june 2015

investment bulletin

Fletcher King
CHARTERED SURVEYORS

Institutional Investment in Property

UK economic activity slowed in the first quarter. Economic growth decreased to 0.4% in Q1 from 0.8% in Q4 2014. Output at the end of Q1 was 2.9% higher than it was at the end of Q1 2014. The UK economy' however, remains on track to record its tenth consecutive quarter of growth. The Markit / CIPS PMI data suggests that manufacturing output and new orders were at their weakest since Q1 2013. The dominant service sector, however, showed strong improvements in June after a slight lull in May caused by the election.

Following the lead of the broader economy, the commercial property market enjoyed its ninth consecutive quarter of increasing prices in the second quarter of the year. The pace of growth which had slowed in Q1 increased once again in Q2. Capital values measured by the IPD Monthly index rose by 2.2% in Q2 compared to 1.6% in Q1. Total returns increased to 3.6% in Q2 from 3.0% in Q1. Total returns in the 12 months to June decreased to 16.7% from 18.3% in the 12-months to March.

Institutional investors' appetite for commercial property diminished in Q1 acquiring property assets worth £1.8 billion and recording sales of £1.4 billion. Net investment in Q1 of £349 million compared to net investment of £1.8 billion in Q4 2014. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 20 out of 22 quarters. In the 12 months to March, net investment by institutions amounted to £4.7 billion compared with net investment of £5.7 billion in the 12 months to December.

In the first quarter, **pension funds** invested a further £33 million compared to £216 million in Q4 2014 and have been net investors for the last thirty two quarters. Total investment by pension funds in the 12 months to March amounted to £974 million compared to £1.1 billion in the 12 months to December 2014 and £682 million in the year to March 2014. **Life companies** continued to acquire property for the sixth consecutive quarter in Q1. Net investment in Q1 amounted to £132 million compared to £947 million in Q4 2014. Total investment in the 12 months to the end of March amounted to £1.9 billion compared to net investment of £2.3 billion in the 12 months ending December 2014 and a disinvestment of £34 million in the year to March 2014. **Property Unit Trusts** invested £180 million in Q1 compared to £666 million in Q4 2014. Net investment in the 12 months to the end of March amounted to £1.6 billion compared with net investment of £2.0 billion in the 12 months ending December 2014 and £1.6 billion in the year to March 2014 (National Statistics, 2015).

Investment in Central London offices in Q2 increased by 15% to £3.9 billion from £3.4 billion in Q1. This key market segment made up 37% of all transactions in Q2 compared to 19% in Q1. Investment decreased across all other segments in Q2 compared to Q1 save one. The exception was Retail Warehouses where investment increased in Q2 by 21% to £736 million from £610 million in Q1 (Property Data, 2015).

Investment by UK institutions and property companies decreased by 32% in Q2 to £5.8 billion from £8.6 billion in Q1. Money into commercial property from overseas investors decreased by 48% to £4.7 billion from £9.0 billion and overseas investors share of the UK investment market decreased from 51% in Q1 to 44% in Q2 (Property Data, 2015).

The largest deal of Q2 was the Canadian Brookfield Group's £2.4 billion acquisition of Center Parcs from Blackstone Group of the USA; which as a corporate deal is excluded from the above numbers.

Total institutional investment returned to positive territory in Q1 as assets worth £7.3 billion were acquired compared to a net disinvestment in Q4 of £10.4 billion. Institutions made net investments in Q1 of £13.2 billion in cash and other short term instruments and £2.7 billion in overseas equities but sold £9.7 billion of UK equities and £4.4 billion of UK gilts (National Statistics, 2015).

Central London property values

What are the risks that investors should look out for?

Only in Central London has commercial property recovered all of the value lost in 2007-2009 by the world financial crisis. Central London shops are 55% higher than their June 2007 values and West End office values are 23% higher. City of London offices remain 4% below their June 2007 high and London industrials have almost recovered their peak. Throughout the rest of the UK the value of commercial real estate still is a long way below its peak.

