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# Institutional Investment in Property

Fletcher King

PROPERTY FUND MANAGERS
CHARTERED SURVEYORS

The UK economy has now posted three consecutive quarters of growth following the end of the deepest recession since the Great Depression. But robust output growth in Q2 of 1.1% may be the strongest for some time to come. Downward trends in the July PMI index constructed from surveys of the services, manufacturing and construction industries suggest that beyond Q2 a more lacklustre pace of recovery may be set to reassert itself in the remainder of the year despite the continuing loose monetary policy.

## Investment in UK property Q1 2010 (£ millions)

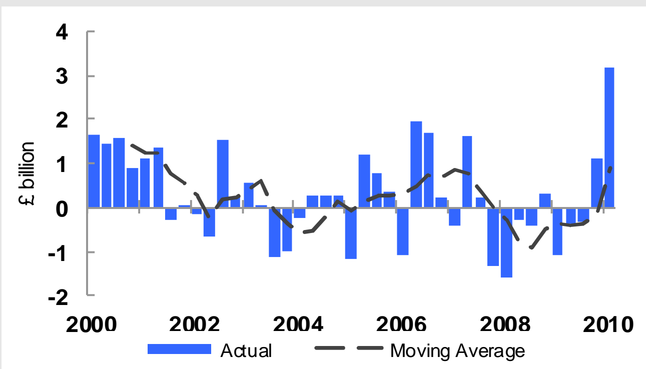
| | Pension Funds | Insurance Companies | Unit Trusts [1] | Total |
|---|---|---|---|---|
| **Purchases** | 667 | 3,030 | 589 | 4,286 |
| **Sales** | 277 | 728 | 116 | 1,121 |
| **Net Investment** | **390** | **2,302** | **473** | **3,165** |

1. Includes Investment Trusts

The British Retail Consortium reported "decent" sales growth in June 2010 and commented that although the Budget is already affecting confidence, it won't be until the impact of the measures is actually felt that it really hits spending. UK retail sales values rose 1.2% on a like-for-like basis and 3.4% on a total basis from June 2009, when like for like sales had increased by 1.4% and total sales by 3.2%.

UK house prices grew by 1.9% in Q2 and by 9.5% in the year to June. Nationwide thinks that provided the economy does not suffer a relapse into recession, the net impact of the Budget on the housing market and house prices should be relatively neutral. This it believes is consistent with the relative stability seen in the housing market during the last major fiscal consolidation in the mid-1990s.

## Net institutional investment in property



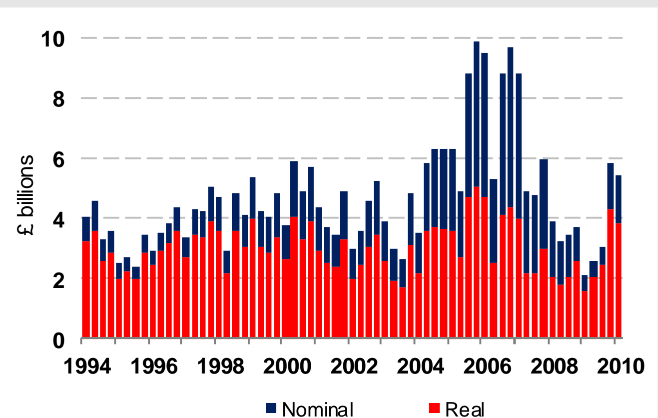

Source: National Statistics

The commercial property market continued its recovery in Q2 albeit at a reduced pace. Capital values as measured by the IPD Monthly index grew by 1.9% in the 3 months to the end of June and total returns on the commercial property market, amounted to 3.6% in Q2 compared to 5.7% in Q1.Total returns in the 12 months to June were 23.9% compared to 16.3% in the 12-months to March.

Institutional investment in commercial property reached their highest ever level in Q1. Property assets acquired in Q1 amounted to £4.3 billion and institutions also sold £1.1 billion. As a result, net disinvestment in Q1 was £3.2 million compared to net investment of £1.1 billion in Q4 2009. In the 12 months to March, net investment by institutions amounted to £3.6 billion compared with net disinvestment of £651 million in the 12 months to December.

