june 2014

investment bulletin

Institutional Investment in Property

The UK economy is about to record its sixth consecutive quarter of growth. Growth was 0.8% in Q1 and 3.1%in the 4 quarters to the end of March. The Markit PMI index constructed from surveys of the services, manufacturing and construction industries indicated that the UK economy enjoyed another period of robust economic expansion in the second quarter, at least matching the 0.8% growth seen in the first quarter. Markit suggested that there was little sign of momentum waning as we move into the second half of the year.

Following the lead of the broader economy, the commercial property market enjoyed its fifth consecutive quarter of increasing prices in the second quarter. The pace of growth has now accelerated and capital values as measured by the IPD Monthly index rose by 3.5% in Q2 compared to 2.5% in Q1. Total returns increased to 5.1% in Q2 from 3.9% in Q1 and to 17.6% in the 12 months to June from 14.0% in the 12-months to March.

As confidence about the outlook for the economy strengthened, institutional investors strengthened their appetite for commercial property in Q1 acquiring property assets worth £2.3 billion and recording sales of £879 million. Net investment in Q1 of £1.4 billion compared to net investment of £1.6 billion in Q4 20103. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 16 out of 18 quarters. In the 12 months to March, net investment by institutions amounted to £3.2 billion compared with net investment of £2 billion in the 12 months to December 2013.

In the first quarter, pension funds invested a further £205 million compared to £380 million in Q4 2013 and have been net investors for the last twenty eight quarters. Total investment by pension funds in the 12 months to March amounted to £892 million compared to £734 million in the 12 months to December 2013 and £1.2 billion in the year to March 2013. Life companies continued to acquire property in Q1. Net investment in Q1 amounted to £598 million compared to £768 million in Q4 2013. Net investment in the 12 months to the end of March amounted to £254 million compared to net disinvestment of £355 million in the 12 months ending December 2013 and a disinvestment of £755 million in the year to March 2013. Property Unit Trusts were net investors for the eighteenth consecutive quarter and invested £548 million in Q1 compared to £415 million in Q4 2013. Net investment in the 12 months to the end of March amounted to £1.6 billion compared with net investment of £1.2 billion in the 12 months ending December 2013 and £426 million in the year to March 2013.

Net investment by overseas investors in Q2 increased from just £178 million in Q1 to £1 billion compared to the five year average of £886 million. Investment in Rest of UK property decreased 31% in Q2 but the longer term trend remains upwards with annual turnover increasing by 5% from £17.6 billion in Q1 to £18.5 billion in Q2.

Investment in Central London offices increased by 63% to £3.6 billion from £2.2 billion in Q1. This key market segment made up 37% of all transactions in Q2 compared to 21% in Q1. Investment in industrials and Rest of UK offices remained steady representing 13% of cash flows. Allocations to shopping centres has increased to 14% by weight of money from 7% at the end of 2013.

Investment by UK institutions in Q2 increased by just 1% to £3.33 billion from £3.31 billion in Q1. Money into commercial property from overseas investors fell 8% to £3.25 billion from £3.54 billion but overseas investors share of the UK investment market increased from 32% in Q1 to 34% in Q2.

Total institutional investment grew by 37% to £19 billion in Q1 from £14 billion in Q4 2014. Institutions made net investments in Q1 of £10.5 billion in cash and other short term instruments, £4.2 billion in overseas equities and £3.3 billion in UK gilts, but were net sellers of £6.9 billion in UK equities.

Investment in UK commercial property

For too long the UK's economic recovery has been poorly balanced. The output of the service sector is 2% higher than it was in March 2008, the last quarter of growth before the onset of the Great Recession. Manufacturing, however, remains 8% below its 2008 peak and construction is still 12% lower. The regional disparity in growth has been similarly disappointing. At the end of 2013 London's economy was 3% higher than its pre-recession peak whereas almost six years on, the combined output of the UK's remaining regions was still 2.3% lower. The UK's commercial property market has responded in a similar vein, leaving the RICS to comment on the unbalanced nature of the commercial real estate sector in recent years with its focus on London offices.

