december 2014

investment bulletin

Fletcher King
CHARTERED SURVEYORS

Institutional Investment in Property

The UK economy is about to record its eighth consecutive quarter of growth. Growth was 0.7% in Q3 and 3.1% in the year to September. The Markit PMI index constructed from surveys of the services, manufacturing and construction industries in December indicated that weaker rates of expansion were seen across all three main sectors of the economy, taking the overall pace of economic growth to the weakest for just over a year-and-a-half. The survey is consistent with GDP growth of 0.5% in the fourth quarter and 2.6% over the whole of 2014.

Following the lead of the broader economy, the commercial property market enjoyed its seventh consecutive quarter of increasing prices in the fourth quarter. The pace of growth moderated slightly form the third quarter as capital values measured by the IPD Monthly index rose by 2.9% in Q4 compared to 3.2% in Q3. Total returns decreased to 4.4% in Q4 from 4.7% in Q3 and total returns in the 12 months to December decreased to 19.3% from 19.7% in the 12-months to September.

As confidence about the outlook for the economy was maintained, institutional investors again strengthened their appetite for commercial property in Q3 acquiring property assets worth £3.0 billion and recording sales of £1.2 billion. Net investment in Q3 of £1.8 billion compared to net investment of £737 million in Q2. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 18 out of 20 quarters. In the 12 months to September, net investment by institutions amounted to £5.8 billion compared with net investment of £4.5 billion in the 12 months to June.

In the third quarter, pension funds invested a further £426 million compared to £307 million in Q2 and have been net investors for the last thirty quarters. Total investment by pension funds in the 12 months to September amounted to £1.2 billion compared to £951 million in the 12 months to June and £580 million in the year to September 2013. Life companies continued to acquire property for the fourth consecutive quarter in Q3. Net investment in Q3 amounted to £350 million compared to £507 million in Q2. Total investment in the 12 months to the end of September amounted to £2.5 billion compared to net investment of £2.1 billion in the 12 months ending June and a disinvestment of £1.8 billion in the year to September 2013. Property Unit Trusts invested £939 million in Q3 compared to a disinvestment of £154 million in Q2 after 18 consecutive quarters of net investment. Net investment in the 12 months to the end of September amounted to £1.7 billion compared with net investment of £1.2 billion in the 12 months ending June and £874 million in the year to September 2013 (National Statistics, 2014).

Investment in Central London offices in Q4 increased by 41% to £5.9 billion from £4.2 billion in Q3. This key market segment made up 37% of all transactions in Q4 compared to 26% in Q3. Investment in Shopping Centres and Industrials increased in Q4 compared to Q3. Investment in Retail Warehouses and Shops fell heavily; and Rest of UK Offices and Leisure property also declined in Q4. (Property Data, 2014).

Investment by UK institutions and property companies decreased by 16% in Q4 to £7.4 billion from £8.8 billion in Q3. Money into commercial property from overseas investors increased by 14% to £8.4 billion from £7.4 billion and overseas investors share of the UK investment market increased from 46% in Q3 to 53% in Q4 (Property Data, 2014).

Total institutional investment more than doubled to £23.2 billion in Q3 from £10.6 billion in Q2. Institutions made net investments in Q3 of £8.3 billion in cash and other short term instruments, £7.9 billion in UK gilts, £1.3 billion in overseas equities but were net sellers of £1.8 billion in UK equities (National Statistics, 2014).

Reflections on 2014 and the outlook for 2015

2014 was cast as the year that the global economic recovery gathered momentum. Since the collapse of Lehman Brothers in September 2008 triggered the near collapse of the banking system and the start of the "Great Recession", Base Rates had been maintained at record low levels across the developed world to support a slow and halting recovery. In 2014 it was expected that Central Banks would finally begin to increase Base Rates albeit slowly and carefully; and without causing any shocks to markets through the use of "forward guidance".

