december 2013

investment bulletin

Fletcher King
CHARTERED SURVEYORS

Institutional Investment in Property

The recovery is finally under way. The economy followed up its increase of 0.7% in Q2 2013 by posting a further 0.8% of growth in Q3. Economic growth in the 12 months to the end of September amounted to 1.6% compared to growth of 1.4% in the 12 months to the end of June.

Despite a pro-longed period when wages have fallen in real terms, rising consumer confidence has been a key factor supporting the growth in the economy seen since the end of Q1 last year. Retail sales have improved and the housing market supported by “Help to Buy” has seen prices increasing across all parts of the UK.

The Markit PMI index constructed from surveys of the services, manufacturing and construction industries indicated that the UK economy enjoyed its strongest quarter of growth in Q4 since the data first became available back in 1998. The survey is consistent with UK economic growth of 1.0% in Q4. In recognition of the pace of recovery the International Monetary Fund has raised its UK growth forecast of 1.9% for 2014 to 2.4%.

At the end of the third quarter GDP was still 2.5% lower than the pre-financial crisis peak in Q1 2008. Addressing this issue, the MPC has said it, “intends to maintain the present highly stimulative monetary policy until the economic slack has been substantially reduced, provided this does not entail material risks to price stability or financial stability.”

In Q4 the UK economy is likely to have achieved a third consecutive quarter of above trend growth and the commercial property market enjoyed its third consecutive quarter of increasing prices. Capital values as measured by the IPD Monthly index rose by 3.0% in Q4 compared to 1.2% in Q3. Total returns increased to 4.7% in Q4 from 2.9% in Q3 and total returns in the 12 months to December increased to 10.9% from 6.5% in the 12-months to September.

Total institutional investment grew by 14% to £31 billion in Q3 from £27 billion in Q2. Institutions made net investments in Q3 of £11.8 billion in overseas equities, £11.1 billion in cash and other short term instruments, £7.4 billion in UK gilts but were net sellers of £6.7 billion in UK equities.

As optimism about the outlook for the economy improved, institutional investors re-discovered their appetite for commercial property market in Q3 acquiring property assets worth £2.4 billion and recording sales of £1.7 billion. Net investment in Q3 of £643 million compared to net disinvestment of £496 million in Q2. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 14 out of 16 quarters. In the 12 months to September, net investment by institutions amounted to £727 million compared with net investment of £1.1 billion in the 12 months to June.

In the third quarter, pension funds invested a further £265 million and have been net investors for the last twenty six quarters. Total investment by pension funds in the 12 months to September amounted to £751 million compared to £1.2 billion in the 12 months to June and £1.4 billion in the year to September 2012. Life companies continued to be sellers but net disinvestment in Q3 shrank to just £16 million from £1.1 billion in Q2. Total disinvestment in the 12 months to the end of September amounted to £1.23 billion compared to disinvestment of £1.16 million in the 12 months ending June and a net disinvestment of £500 million in the year to September 2012. Property Unit Trusts were net investors for the sixteenth consecutive quarter and invested £264 million in Q3. Net investment in the 12 months to the end of September amounted to £692 million compared with net investment of £552 million in the 12 months ending June and £393 million in the year to September 2012.

Central London offices remain the key destination for capital. The value of investment transactions in this segment amounted to £5.3 billion in Q3 rising to £6.8 billion in Q4 representing 50% of all transactions.

Overseas investors continue to be dominant players in the UK investment market. Investment from overseas amounted to £4.2 billion in Q3 rising to £7.6 billion in Q4 representing 46% of all commercial investment transactions. Investment turnover in Q4 was heightened by the purchase of a 50% stake in Broadgate for £1.7 billion by Singapore’s sovereign wealth fund and the acquisition by Kuwaiti owned St Martins Property Corporation of More London on the Southbank also for a further £1.7 billion.

