

# Institutional Investment in Property

In Q3 the stock market rally continued and the FTSE 100 index rose by a further 21%. By the end of September it had risen by 46% since its most recent low in early March of this year. But tellingly for long term equity investors the market remains 26% below its peak level achieved prior to the dot.com bust in January 2000.

## Investment in UK property Q2 2009 (£ millions)

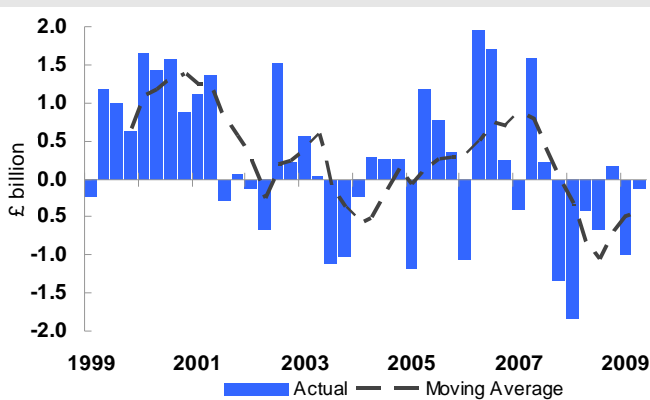
	Pension Funds	Insurance Companies	Unit Trusts <sup>1</sup>	Total
<b>Purchases</b>	657	578	83	1,318
<b>Sales</b>	61	1,008	377	1,446
<b>Net Investment</b>	596	-430	-294	-128

1. Includes Investment Trusts

House prices have been increasing since March according to the Nationwide, consumer confidence continues to improve and the British Retail Consortium have just welcomed the best monthly sales growth figures since January 2008. Surveys of the financial services sector suggest a further recovery in the sector's confidence. Even the manufacturing sector is benefiting from a rise in new orders and sterling's current weakness is supporting export sales as overseas markets improve.

However, the latest GDP figures indicate that the UK economy contracted by a further 0.4% in the third quarter of 2009, compared with a decrease of 0.6% in the second quarter. These latest numbers are particularly disappointing and confound the more optimistic news that preceded their publication. The loose monetary policy of low interest rates and quantitative easing seems certain to remain in place for some time yet.

## Net institutional investment in property



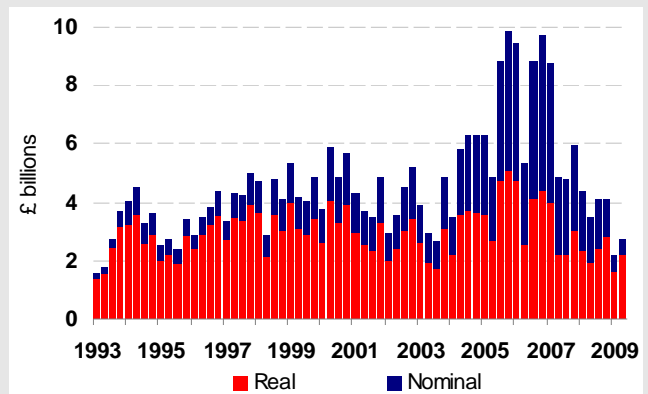
Source: National Statistics

Nevertheless, the commercial property market finally ended its run of declining capital values in the third quarter after 25 consecutive months. Commercial property looks good value compared to all other assets following a 44% fall in values and in the third quarter anecdotal evidence of a market revival was translated into hard data. Capital values as measured by the IPD Monthly index grew by 1.2% in the 3 months to the end of September and total returns on the commercial property market, amounted to 3.3% in Q3 compared to -2.7% in Q2. Total returns in the 12 months to September were -19.3% compared to -25.6% in the 12-months to June.

The latest figures published by National Statistics show that commercial property market activity increased by 27% in the

second quarter of 2009 compared to the first quarter. Property assets acquired in Q2 amounted to £1.3 billion but institutions also sold £1.4 billion. As a result, net disinvestment in Q2 was £128 million compared to net disinvestment of £1 billion in Q2. In the 12 months to June, net disinvestment by institutions amounted to £1.6 billion compared with net disinvestment of £2.0 billion in the 12 months to March.

