march 2015

investment bulletin

Fletcher King

CHARTERED SURVEYORS

Institutional Investment in Property

Although the recovery remains the slowest in modern times, the economy grew by 0.6% in Q4. Output at the end of 2014 was 2.8% higher making it the strongest year for the economy since 2006. The latest official data suggests that the economy slowed in Q1 as manufacturing and construction activity weakened. However, the UK economy remains on track to record its ninth consecutive quarter of growth as PMI data suggests that both manufacturing and construction recovered in March, while service sector output accelerated.

Following the lead of the broader economy, the commercial property market enjoyed its eighth consecutive quarter of increasing prices in the first quarter of the year. While still strongly positive, the pace of growth has been slowing since last July. Capital values measured by the IPD Monthly index rose by 1.6% in Q1 2015 compared to 2.9% in Q4 2014. Total returns decreased to 3.0% in Q1 from 4.4% in Q4 and total returns in the 12 months to March decreased to 18.3% from 19.3% in the 12-months to December.

As confidence about the outlook for the economy remained strong, institutional investors maintained their appetite for commercial property in Q4 acquiring property assets worth £3.1 billion and recording sales of £1.3 billion. Net investment in Q4 of £1.85 billion compared to net investment of £1.79 billion in Q3. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 19 out of 21 quarters. In the 12 months to December, net investment by institutions amounted to £5.73 billion compared with net investment of £5.69 billion in the 12 months to September.

In the fourth quarter, **pension funds** invested a further £263 million compared to £402 million in Q3 and have been net investors for the last thirty one quarters. Total investment by pension funds in the 12 months to December amounted to £1.15 billion compared to £1.16 billion in the 12 months to September and £558 million in the year to December 2013. **Life companies** continued to acquire property for the fifth consecutive quarter in Q4. Net investment in Q4 amounted to £904 million compared to £349 million in Q3. Total investment in the 12 months to the end of December amounted to £2.36 billion compared to net investment of £2.55 billion in the 12 months ending September and a disinvestment of £613 million in the year to December 2013. **Property Unit Trusts** invested £666 million in Q4 compared to £918 million in Q3. Net investment in the 12 months to the end of December amounted to £1.95 billion compared with net investment of £1.70 billion in the 12 months ending September and £1.21 billion in the year to December 2013 (National Statistics, 2015).

Investment in Central London offices in Q1 2015 decreased by 63% to £2.7 billion from £7.3 billion in Q4 2014. This key market segment made up 23% of all transactions in Q1 compared to 34% in Q4. Investment decreased across all segments in Q4 compared to Q3 save one. The exception was shops and supermarkets where investment increased in Q1 by 63% to £1.3 billion from £820 million in Q4 (Property Data, 2014).

Investment by UK institutions and property companies decreased by 44% in Q1 to £6.1 billion from £10.9 billion in Q4. Money into commercial property from overseas investors decreased by 48% to £5.5 billion from £10.5 billion and overseas investors share of the UK investment market decreased from 49% in Q4 to 47% in Q1 (Property Data, 2014).

Total institutional investment went into reverse in Q4 as assets worth £11.0 billion were sold compared to a net investment in Q3 of £16.6 billion. Institutions made net disinvestments in Q4 of £8.5 billion in UK equities, £7.0 billion in cash and other short term instruments, £2.7 billion in UK gilts and £1.7 billion in overseas equities (National Statistics, 2014).

Retail and industrial; a tale of two sectors

The influence of digital technology continues to impact the UK's commercial property market; particularly the retail and industrial sectors.

Morrisons recently announced that it intends to shut 23 of its M convenience stores and halt new openings as the expansion of supermarkets convenience store operations comes to an end. In January Tesco announced the closure of 43 stores including 30 Metro and Express stores. After writing down the value of its stores by £3.8 billion in its latest report and accounts, analysts are calling for the closure of another 200 under-performing stores.

Tesco has, however, opened six "dark stores" around London, just to handle home-delivery orders. While Waitrose continues to grow its Little Waitrose format it has also opened a second e-commerce grocery fulfilment depot at Coulsdon, in March to support its expanding online offer.

With the exception of Central London shops, the retail sector remains commercial property's poor relation. In the year to March 2015 the rental values for Shopping Centres and Rest of UK shops declined by 1% while Retail Warehouse rental values stood still. After nine consecutive quarters of economic growth rental value growth has now spread to every other non-retail segment of the UK market.

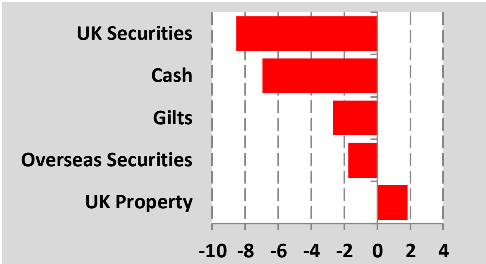
South East industrial values increased by 4% in the year to March 2015 and Rest of UK industrial rental values by 3%. UK shop rents remain 14% below their peak and Shopping Centres are 19% lower. Industrial rents are just 5% below their peak.

