Institutional Investment in Property

Fletcher King
PROPERTY FUND MANAGERS
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In Q4 recession ceased to be a threat and became a reality. It is likely that figures published at the end of January will show that UK economic output declined by around 1.5% in Q4 and by 1.8% over the whole of 2008. The government and the Bank of England moved from a piecemeal approach to the banking crisis to a costly but necessary re-capitalisation of the complete banking system. Meanwhile interest rates fell to 1.5% in the UK in an effort to boost economic activity and in January the government announced further measures designed to encourage lending by the banks.

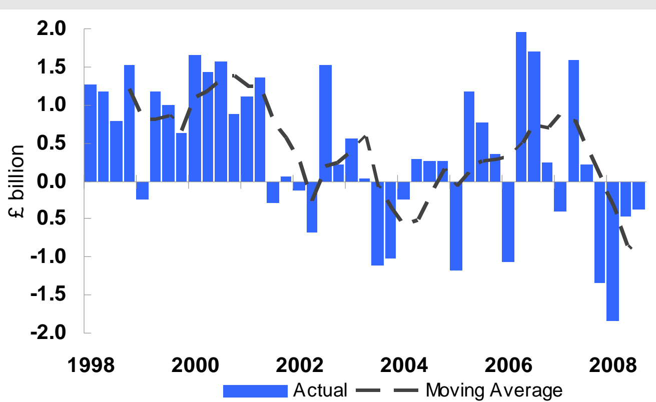
Investment in UK property Q3 2008 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts [1]	Total
Purchases	765	1,222	29	2,016
Sales	417	1,793	182	2,392
Net Investment	348	-571	-153	-376

1. Includes Investment Trusts

Against this background it is hardly surprising that the commercial property market fell further as capital values declined by -15.0% in the 3 months to the end of December making it the worst ever quarter since IPD started its monthly series in December 1986. Total returns on the commercial property market as measured by the IPD Monthly index, have decreased to -22.5% in the year to December from -18.1% in the year to September.

Net institutional investment in property



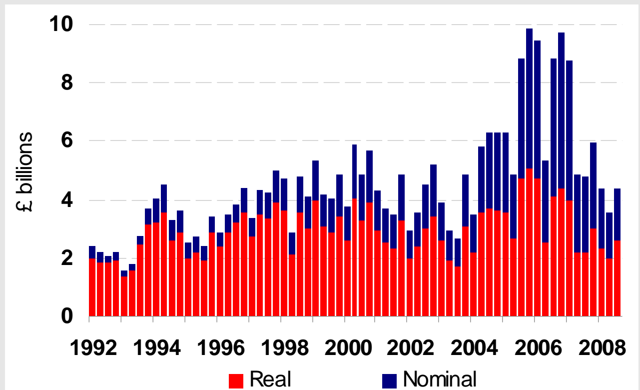
Source: National Statistics

The latest figures published by National Statistics show that market activity actually increased in the third quarter of 2008. Property assets acquired in Q3 amounted to £2.02 billion but institutions also sold £2.39 billion. As a result, net disinvestment in Q3 was £376 million compared to disinvestment of £472 million in Q2. In the 12 months to September, net disposals by institutions amounted to £4.0 billion compared with net disinvestment of £3.4 billion in the 12 months to June. Anecdotal evidence from market participants continues to suggest that investment activity has remained strictly limited again in Q4.

In the third quarter, pension funds again continued their counter-cyclical behaviour by acquiring a further £765 million and selling £417 million of property. Total net investment by pension funds in the 12 months to September increased to £1.02 billion from £831 million in the 12 months to June. Life companies made a net disinvestment of £684 million in Q3.

Their total disinvestment in the 12 months to the end of September amounted to £3.9 billion compared to a net disinvestment of £3.2 billion in the 12 months ending June. Not surprisingly, given their continuing need to raise cash to fund redemptions, Property Unit Trusts disinvested £156 million in Q3 and have been net sellers of £1.2 billion in the 12 months to the end of September compared with a net disinvestment of £981 million in the 12 months ending June.

Property market liquidity

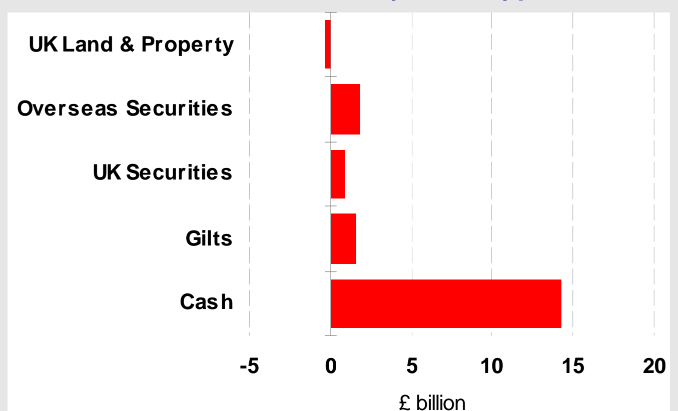


Source: National Statistics & Fletcher King

In the 18 months since the end of June 2007, capital values have decreased by 36% and the All Property initial yield on the IPD Monthly Index is 7.0% having risen by 246 basis points since the end of June 2007. Declines in the index have been particularly large in Q4 but anecdotal evidence suggests that even though the "price on the ground" may reflect the bottom of the market the indices still have some catching up to do.

