Institutional Investment in Property

Fletcher King
PROPERTY FUND MANAGERS
CHARTERED SURVEYORS

In Q1 the economy remained weak. The number of people unemployed rose to over 2 million for the first time since 1997 and is forecast to reach more than 3 million echoing the downturns of the 1980's and 1990's. The MPC's latest forecasts suggest that although Q1 may mark the nadir of the recession the economy will continue to shrink further in Q2 and Q3. In an effort to stimulate economic activity the bank base rate has been reduced to 0.5% and the MPC has now moved beyond conventional responses to initiate the more unconventional quantitative easing.

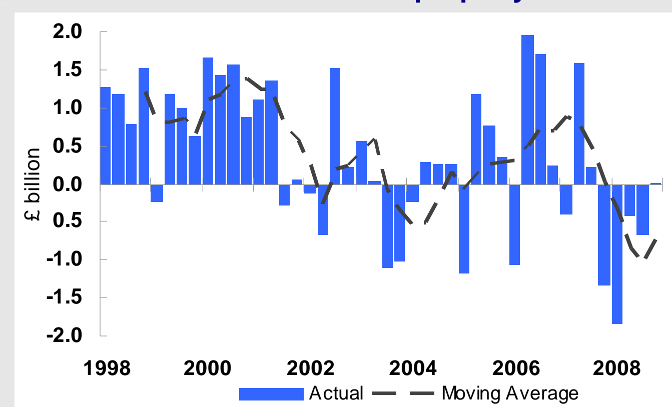
Investment in UK property Q4 2008 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts [1]	Total
Purchases	814	1,351	21	2,186
Sales	83	1,843	255	2,181
Net Investment	731	-492	-234	5

1. Includes Investment Trusts

Against this background it is hardly surprising that the commercial property market fell further as capital values declined by -8.9% in the 3 months to the end of March. Total returns on the commercial property market as measured by the IPD Monthly index, have decreased to -25.5% in the year to March from -22.5% in the year to December.

Net institutional investment in property

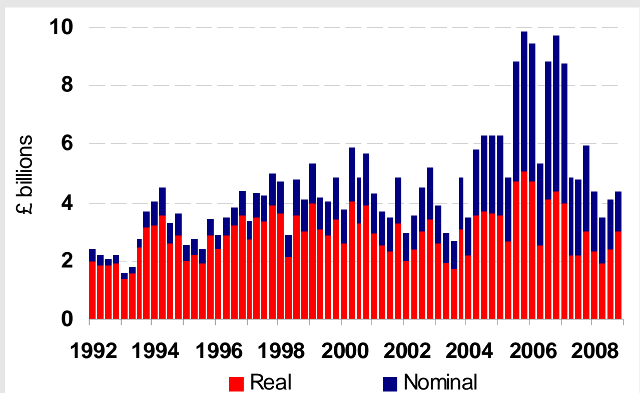


Source: National Statistics

The latest figures published by National Statistics show that market activity actually increased in the fourth quarter of 2008 as the last three months of 2008 marked the first quarter of positive institutional net investment since Q3 2007. Property assets acquired in Q4 amounted to £2.186 billion but institutions also sold £2.181 billion. As a result, net investment in Q4 was £5 million compared to disinvestment of £680 million in Q3. In the 12 months to December, net disposals by institutions amounted to £9.6 billion compared with net disinvestment of £11.1 billion in the 12 months to September. Increasingly there is talk of renewed investor interest in commercial property as property yields now look attractive relative to other assets following a 41% fall in values. But so far there has been little evidence of any action.

In the fourth quarter, pension funds continued their counter-cyclical behaviour by acquiring a further £814 million and selling £83 million of property. Total investment by pension funds in the 12 months to December amounted to £1.3 billion compared to £780 million in the 12 months to September and £38 million in 2007. Life companies made a net disinvestment of £547 million in Q4. Their total disinvestment in the 12 months to the end of December amounted to £3.3 billion compared to a net disinvestment of £3.9 billion in the 12 months ending September. Not surprisingly, given their continuing need to raise cash to fund redemptions, Property Unit Trusts disinvested a further £237 million in Q4 and have been net sellers of £1.1 billion in the 12 months to the end of December compared with a net disinvestment of £1.2 billion in the 12 months ending September.