Investment in UK Property
Q4 2014 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	654	1,662	806	3,122
Sell	391	744	140	1,275
Net	**263**	**918**	**666**	**1,847**

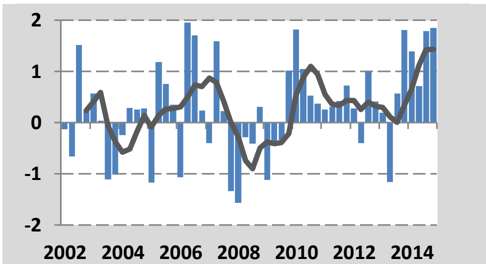
Source: National Statistics

Net Institutional Investment (£billion) Q4 2014
By asset type



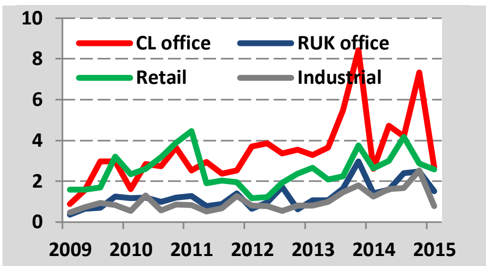
Source: National Statistics

Net Institutional Investment in Property (£billion)



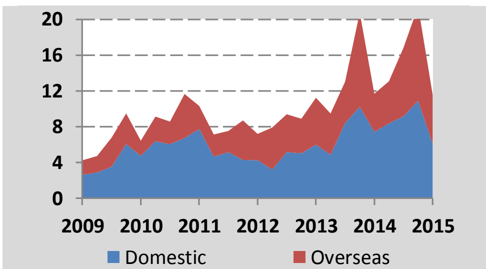
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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A survey by PwC and the Local Data Company indicates that a buoyant economy is not sufficient to make up for the long term structural problems afflicting the High Street. The asymmetric nature of the economic recovery means that although the economy has grown by 10% since the trough, real average weekly earnings are at levels last seen in 2000/01 (see chart). This is compounded by the continuing encroachment of digital technology. Internet sales now account for 4% of food sales and 12% of Clothing and Footwear. As the UK entered the Great Recession in March 2008, internet sales were just 4.5% of all retail sales.

The PwC Local Data Company study of 500 UK town centres showed that the number of retail premises left empty last year almost tripled; 5,839 shops were closed and 4,852 were opened. Net closures increased to 987 in 2014, up from 371 in 2013.

The biggest casualties were mobile phone retailers, which lost a net 419 stores, or 18% of their total number of shops. Most of those losses were caused by the failure of Phones 4U in September.

Tougher rules for short-term lenders and the collapse in the gold price forced the closure of 233 cheque cashing and pawnbroking shops. Britain's biggest payday lender, Wonga, recently reported losses of £37 million after the Financial Conduct Authority forced it to write off £220 million of loans to customers who should never have been given loans and the Church of England branded the company as morally wrong.

The impact of the internet is, of course, global. In the USA e-commerce accounts for 6.2% of all sales; and since 2012 the amount of industrial space in use has grown at an annual rate of 14.5 m square metres—double the pace in 2008. E-commerce accounts for a large proportion of this growth. At Prologis, the world's biggest industrial-property owner, 30% of projects built for specific tenants are tied to online sales.

Industrial rents in the USA rose by 3.4% last year, bringing them within 6% of their 2008 level. Meanwhile US retail rents are still 12% off their peak.

In the UK, the growth of internet shopping and a strong rise in the demand for warehouses is reflected in the 7% growth in the Transport and Storage sector of the economy in 2014; and the demand for industrial investments. In 2014 institutional investment turnover in UK industrial property was second only to offices.

New investors have been attracted by the prospects offered by the industrial sector. In 2012 Blackstone, a New York-based private-equity fund, set up a firm called Logicor to buy industrial assets in Europe. Logicor now owns 67 million sqm throughout Europe of which 1.35 million sqm are located in the UK.

SEGRO, a UK Reit, has a portfolio of £4.7 billion of assets located in the UK and across Europe. In 2014 as investment demand for logistics remained strong the Reit reported a 17.1% increase in the value of its UK portfolio, located in London, the South East and the Midlands' logistics 'golden triangle'.

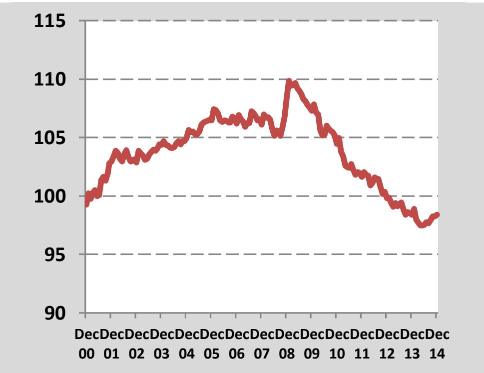
In 2015 Sego expects to experience a healthy demand for newly developed buildings, and further rental growth in London and South East England. Investment markets are also expected to remain strong supported by relatively high yields, the on-going low interest rate environment, and rental growth in UK industrial markets.

As online sales continue to grow, the UK's most successful brands have generally developed a multichannel offer. As well as a profitable location in its own right, the store can also function as a showroom for the product or a distribution location for their online sales. More and more, retailers note that online customers are opting to click and collect, allowing the retailer to minimise their distribution costs and enhance sales through further purchases once in store. Retailers need fewer stores to cover the UK population than 20 years ago but increasingly need to focus on prime destinations.

Shoppers are buying more goods over the internet or at shopping centres and mid-market retailers such as the lingerie chain La Senza, which collapsed in July, are increasingly losing out to upmarket brands and low-cost operators such as Primark.

Reflecting the shifting balance between retail and industrial property, UK institutional industrial development expenditure in 2014 was the highest since 2007 and since 2010 has outpaced development expenditure on shopping centres. New shopping centre development levels fell to an all-time low in 2014 and even by 2019 the supply is only expected to have reached around 3 million sq. ft. In 2008, a record year, over 8 million sq. ft. of new shopping centre space was built in the UK.

Real average weekly earnings index (2000=100)



Source: National Statistics

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