# Institutional Investment in Property

Fletcher King
PROPERTY FUND MANAGERS
CHARTERED SURVEYORS

The deficit reduction programme commenced in earnest with the start of the new tax year on 6th April. But even before then, a combination of falling confidence and wintry December weather caused the UK economy to shrink by 0.5% in the fourth quarter of 2010. Over the whole year output grew by 1.6%. According to the Office for Budget Responsibility, "higher-than-expected" inflation is likely to squeeze household disposable income in the coming months and thereby weaken consumer spending growth. Recent data also shows that the economy had less momentum than we expected entering 2011, even after adjusting for the temporary impact of December's heavy snowfall. Largely reflecting these two factors, we have revised down our central forecast for economic growth in 2011 from 2.1 per cent to 1.7 per cent."

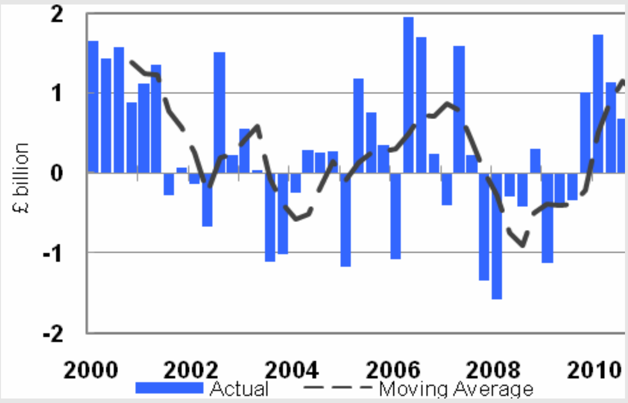
### Investment in UK property Q4 2010 (£ millions)

| | Pension Funds | Insurance Companies | Unit Trusts[1] | Total |
|---|---|---|---|---|
| **Purchases** | 538 | 539 | 254 | 1,331 |
| **Sales** | 102 | 662 | 79 | 843 |
| **Net Investment** | **436** | **-123** | **175** | **488** |

1. Includes Investment Trusts

In April, the PMI index constructed from surveys of the services, manufacturing and construction industries pointed to a strong economic rebound in the first quarter. The survey suggests that the service sector grew at its fastest pace in more than a year in March although manufacturing growth suffered its largest one-month fall since November 2008. The surveys also suggest that growth could weaken in the second quarter. With the economic growth data for the last two quarters distorted by bad weather and a subsequent rebound, it will probably not be until the second quarter of 2011 that true underlying growth momentum can be properly estimated.

### Net institutional investment in property



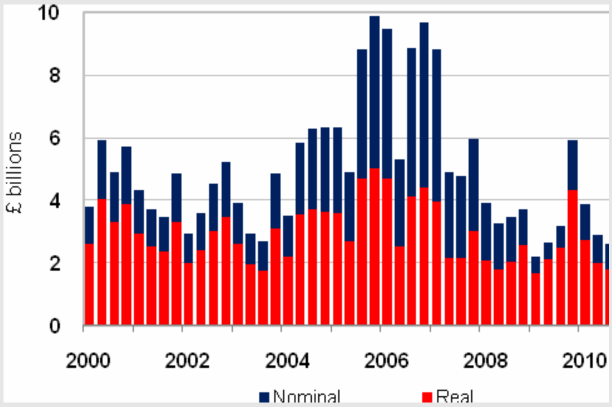

Source: National Statistics

The commercial property market strengthened slightly over the course of Q1. Capital values as measured by the IPD Monthly index increased to 0.6% in Q1 from 0.5% in Q4 2010 and total returns increased to 2.3% in Q1 from 2.2% in Q4 2010. Total returns in the 12 months to March decreased to10.7% from 14.5% in the 12-months to December.

2010 was the third highest year for net institutional investment in property after 1998 and 2000. But market activity slowed towards the end of the year. In Q4 net investment in commercial property fell back for the third consecutive quarter as institutions acquired property assets worth £1.3 billion and recorded sales of £840 million. As a result, net investment in Q4 was £490 million compared to £690 million in Q3. In the 12 months to December, net investment by institutions amounted to £4.0 billion compared with net disinvestment of £852 million in the 12 months to December 2009.