Property market liquidity

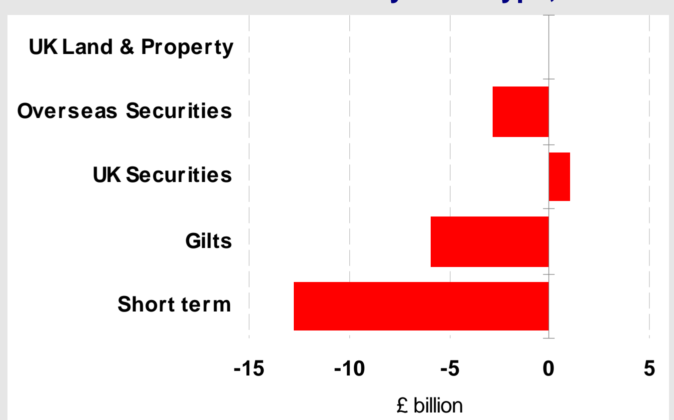


Source: National Statistics & Fletcher King

As a result of the large decline in values the All Property initial yield on the IPD Monthly Index is now 7.7% having risen by 310 basis points since the end of June 2007. But capital values may have still further to fall. All property rents declined at an annualized rate of 11.6% in Q1. Real estate equities continue to under-perform the market and property derivatives imply a fall in values of around 26% in 2009.

The worldwide economic slowdown has been reflected in an increase in market volatility and large declines in the value of shares. It has been suggested that investors are liquidating assets to meet daily cash-flow requirements. In Q4 institutional investors sold assets to the value of £17.1 billion having previously bought £17.6 billion of assets in Q3. Sales of short term instruments such as treasury bills amounted to £12.8 billion and sales of gilts amounted to a further £5.9 billion.

Net institutional investment by asset type, Q4 2008



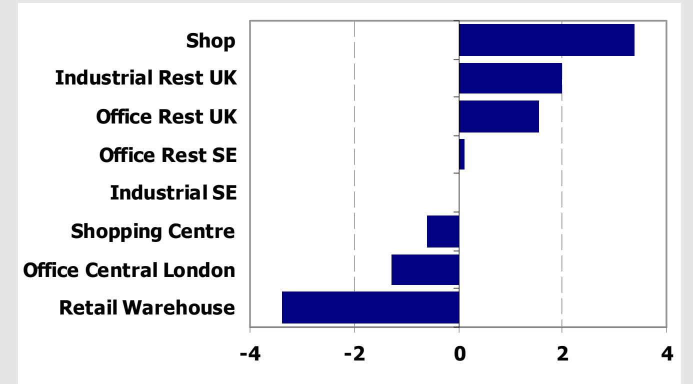
Source: National Statistics

The Performance of Property in 2008

The IPD market return for 2008 was –22.1%. In many ways this was the worst performance on record. It was the lowest total return and greatest fall in value not only in the history of the IPD index which runs from 1971 but also in the pre-IPD history which records property performance from 1921. However, in inflation adjusted terms the fall in value experienced in 1974 was greater.

The main component of performance was a decrease in capital values. Income return contributed 5.6%, whilst reductions in capital value amounted to -26.3%. mainly as a result of yields softening by 212 basis points.

