march 2016

# investment bulletin

Fletcher King
CHARTERED SURVEYORS

## Institutional Investment in Property

Preliminary indications appear to have exaggerated the extent of the slowdown in UK economic growth last year. In Q4 2015 output grew 0.6% and ended the year 2.2% higher than it was at the end of Q4 2014. A year earlier growth of 2.8% had been recorded.

March's Markit/CIPS PMI survey indicates that UK economic growth slowed in the first quarter. The data suggests that the pace of growth is more likely to ease further in coming months as business confidence remains unsettled by concerns surrounding Brexit, further austerity at home and a slowing global economy. The February and March PMI surveys are consistent with just a 0.3% quarterly rate of GDP growth in Q1.

IPD data indicates that the market suffered its first quarter of falling prices since March 2013. Capital values as measured by the IPD Monthly index fell by –0.2% in Q1 2016 in a reaction to a 1% increase in stamp duty announced in March's Budget.

Institutional investors sold commercial property in Q4 acquiring property assets worth £1.8bn but recording sales of £2.4bn. Net disinvestment in Q4 of £657m compared to net investment of £300m in Q3. This is the first quarter of net disinvestment since Q2 2013 when capital values were still in decline. In the 12 months to December, net investment by institutions amounted to £1.1bn compared with net investment of £3.3bn in the 12 months to September.

In the third quarter, **pension funds** disinvested a further £67m compared to a net disinvestment of £21m in Q3. Total investment by pension funds in the 12 months to December amounted to £151m compared to £362m in the 12 months to September and £829m in the year to December 2014. **Life companies** also sold property for the first quarter since Q2 2013. Net disinvestment in Q4 amounted to £810m compared to net investment of £16m in Q3. Total disinvestment in the 12 months to the end of December amounted to £525m compared to net investment of £1.1bn in the 12 months ending September and £2.0bn in the year to December 2014. **Property Unit Trusts** invested £145m in Q4 compared to investment of £299m in Q3. Net investment in the 12 months to the end of December amounted to £1.2bn compared with net investment of £1.8bn in the 12 months ending September and £2.0bn in the year to December 2014 (National Statistics, 2016).

In Q1 2016 total investment in UK commercial property by all domestic and overseas investors decreased by 50% to £9.1bn from £18.0bn in Q4 2015.

Investment in Central London offices in Q1 decreased by 67% to £2.0bn from £6.1bn in Q4. This key market segment made up 22% of all transactions in Q1 compared to 34% in Q4. Investment decreased across all other segments in Q1 compared to Q4 2015. (Property Data, 2016).

Investment by UK institutions and property companies decreased by 47% in Q1 to £5.0bn from £9.3bn in Q4 2015. Money into commercial property from overseas investors decreased by 53% to £4.1bn from £8.8bn in Q4 2015 and overseas investors share of the UK investment market decreased from 49% in Q4 2015 to 45% in Q1 (Property Data, 2016).

The largest deals of Q1 saw former fringe London locations under the spotlight as AustralianSuper took a 36% stake in Kings Cross Central and Deutsche acquire the Financial Conduct Authority's office on the Olympic Park in Stratford. Outside London and the South East the largest deals were the sales of Grand Central, Birmingham and Liverpool One shopping centres.

Total institutional investment remained positive in Q4 2015 as net investment amounted to £9.7bn compared to net investment in Q3 of £30.8bn. Institutions made net investments in Q4 2015 of £9.0bn in cash and other short-term instruments, £2.6bn in UK gilts and £1.2bn in overseas equities, but sold £4.3bn of UK equities. (National Statistics, 2015).

## The implications of Brexit

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

A recent report issued by HM Treasury concludes that the damage inflicted on the UK economy by a vote to leave the EU would be considerable and not just limited to the short term. This report was issued in the same week that opinion polls are suggesting that the electorate is split down the middle making the outcome on the referendum to decide the UK's future relations with Europe too close to call.

