september 2015

investment bulletin

Institutional Investment in Property

After slowing in the first quarter UK economic growth picked up pace again in Q2. Economic growth increased to 0.7% from 0.4% in Q1. Output at the end of Q2 was 2.7% higher than it was at the end of Q2 2014.

Uncertainty over the outlook for global economic activity resulted in the slowest rate of economic growth for two-and-a-half years in Q3. The Markit/CIPS PMI data suggests that growth slowed to 0.5% in Q3 and going into Q4 the pace of growth has slipped further to just 0.3%.

Shrugging off any doubts created by the broader economy, the commercial property market enjoyed its tenth consecutive quarter of increasing prices in the third quarter of the year. Capital values measured by the IPD Monthly index rose by 2.1% in Q3 compared to 2.2% in Q2. Consequently, total returns decreased slightly to 3.4% in Q3 from 3.6% in Q2. Total returns in the 12 months to September decreased to 15.3% from 16.7% in the 12-months to June.

Institutional investors' appetite for commercial property increased in Q2 acquiring property assets worth £2.4 billion and recording sales of £1.2 billion. Net investment in Q2 of £1.2 billion compared to net investment of £104 million in Q1. Since the start of the market recovery in Q4 2009 institutions have been net purchasers of commercial property in 21 out of 23 quarters. In the 12 months to June, net investment by institutions amounted to £4.9 billion compared with net investment of £4.5 billion in the 12 months to March.

In the second quarter, **pension funds** invested a further £198 million compared to a net disinvestment of £17 million in Q1 when pension funds sold property for the first time since 2007. Total investment by pension funds in the 12 months to June amounted to £813 million compared to £924 million in the 12 months to March and £953 million in the year to June 2014. **Life companies** continued to acquire property for the seventh consecutive quarter in Q2. Net investment in Q2 amounted to £137 million compared to £132 million in Q1. Total investment in the 12 months to the end of June amounted to £1.6 billion compared to net investment of £1.9 billion in the 12 months ending March and £2.0 billion in the year to June 2014. **Property Unit Trusts** invested £754 million in Q2 compared to disinvestment of £15 million in Q1. Net investment in the 12 months to the end of June amounted to £2.3 billion compared with net investment of £1.4 billion in the 12 months ending March and £1.2 billion in the year to June 2014 (National Statistics, 2015).

Investment in Central London offices in Q3 decreased by 36% to £3.3 billion from £5.1 billion in Q2. This key market segment made up 32% of all transactions in Q3 compared to 31% in Q2. Investment decreased across all other segments in Q3 compared to Q2 except Shopping Centres and Retail Warehouses. Shopping Centre investment increased by 60% to £813 million and Retail Warehouses investment increased by 30% to £1.2 billion. (Property Data, 2015).

Investment by UK institutions and property companies decreased by 30% in Q3 to £5.9 billion from £8.5 billion in Q2. Money into commercial property from overseas investors decreased by 45% to £4.4 billion from £8.1 billion and overseas investors share of the UK investment market decreased from 49% in Q2 to 43% in Q3 (Property Data, 2015).

The largest deal of Q3 was Goldman Sachs sale of a portfolio of 44 hotels to Metropark for £400 million. The sale of the Alphabeta Building for £280 million was Central London's largest transaction. Outside London and the South East the largest deal was the sale of Parkgate Retail Park in Rotherham for £175 million.

Total institutional investment remained in positive territory in Q2 as assets worth £20.4 billion were acquired compared to a net investment in Q1 of £11.7 billion. Institutions made net investments in Q2 of £8.2 billion in UK gilts and £6.4 billion in overseas equities but sold £2.2 billion of cash and other short term instruments and £8.6 billion of UK equities and (National Statistics, 2015).

Regional property

The regions outside London and the South East offer better value to investors

London dominates the UK's economy to a degree that is unusual in many other European countries. It accounts for 22% of the UK economy. London and the South East together represent 37% of UK gross value added (GVA). The North West is the next largest regional economy with 9% of the UK's GVA.

