december 2016

investment bulletin

Fletcher King

CHARTERED SURVEYORS

Institutional Investment in Property

January's Markit PMI surveys indicate that the UK economy ended 2016 strongly. Improved rates of expansion were seen in all three major sectors of the economy in December. Service sector growth accelerated for a third straight month. Manufacturers saw the second-largest increase in output for two-and-a-half years, while construction firms reported the biggest rise in activity for nine months. The outcome of the survey is consistent with economic expansion of 0.5% in Q4 and 2.0% for the year overall.

MSCI data indicates that the commercial property market staged a recovery in Q4. Capital values as measured by the MSCI Monthly index grew by 1.1% in Q4 as the market reacted to the better than expected macro-economic news.

Institutional investors sold commercial property in Q3 2016 acquiring property assets worth £1.77bn but recording sales of £1.84bn. Net disinvestment in Q3 of £70mn compared to net investment of £465mn in Q2. In the 12 months to September, net disinvestment by institutions amounted to £2.8bn compared with net investment of £2.4bn in the 12 months to June.

In the third quarter, **pension funds** invested a further £297mn compared to a net investment of £134mn in Q2. Total investment by pension funds in the 12 months to September amounted to £486mn compared to £182mn in the 12 months to June and £299mn in the year to September 2015. **Life companies** bought property for the first quarter in the last four. Net investment in Q3 amounted to £190mn compared to net disinvestment of £500mn in Q2. Total disinvestment in the 12 months to the end of September amounted to £1.2bn compared to £1.3bn in the 12 months ending June and net investment of £1.1bn in the year to September 2015. **Property Unit Trusts** disinvested £795mn in Q3 compared to investment of £64mn in Q2. Net disinvestment in the 12 months to the end of September amounted to £2.1bn compared with net disinvestment of £1.4bn in the 12 months ending June and investment of £2.4bn in the year to September 2015 (National Statistics, 2016).

In Q4 2016 total investment in UK commercial property by all domestic and overseas investors decreased by 5% to £9.2bn from £9.7bn in Q3.

Investment in Central London offices in Q4 increased by 69% to £3.5bn from £2.1bn in Q3. This key market segment made up 38% of all transactions in Q4 compared to 21% in Q3. Investment also increased in Shopping Centres and Industrials but decreased across all other segments in Q4 compared to Q3. (Property Data, 2017)

Investment by UK institutions and property companies decreased by 14% in Q4 to £4.5bn from £5.2bn in Q3. Money into commercial property from overseas investors increased by 5% to £4.7bn from £4.5bn in Q3 and overseas investors share of the UK investment market increased to 51% from 46% in Q3. (Property Data, 2016)

The largest deals of Q4 were Brookfield's acquisition of City Point, EC2 for £560mn; a £350mn mixed portfolio sold by Alecta Pensionsforsakring; and a £300mn portfolio of 34 buildings in Holborn. The largest single asset transaction outside London was ADIA's £130mn acquisition of the Queensmere Shopping Centre in Slough.

Total institutional investment turned negative again in Q3 as investors continued to reduce their exposure to risky assets. Net disinvestment amounted to £14.6bn compared to net investment in Q2 of £6.0bn. Institutions made net disinvestments in Q3 of £9.4bn in Overseas equities, £4.6bn in UK equities and £900mn in UK gilts, but increased their holdings of cash. (National Statistics, 2016)

Reflections on 2016 and the outlook for 2017

2016 was a year of surprises creating uncertainty for commercial property investors

2016 was a year of huge political upsets. In the USA Hilary Clinton was the front-runner to secure the Democratic nomination and succeed President Obama. In the UK, David Cameron was widely expected to lead a successful Remain campaign.

The World Bank reported that global growth in 2016 was estimated to have fallen to a post-crisis low of 2.3% from 2.7% in 2015. Advanced economies grew by just 1.6% whereas Emerging market and developing economies grew by 3.4% (see Table 1). China's economy grew by 6.7% in 2016 but this was the slowest rate of growth since 1990 and a key factor behind the overall slow level of growth.