The economic arguments appear indisputably pro-EU. A 2013 review by the Centre for European Policy Studies of the "balance of competences" between the EU and its member states concluded that the present balance works well for Britain. Comprehensive change would be against the UK's national interest

A paper published in December 2015 by the Centre for Economic Policy Research finds that UK GDP per capita was 9% higher after 10 years of EU membership and 24% by today. These are much bigger effects than the Treasury has just estimated.

Most businesses want to stay in the European Union but some are cautious about saying so for fear of offending customers or clients. A survey by the Confederation of British Industry found 80% of members for Remain, with only 5% for Leave. The Institute of Directors and the British Chambers of Commerce, with memberships that have a higher share of SMEs than the CBI, find most in favour. Even a majority of the Federation of Small Businesses narrowly backs Remain.

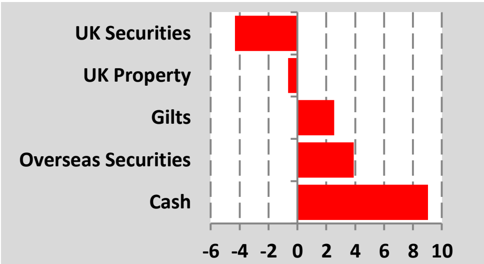
Thanks to foreign ownership and investment attracted by a gateway into the EU single market the British car industry accounts for 800,000 jobs and 12% of British exports. Britain now produces more cars than France. Fully 77% of the members of the

**Investment in UK Property**
***Q4 2015 (£m)***

| | Pension Funds | Insurance Companies | Unit Trusts | Total |
|---|---|---|---|---|
| Buy | 582 | 859 | 343 | 1,784 |
| Sell | 649 | 1,594 | 198 | 2,441 |
| Net | -67 | -735 | 145 | -657 |

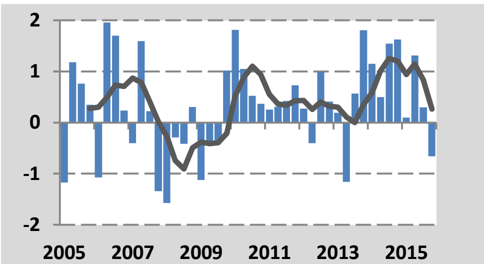
*Source: National Statistics*

**Net Institutional Investment (£bn) Q4 2014**
***By asset type***



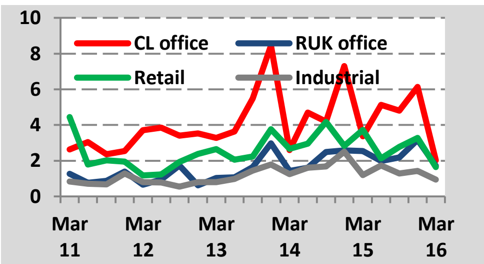

*Source: National Statistics*

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



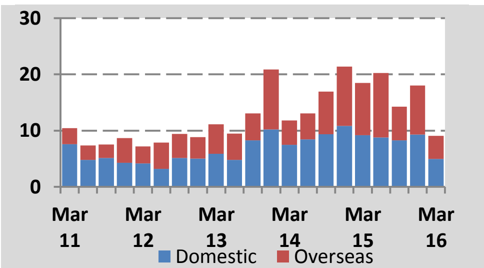

*Source: National Statistics*

**Investment by sector (£bn)**




*Source: Property Data*

**Property investors by type (£bn)**




*Source: Property Data*

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Society of Motor Manufacturers and Traders favour Remain,

Toyota, Nissan and BMW, whose UK businesses include Rolls Royce motors and Mini, have all warned that exit from the European Union would reduce competitiveness, increase costs and prices and reduce jobs.

Major aerospace and defence manufacturers such as BAE Systems, Babcock and GKN, believe that Britain must remain part of the European economic community to protect opportunities for investment, partnership and growth.

It is a similar story for financial services. The City of London Corporation has come out strongly for Remain in line with the views of the overwhelming majority of City firms. HSBC has published research which concluded that working to complete the single market in services and reforming the EU to make it more competitive were far less risky than going it alone, given the importance of EU markets to British trade.

