september 2014

investment bulletin

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Institutional Investment in Property

The UK economy is about to record its seventh consecutive quarter of growth. Growth was 0.9% in Q2 and 3.2%in the year to June. The Markit PMI index constructed from surveys of the services, manufacturing and construction industries in September indicated that the UK economy enjoyed another period of above trend economic growth in the third quarter. The survey is consistent with GDP growth of 0.8% in the third quarter, down from 0.9% in the three months to June; and there are signs that economic growth could slow further in the fourth quarter. The impact of weak economic growth in the euro area, the UK's largest export market, has been exacerbated by a marked appreciation in sterling in recent months.

Following the lead of the broader economy, the commercial property market enjoyed its sixth consecutive quarter of increasing prices in the third quarter. The pace of growth moderated slightly form the second quarter as capital values measured by the IPD Monthly index rose by 3.2% in Q3 2014 compared to 3.5% in Q2. Total returns decreased to 4.7% in Q3 from 5.1% in Q2 but total returns in the 12 months to September increased to 19.7% from 17.6% in the 12-months to June.

As confidence about the outlook for the economy was maintained, institutional investors again strengthened their appetite for commercial property market in Q2 acquiring property assets worth £2.5 billion and recording sales of £968 million. Net investment in Q2 of £1.5 billion compared to net investment of £1.3 billion in Q1. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 17 out of 19 quarters. In the 12 months to June, net investment by institutions amounted to £5.2 billion compared with net investment of £3.1 billion in the 12 months to March.

In the second quarter, pension funds invested a further £173 million compared to £108 million in Q1 and have been net investors for the last twenty nine quarters. Total investment by pension funds in the 12 months to June amounted to £922 million compared to £795 million in the 12 months to March and £1.1 billion in the year to June 2013. Life companies continued to acquire property for the third consecutive quarter in Q2. Net investment in Q2 amounted to £505 million compared to £598 million in Q1. Total investment in the 12 months to the end of June amounted to £1.8 billion compared to net investment of £254 million in the 12 months ending March and a disinvestment of £1.1 billion in the year to June 2013. Property Unit Trusts were net investors for the nineteenth consecutive quarter and invested £770 million in Q2 compared to £548 million in Q1. Net investment in the 12 months to the end of June amounted to £2.1 billion compared with net investment of £1.6 billion in the 12 months ending March and £597 million in the year to June 2013 (National Statistics, 2014).

Investment in Central London offices decreased by 28% to £3.4 billion from £4.6 billion in Q2. This key market segment made up 27% of all transactions in Q3 compared to 37% in Q2. Investment in Rest of UK offices, retail warehouses and leisure property increased in Q3 compared to Q2. Retail warehouse investment more than doubled from £480 million to £1.2 billion. Investment in shops, shopping centres and industrials declined in Q3 (Property Data, 2014).

Investment by UK institutions and property companies in Q3 decreased by 13% to £7.1 billion from £8.2 billion in Q2. Money into commercial property from overseas investors increased by 21% to £5.3 billion from £4.4 billion and overseas investors share of the UK investment market increased from 35% in Q2 to 43% in Q3 (Property Data, 2014).

Total institutional investment shrank by 51% to £14.8 billion in Q2 from £30.4 billion in Q1. Institutions made net investments in Q2 of £5.4 billion in cash and other short term instruments, £4.3 billion in overseas equities, £3.7 billion in UK gilts, but were net sellers of £4.2 billion in UK equities (National Statistics, 2014).

Investment in UK commercial property

The initial UK commercial property market recovery from the great crash of 2007, 2008 and 2009 when capital values fell 44% lasted just 27 months before the full implications of the Government's austerity programme were considered. The second leg of recovery which set in once a wider economic recovery became entrenched has now lasted 16 months and values are now 26% higher than they were at the bottom of the market.

At this stage in the cycle should investors be cautious about putting more money into the market or indeed consider taking some money out.