Across the UK average initial yields remain 58 basis points (bps) above their June 2007 levels. Central London shops are, however, 92 bps below their 2007 level. City and West End office yields are now 50 bps lower than the level achieved at the top of the market. Clearly there is further room for some strong growth in all segments of the market outside Central London. In Central London, however, the focus is more on value and the likely trigger of the next downturn?

A comparison of the pricing, however, of Central London assets in June 2007 and today can only take us so far. Conditions now and then were very different. In June 2007 the Bank of England base rate was 5.50% and the 5-15 year gilt yield was 5.25%. Today, the base rate is 0.5% and the gilt yield is 2.0%. In 2007 Central London shops and offices and London industrials were valued at a discount to the then prevailing gilt rate. Today although the same sectors are valued at record low yields the multiple applied reflects a premium to the gilt rate.

Current yields in Central London are supported by robust levels of rental growth and investment demand particularly from overseas investors. Development starts in the first half of 2015 were at the second highest level for 20 years yet there is little immediate prospect of oversupply and falling

Investment in UK Property
Q1 2015 (£m)

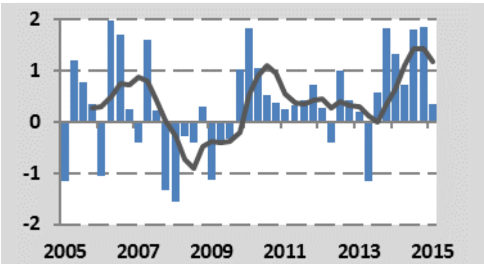
	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	793	568	434	1,795
Sell	760	442	244	1,446
Net	33	126	190	349

Source: National Statistics

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

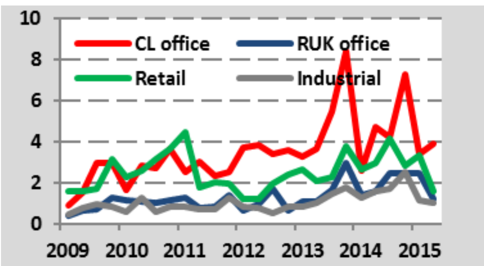
Source: National Statistics

Net Institutional Investment in Property (£billion)



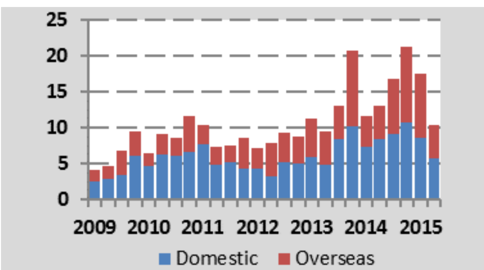
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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rental values. New office space of 4.4 million sq ft has to be seen in the context of take-up of 15 million sq ft in 2014 and low availability rates. In addition since 2002 development completions have averaged 4.7 million sq ft a year.

Could any outside threats severely damage investor or occupier sentiment and trigger a collapse in London's commercial property prices?

The **Greek crisis** has dominated headlines in the financial markets. As a result, gilt yields have been volatile over the past month and have risen by 46bps since the end of March. As yet there are few signs of an adverse impact on consumer and non-financial business sentiment.

The first round of **public expenditure cuts** after the 2010 General Election seem to have contributed to the ill balanced nature of the UK's economic recovery. The latest figures available for regional and sub-regional economic activity show that between 2007 and 2013 only London and the South East have enjoyed growth greater than the UK average.

The recent Treasury announcement of £20 billion of cuts required from non-protected Whitehall Departments as well as £12 billion of welfare savings is likely to further slow growth in the regions. London, however, as the only global rival city to New York is unlikely to feel the chill wind of austerity.

Arguably these events because they have long been known about have already been priced in or discounted as having little impact on the pricing of Central London property.

Two further categories of risk need consideration. The first being the possibility of the UK voluntarily leaving the EU and the second being Donald Rumsfeld's "unknown unknowns".