The outcome was slightly different. Global growth picked up only marginally to 2.6% in 2014 from 2.5% in 2013. Growth gained momentum in the USA and UK but disappointed in the Euro Area, Japan and emerging Europe i.e. Russia.

One of the biggest financial events of last year was the fall in the price of oil from $100 to $50. Some oil economists have suggested that the price could fall as low as $20. OPEC and in particular Saudi Arabia seem determined to maintain output by lowering prices to a level where the output of more expensively produced North American shale oil and gas is reduced to balance supply and demand.

Supported by an encouraging macro-economic background, stock markets in the USA delivered robust returns. On Wall Street, the S&P 500 was up 11.4% on the year and the Dow Jones Industrial Average rose 7.5%. The return on the FTSE North American index was 12.6%.

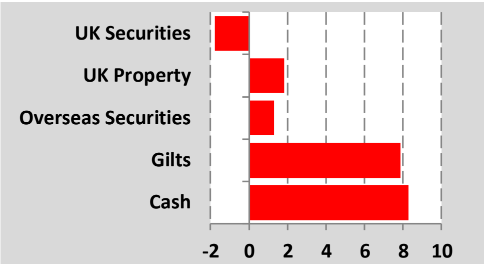
The return on equities listed on the major stock markets elsewhere disappointed. In Europe, the total return on the FTSE Eurobloc was -8.0%, with

Investment in UK Property
Q3 2014 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	796	920	1,326	3,042
Sell	370	451	387	1,208
Net	**426**	**469**	**939**	**1,834**

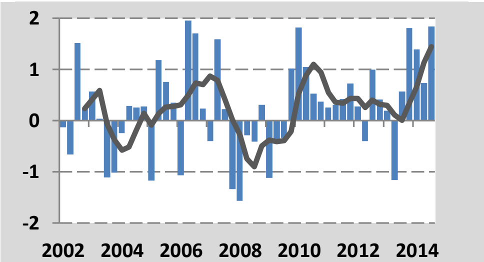
Source: National Statistics

Net Institutional Investment (£billion) Q3 2014
By asset type



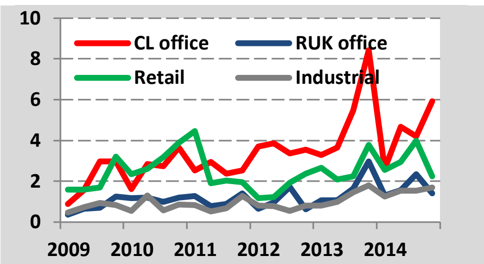
Source: National Statistics

Net Institutional Investment in Property (£billion)



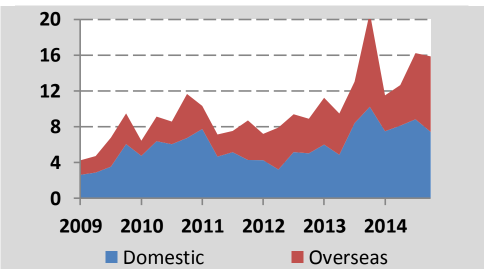
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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Germany's Xetra Dax, finishing just 2.7% higher and France's CAC 40 down -0.5% on the year. London's FTSE 100 produced a total return for the year of just 0.7%. Total returns on the FTSE 250 index, more exposed to the domestic economy than the FTSE 100, were 3.7%.

Gold suffered heavy losses in 2013, recording the biggest fall for three decades and grew by just 0.4% in 2014.

The return on bonds surprised on the upside as inflation expectations declined and tightening of monetary policy appeared likely to be delayed further. In Germany the yield on 10 year bonds decreased from 1.9% in 2013 to 0.5% at the end of 2014, and in the USA the yield on 10 year Treasuries decreased from 3.0% to 2.2%. The FTSE Actuaries 5-15 year gilt index recorded a total return of 12.2% in 2014.

