Institutional Investment in Property

It now appears that UK economic output expanded by 0.2% in Q1 compared to 0.4 % in Q4 2009. Economists were expecting stronger growth. In March, the PMI index constructed from surveys of the services, manufacturing and construction industries recorded its highest reading since August 2007 and was consistent with GDP rising by approximately 0.5% in Q1. It is quite possible that this preliminary estimate is revised up subsequently, just as the original Q4 2009 estimate was revised up from 0.1%.

Investment in UK property Q4 2009 (£ millions)

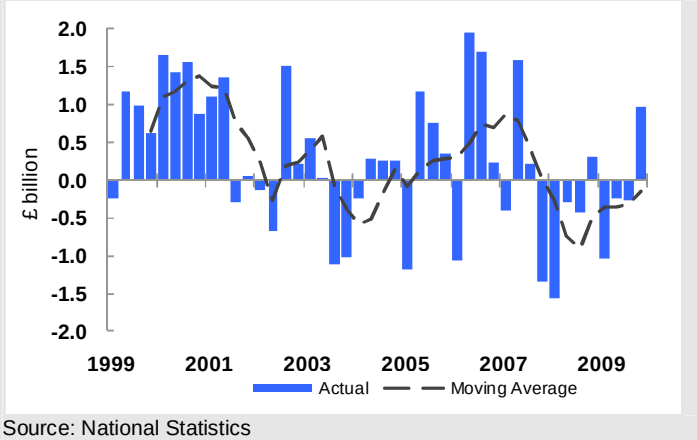
	Pension Funds	Insurance Companies	Unit Trusts [1]	Total
Purchases	858	1,809	549	3,216
Sales	364	1,764	115	2,243
Net Investment	**494**	**45**	**434**	**973**

1. Includes Investment Trusts

Having ended its run of 25 consecutive months of declining capital values in the third quarter of last year, the commercial property market continues to disregard any concerns over the mixed outlook for the economy. Capital values as measured by the IPD Monthly index grew by 3.9% in the 3 months to the end of March and total returns on the commercial property market, amounted to 5.6% in Q1 compared to 9.5% in Q4 which were the strongest quarterly performance figures since the inception of the monthly index in 1987. Total returns in the 12 months to March were 16.3% compared to 2.2% in the 12-months to December.

The certainty of fiscal tightening after the general election has led to expectations of a weak recovery and supports the view that rental values will continue to fall throughout 2010 and possibly 2011. In such a scenario, once momentum from the investment led recovery that is currently driving values higher has been exhausted and pending the return of rental value growth, we expect the property market to revert to a situation where there is little scope for further yield compression and income is paramount. A stronger economic recovery would encourage expectations of a quicker return to rental value growth and support the case for further yield compression.

Net institutional investment in property

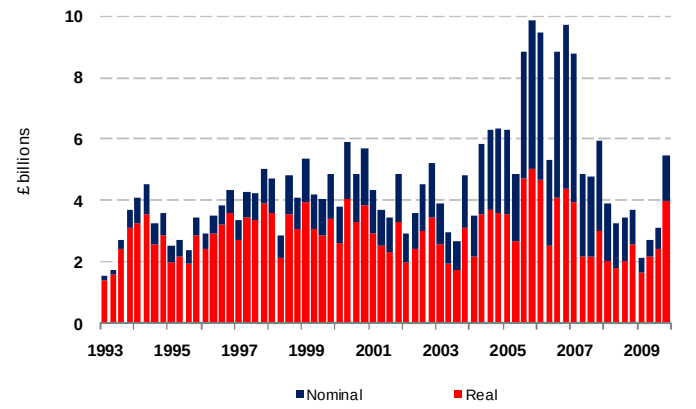


Source: National Statistics

As expected following on from Q4's strong investment performance the latest figures published by National Statistics show that total market activity increased by 75% in the fourth quarter of 2009 compared to the third quarter although it remained below the peak levels recorded in 2004, 2005 & 2006. Property assets acquired in Q4 amounted to £3.2 billion but institutions also sold £2.2 billion. As a result, net investment in Q4 was £973 million compared to net disinvestment of £265 million in Q3. In the 12 months to December, net disinvestment by institutions amounted to £554 million compared with net disinvestment of £1.2 billion in the 12 months to September.

