december 2015

# investment bulletin

Fletcher King
CHARTERED SURVEYORS

## Institutional Investment in Property

UK economic growth slowed to 0.4% in Q3 from 0.7% in Q2. Output at the end of Q3 was 2.9% higher than it was at the end of Q3 2014. Construction and manufacturing contracted but the dominant service sector expanded by 0.6%.

The Markit PMI data suggests that growth increased to 0.5% in Q4 although there are signs that the recovery remains worryingly unbalanced and that business confidence is waning. Manufacturers remain worried about the strength of sterling and weak demand; and expectations about future workloads in the service sector fell to the lowest for three years.

Shrugging off any doubts created by the broader economy, the commercial property market enjoyed its eleventh consecutive quarter of increasing prices in the fourth quarter of the year. Capital values measured by the IPD Monthly index rose by 1.7% in Q4 compared to 2.1% in Q3. Consequently, total returns decreased slightly to 3.1% in Q4 from 3.4% in Q3. Total returns in the 12 months to December decreased to 13.8% from 15.3% in the 12-months to September.

Institutional investors' appetite for commercial property decreased in Q3 acquiring property assets worth £2.3 billion but recording sales of £1.8 billion. Net investment in Q3 of £423 million compared to net investment of £1.3 billion in Q2. Since the start of the market recovery in Q4 2009 institutions have now been net purchasers of commercial property in 22 out of 24 quarters. In the 12 months to September, net investment by institutions amounted to £3.5 billion compared with net investment of £4.6 billion in the 12 months to June.

In the second quarter, **pension funds** invested a further £101 million compared to a net investment of £280 million in Q2. Total investment by pension funds in the 12 months to September amounted to £520 million compared to £733 million in the 12 months to June and £952 million in the year to September 2014. **Life companies** continued to acquire property for the eighth consecutive quarter. Net investment in Q3 amounted to £16 million compared to £137 million in Q2. Total investment in the 12 months to the end of September amounted to £1.1 billion compared to net investment of £1.4 billion in the 12 months ending June and £2.3 billion in the year to September 2014. **Property Unit Trusts** invested £299 million in Q3 compared to investment of £818 million in Q2. Net investment in the 12 months to the end of September amounted to £1.8 billion compared with net investment of £2.4 billion in the 12 months ending June and £1.7 billion in the year to September 2014 (National Statistics, 2015).

In 2015 total investment in UK commercial property by all domestic and overseas investors decreased by 4% to £60.5 billion from £63.3 billion in 2014.

Investment in Central London offices in Q4 decreased by 18% to £3.9 billion from £4.7 billion in Q3. This key market segment made up 35% of all transactions in Q4 compared to 34% in Q3. Investment decreased across all other segments in Q4 compared to Q3. (Property Data, 2015).

Investment by UK institutions and property companies decreased by 35% in Q4 to £5.2 billion from £7.9 billion in Q3. Money into commercial property from overseas investors increased by 2% to £5.9 billion from £5.8 billion and overseas investors share of the UK investment market increased from 43% in Q3 to 54% in Q4 (Property Data, 2016).

The largest deal of Q4 was the purchase of 123 Buckingham Palace Road for £499 million by Hong Kong based private equity firm GAW Capital. Outside London and the South East the largest deal was the sale of a portfolio of retail warehouse parks in Gateshead, Dundee and Derby for £274 million by Land Securities to Ares Management from Los Angeles.

Total institutional investment remained in positive territory in Q3 as a net investment amounted to £32.8 billion compared to a net investment in Q2 of £9.9 billion. Institutions made net investments in Q3 of £23.8 billion in overseas equities, £5.8 billion in UK gilts, and £3.2 billion in UK equities but sold £3.5 billion of cash and other short term instruments (National Statistics, 2015).

## Reflections on 2015 and the outlook for 2016

*Central London assets continue to drive the strong performance of commercial property.*

At the start of 2015 a major acceleration of global growth was expected, supported by persisting soft oil prices. During 2015, as worldwide oil inventories remained high and OPEC appeared to be unable to agree to any co-ordinated cuts in production, the oil price fell from $50 to below $30 per barrel. Cheaper oil was supposed to boost the world economy as oil importers benefitted albeit at the expense of oil exporters. The World Bank, however, reported that economic growth in 2015 slowed to 2.4% in 2015, from 2.6% in 2014.

Economic growth maintained momentum in the UK and USA and strengthened in the Eurozone from 0.9% in 2014 to 1.5% in 2015 but disappointed in Japan. BRIC economic growth declined to 3.9% from 5.1% in 2014 as the Russian and Brazilian economies shrank by more than 3.5% while Chinese growth disappointed by decreasing from 7.3% in 2014 to 6.9%.