In 1993 after 16 months of falling values an initial recovery lasted 13 months before petering out as rental values continued to fall. The return of rental growth in mid-1996 heralded a return of confidence and values increased for all but three out of the next 57 months as the UK economy grew by 3% a year over that period.

The recovery from the dip caused by the bursting of the dot-com bubble and recession in the United States stretched out for 65 months as the UK economy again grew at an annualised average of 3%. So by the standards of the recent past we could expect this growth stage of the current cycle to stretch out for a further 40 months or so.

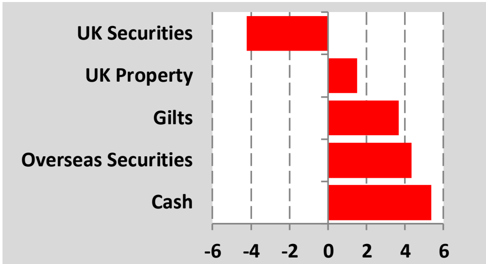
The key driver of performance in each period was strong underlying macro-economic performance. Today it is no coincidence that the robust performance from commercial property has coincided with growth in UK output which has averaged 2.9% a year since the end of 2012. Recent

Investment in UK Property
Q2 2014 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	656	940	895	2,491
Sell	483	360	125	968
Net	**173**	**580**	**770**	**1,523**

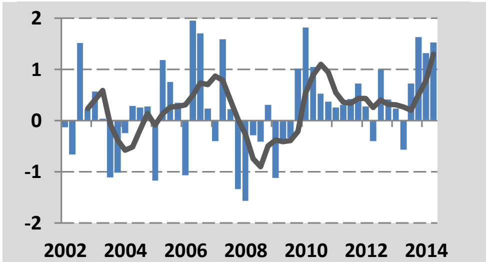
Source: National Statistics

Net Institutional Investment (£billion) Q2 2014
By asset type



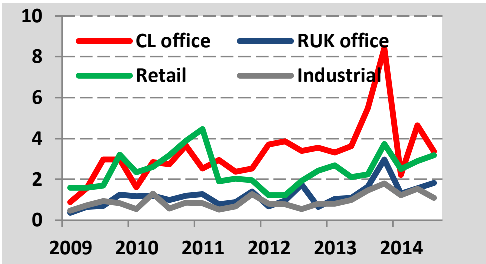
Source: National Statistics

Net Institutional Investment in Property (£billion)



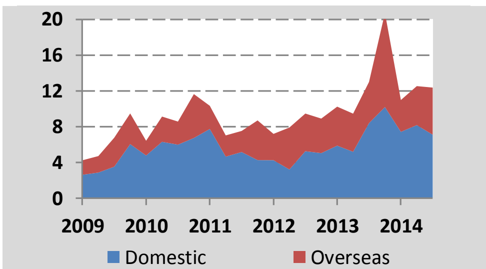
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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statements from the IMF and the Bank of England's Chief Economist, however, indicate that growth in output is set to weaken over the coming months. Consequently, expect growth in the capital values of UK commercial property to slow from the current rate of 7.4% a year achieved since December 2012.

Values remain 29% below their peak suggesting that the recovery has plenty left in its legs yet.

It is by no means certain, however, that the market will recover its 2007 high. During the dot-com boom the FTSE100 index peaked at 6,930 in December 1999. As that bubble burst, the market more than halved in value to 3,287 in March 2003. The index recovered to 6,732 in June 2007 before the onset of the credit crunch and Great Recession sent the market back down to 3,512 in March 2009. Now almost 15 years later the FTSE100 index stands at 6,260, still 10% below its 1999 peak.

Valuations were so stretched by June 2007, that as interest rates peaked at 5.75% and the sub-prime mortgage crisis in the USA triggered the credit crunch, they fell for 12 consecutive months before the onset of the Great Recession and without any corresponding decline in rental values.