Reflections on 2013 and the outlook for 2014

The collapse of Lehman Brothers in September 2008 triggered the near collapse of the banking system and the start of the “Great Recession”, the recovery from which has been slow and halting. The world economy, however, had a good 2013 as the year saw more signs that a corner might have been turned. The Eurozone had one of its quieter of recent years. European government deficits have fallen by half. Productivity is improving, unit labour costs are falling and once-large current-account deficits in Italy, Spain and Portugal are disappearing, enabling investors to strike “euro debt woes” off their list of possible risks for 2014.

The USA was the scene for the two biggest financial events of 2013.

In May the US Federal Reserve hinted that the $85bn a month bond-buying stimulus could be wound down. Investors took fright and US stock market and bond prices plunged. In December, when the Fed announced a modest $10bn a month trimming of the stimulus, markets soared.

Investment in UK Property
Q3 2013 (£m)

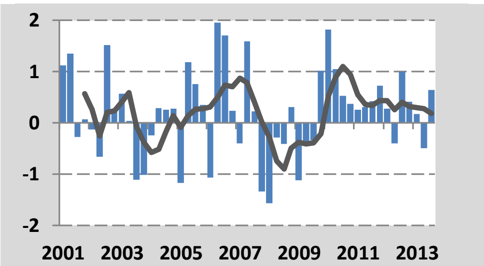
	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	877	1,009	500	2,386
Sell	612	895	236	1,743
Net	**265**	**114**	**264**	**643**

Source: National Statistics

Net Institutional Investment (£billion) Q3 2013
By asset type

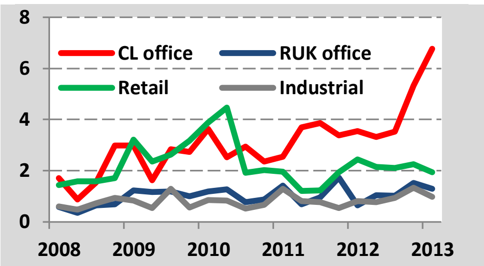
Source: National Statistics

Net Institutional Investment in Property (£billion)



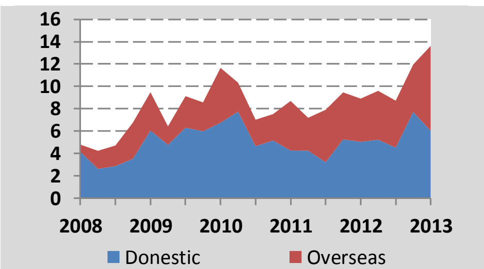
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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In October the US government was shut down for 16 days as Congress failed to agree a budget for 2014. As many as 700,000 federal workers were sent home. President Barack Obama said the shutdown caused "completely unnecessary damage" to the world's largest economy. The cost to the US economy was $24bn, a loss of 0.6% of output for the quarter

Major stock markets ended the year at record highs as they benefited from record low interest rates in the US and Europe and a benign outlook for inflation.

The FTSE All World Index ended the year on a new high. It was up almost 20% for the year – its biggest annual advance since 2009. Government bond prices, meanwhile, dropped and yields rose as investors sought higher returns on riskier assets. Gold also suffered heavy losses, recording the biggest falls for three decades.

On Wall Street, the S&P 500 was up almost 30% on the year. In Europe, the FTSE Eurofirst marked up an annual gain of 16%, with Germany's Xetra Dax, finishing 26% higher, making it the best performer of the major European markets. London's FTSE 100 closed the year with gains for 2013 of 14.4%. The FTSE 250 index, more exposed to the domestic economy than the FTSE 100, is ended the year 29% higher.

UK commercial property was another asset class to benefit from the improving economic conditions. As the year started, IPF Consensus forecasts were for commercial property to provide total returns of 6.4% in 2013. As it turns out, these expectations were on the low side. Rental growth of 0.6%, which was the highest in a calendar year since the end of 2007, together with yield compression of 32 bps meant that All Property total returns amounted to 10.9% in 2013.