At the beginning of 2016 worries about deflation and a slowing Chinese economy weighed on financial markets. By the middle of February the Dow Jones had fallen 10% and the FTSE 11%. But by the end of the year Wall Street was enjoying a "Trump rally" fuelled by the incoming President's plans for fiscal stimulus to the US economy. The Dow Jones ended the year 26% higher than its February low.

In the UK, the long-term economic uncertainty arising from the vote to leave the European Union caused the pound to fall 16% against the Euro and 20% against the dollar. But the economy has so far proved to be more resilient than was feared and is likely to have grown by 2% in 2016. The FTSE 100 ended the year at record levels. It was up 14% on the year and 29% on February's low.

In dollar terms, however, the FTSE 100 was actually down 5% over the year, because of the decline in the pound. Analysts at KPMG said the performance of FTSE 100 companies with more than 70% of their market outside the UK was up 20% over the year. But those with 70% of their business in the UK were down 6%. The more domestically focused FTSE 250 also rose during the year, but by a much less impressive 3.7%.

Germany's Dax added 6.87% over the course of 2016, and France's Cac climbed 4.86%. Italy's FTSE MIB fell 10.2% as the banking worries, most recently

Investment in UK Property
Q3 2016 (£m)

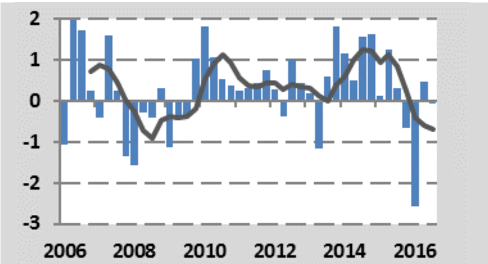
	Pension Funds	Insurance Companies	Unit Trusts	Total
Buy	601	881	291	1,773
Sell	304	674	865	1,843
Net	**297**	**207**	**-574**	**-70**

Source: National Statistics

Net Institutional Investment (£bn) Q3 2016
By asset type

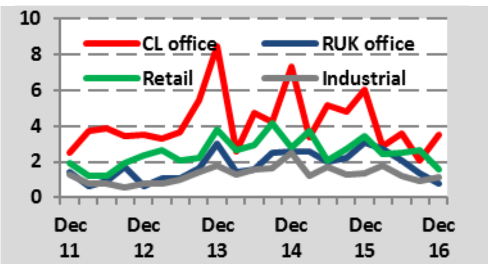
Source: National Statistics

Net Institutional Investment in Property (£bn)



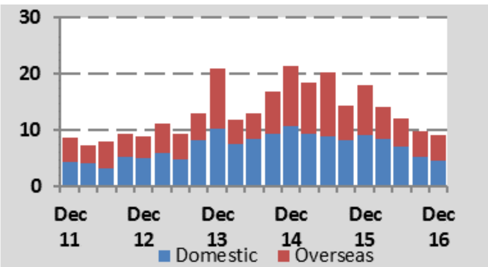
Source: National Statistics

Investment by sector (£bn)



Source: Property Data

Property investors by type (£bn)



Source: Property Data

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the proposed state bailout of Monte dei Paschi di Siena, combined with the resignation of the country's prime minister, Matteo Renzi, to unnerve investors. Spain's Ibex lost 2.01%. China's Shanghai Composite fell 12% (see Chart 1).

Table 1; World economic growth

	2016 estimate	2017 forecast
BRICs	4.3	5.1
Canada	1.2	2.2
Euro Area	1.6	1.5
France	1.2	1.2
Germany	1.7	1.4
Italy	0.9	0.9
Japan	1.0	0.9
United Kingdom	2.0	1.2
United States	1.6	2.2
World	2.3	2.7

Source; World Bank

Gold rose 9% after three years of decline, benefitting from its status as a haven for investors during times of political and economic uncertainty. Brent crude prices jumped nearly 53%, both on signs of economic recovery but mainly due to a long-awaited agreement between Opec and other oil producers to curb output. This marked the biggest annual gain since 2009.

The UK commercial property market was already slowing before reaction to June's referendum result forced seven open-ended property funds to impose fair value adjustments and block redemptions indefinitely. All Property values fell by 3.6% in Q3 and ended the year down 2.8% after a rally in the fourth quarter.