UK commercial property was one asset class to produce outstanding performance as it benefitted from the support given by the strength of the domestic economic recovery. As the year started, IPF Consensus forecasts were for commercial property to provide total returns of 12.1% in 2014. As was the case the previous year, expectations were on the low side. Rental growth of 3.1%, which was the highest in a calendar year since the end of 2007, together with yield compression of 76 bps meant that All Property total returns amounted to 19.3% in 2014.

The best performing segments of the UK commercial property market in 2013 were Central London shops accompanied by Rest of South East offices and industrials, with City, Midtown and West End offices once again amongst the top performers (see Chart).

Outside of London the best performing office markets were Cambridge, Cardiff, Leicester, Leeds & Guildford. The best performing industrial centres were Chester, Sheffield, Oxford, Bristol & Birmingham. In the first three quarters of the year capital growth on the IPD Key Centre index for Chester and Sheffield industrials was greater than the annualised equivalent of 20%.

Retail property continued to flounder as not one retail segment outperformed the All Property average. The worst performing segment was Rest of UK shops, where although capital values increased by 3.0%, rental values decreased by -0.7%. Shopping Centres and Retail Warehouses also had another weak year as rental values were barely maintained.

The only retail centre outside of London to outperform the All Property average is likely to have been Brighton, where over the first three quarters of the year investors enjoyed capital growth at the annualised equivalent of 14%.

All Property capital values have increased by 15.4% in the last two years. The values of Central London shops are now 32% higher than their pre-crash peak and West End offices are now 8% higher. But they are the only two segments of the market to have recovered all the ground lost since 2007. All property capital values remain 29% lower than the levels seen at the top of the market while City offices are still 16% off their peak. As a result, Property's great advantage continues to be its income return. The initial yield on the IPD index is 5.4%. The yield on the FTSE Actuaries 5-15 year gilt index is 1.6% and the dividend yield on the FTSE100 index is 3.4%.

2015 should see a different investment environment to that prevailing over the last two years. There is now little scope for any further re-rating of property yields and performance will need to be driven by rental value growth.

In most office and industrial markets, after the economic turbulence experienced since 2008, rents are low by historical standards and new development has been negligible. Any increase in demand from businesses seeking to expand will lead to a rapid decrease in availability driving rental values higher.

Retail markets will continue to underperform as the scope for rental value growth remains limited. The impact of internet shopping from computers, tablets and mobile phones, on traditional retailing still has further to go.

Risks remain. The global economy is not likely to return to the pre-2007 world of constant growth and low inflation. On the upside, as Anatole Kaletsky writing in the Guardian observed, every global recession since 1970 has been preceded by at least a doubling of the oil price, and every time the oil price has fallen by half and stayed down for six months or so, a major acceleration of global growth has followed. Soft oil prices are expected to persist, supporting global growth albeit dampening prospects for oil-exporting countries.

On the downside, tightening of monetary policy through unwinding quantitative easing or raising interest rates could result in increased volatility in markets and unexpected events. Low inflation and forecasts of reduced growth across the world's advanced economies, however, make the prospect of a rapid and de-stabilising rise in rates unlikely.

References

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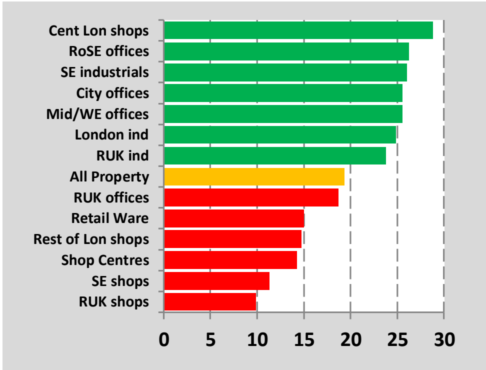
Property Data. The UK Property Investors Bulletin, September 2014.

Anatole Kaletsky (January 2015), "What is the future direction of oil prices". The Guardian.

Total return(%) by segment 2014



Source: IPD

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