june 2016

investment bulletin

Fletcher King

CHARTERED SURVEYORS

Institutional Investment in Property

Whether caused by understandable caution from the business sector as the Euro Referendum approached or a slowing world economy, the rate of UK economic growth slipped in the first quarter of 2016. In Q1 2016 output grew 0.4% and by 2.0% in the year to March 2016. In comparison output grew by 0.5% in Q4 2015 and by 2.2% in the year to December 2016.

June's Markit PMI survey indicates that the pace of UK economic growth slowed to just 0.2% in the second quarter as Brexit anxiety intensified. Uncertainty meant that the number of people recruited in June fell for the first time since September 2012. A further slowing, and possible contraction, looks highly likely in coming months as a result of the uncertainty created by the EU referendum.

IPD data indicates that the market suffered its second consecutive quarter of falling prices. Capital values as measured by the IPD Monthly index fell by –0.1% in Q2 as the property market reacted to the uncertainty created by the referendum result.

Institutional investors sold commercial property for the second consecutive quarter in Q1 2016 acquiring property assets worth £993mn but recording sales of £3.8bn. Net disinvestment in Q1 of £2.85bn compared to net disinvestment of £680mn in Q4 2015. In the 12 months to March, net disinvestment by institutions amounted to £1.9bn compared with net investment of £1.0bn in the 12 months to December.

In the first quarter, **pension funds** disinvested a further £27mn compared to a net disinvestment of £93mn in Q4. Total investment by pension funds in the 12 months to March amounted to £119mn compared to £123mn in the 12 months to December and £670mn in the year to March 2015. **Life companies** also sold property for the second quarter in succession. Net disinvestment in Q1 amounted to £189mn compared to net disinvestment of £807mn in Q4. Total disinvestment in the 12 months to the end of March amounted to £843mn compared to £522mn in the 12 months ending December and net investment of £1.7bn in the year to March 2015. **Property Unit Trusts** disinvested £2.6bn in Q1 compared to investment of £145mn in Q4. Net disinvestment in the 12 months to the end of March amounted to £1.4bn compared with net investment of £1.2bn in the 12 months ending December and £1.4bn in the year to March 2015 (National Statistics, 2016).

In Q2 2016 total investment in UK commercial property by all domestic and overseas investors decreased by 35% to £9.0bn from £13.9bn in Q1.

Investment in Central London offices in Q2 increased by 11% to £3.2bn from £2.9bn in Q1. This key market segment made up 36% of all transactions in Q2 compared to 21% in Q1. Investment decreased across all other segments in Q2 compared to Q1 except retail warehousing. (Property Data, 2016).

Investment by UK institutions and property companies decreased by 44% in Q2 to £4.6bn from £8.2bn in Q1. Money into commercial property from overseas investors decreased by 23% to £4.4bn from £5.7bn in Q1 and overseas investors share of the UK investment market decreased remained at 49% as in Q1 (Property Data, 2016).

The largest deals of Q2 included Oxford Properties sale to Mapletree Investments of Green Park, Reading and Intu Properties purchase of Merry Hill Shopping Centre from QIC. In London Principal Place EC2; Aldgate Tower E1; 88 Wood Street EC2; 6 Bevis Marks EC3; and 50 New Bond Street W1 all changed hands.

Total institutional investment turned negative in Q1 as investors reduced their exposure to the UK and other risky assets ahead of the Brexit vote. Net disinvestment amounted to £3.4bn compared to net investment in Q4 of £9.2bn. Institutions made net investments in Q1 of £5.1bn in cash and other short-term instruments, but sold out of UK gilts, UK and Overseas equities. (National Statistics, 2016).

Brexit re-visited

The UK electorate is about to take the most important decision for a generation.

David Cameron, in his first conference speech as leader warned his party against "banging on about Europe". We, however, have decided to ignore this piece of advice and again return to discussions surrounding the implications of the vote to leave the EU.

The Brexit result has already seen the resignation of one Prime Minister and a vote of no confidence in the leader of the Opposition. Much else besides politicall turmoil was forecast. The Treasury, the OECD, the IMF and others lined up to warn of the consequences for the economy and capital markets of a vote to quit the Eurozone.