In the fourth quarter, pension funds invested a further £490 million and have been net investors for the last eleven quarters. Total investment by pension funds in the 12 months to December amounted to £1.6 billion compared to £1.8 billion in the 12 months to September and £1.2 billion in the year to December 2008. Life companies made a net disinvestment of £27 million in Q4 and have been net sellers of property assets for the last ten quarters. Their total disinvestment in the 12 months to the end of December amounted to £2.2 billion compared to a net disinvestment of £2.4 billion in the 12 months ending September. Property Unit Trusts became net investors for the first time in nine quarters as the Association of Real Estate Funds reported record net cash inflows of £2.8 billion. They invested £430 million in Q4 but remain net sellers of £162 million in the 12 months to the end of December compared with a net disinvestment of £801 million in the 12 months ending September.

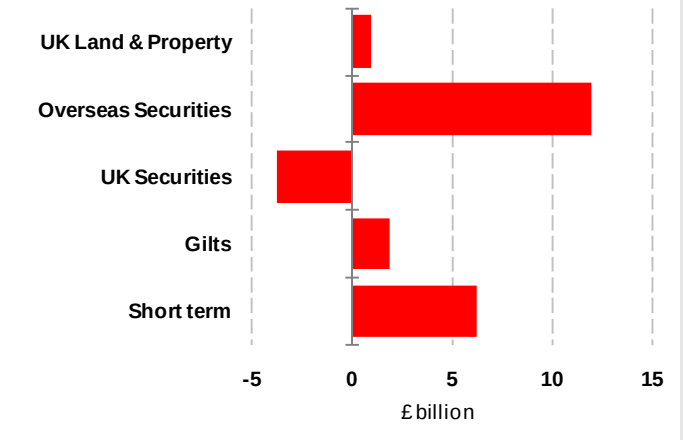
Property market liquidity



Source: National Statistics & Fletcher King

Total institutional investment grew by £24.8 billion in Q4 having previously grown by £20.3 billion in Q3. In Q4 institutions made net purchases of £1.9 billion in UK government gilts but sold £3.7 billion in UK equities. They also increased their holdings of cash and other short term instruments by £6.2 billion and increased their holding of overseas equities by £11.9 billion.

Net institutional investment by asset type, Q4 2009



Source: National Statistics

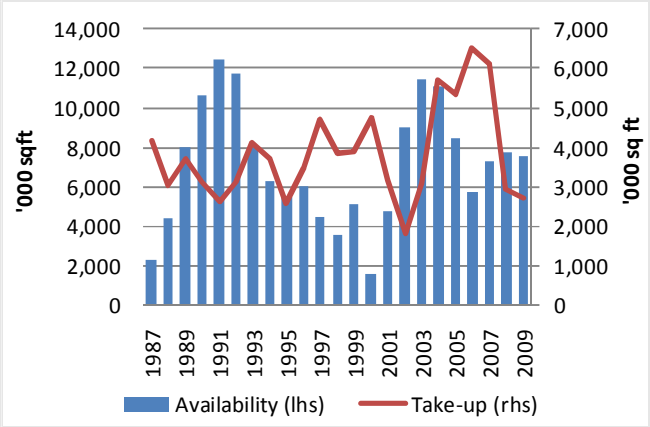
After the deluge.

The City of London office market.

The recent recession was caused by the worst banking crisis in living memory and many commentators likened the situation to the Wall Street Crash and subsequent depression of the early 1930's. It was argued that the UK economy would be one of the worst affected by the banking collapse because of its over reliance on financial services. Within the UK, Central London and in particular the City of London could expect to see the loss of tens of thousands of financial sector jobs with dire consequences for the office markets. In what looks like the second quarter of economic recovery we examine below how the City of London's office markets actually fared.

In the City of London availability started rising in September 2007 and rose for 8 consecutive quarters peaking in June 2009 at 9.4 million sq ft. In Q1 City of London availability decreased by 13% to 6.6 million sq ft from 7.6 million sq ft in Q4 2009. Over the last 12 months availability has decreased by 23% from 8.6 million sq ft available in Q1 2009. This quarter the vacancy rate has decreased to 9.2% from 10.5% in Q4 2009 having peaked at 13%. Rental values fell by 24% between March 2008 and December 2009.