## Property market liquidity

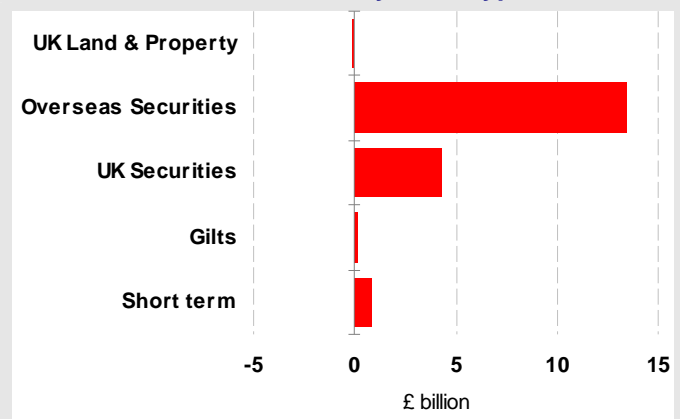


Source: National Statistics & Fletcher King

In the first quarter, pension funds continued their counter-cyclical behaviour by acquiring a further £657 million and selling £61 million of property. Total investment by pension funds in the 12 months to June amounted to £1.5 billion compared to £1.3 billion in the 12 months to June and £875 million in the year to June 2008. Life companies made a net disinvestment of £452 million in Q2. Their total disinvestment in the 12 months to the end of June amounted to £2.5 billion compared to a net disinvestment of £2.8 billion in the 12 months ending March. Property Unit Trusts disinvested a further £294 million in Q2 and have been net sellers of £861 million in the 12 months to the end of June compared with a net disinvestment of £683 million in the 12 months ending March.

Institutional investment grew by £23.5 billion in Q2 having previously grown by £10.3 billion in Q1. IN Q2 institutions made net purchases of £152 million in UK government bonds and £4.3 billion in UK equities. They also increased their holding of overseas equities by £13.45 billion.

## Net institutional investment by asset type, Q2 2009



Source: National Statistics

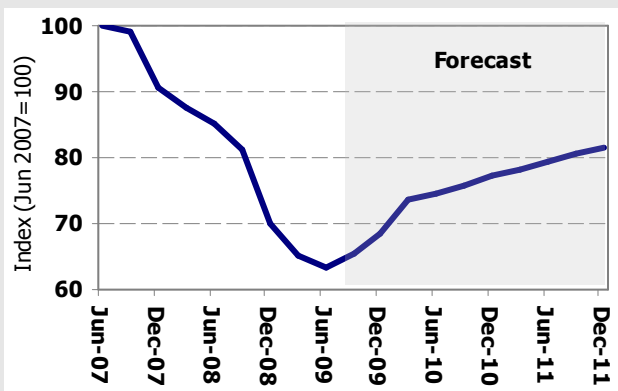
## Recovery

### *How the outlook for the commercial property market will be shaped by a weak economic recovery and cautious financiers.*

Back in July we noted that the performance of Reits indicated that the stock market was not anticipating any immediate recovery in the underlying commercial property market and that the price of the calendar 2009 All Property Swap had increased from -17.5% at the end of April to -13.5%.

What a difference three months makes. The latest IPD monthly index indicates that All Property capital values grew by 1.2% in September. This was the biggest monthly increase since June 2006. In Q3 the FT Real Estate sector rose by 32%. The price of the calendar 2009 All Property Swap has now come in to -1.5% and the calendar 2010 All Property Swap is priced at 9.8%. What can we expect next during the recovery phase of this cycle?