One month after the referendum result if seems appropriate to try and cut through all the hyperbole to see if hard data can shed any light on the likely consequences of the decision for the commercial property market.

The domestic economy is an important driver of commercial property performance. As noted above UK economic growth slowed in the first quarter and is likely to slow further in the second quarter.

On 20th July, the Bank of England published a summary of Business Conditions in the UK providing a summary of intelligence gathered following the vote to leave the EU.

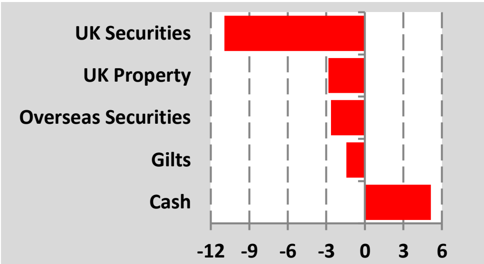
The Bank's agents reported that following the EU referendum, business uncertainty had risen markedly. Many firms had only just begun to formulate new business strategies in response to the vote and, for the time being, were seeking to maintain 'business as usual'. A majority of firms spoken with did not expect a near-term impact from the result on their investment or staff hiring plans. But around a third of contacts thought there would be some negative impact on those plans over the

Investment in UK Property
Q1 2016 (£m)

	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	423	568	n/a	n/a
Sell	450	771	n/a	n/a
Net	-27	-203	-2,615	-2,845

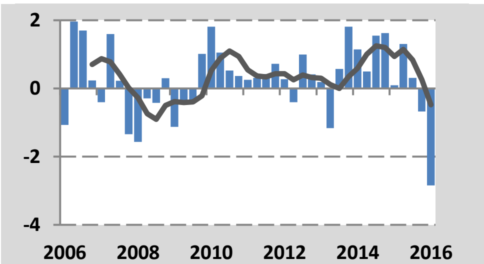
Source: National Statistics

Net Institutional Investment (£bn) Q1 2016
By asset type



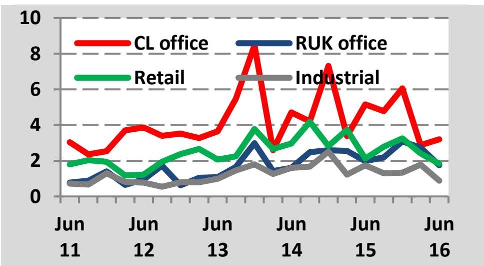
Source: National Statistics

Net Institutional Investment in Property (£bn)



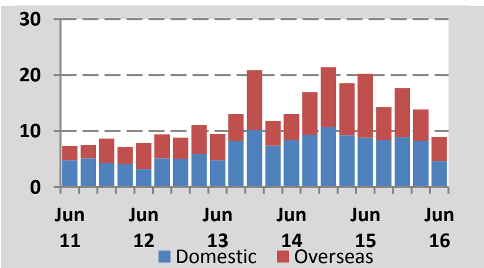
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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next twelve months. As yet, there was no clear evidence of a sharp general slowing in activity.

The average forecast for GDP growth in 2016 in July's edition of Forecasts for the UK Economy published by HM Treasury has decreased to 1.6% from 1.8% in June; and the average forecast for GDP growth in 2017 has decreased to 0.8% from 2.1% in June. But this again is all conjecture.

June's GfK Consumer Confidence Index indicated that in the run up to the referendum there was a deepening pessimism over the general economic situation. However, before the referendum there was an uptick in confidence about personal finances, and as of mid-June this measure was more positive than 12 months ago.

The latest edition of the British Retail Consortium's (BRC) Retail Sales Monitor is similarly mixed in tone. In the five weeks to 2nd July, UK retail sales decreased by 0.5% on a like-for-like basis from June 2015, when they had increased 1.8% from the preceding year. But it was considered too early to assess the impact of the vote for Brexit on sales.

Superficially it appears that the UK jobs market defied concerns about pre-Brexit vote jitters, with employment increasing by 176,000 in the three months to the end of May and the jobless rate falling to 4.9%. However, self-employment accounts for 68% of the total increase suggesting that employers have been increasingly cautious. It would be unwise to draw upon the strong headline figures as evidence that the shock of Brexit on jobs will prove to be mild.