In 2015 stock markets in the USA delivered variable performance. The S&P 500 declined 0.7% in the year weighed down by significant falls amongst oil and commodities stocks. This was its worst showing since the financial crisis in 2008 when it dropped by nearly 40%.

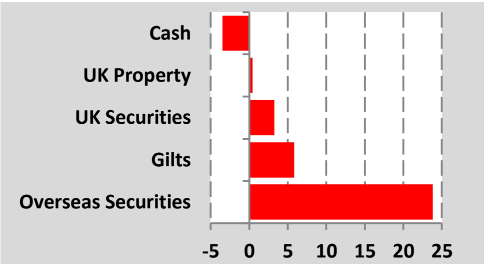
The Nasdaq Composite focused on fast-growing technology and consumer companies rose nearly 6%, supported by the 'Fangs'— Facebook, Amazon, Netflix and Google; and the 'nifty nine', which adds Priceline, eBay, Starbucks, Microsoft and Salesforce. Video streaming website Netflix has surged 134% to

**Investment in UK Property**
***Q3 2015 (£m)***

| | Pension Funds | Insurance Companies | Unit Trusts | Total |
|---|---|---|---|---|
| Buy | 927 | 722 | 616 | 2,265 |
| Sell | 826 | 697 | 319 | 1,842 |
| **Net** | **101** | **25** | **297** | **423** |

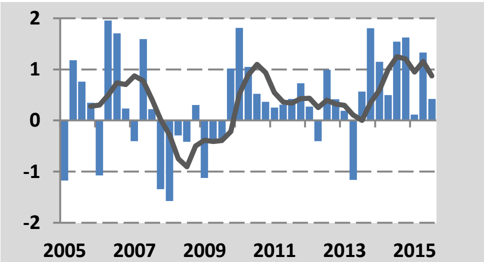
*Source: National Statistics*

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



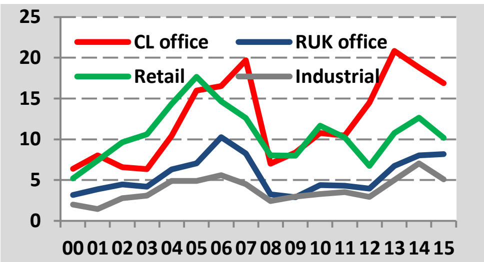

*Source: National Statistics*

**Net Institutional Investment in Property (£billion)**



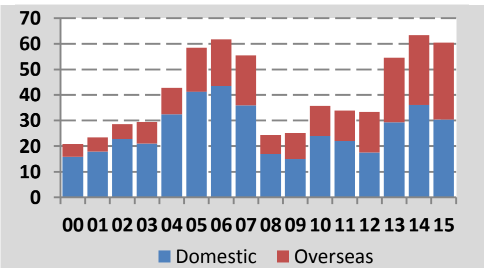

*Source: National Statistics*

**Investment by sector (£bn)**




*Source: Property Data*

**Property investors by type (£bn)**




*Source: Property Data*

december 2015

# investment bulletin

lead the Fangs as its subscriber base has continued growing strongly. Facebook is up 34%, while Amazon has gained 118%. Google has risen by 45%.

European stock markets performed satisfactorily in 2015. The pick of them being Italy's FTSE MIB which rose 12.7% in local currency terms but given the euro's weakness was only 1.1% higher in US dollar terms. The fall in commodites drove the FTSE 100, down 4.9% on the year. Anglo American fell 75% and Glencore dropped 70%. In contrast, the domestically focused FTSE 250 ended up 8.4%.

In the Far East, the Shanghai Composite ended the year 9.4% higher after a particularly volatile year and Japan's Nikkei was up 9.1% which was 8.5% higher in dollar terms thanks to a stable yen.

The return on government bonds in 2015 was unexciting. In the USA and UK expectations of some tightening of monetary policy led to an increase in yields. The Barclays US Treasury index registered a total return for the year of 0.84% and the long-dated Treasury index was down 1.2%. The total return on Barclay's Eurozone Aggregate Treasury index was 1.7% and the FT Gilt 5-15 yr total return index rose just 1.1% (see Chart 2).

Rewarding investors prepared to move further out along the risk curve, Ukrainian, Russian and Greek government bonds offered some of the best returns in 2015. Ukraine and Greece came within a whisker of defaulting, and the prices of their bonds plummeted amid fraught negotiations with their creditors. But when they finally struck deals, their bonds soared.