In 2013 the UK economy grew by 2.7%, London's annual growth in output was 3.1% and growth in the remaining UK regions is likely to have been in the region of 2.6% compared with a 15-year annualised average of 1.6%. It seems likely that the last six months have witnessed a change in fortunes for at least some of the regions. Across the UK the size of the workforce is now 5.7% larger than it was in March 2008. The East of England, South East and North West regions as well as London, all now have a larger workforce than in 2008 (see chart over page).

London represents 23% of the UK's economy and 34% of all commercial property in the UK; yet in the period since the second half of 2009 when the commercial property market staged its initial recovery, Central London has accounted for more than 43% of all investment transactions. In the last

Q1 2014 (£m)

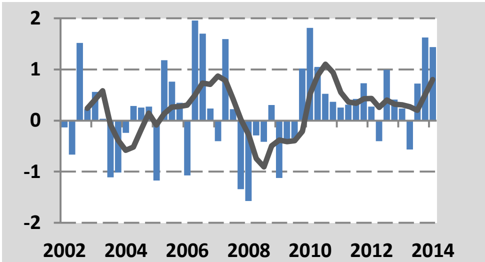
	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	614	918	783	2,315
Sell	409	237	233	879
Net	**205**	**681**	**550**	**1,436**

Source: National Statistics

Net Institutional Investment (£billion) Q1 2014
By asset type

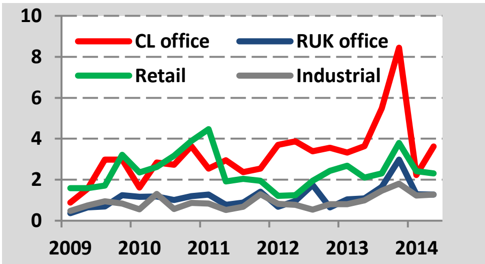
Source: National Statistics

Net Institutional Investment in Property (£billion)



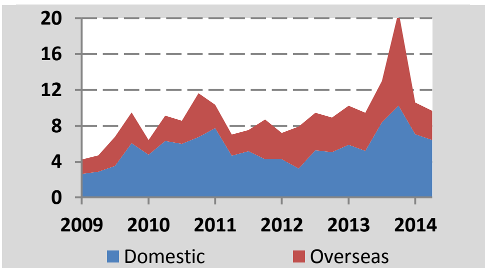
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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six months, however, investment in Central London has declined to 31% of all investment even though overall investment levels have maintained their recent strong levels.

Yields on prime Central London offices are now more than 120 bps below their long run average and 25 bps below the level seen at the top of the market in June 2007. Although supported by rental growth and strong levels of occupational take-up, this segment of the market now carry some downside risk from changes to investors' asset allocation strategies or rising interest rates.

Other segments of the market offering a yield greater than the All Property average of 5.6% seem to offer better value. Such segments include shops, shopping centres, retail warehouses, offices and industrials outside of Central London. The very highest yielding segments are Rest of UK industrials and offices in both the South East and Rest of UK offering a yield of between 7.2% and 6.9% according to the IPD Quarterly Index.

The Q1 2014 RICS UK Commercial Property Market Survey highlights a broad based strengthening in both the occupier and investment sectors across the regions. Increasing occupier demand, decreasing availability, falling tenant inducements and upward pressure on rents is evident across the retail, office and industrial sectors and not only London, but also the South, Midlands and Wales and the North.

In the key South East office centres of Cambridge, Guildford and Reading capital values advanced by 9% in the six months ending March 2014 and in the Big Six [1] regional towns office capital growth over the same period amounted to 4%. Over the same period capital values in key South East industrial centres grew by 7% as did values in the largest Rest of UK industrial centres.