The All Property initial yield is currently 5.7%. At the top of the market the property yield was 4.6%. As we have noted above this level was unsustainable and reference to the average initial yield over the last 10 years of 6.0% sheds a different light on the valuation of the current market.

Across each market segment capital values have reached a level that reflects an initial yield below the 10 year average with the exception of Rest of UK shops and retail warehouses. The valuations of Central London shops and prime Central London offices reflect yields that are lower than those achieved at the top of the market. This simplistic analysis would indicate that investors will be unlikely to benefit from any further yield re-rating of any significance.

Risky assets such as equities and commercial property should be valued by reference to the risk free rate which is taken as the rate offered by benchmark government bonds; Treasuries in the USA and gilts in the UK. At its current level the All Property initial yield benefits from a 360 basis point margin over the 5-15 year gilt yield of 2.3%. The average yield gap over the last 10 years of 226 bps suggests that there may yet be scope for further capital value growth.

Interest rates are, of course, at record lows and will only increase from their current level. In the last two months, two dissenting voices have appeared on the minutes of the interest rate setting Monetary Policy Committee arguing for an immediate increase in rates.

If All Property yields remain static, an increase in interest rates of 1% together with a corresponding increase in gilt yields would reduce the property – gilt yield gap below the 10 year average and that starts to make property valuations look expensive.

When are interest rates likely to rise?

In September inflation fell to 1.2% year on year and is comfortably below the 2.0% target. This would normally suggest that interest rates should be reduced further rather than increased.

Pressure on interest rates from wage growth is also limited. The latest figures show that although the economy generated more than 750,000 jobs over the last 12 months, average earnings were just 0.7% higher in the year to July 2014. In his speech to the TUC Congress in September, Mark Carney, The Governor of the Bank of England, noted that, "adjusted for inflation wages have fallen by a tenth since the onset of the crisis. And in order to find such a fall in the past, you would have to go back to the early 1920s." He believes that as a result of an increase in part-time work and self-employment wage are as low today as if the unemployment rate were 10%, not the 6.0% rate it currently is. Consequently, the Bank's latest forecast is that it will be the middle of 2015 before any real wage growth is experienced.

Not surprisingly, the October edition of Forecasts for the Economy published by the Treasury shows that independent forecasters expect interest rates to remain unchanged at 0.5% at the end of the current year but to rise by 0.75% to 1.25% in 2015. In addition, the path of bank rates in the future implied by certain financial market instruments which condition the MPC's CPI and GDP forecasts, indicate that the bank rate is expected to rise further to 2.0% by the end of 2016.

Even when the Bank Rate does eventually increase the impact on the longer term interest rates used to benchmark property pricing could be limited. Longer term gilt yields have consistently been pricing in an increase in Base Rate See chart).

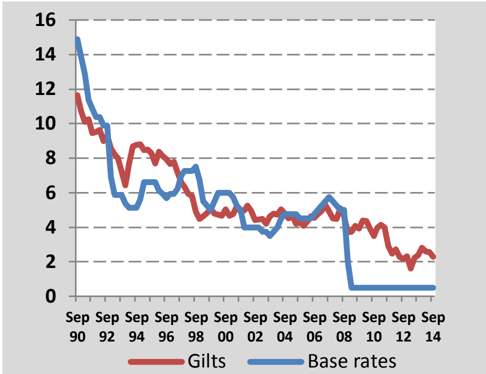
Investors adopting a risk averse approach should not rely too much on any further re-rating of yields to drive returns. On the up-side property yields are unlikely to soften in response to the expected rise in Base Rate. Investors should instead look to growth in rental values to support valuations. Encouragingly All Property rental values have been improving throughout the year and are now running at 2.5% year on year. The down side is that a slow-down in economic growth will restrain rental growth and any further tightening in yields may be unwound.

References

Office for National Statistics. Investment by Insurance Companies, Pension Funds and Trusts, Q2 2014

Property Data. The UK Property Investors Bulletin, September 2014.

Interest rates



Source: FTSE & Bank of England

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