City of London availability & take-up



Source: Fletcher King Research

The previous two office market falls started in February 1990 and in February 2002. In 1990 the fall in the office market was caused by the contemporaneous recession resulting from an increase in interest rates to 15% in response to price inflation which had started the year at 8% and climbed to 11% in September before gradually subsiding. In 2002 the fall in the office market was caused by recession in the USA and Eurozone and thus reflected the global nature of capital markets and the financial products traded in the City of London.

Office availability peaked at 13 million sq ft in March 1992 reflecting a vacancy rate of 16.5% having risen for 21 consecutive quarters. In December 2004 office availability peaked at 11.1 million sq ft reflecting a vacancy rate of 16% having risen for 16 quarters.

The current relatively low peak in availability compared to the previous two cycles is partly the result of lower development activity. The average long run rate of development completions stands at 2.2 million sq ft a year. In the four years from 1989 to 1993 development completions averaged 4.8 million sq ft a year as developers competed to provide the modern office space and trading floors required by the new class of investment bank that emerged in the wake of the City's "big bang" when banks were allowed to buy up and roll together broking and jobbing houses which had previously been required to act independently of each other. Between 1990 and 1993, City of London office rental values collapsed by 58%.

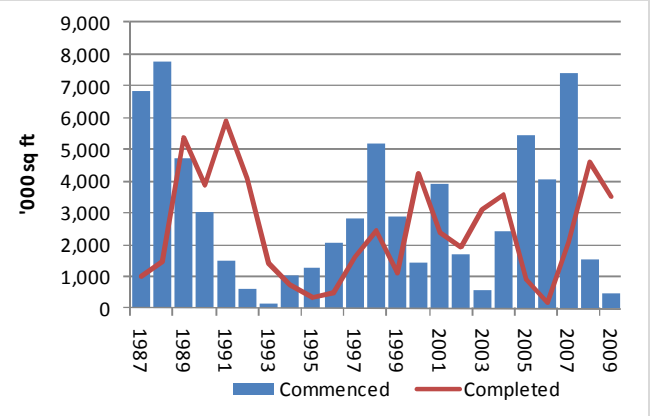
Office rental values in the City of London slowly recovered post 1993 and in 1997 and 1998 grew at an annualized average of 15%. In the years from 2000 to 2004 development completions averaged 3 million sq ft. But in 2002 rental values again began to fall and decreased by 19% in three years.

In the latest cycle, development completions peaked in 2008 at 4.6 million sq ft. In 2009 3.5 million sq ft of newly developed office space was completed. In 2010, a further 2.9 million sq ft is scheduled for completion and by the end of this year it is likely that development completions will have averaged 3.3 million sq ft for the four years. So whilst it is true that development activity was much stronger in the years after 1989 it is not the case in the years after 2000.

A further reason that the peak in availability has surprised on the downside is that demand or take-up has remained relatively robust. In 1990 – 93 office take-up fell below its long run quarterly average of 973,000 sq ft for eleven out of thirteen quarters. In 2000 – 04 office take-up fell below its long run average for 14 quarters. In the most recent downturn office take-up fell below its long term average for six quarters from March 2008 but recovered to 1.2 million sq ft in Q3 2009. In Q1 take-up decreased by 25% to 1.2 million sq ft from 1.6 million sq ft in Q4 2009. Twelve months earlier in Q1 2009 take-up was just 202,000 sq ft.

So the answer to how did the City of London's office market fare must be better than expected. The financial services hiring market in London saw a second month of growth in February 2010 with a 13% month-on-month rise in job numbers from 4,650 to 5,250. Compared to the same month last year, there was a 67% increase in job numbers from 3,150. This increase in job availability follows the pattern of growth that began in Q2 2009 and has continued into 2010. Expectations now are that City of London office rents may see some robust levels of growth in 2010 and 2011. Achievable rents for Grade A space in the City increased to £47.50 per sq ft in Q1 from £42.50 per sq ft in Q4 2009. In the year to March 2010 headline rental values have now risen back up to the level achieved 12 months earlier.

City of London development cycle



Source: City Corporation

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