Supported by the continued strength of the domestic economic recovery, UK commercial property once again produced outstanding relative performance. As the year started, IPF Consensus forecasts were for commercial property to provide total returns of 10.8% in 2015. These expectations were on the low side. Rental growth rose to 4.2%, the highest in any 12-month period since mid-2001, as yields compressed by a further 35 bps. The outcome being that All Property total returns amounted to 13.8% in 2015.

Once again, the best performing segments of the UK commercial property market in 2015 were Central London shops and Rest of London offices. City, Midtown and West End offices and London industrials were once again amongst the top performers reflecting the London centric nature of the economic recovery (see Chart 2).

Outside of London the best performing office markets were Leicester, Cambridge, Bristol, Southampton and Leeds. Leicester and Cambridge office total returns for the year to September were greater than 20%.

The best performing industrial centres were Liverpool, Leicester, Edinburgh, Manchester and Birmingham. In each of these industrial centres, total returns were greater than 20% for the year to September.

Retail property continued to flounder. Central London shops was the only retail segment to outperform the All Property average. The worst performing segment was Retail Warehousing, where capital values increased by 2% and rental values increased by 1%. Shopping Centres and Rest of UK shops also had another weak year as rental values continued to slip.

All Property capital values have increased by 26% in the last three years. The values of Central London shops are now 66% higher than their pre-crash peak; Midtown and West End offices are 31% higher; London industrials are 8% higher; and City offices 3% higher. But they are the only four segments of the market to have recovered all the ground lost since 2007.

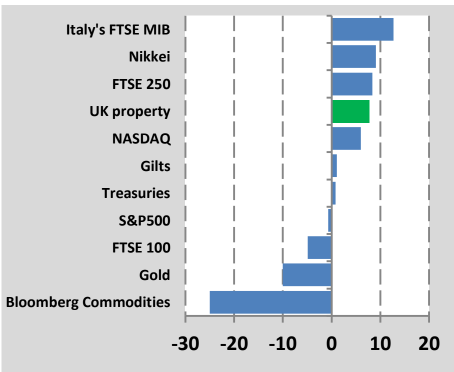
The initial yield on IPD's monthly index now stands at 5.0% having hardened by 8 bps in Q4. The capitalization rate is now at a level last seen in March 2006; 15 months before the top of the last cycle. But All Property capital values remain 21% lower than their peak levels. Current UK wide pricing levels are considered to be either at or below fair value by 85% of respondents to the RICS survey.

In this era of low interest rates, the asset class is still attractively priced relative to risk free rates. Gilt yields rose by 28 bps in Q4 in anticipation of a tightening of monetary policy. But the current property initial/gilt yield gap of 3.1% continues to compare favourably to the long run average of 2.5%.

The Investment Property Forum's latest consensus forecast published in November shows total return expectations of 9.5% in 2016 and 4.7% in 2017 and an annualised average of 7% in the 3 years to 2018. The long run annual average total return since 1980 is 9.8%.

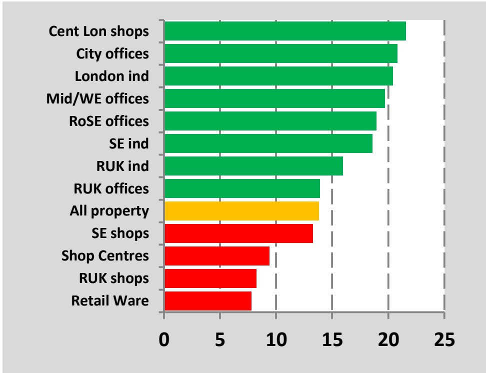
However, the UK economy is reliant on spending by households and exposed to growing risks from external forces. Sterling is 9% higher than it was 3 years ago and the manufacturing sector is in recession. The FTSE100 has fallen 20% since the market peaked in May last year reflecting concerns regarding the outlook for the global economy. A sharp slow-down in economic growth could restrain rental growth causing yields to soften. We also remain concerned that uncertainty created by the proposed referendum on membership of the EU could result in the withdrawal of foreign money from UK commercial property.

**Chart1: Capital growth of assets (%) in 2015**




*Source: FT.com*

**Chart 2; Total return (%) by segment 2015**




*Source: MSCI/IPD*

**CONTACT**

Fletcher King
61 Conduit Street
London
W1S 2GB

www.fletcherking.co.uk

020 7493 8400

**OUR SERVICES**

Fletcher King Property Fund Managers and Chartered Surveyors provide a wide range of real estate services:

- Investment
- Fund Management
- Asset Management
- Landlord & Tenant
- Valuation
- Rating
- Transactions
- Development

**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@alexanderpropertyreserch.com
w: alexanderpropertyresearch.com