At the end of 2013, the last year for which figures are available, London's economy was 9% larger than it was in 2007. Outside London and the South East, the West Midlands and Scotland are the next best performing regional economies. They are both 0.4% larger than they were in 2007. London's office market is ten times larger than its nearest rivals, Glasgow and Manchester. It is also twice as large as the combined office stock of the UK's big six regional office centres.

It is therefore no surprise that London has been the destination of choice for domestic and overseas property investors. As a result, yields on prime Central London offices are 140 bps lower than their fifteen year average and 50 bps lower than the level achieved in June 2007 immediately before the market imploded. Central London shops and offices and Greater London industrials are the only segments of the market that have recovered all of the value lost after 2007. This presumably is why 50% of contributors to the Q2 2015 RICS UK Commercial Property Market Survey felt that commercial property valuations in London are above fair value.

In contrast, across the UK (excluding London), 95% of respondents to the RICS survey believe that

Investment in UK Property
Q2 2015 (£m)

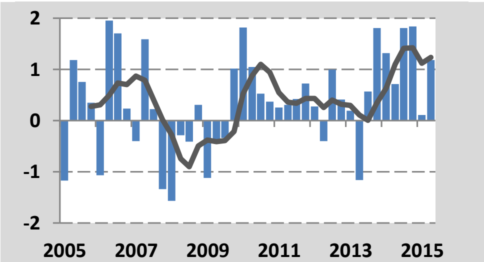
	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	671	784	909	2,364
Sell	473	550	155	1,178
Net	198	234	754	1,186

Source: National Statistics

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

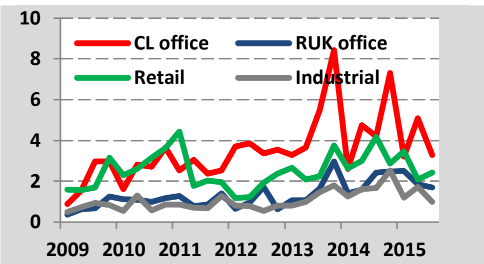
Source: National Statistics

Net Institutional Investment in Property (£billion)



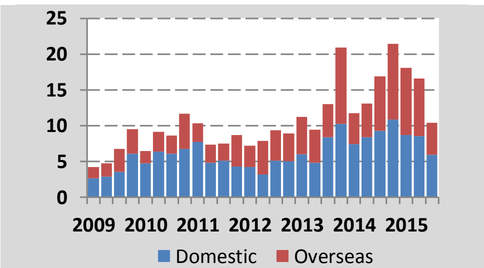
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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CHARTERED SURVEYORS

current market valuations are either at or below fair value. Prime office yields in this part of the UK are still 70 bps above the level achieved in June 2007. Rest of UK shop and office values are still 40% below the level achieved in 2007 and Rest of UK industrial values are 27% lower.

At the regional level only the economies of London and the South East had fully recovered from the recession by the end of 2013. At the city level, however, the outlook is more promising. By the end of 2013, the economies of Birmingham, Manchester and Glasgow were all bigger than they were immediately before the onset of the Great Recession. Whereas the economies of Bristol and Edinburgh had repaired any damage suffered. The economy of Leeds, however, remained 7% below its pre-recession level at the end of 2013.

In 2013 the economies of Birmingham, Manchester and Leeds grew faster than the UK average. Greater Manchester South comprising Manchester, Salford, Stockport, Tameside and Trafford grew by 3.9%, Birmingham by 4.2% and Leeds by 2.4%. The UK national average was 1.6%. The economies of Bristol, Edinburgh and Glasgow, however, under-performed the national average in 2013.

Investment in commercial property in the regions outside London and the South East has steadily improved since December 2012. Since June 2014 investment in the regions has eclipsed investment in Central London and has carried on growing whilst the levels of Central London investment have declined (see Chart 1).

The favourite City destinations for commercial property investment capital since the end of 2012 have been Manchester and Birmingham. Investment in these two cities was greater than the combined investment in Bristol, Edinburgh, Glasgow and Leeds combined.