In the first quarter, pension funds invested a further £390 million and have been net investors for the last twelve quarters. Total investment by pension funds in the 12 months to March amounted to £1.7 billion compared to £1.4 billion in the 12 months to December and £1.3 billion in the year to March 2009. Life companies were net investors for the second consecutive quarter in Q1 having previously been net sellers of property assets for the previous nine quarters. Net investment in Q1 amounted to £2.2 billion. Their total investment in the 12 months to the end of March amounted to £1.1 billion compared to a net disinvestment of £2.0 billion in the 12 months ending December. Property Unit Trusts were net investors for the second consecutive quarter in Q1 as the Association of Real Estate Funds continued to report strong net cash inflows. They invested £473 million in Q1 and £499 million in the 12 months to the end of March compared with a net disinvestment of £196 million in the 12 months ending December.

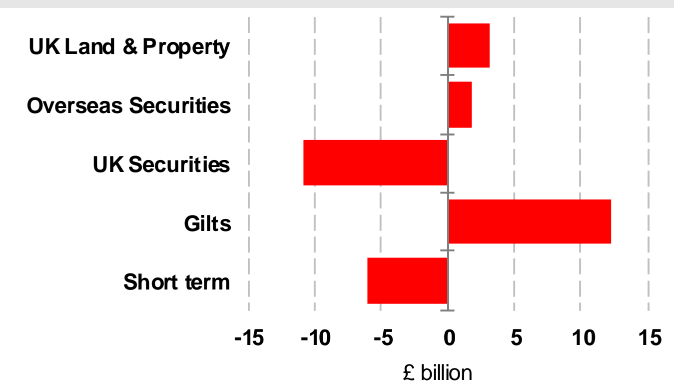
## Property market liquidity




Source: National Statistics & Fletcher King

Institutional investment grew by just £5.0 billion in Q1 having previously grown by £25.1 billion in Q4. In Q1 institutions made net purchases amounting to £12.2 billion in UK government gilts but sold £10.8 billion in UK equities. They also decreased their holdings of cash and other short term instruments by £5.9 billion and increased their holding of overseas equities by £1.8 billion.

## Net institutional investment by asset type, Q1 2010



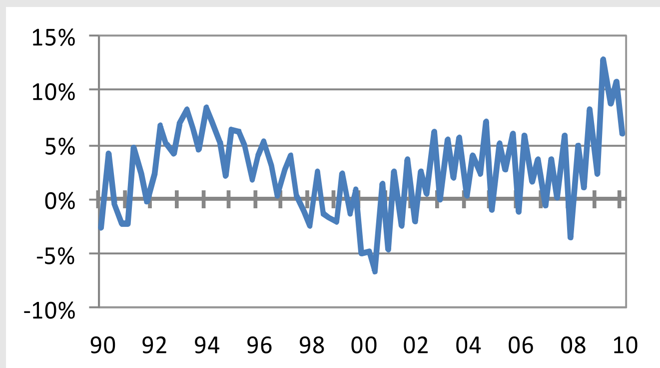

Source: National Statistics

## The longer term implications of the emergency budget for UK property

The deepest recession since the Great Depression has ended. Whether out of a growing confidence in a recovery that has been stronger than expected worldwide; or concern to avoid the spread of sovereign debt problems from southern Europe, a new government in the UK has changed the rhetoric from the need for further stimulus to the need for fiscal tightening. It plans to eliminate a budget deficit amounting to an estimated 6% of gdp in the space of a single parliament. How will this affect the UK's economy and what are the consequences for the commercial property market?

Economists are divided on the issue. The fiscal hawks talk of the threat of higher interest rates arising from any down grading in the UK's credit rating. They also suggest that private sector confidence will be improved by the government's determination to reform public sector finances. This improved confidence should encourage investment by the private sector and boost the recovery. However, the neo-Keynesians counter that spending cuts and tax increases will weaken domestic demand and threaten what has so far been a rather lacklustre recovery in the UK, regardless of the strength of the world economy and in particular Asian markets. The excess capacity in the economy and a damaged banking sector means that the low levels of investment could continue for some time yet. Furthermore, if the economy does weaken significantly, there is little room for manoeuvre from the Bank of England which is already running a very loose monetary policy.