2008 property segment total return relative to the market average of -22.1%



Source: IPD & Fletcher King

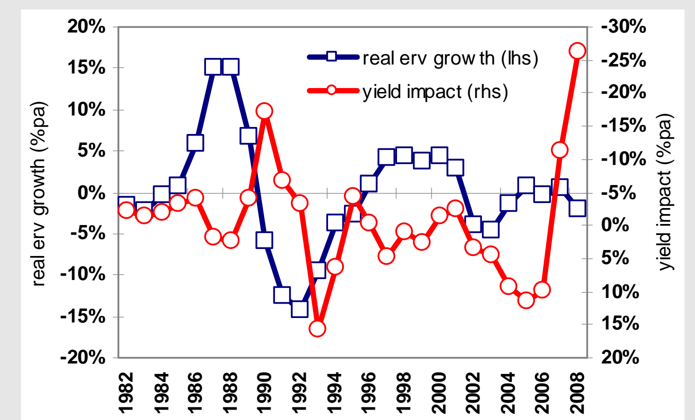
The conventional view is that the property market is driven by the economic cycle. Increased economic activity encourages businesses to expand and take on more space to accommodate a larger staff. The supply of new buildings through development can only respond slowly to this increase in demand thus causing upward pressure on rents until the development pipeline delivers more space on to the market. In earlier property cycles e.g. 1972-74 and 1987-1992, yields hardened as rental value growth strengthened. Conversely, yields softened as rental value growth declined from its peak.

However, the last seven years represent a unique cycle for the property market. Performance was largely driven by weight of money and marks the first time that the commercial property market has experienced major yield movements without any major increase or decrease in rental values. In the period running from December 2001 through to June 2007 yields hardened month on month but rental values grew by the equivalent of just 1.5% a year. Thereafter, from the second half of 2007 through to December 2008 yields softened month on month and rental values grew by the equivalent of 0.1% a year. By the end of December 2008 capital values were only 1% higher than values in December 2001. Six years of capital value growth had been lost in just 18 months.

In 2008 shopping centres, retail warehouses and Central London offices have been the poorest performing segments of the market. These are the three largest segments of the market with the largest asset values. The return on shopping centres was -22.7% while the return on Central London offices was -23.4%. For the first time in its history, retail warehouses were the poorest performing segment of the market with a return of -25.5%. The best performing segment of the market was standard shops for the first time since 1985 with a return of -18.7%.

With the single exception of Central London offices, rental value growth across all segments of the market was insignificant in 2008. The rental value of Central London offices declined by -6.7%. Central London shops benefited from a 2.3% increase in rental values but in all other segments of the market rental values grew between -1.2% in the case of Rest of UK office parks and 1.4% in the case of South East industrials.

All property ERV growth & yield impact



Source: IPD & Fletcher King

Again, with the single exception of Central London offices rental value growth has been mild across most segments over the course of the whole cycle. West End office rental value growth peaked in 2007 at 17.8% and has grown by an annual average of 6.5% over the last 5-years. In all other segments of the market rental values over the last 5 years have grown by an annual average of between 0.8% in the case of Rest of UK industrials and 2.9% in the case of retail warehouses.

The dominant theme over the course of the cycle has been investment cash-flows into and subsequently out of the market caused in the first place by excessive leverage, over lenient lending, a chase for yield and a miss-pricing of risk; and in the second place by the credit crunch and an unwillingness on the part of the banks to lend to the property sector. Investment peaked in the middle of 2007 as £16.6 billion was put into the market in Q2 and a further £16.3 billion put into the market in Q3. In the last year net investment in commercial property has been running at 41% of its quarterly average in the six years of the boom between December 2001 and June 2007.

Early indications from the first quarter of 2009 are, however, that the property downturn is continuing. Yields are still de-rating month on month but now for the first time in the current downturn rental values across all sectors are declining at greater rates. The total return on the IPD monthly index for the 12-months to the end of March was -25.5%. All Property rental values declined by -4.9% in the year to March and at the annual equivalent of -11.6% in the first three months of the year.

Our central forecast is that total returns in 2008 will again be in negative territory, lying in a range between -7% and -10% with a slow recovery from the second half of 2010. However, the risks to any forecast from the uncertain economic conditions are considerable. The IPF consensus forecast is for a return of -9.7% in 2009 but the range in the contributions to this survey lie between -4.4% and -16.3%. The pricing of the 2009 property swap is more pessimistic still and implies a return of -18.1%.

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