As the year started, IPF Consensus forecasts were for commercial property to provide total returns of 7.9% in 2016. These expectations were on the high side. Rental growth decreased to 2.0% from 4.2% in 2015 and yields expanded by 38 bps. The outcome being that All Property total returns amounted to 2.6% in 2016.

Once again, the best performing segments of the UK commercial property market in 2016 were located in London and the South East reflecting the London centric nature of the economic recover. But rather than shops and offices, industrials ended up as the top performers.

Outside of London the best performing office markets were Nottingham, Sheffield, Cambridge, York and Glasgow. Total returns in these markets were in a 5% - 7% range rather than 20% achieved last year. Although the price of oil increased by 45% in 2016, total returns of -4.9% in Aberdeen reflected the problems faced by the oil industry following falling prices in 2014 and 2015.

The best performing industrial centres were Manchester, Bristol, Exeter, Southampton and Portsmouth. But as above with offices, returns in these centres were 7% - 8% for the year to September rather than 20% or more achieved last year.

Retail property continued to flounder in 2016. Central London and South East shops outperformed the All Property average. The worst performing segment was Shopping Centres, where capital values decreased by 8% and rental values increased by less than 1%. Retail Warehouses and Rest of UK shops also had another poor year as rental value growth was negligible (see Chart 2).

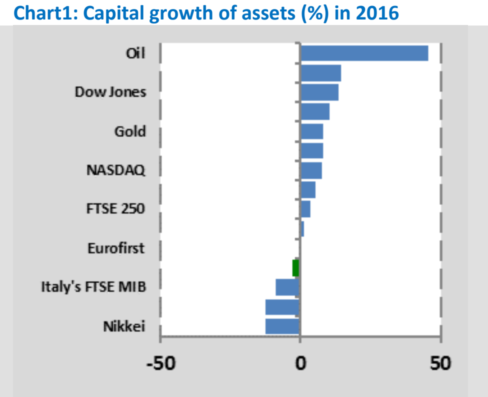
All Property capital values have increased by 38% since the bottom of the market in June 2009 but remain 23% lower than their peak in June 2007. The values of Central London shops are now 82% higher than their pre-crash peak; Midtown and West End offices are 28% higher; London industrials are 14% higher; and City offices just 1% higher. But they remain the only four segments of the market to have recovered all the ground lost since 2007.

Responding to the renewed threat from inflation gilt yields rose by 41 bps in Q4. Commercial property, however, remains attractively priced relative to risk free rates. The initial yield on IPD's monthly index now stands at 5.27% having softened by 38 bps in 2016. The current property initial / gilt yield gap has narrowed to 4.2% from 4.5% at the end of Q3 but continues to compare very favourably to the 10-year average of 2.8%.

Rising interest rates may narrow the yield gap further. Annual Consumer Price inflation rose to 1.6% in December. The MPC may tolerate somewhat higher consumer price inflation in exchange for a more modest increase in unemployment. But there are limits to the extent to which above-target inflation can be tolerated before interest rates have to rise.

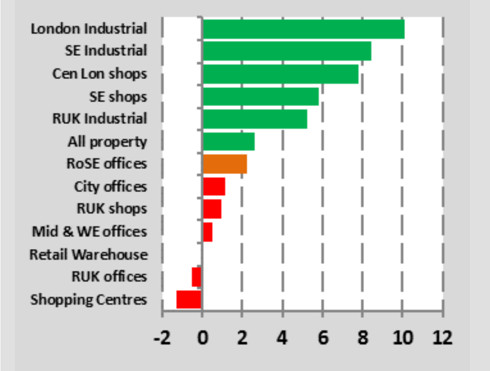
The Investment Property Forum's latest consensus forecast published in November indicates that expectations are for total returns to decrease to 1.3% in 2017 and recover to 5.1% in 2018. Capital values are expected to fall by a further 3.6% by year-end 2017. We continue to expect the Brexit vote eventually to precipitate a slow-down in economic growth that restrains rental growth and causes yields to soften. Consequently we believe that the forecast risks are weighted heavily towards the downside.

Chart1: Capital growth of assets (%) in 2016



Source; Financial Times

Chart 2; Total return (%) by segment 2016



Source: MSCI

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