it happens, the first two threats were avoided. The UK economy returned to growth and subsequent revisions to the domestic data even air-brushed away the second leg of the double dip recession. Mario Draghi and the ECB combined to steer the Euro away from crisis by announcing they would do whatever it took and if necessary would buy unlimited quantities of sovereign debt.

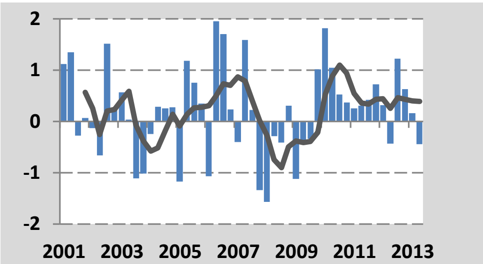
What can we now expect from the economy and the commercial property market?

Investment in UK Property
Q2 2013 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	411	912	294	1,617
Sell	253	1,780	29	2,062
Net	**158**	**-868**	**265**	**-445**

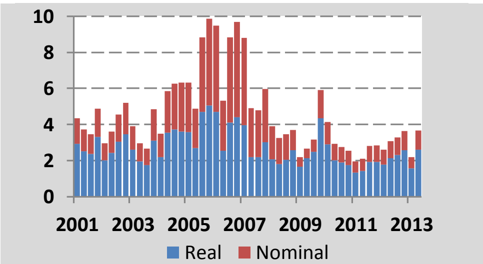
Source: National Statistics

Net Institutional Investment in Property (£billion)



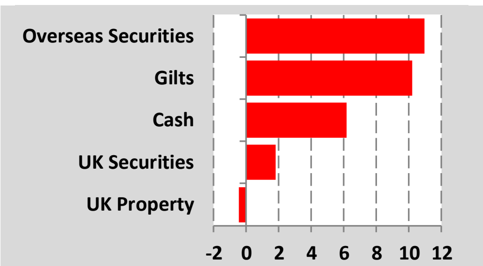
Source: National Statistics

Property Market Liquidity (£billion)



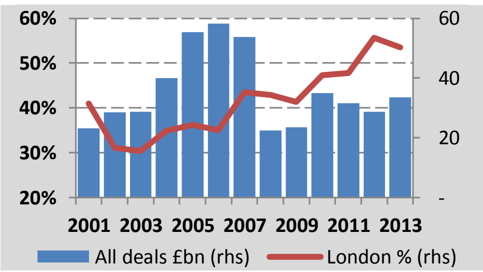
Source: National Statistics & Alexander Property Research

Net Institutional Investment (£billion) Q1 2013
By asset type



Source: National Statistics

Investment transactions; London v Rest of UK



Source: Property Data & Alexander Property Research september 2013

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The 1990-91 recession

After the recession of 1990-91, the UK economy enjoyed eight years of strong above trend growth during which time the economy expanded by 37% before the 2001 recession in the USA slowed growth across the globe.

In the UK 1992 marked the bottom of the cycle for commercial property but as with the wider economy recovery from the slump was equally robust. In the eight years between 1992 and the end of 2000, capital values grew by 41% or 4.4% a year. The market had to wait until 1994 for the trough in the rental cycle but thereafter rents themselves grew by 41% or 5.0% a year between the end of 1994 and 2000.

Unfortunately, neither the UK economy nor the commercial property market are likely to see a rerun of the recovery from the last recession.

In the latest Inflation Report issued in August of this year, the Monetary Policy Committee noted that a recovery was taking hold but added, "the legacy of adjustment and repair left by the financial crisis means that the recovery is likely to remain weak by historical standards". Their latest forecasts suggest that the outlook for growth is stronger than in May, mainly reflecting a marked improvement in business and consumer sentiment. The numbers under pinning these forecasts, however, show that economic output will not return to trend levels until the middle of 2016. The output gap will continue to widen and the underutilised productive capacity of the economy will grow further.

Rental growth

Without the support of a pro-longed period of above trend economic growth, commercial rental values outside London are unlikely to see any growth of substance.

High vacancy rates in all three sectors mean that even if occupiers now feel confident to take on more staff, there is enough surplus real estate to accommodate any increased demand without putting upward pressure on rents.

There may not even be any increase in the demand for space. Unexpectedly low unemployment figures during the downturn have led many economists to suspect that employers have been hoarding labour. This has caused a worsening in productivity. So there should in fact be the scope for businesses to expand without the need for hiring any further staff.

According to the Local Data Company, across the UK 1 in 7 shops are vacant. The vacancy rate in the top 650 town centres is high but at least remains largely stable decreasing to 14.1% in 2013 from 14.2% in 2012. A recent study by PwC and the Local Data Company of 500 town centres showed that 3,366 stores closed in a six-month period compared to 3,157 openings, a net reduction of 209 shops.

Office and industrial vacancy rates also remain high. Across seven of the largest regional office centres, vacancy rates range from 15% in Birmingham to 19% in Reading and Bristol. Although a complete absence of development activity does suggest that a shortage of Grade A space may be looming.

Across the whole of the UK the industrial vacancy rate at 12.0% is high but improving when compared to the 5 year average of 13.3%. Wales and the North East have vacancy rates of 19-20%, while the vacancy rate for London industrials is 6% and the South East and East of England both have vacancy rates below 10%.

Investment

Central London to a greater extent and other prime assets outside of London to a lesser extent, have been the main focus of investor activity since 2010. In each of the last four years, Central London offices or shops have accounted for at least 50% of all investment transactions (see chart above). Yields for these assets have hardened to such a degree that they are at or in some cases below yields at the top of the market in 2007.

On both an absolute and a risk-adjusted basis, segments such as industrials and offices outside of Central London are now starting to look more attractive. Yields are high in these sectors by historical standards, and are particularly so, relative to prime real estate.

If the emerging economic recovery improves sentiment as it seems to be doing, investors will become less risk averse and start to look at higher yielding assets. Even without any rental growth yield compression could drive strong returns over the next few years.

Remaining risks

Risks to the UK economy remain through the forces of globalisation. American politics still has the potential to destabilise the global economy as the budgetary stand-off between the Democrats and Tea Party affiliated Republicans has only been postponed and not settled. The big emerging market economies – China, India, Brazil, Russia and South Africa – are not growing as quickly as they were two years ago. The US Federal Reserve could begin to taper its $85bn-a-month stimulus programme causing bond yields to rise. The Eurozone is only just emerging from a double-dip recession but there is a wide disparity between the growth now seen in France and Germany and the continued contraction of Spain, Italy and, of course, Greece. As we have observed above risks to the UK economy are risks to the commercial property market; market sentiment can be fragile.

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