Deregulation of Britain's financial markets just as new European rules made it possible for firms based in London to do business anywhere in the EU attracted foreign firms to London in the early 1990s. This makes the prospect of "**Brexit**" especially worrisome to London's economy.

The biggest fear is that firms based in London will lose their rights to do business throughout the EU while being supervised only by British regulators. In theory, a departing Britain might negotiate a treaty with Europe which retained such privileges but this is highly unlikely as France and Germany would seek to grow Paris and Frankfurt as rivals to London.

In the worst-case scenario, Britain would have to negotiate access for its financial firms country by country. EU regulators would seek to limit the flow of money to an offshore financial centre. Pressure would be placed on European fund managers funds to manage their investments within the bloc.

Employees already complain about the difficulty of arranging work permits for migrants from outside the EU. After Brexit new immigration rules are likely to strip current and future European employees, of which London has many, of the right to work in Britain.

Advocates of Brexit talk up the advantages of escaping from European rules on finance, in particular the cap on bankers' pay. In the wake of the financial crisis Britain has moved far away from "light touch" regulation and, if anything, has stricter regulation than required by Brussels.

London's ability to adapt would be tested by a shock as deep as Brexit. For the moment, however, polls suggest that Britain will opt to remain in the EU. Businesses are unlikely to start shifting functions as long as that remains the case. But there are already reports of firms delaying opening a London office until after the referendum.

At the start of 2007 collateralised debt obligations and residential mortgage backed securities were many property fund managers equivalent of "unknown unknowns". In earlier cycles in the 1970's, 80's and 90's rental growth was driven by macro-economic movements. Yields contracted as rental value growth swung up and expanded as rental value growth slowed.

The property boom of 2003-2006 and the associated crash of 2007-2009 was the first recorded property cycle which exhibited major yield movements without any associated signal from the economy or rental growth (see Chart 1). The onset of the crash was not caused by an economic downturn but by a crisis of confidence and a withdrawal of liquidity.

Rising interest rates caused the housing market in the USA to turn down in 2007 and exposed fragilities in the financial system. The financial engineering that pooled bundles of low quality loans did not provide investors with the promised protection. Mortgage-backed securities slumped in value and supposedly safe CDOs turned out to be worthless, despite the ratings agencies' seal of approval.

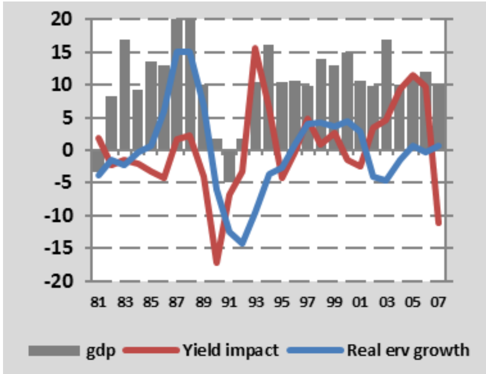
Eventually, banks started questioning the viability of their counterparties. They and other sources of wholesale funding began to withhold short-term credit, causing those most reliant on it, such as Northern Rock, to founder. From September 2007 banks began to withdraw new credit from the commercial real estate sector and net investment fell sharply. By the end of the year UK All Property capital values were down 11% and by the end of March 2008 they were off 15%. The "known" risks from a declining economy and decreasing rental value growth, however, continued on an upwards trajectory as rental values grew at an annualised rate of almost 4% until the onset of recession in June 2008.

Although good opportunities always exist in Central London, commercial real estate is fully valued but supported by market fundamentals. Known risks appear to have been discounted. The real risks are the unknown consequences of "Brexit"; or something totally out of left field.

Sources

New Capital Markets & the New Property Cycle; Tony Key.
A Chance of Showers; The Economist, 28th July 2015.
Origins of the Financial Crisis; The Economist 7th Sep 2013.

Chart 1; GDP, real erv & yield impact1981-2007



Source: IPD

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