In the fourth quarter, pension funds invested a further £436 million and have been net investors for the last fifteen quarters. Total investment by pension funds in the 12 months to December amounted to £1.71 billion compared to £1.73 billion in the 12 months to September and £1.4 billion in the year to December 2009. Life companies were net sellers for the first time in five quarters. Net disinvestment in Q4 amounted to £122 million. Their total investment in the 12 months to the end of December amounted to £840 million compared to £1.1 billion in the 12 months ending September and a net disinvestment of £2.1 billion in the year to December 2009. Property Unit Trusts were net investors for the fifth consecutive quarter in Q4 as the Association of Real Estate Funds continued to report net cash inflows. They invested £172 million in Q4 and £1.3 billion in the 12 months to the end of December compared with a net investment of £1.5 billion in the 12 months ending September.

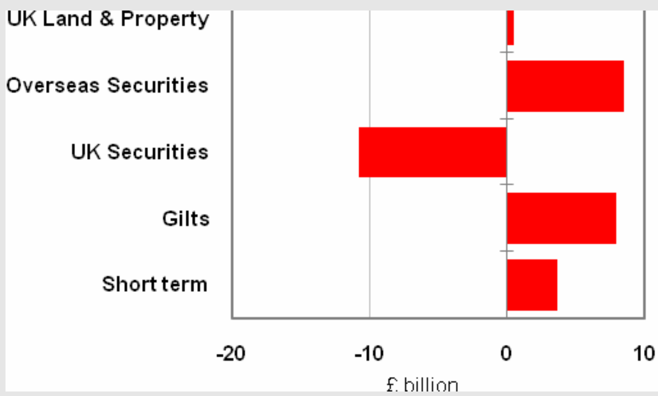
### Property market liquidity




Source: National Statistics& Fletcher King

Total institutional investment grew by £18.4 billion in Q4 having previously grown by £16.2 billion in Q3. In addition to the net investment of £490 million in UK Property noted above, institutions also made net purchases in Q4 amounting to £7.9 billion of UK government gilts and £8.5 billion of overseas equities. However, they sold £10.8 billion of UK equities while holdings of cash and other short term instruments increased by £3.6 billion.

### Net institutional investment by asset type, Q4 2010



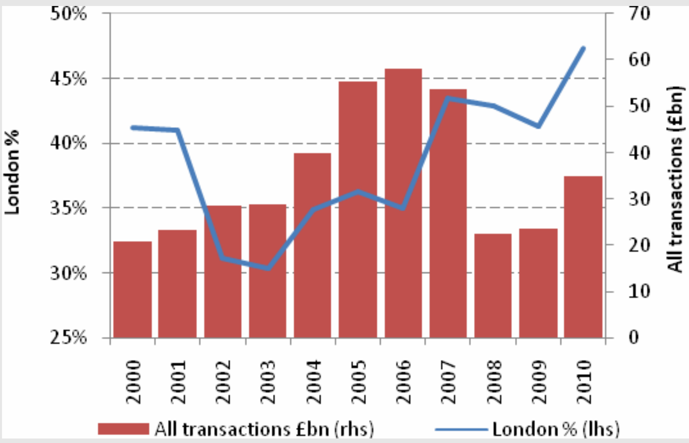

Source: National Statistics

## Investment trends in the UK's commercial property market.

There are two underlying trends that shaped the performance of property portfolios in 2010 and will do the same in the short to medium term future. These are namely, the focus by investors on Central London or Central London and the South East rather than the whole of the UK and the requirement for prime rather than secondary assets.

London and the South East dominate the UK commercial property investment market. Using IPD data, property in London represents 34% of the database and London and the South East together represent 52%. This is rather more than would be expected from the relative size of the regional economies. London accounts for 21% of UK economic output and London and the South East together account for 35% of output.