In response to the perceived crisis in the economy and markets caused by the Brexit vote investors put more money into risk-free assets. The redemption yield on 5-15 year gilts decreased from 1.4% at the end of May to 0.9% at the end of June. In the middle of July the UK Debt Management Office announced the successful auction of £1,250 million of a 2016 Index-Linked Treasury Gilt at a real yield of -1.6%.

As expected equity prices fell after the vote for Brexit but the slump was never quite as dramatic as predicted. In the days following the vote, the FTSE100 index declined 6% but trading comfortably above the level reached in January when concerns regarding the growth in China and low oil and commodity prices put the index into bear territory. Indeed the FTSE100 index is now trading at a level 6% above its pre-vote level.

In the June 2008 the FTSE100 index fell more than 10% as recession hit the UK and later on in the same year it fell a further 10% as Lehman Brothers filed for bankruptcy protection. During the last financial crisis of 2008-09 the peak to trough fall in the index was 41%.

A better bellwether for the UK economy is the FTSE250 index, the constituents of which have a more domestic outlook than the more international FTSE100. On the Friday after the vote the FTSE250 closed down 7% and by the end of Monday the index was down 14% from it's pre-vote level. Today the FTSE250 is just 2% below its pre-vote level.

Despite the overall strength of the stock market, the listed Real Estate sector fell by 7.3% in Q2 and by 14.6% in the year to June. However, the latest MSCI data indicates that the market suffered its second consecutive quarter of falling prices at the end of June. Capital values as measured by the MSCI Monthly index fell by a further –0.1% in Q2 following a fall of –0.2% in Q1 which was seen as a reaction to a 1% increase in stamp duty announced in March's Budget

In the days after the Brexit vote seven retail investor facing open-ended property funds blocked redemptions indefinitely. So far only one, Aberdeen Asset Management, has reopened for business after applying "total property asset reductions" of 26% comprising an 18% "quick sale" price adjustment to reflect the discount it would need to apply if forced to offload its property portfolio quickly; a 1% sales cost; and a 7% "fair value" adjustment for long-term holders.

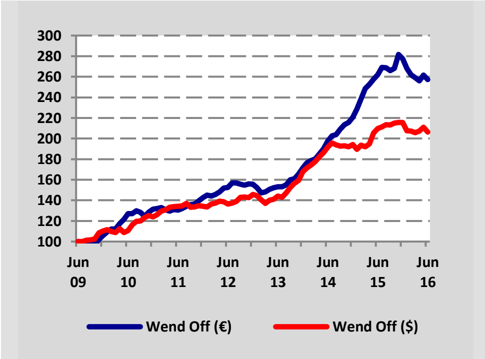
The Legal & General UK Property Fund remains open for trading. It has recently announced that the post-Brexit vote discount to its unit pricing has been reduced from 15% to 10%.

The size of the problem facing these funds is put in perspective by the 10%-15% buffers they hold in cash and other liquid assets. They are now preparing assets from their portfolios for sales after the summer vacations, which will be tests for commercial property pricing levels.

Sales by these open-ended fund sales may offer buying opportunities for other investors, especially those domiciled overseas. However, despite the fall in the sterling exchange rate it is clear that UK commercial property is not yet spectacularly cheap (see Chart).

The economy is slowing and recruitment has declined. But there is no evidence of a sharp contraction. The economic consensus forecasts for 2016 have been revised down marginally but the forecasts for 2017 are markedly lower. Confidence regarding personal finance is stronger than 12 months ago and the BRC considers it too early to assess the impact of the vote. Stock markets have recovered all of the ground lost in the immediate aftermath, interest rates are at record low levels and the property indices suggest that any decline in All Property values is limited so far. The answer to the question posed at the top of this article therefore must be that the data available indicates that the fall out from the Brexit vote has been limited so far. But we have a long way to go before the UK's relationship with Europe and the rest of the world is once again more certain.

West End offices capital values in € and $ terms



Source: APR

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