Recent macro-economic events have been reflected in a further increase in market volatility and large declines in the value of shares. In Q3 institutional investors responded to market volatility by limiting their additional exposure to any asset class other than cash and other short term instruments which saw net investment of £14.3 billion in the quarter. Although there has been some speculation that equity markets might recover in 2009, so far any recovery has been followed by a bout of profit taking that has driven the markets back down.

Net institutional investment by asset type, Q3 2008



Source: National Statistics

The Outlook for Property in 2009

In 2008 the asset price bubble caused by low interest rates and excessive lending finally burst. Commercial property prices fell by 27% and property company share prices decreased by 49% reflecting the destructive effects of gearing in a falling market. The FT All Share index declined by 33% and house prices fell by 16%. Commodity prices have also fallen sharply. The price of oil is down 50% on the year, copper prices are down 54% and wheat prices have fallen 40%.

On many measures the commercial property market appears to be valued at or below fair value. The initial yield on commercial property currently stands at 7% and is back to levels seen at the end of 2002. But in the property slump that accompanied the recession of 1990-92 the initial yield on commercial property rose to 9% in the second quarter of 1993.

Property initial yield – gilt yield gap

Source: IPD & Fletcher King

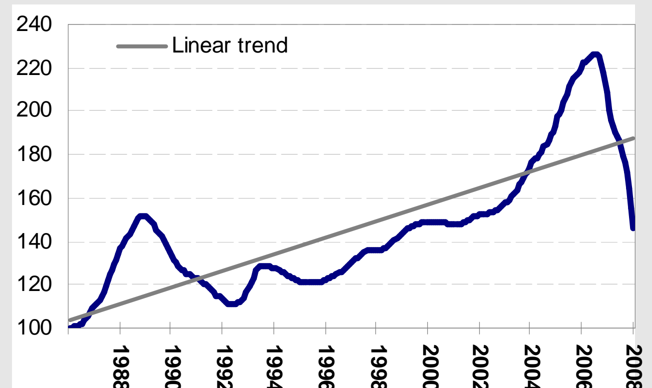
At the time this reflected a real yield of almost 8% as by then inflation had fallen to 1.3% year on year as a result of six quarters of economic contraction. Today the real yield is 6% as rpi inflation has fallen to 1% year on year. But with falling food, energy and housing costs forecast to continue, inflation is expected to decline further. Capital Economics expect cpi inflation to fall to -3% and the fall in rpi inflation that includes housing costs will be even greater. By the middle of this year the real yield on commercial property could be 10% without factoring in any further decrease in values.

Since the peak of the market in June 2007 initial yields have risen 246 bp's. In contrast gilt yields have declined by 79 bp's in the course of 2008 and by 156 bp's since June 2007 reflecting the much lower outlook for inflation and short term interest rates and increased investor demand caused by a move towards risk free assets. Today the yield on 5 and 10 year gilts is 2.9% and 3.6% respectively. Consequently the gap between property initial yields and gilt yields has now widened to 340 bp's compared to an average over the last 10 years of 150 bp's (see chart above).

In a similar way the base rate has decreased from 5.75% in November 2007 to 1.5% today and three month libor currently stands at 2.2%. The gap between the property initial yield and base rate has now widened to 550 bps compared to an average over the last 10 years of 135 bp's and the gap between the property yield and three month libor has widened to 430 bp's compared to an average over the last 10 years of 118 bp's.

In the current cycle property values have fallen further and faster than in the early 1990's slump and currently stand at a larger discount to their trend value. In the 18 months between the end of June 2007 and December 2008, capital values have decreased by 36% and the market now stands at a level that is 22% below its trend level (see chart below). In the 1990's values decreased by 27% in the 43 months between October 1989 and May 1993 and at the trough property values were 14% below their trend values.

All property capital value index & linear trend



Source: IPD & Fletcher King

However, in spite of these indications that commercial property is valued at or below fair value, the current environment makes it extremely difficult to provide forecast returns for 2009. The range of views can be neatly illustrated by the following recent quotes from two influential investors.

Anthony Bolton of Fidelity Investments considers that, "the gap between base rates and the yield on commercial property is now so wide that investors are being more than adequately compensated for the risk that some tenants might go bust. All things being equal, the differential … should tempt a wall of money back into prime office blocks, industrial estates, retail parks and the like."

However, for Rupert Clarke of Hermes, "the lack of new bank lending and the repayment of £250bn of existing debt will be the major driver of further price falls. The consequences of any return of institutional money and sovereign wealth funds will be miniscule in comparison."

In our view the outlook for the property market depends on two factors. Firstly on the return to some form of normality in the debt markets and secondly on the economy. It is too early to assess the impact on lending of the government's giant loan insurance scheme announced this month although it is certain that the banks will be required to increase their lending to businesses and households in exchange for their participation in the scheme. However, it is likely that any improvement in the availability of credit will not be evident until the second half of the year. As far as the economy is concerned, despite unprecedented low interest rates that seem certain to be cut even further, any sign of a recovery will be postponed until credit becomes more readily available through the banking system whether nationalized or not.

Expectations for 2009 remain bleak with the pricing of the 2009 property swap suggesting a total return of -18% which would make it the second worst year ever after 2008. The swap market is also suggesting it will be a slow climb back for commercial property with the price for the 2010 swap implying a forecast return of 0% in 2010 and 11% in 2011. However, given the pointers of value outlined above as soon as any signs at all of economic recovery are observed we would expect to see a surge of investment activity accompanied by a strong improvement in property values.

Richard Goode richardgoode@fletcherking.co.uk 020 7493 8400