The increased levels of investment have been reflected in strong growth in capital values. Office values in Birmingham, Bristol Edinburgh, Leeds and Manchester have all increased by 10% or more in the year to June 2015. Industrial capital growth across all six major centres has been stronger still. Birmingham industrial capital values grew by 17% in the year to June 2015.

Birmingham has been the top destination for relocations from London according to a report from the Office for National Statistics. HSBC has moved its retail banking headquarters to the city and Deutsche Bank has expanded its presence in Birmingham where it employs 1,500 people in technology and support functions. The city is also increasingly on the radar of international companies.

The city is also increasingly on the radar of international companies. The Greater Birmingham and Solihull Local Enterprise Partnership attracted more foreign direct investment than any other partnership in the UK. Investments numbering 73 have creatrd nearly 4,800 jobs. Extraenergy, a German power supplier, is a recent investor. It has 500,000 customers and is moving its 400 staff to bigger offices.

Although it won't go down well in Liverpool or Yorkshire, Manchester has recently become the de facto capital of the North as it becomes the first UK city outside London to be run by an elected mayor and receive fiscal powers devolved from Whitehall. The Government is keen to develop the idea of a Northern Powerhouse to redress the economic imbalance between the North and the South and to attract investment into northern cities and towns. Central to this aim are plans to improve communications between Liverpool, Manchester, Leeds, Sheffield and Hull.

RBS has moved thousands of roles to Manchester while the BBC employs more than 2,000 people giving a boost to the local digital and creative industries.

Latham & Watkins, one of the USA's biggest law firms, announced plans in January to open a new business services office in Manchester. Another law firm Berwin Leighton Paisner, Ford Credit Europe, the financing arm of the carmaker, and Towergate Insurance have also moved to Manchester in the past year.

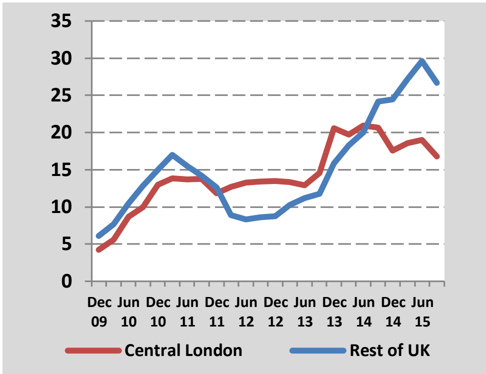
Manchester's inward investment agency, Midas, has confirmed that at least seven big companies including the law firm Freshfields are considering opening in Greater Manchester rather than expand in London. Each one is looking for about 100,000 sq ft of space, suggesting about 600 people would move or be hired.

A resurgence in economic activity and demand for commercial space in the UK's biggest regional cities is being reflected by increasing rental value growth. In the year to June 2015 All Property rental values grew by almost 3% in Birmingham, Bristol and Manchester. Such rates of growth have not been seen since 2007.

Retail rental value growth has been weak across the UK's major Cities but office rental values in Bristol and Manchester grew by 5% in the year to June 2015 and by 3% in Birmingham. Growth has been even higher for industrials with Birmingham sheds seeing rental value growth of 7% over the same period.

Strong post-recession economic growth in London has resulted in high rental levels. Rents are £67.50 in the City and £125 in the West End. Many consider investment values to be above fair value. As the economies of the UK's largest cities recover, occupiers and property investors are looking to the better value available outside London and the South East.

Chart 1; Rolling 12m investment (£billions)



Source: Property Data and Alexander Property Research

CONTACT

Fletcher King
61 Conduit Street
London
W1S 2GB

www.fletcherking.co.uk

020 7493 8400

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FUND MANAGEMENT & INVESTMENT CONTACTS

For further information, please contact:

Richard Goode
e: Richard.Goode@fletcherking.co.uk
t: 020 7458 0633

David Mayes
e: David.Mayes@fletcherking.co.uk
t: 020 7458 0624

Paul Morris
e: Paul.Morris@fletcherking.co.uk
t: 020 7458 0645

RESEARCH

Alexander Property Research
e: keith@alexanderpropertyresearch.com
w: alexanderpropertyresearch.com