**Chart 1; Investment transactions**




Source: PwC and National Statistics

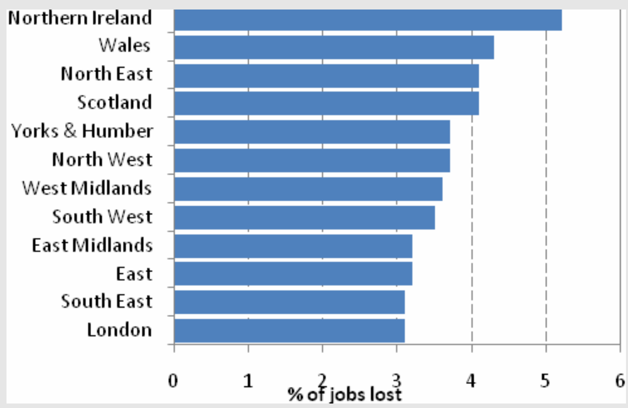
In 2010 London represented 27% of investment transactions by number but 48% by value continuing a trend that has established itself since 2004 (see chart 1). The average yield on Rest of UK investment transactions was 6.7% but the average yield on London transactions was 5.8% with an average yield of 4.8% on transactions in London's West End.

It is widely anticipated that the public spending cuts associated with the Government's deficit reduction programme will hurt the northern regions more than the south. Analysis by Pricewaterhouse Coopers[i] shows that the regions that are likely to suffer the most from public spending cuts are the devolved administrations of Northern Ireland, Scotland and Wales as well as the North East of England, due to the heavy dependence on the public sector for employment (see Chart 2).

For the UK as a whole, total job losses related to the public spending cuts including knock-on multiplier effects on the private sector might amount to around 3.4% of employment (around 943,000 in absolute terms), but for Northern Ireland this might rise to around 5.2% (around 36,000 in absolute terms).London and the South East could see job losses of around 230,000 in absolute terms. However, this amounts to only around 3% of employment in these two regions given the larger size of their economies.

Forecasts for the UK economy in March have been revised down to an average of 1.7% from 2.0% in December 2010. But some simple arithmetic suggests that this still leaves scope for London and the South East to grow at around the trend rate of 2.5% while the Rest of the UK is blighted by growth of just 1.25%. In property terms this implies that half of the investment market located as it is in London and the South East will be reasonably well supported by underlying economic factors.

**Chart 2; Effects of spending cuts on regional employment**




Source: PwC and National Statistics

The second trend is reflected by the preference of investors for prime assets in the City, West End and to a lesser degree in the six main regional centres.

Some of this is captured by the IPD data which draws on the portfolios of pension funds, life and general insurance companies, pooled property funds, Reits and traditional estates and charities. Their data suggests that across all sectors, save Retail Warehouses and Central London offices, the lowest yielding assets enjoyed the highest capital growth in 2010. Although low yielding retail warehouses grew by 8.8% in 2010 higher yielding retail warehouses grew by 10.3% whilst low, middle and high yielding Central London offices all benefited from capital growth of between 16.3% and 16.5%

Anecdotal evidence adds further support. In 2010 48% of all investments were purchased by sovereign wealth funds and other overseas investors, private property companies and private individuals who do not typically submit their data to IPD. Some of these were the biggest investment players of 2010. Examples include the Dutch Civil Service pension fund which paid £872 million for 50% of Westfield's Stratford City shopping centre on the fringe of the 2012 Olympic site; the Olayan Group, a Saudi Arabian based affiliation of businesses, which paid £600 million for a retail portfolio known as the Knightsbridge Estate; and the Norwegian Government pension fund which paid £448 million for a portfolio of shops and offices on Regent Street.

Yields on Central London offices and shops are now near to the levels prevailing at the very peak of the market in mid-2007. Pricing is now at a level that fully reflects expectations of robust levels of rental growth. Whereas the transaction yields on even the better assets in office and industrial markets outside the capital reflect better value. But until the economic outlook for the Rest of the UK improves investors may remain wary of these sectors.

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[i] PwC (October 2010). Sectoral and regional impact of the fiscal squeeze.

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