#### Actual & forecast all property total returns



Source: IPD & Fletcher King

Property is currently attractively priced relative to other assets. The All Property initial yield on IPD's September monthly index is 7.7%. Savings rates of 3.25% a year are available for instant access accounts although it is possible to obtain a 5-year fixed rate bond offering 5.25% a year. The dividend yield on the FT All Share is 3.3%. The benchmark 5 year gilt is 2.7% and the 10 year gilt is 3.6%.

Liquidity is finally improving. More than half of UK institutional investors expect to increase their investments in commercial property over the next three years, according to a survey by the Pensions Management Institute and Prupim. Those polled manage about £150bn assets jointly. In September Songbird Estates, the owner of Canary Wharf, raised £1.03 billion to repair its balance sheet. BNP Paribas has announced plans to raise £150 million of equity by the end of the year from smaller UK pension funds, fund managers and overseas investors for investment in UK commercial property. The Libyan Investment Authority, paid £155 million for Portman House in the West End in July, and British Land has sold 50% of Broadgate to Blackstone, the American private equity group, for just over £1 billion. Land Securities has sold its one third ownership of the Bullring to an Australian Government investment fund for £210 million.

The number of banks prepared to lend significant amounts for real estate investment has almost doubled in the past six months. In March, there were only 12 lenders willing to back deals of more than £25m in the UK market. The stabilisation of finance markets has seen lenders look to take advantage of the recent recovery in real estate. There are now 23 lenders prepared to lend more than £20m for real estate investment and

about six willing to lend more than £100m to the sector.

In the short term we therefore expect to see an investment led recovery that could see capital values increase by up to 10%. Leveraged investors could benefit from stronger uplifts in value depending on their loan to value ratios and the interest payable to their lenders.

However, in the medium term we expect the property market to revert to a situation where there is little scope for yield compression, rental growth is limited and income is paramount. This is a reflection of a weak macro-economic recovery, declining or at best weak rental growth and a more cautious approach from the banks towards lending to the commercial property sector.

The MPC believes that the prospects for domestic economic activity are underpinned by the considerable stimulus from the easing in monetary and fiscal policy and the past depreciation of sterling. But there are also factors that are likely to hinder recovery. Credit conditions are likely to remain tight as banks continue to repair their balance sheets, and past falls in asset prices and high levels of public and private debt will weigh on spending. On balance, the stimulus should lead to a slow recovery in economic activity, but the timing and strength of that recovery remains highly uncertain.

Between June 1990 and June 1992 the economy fell by 2.4%. Rental values peaked in December 1990 and fell month on month until June 1995. Rental values declined 21% over that period and did not recover their December 1990 value until June 2001. In the current recession economic output has fallen by 6.4% and rents have so far fallen 9% between March 2008 and September. If the earlier scenario is followed rental values could continue to descend until the end of 2012. Bearing in mind the likelihood of a weak macro economic recovery and the size of the fall experienced so far, this outcome cannot be disregarded.

While we expect rental growth to be held back by the size of the economic contraction and the slow pace of recovery, we also expect investment activity to be limited by a cautious approach to lending from banks and other financial institutions.

As noted above banks are again starting to lend money on low-risk real estate opportunities. But these deals do not mean a return to the time before the property crash, when finance was easily available. For the foreseeable future lenders will tread a path of prudence and lending volumes will remain reduced due to a scarcity of good quality product and the return of prudence.

The size of the problem is daunting. The most recent estimates suggest that there was £225bn of debt secured against UK commercial property at the end of 2008; of which £43.8bn is due for refinancing in 2009, with £32.6bn coming to maturity in 2010 and £31.5bn in 2016. At the height of the boom banks were lending up to 90% of the value of a property. But by the middle of this year commercial property values had fallen 44% from their peak. Consequently banks have already taken losses on real estate and also made large impairments to provide against future losses.

For the moment the banks are willing to work with customers to recapitalise loans. All banks are keen to avoid crystallising losses on loans and this will result in them following a 5 to 10 year workout.

In the medium term we therefore expect to see commercial property returns being driven by income. But in a low interest rate environment and with initial yields of around 7% property should still look attractive relative to other asset classes.