Businesses therefore are very strongly in favour of remaining within the EU. The vote, however, will be decided by an electorate focused on immigration and egged on by the mainly Europhobe papers that are passionately pushing Brexit. What then is the outlook for UK commercial real estate in the last remaining 2 months before the vote and indeed afterwards.

In March the Financial Policy Committee (FPC) at the Bank of England said that uncertainty as the date of the EU referendum approached and a period of pro-longed uncertainty following a vote to leave has the potential to increase the risk premium required by investors on UK assets.

Domestic investors are exposed to the risk of asset values softening. Overseas investors are also exposed to currency risk. Sterling has already depreciated by 6% since the start of the year and by 9% since the middle of last year. Rolling 12-month investment by overseas investors has decreased in each of the last three quarters and fell by 15% in Q1 2016.

Bank lending to property has fallen in every quarter since Q3 2009 with the sole exception of Q1 2015. In anticipation of the risks, the FPC is providing banks with options for extra liquidity in the weeks around the 23rd June referendum date. It is also raising the minimum capital levels for the UK's largest banks; which should have the effect of reducing lending further and raising the cost of debt.

The Scottish referendum should have alerted UK asset management companies to the "destabilising" effect of the vote to leave. The Scottish vote triggered £1bn of outflows from UK equity funds in the week before the referendum, and many Scotland-based financial groups were forced to consider shifting their headquarters south of the border in the event of a Yes vote.

The Investment Association represents UK investment managers responsible for managing more than £5.5 trillion for clients around the world reported that UK investors pulled more money out of property funds in February than in any month since 2008.

Land Securities CEO Robert Noel said in February that a vote to leave the political bloc would cause demand for office space to fall and values could plummet. The FTSE Real Estate index lost 7% in the first quarter, wiping £4.6bn off the value of UK commercial property groups. In February, the two largest UK Reits, Land Securities and British Land, were trading at their biggest discounts to net asset value since 2011.

EU referendum clauses are being added into contracts with deals agreed to complete on 24 June, the day after the vote, but with an option not to proceed if the vote goes in favour of Brexit.

Recent data releases have confirmed suspicions of a slowdown in the direct market. According to CoStar investment in UK commercial property declined 19% in the second half of 2015 from a year earlier. Property Data records a decrease of 16% in the second half of 2015 from a year earlier.

The attempted sale of the City of London's Heron Tower to the Chinese insurer Anbang, which fell through in September, is illustrative of this slowdown. Another major asset, Devonshire Square, was put up for sale but then removed from the market and a series of other properties on the market for about £100m were subsequently withdrawn.

Of course, the breakdown of these transactions may not be solely attributable to the Brexit referendum. Other concerns include China's weakening economy and falling oil prices reducing the levels of investment into the UK from overseas.

Union Investment Germany's biggest manager of real estate mutual funds, however, was more specific. Talks to buy 51 Eastcheap for about £50m were suspended at the end of February. The fund had planned to extend and refurbish the building but Union's CIO said they were apprehensive ahead of the referendum and were cautious with speculative investments in London which have leasing risk.

Many of the risks flowing from a vote to leave the EU may be more focused on core Central London markets which have enjoyed the greatest interest from overseas investors and international business occupiers. As a consequence values and rents are now in excess of peak 2007 levels.

Investors have started to shift their focus to the regions of the UK. Some £4.6bn flowed into the nine largest UK regional cities in 2015; the highest level since before the 2008 financial crisis.

Union may have pulled out of the Eastcheap deal but it isn't pausing all its UK activity. The fund manager is now in talks to buy Allied London's XYZ Building in Manchester for about 85m pounds.

In the weeks and months leading up to the referendum it is likely that transaction volumes will decrease further particularly from overseas investors. For the less risk inverse investor the next two months could present an opportunity. If the Remain campaign is successful, there is a general expectation that commercial property values could react positively in the second half of the year boosted by a pick up in lending. But if the vote goes in favour of Brexit, a pro-longed period of uncertainty whilst the UK's future relationship with the EU and the rest of the world is negotiated may see current commercial property values coming under increasing pressure; particularly in Central London.

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