In office centres around the M25 take-up amounted to 750,000 sq ft in Q1 2014, taking the total for the last 12 months to 2.7m sq ft. This is the highest level achieved since Q4 2008 and slightly above the 10-year annual average. The M25 vacancy rate has been steadily decreasing and at 6.8% is now back to its previous low level last achieved in Q2 2008. Limited speculative development is also being undertaken with the pipeline totalling 1 million sq.ft. of which 250,000 sq.ft. has been pre-let.

Across South East and East of England industrial centres take-up amounted to 1.2 million sq ft in Q1 2014, taking the total for the last 12 months to 8 million sq ft. Although this is some 11% below the 10-year annual average, the vacancy rate has been steadily decreasing and at 8.2% is now back to its 2008 level. The industrial pipeline is 1.3 million sq.ft. with all but 108,000 sq.ft pre-let.

Across the South East and Eastern regions investment transactions increased by 37% in Q2 to £2.5 billion taking the total in the last 12 months to £9.6 billion; an increase of 62% on the total amount transacted in the 12 months to June 2013.

In the Big Six regional towns office leasing activity has been more limited but is nevertheless recovering. Take-up in Q1 amounted to 240,000 sq ft, taking the total for the last 12 months to 920,000 sq ft. Annual take-up which last exceeded a million sq ft in 2008 was 907,000 sq ft in 2013. The Big Six vacancy rate has also been decreasing and is now 15% having been as high as 18% in 2012. Speculative development is once again starting up having ceased completely post-recession. The pipeline currently amounts to 1.6 million sq ft of which 700,000 sq ft has been pre-let.

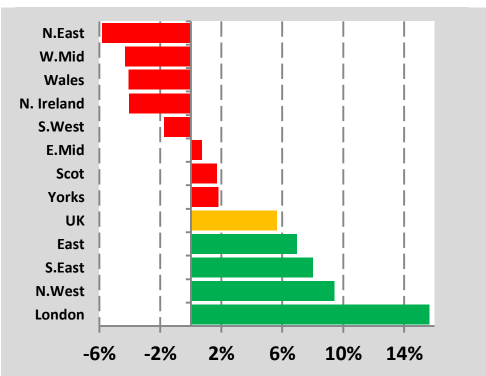
Take-up of Rest of UK industrials has exceeded its long run average of 35 million sq ft in each of the last four years. Vacancy rates peaked at 17.4% in 2012 but are now 10.5% and the lowest since 2008.

Across a range of key regional centres investment transactions increased by 32% in Q2 to £989 billion taking the total in the last 12 months to £3.3 billion; an increase of 56% on the total amount transacted in the 12 months to June 2013.

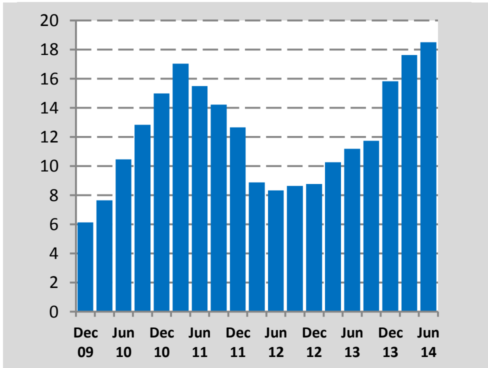
There are signs that over the last six months economic recovery has slowly started to seep out of London and into the regional economies. Businesses have responded to this by cautiously taking on staff and acquiring additional space. For the real estate sector this means that leasing activity is increasing and availability is finally coming down. Commercial property construction ceased completely in the aftermath of the crash so any occupier requiring 20,000 sq ft or more of Grade A office space in the regional centres will find it a challenge. Consequently the development pipeline is starting to grow once more.

Whether responding to the signs of growth or seeking a yield advantage over the high Central London prices, investors have increased their exposure to regional property in the last six months (see Chart). These early movers should benefit from an upwards re-rating of their assets as more cautious investors now seek to put their money into the market.

Workforce growth by region Mar 2008 – Mar 2014.



Rolling 12m Rest of UK investment (£bn)



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[1] The Big Six regional centres are Birmingham Bristol, Edinburgh, Glasgow, Leeds and Manchester.