The best performing segments of the UK commercial property market in 2013 were once again Central London shops and Midtown and West End offices. But there the similarities with the last few years ended. As the recovery extended beyond London, South East offices and industrials benefitted from capital growth of more than 6%; and the values of Rest of UK industrials and South East shops grew by almost 5%.

Retail property outside London and the South East continued to flounder. Rest of UK shop values fell by almost 1% and the worst performing segment was Rest of UK shopping centres where values fell more than 3%. Rest of UK offices also had another weak year as they struggled to cope with high vacancy rates and a strictly limited supply of new Grade A space to drive occupier demand.

Asset allocators have been presented with an unusual economic background in 2014 that presents them with a series of problems that could be solved by real estate. Firstly, that a policy of "financial repression" will seek to maintain low real interest rates and use inflation to reduce the real value of debt relative to GDP. Secondly, that tighter regulation of the banking system will limit the availability of derivative products that investors have become accustomed to using to hedge against inflation risks. Lastly, that aging populations and the closing of defined benefit schemes will require a switch out of growth to income producing assets.

In the context of these issues property's great advantage is its income return. The initial yield on the IPD index is 6.0%. The yield on the FTSE Actuaries 5-15 year gilt index is 2.8% and the dividend yield on the FTSE100 index is 3.5%. In fact income provides 70% of the total return on UK commercial real estate.

In the last 10 years alternative property investments have grown from 3% of IPD funds to 8%. Such assets are typically hotels, care homes, residential apartments and student accommodation. They are let on long leases, the average unexpired lease term is 26 years; and with index linked rents. As such they are a useful vehicle for long term asset liability matching and inflation hedging. There is a view that the number of such properties owned by IPD funds will grow in the next few years until they represent at least 15% of the index.

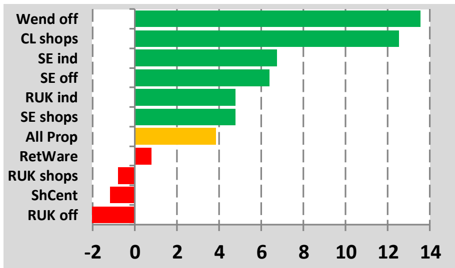
2014 should see a different investment environment to that prevailing over the last three years.

Secondary investment markets will benefit from the improvement in investor confidence. Yields in these markets will re-rate and starting in the South East, performance in the rest of the country will catch up and eventually surpass Central London.

Retail markets will continue to underperform. The growth of on-line sales has fundamentally changed the structure of retailing. Some traditional retailers are successfully competing against pure internet retailers by combining a strong web presence with traditional high street outlets through click and collect strategies. However, as result of the growth of internet shopping from computers, tablets and mobile phones, the number of stores required by a national multiple retailer to cover the UK market has decreased from 150 to 50.

Risks remain as the global economy is not likely to return to the pre-2007 world of constant growth and low inflation. Tightening of monetary policy through unwinding quantitative easing or raising interest rates could result in increased volatility in markets and unexpected events. Core Central London residential and commercial property markets are currently supported by overseas money. Higher interest rates in the USA could cause international investors to switch capital out of London.

2013 capital growth by segment (%)



Source: IPD

CONTACT

Fletcher King
61 Conduit Street
London
W1S 2GB

www.fletcherking.co.uk

020 7493 8400

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FUND MANAGEMENT & INVESTMENT CONTACTS

For further information, please contact:

Richard Goode
e: Richard.Goode@fletcherking.co.uk
t: 020 7458 0633

David Mayes
e: David.Mayes@fletcherking.co.uk
t: 020 7458 0624

Paul Morris
e: Paul.Morris@fletcherking.co.uk
t: 020 7458 0645

RESEARCH

Alexander Property Research
e: keith@alexanderpropertyresearch.com
w: alexanderpropertyresearch.com