### Public sector net cash requirement as % of gdp




Source: National Statistics

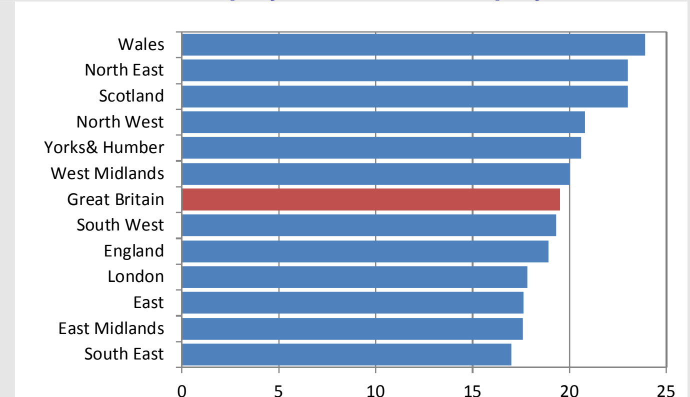
During the last major fiscal consolidation the public sector net cash requirement peaked at 8.3% in 1993 and by the end of 1997 the deficit had been eliminated. Over that period public expenditure was reduced by -7% from £606 billion in 1992-93 to £563 billion in 1996-97. Indeed public expenditure continued to fall until 1999-2000 when it reached £537 billion representing a total decrease of -11.3% but a 5.4% increase in real terms. In contrast the 25% inflation-adjusted reduction planned for this Parliament appears hugely ambitious.

Over the period from 1993 to the end of 1997 All Property rental values decreased at an annualised rate of -0.06% representing a total decrease of -0.3%. In real terms rental values decreased at an annualised rate of -2.9% representing a total decrease of -13.2%. It therefore seems likely that at best the next five years will see a period of stagnation in rental values or at worst a second leg to the current bear market in rents.

The Treasury estimates that the planned reduction in public spending will result in the loss of up to 1.3m jobs across the economy over the next five years. Between 500,000 and 600,000 jobs may be lost in the public sector as a direct result of the cuts and between 600,000 and 700,000 may disappear in the private sector through the loss of government contracts and from the impact of lower public spending.

The Treasury is also assuming that growth in the private sector will create 2.5m jobs in the next five years to compensate for the spending squeeze. However, this appears unlikely. In the period from 1993 to the end of 1997 the private sector created 1.4 million jobs at a time when the economy grew at an annualised rate of 3.3% whereas the Monetary Policy Committee's May forecasts are suggesting that economic growth will average 2.8% a year over the next three years.

### Public sector employment % of all employment




Source: National Statistics

The job losses will not be distributed equally across the country as a whole. Those regions with higher than average public sector employment will suffer from larger job losses which could result in an increase in office vacancy rates and poorer rental performance. However, those regions with lower than average public sector employment should benefit from stronger rental value growth. The number of jobs in the financial and business services sector rose strongly in Q1 and the underlying financial sector recruitment activity in Central London remains strong. This demand side recovery together with an anticipated shortage in new office space has seen headline Grade A office rents in the City of London grow by 18% in the last twelve months from £45 per sq ft to £53 per sq ft.

Spending cuts and tax increases will clearly squeeze household disposable incomes, consumer spending and the performance of retail property. However, the acceleration of the fiscal consolidation means that interest rates are likely to be lower than they otherwise would have been which should provide some offsetting support to households and the retail sector. To the extent that an improvement in the public finances raises confidence in interest rate stability, it could even attract increasing levels of consumer spending over time.

The impact of fiscal consolidation is likely to be more varied across the retail sector. UK retail sales values rose 1.2% on a like-for-like basis from June 2009. But in Central London retail sales in June were 14.4% higher on a like-for-like basis than a year ago. Sales in London were boosted by stronger consumer confidence than in the UK as a whole and sterling's weakness continued to attract overseas visitors. It may be reasonable to expect a similar outcome in major retail locations that also attract large numbers of overseas visitors.

The government's ambitious plans for fiscal retrenchment will have a profound impact on the performance of commercial property. Some segments of the market will benefit from robust levels of outperformance but there is a big risk that the gap between the north and the south or even London and the rest of the country will widen still further.

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