

Institutional Investment in Property

The outlook for the UK economy continues to weaken as the Government steadfastly pursues its deficit reduction programme. Attempts to tilt the focus of the economy away from financial engineering towards manufacturing led exports are being undermined by the EU, which buys approximately 50% of the UK's exports. This key market is seeing its own economic activity slowing as a result of fiscal tightening, the sovereign debt crisis and financial market volatility.

In announcing the decision to initiate a further £75 billion round of Quantitative Easing, Sir Mervyn King, the Governor of the Bank of England, proclaimed that the UK economy was experiencing the most serious financial crisis since the 1930's, if not ever. The root cause of this is the possibility of default on sovereign debt within the European Union (EU). In typical European fashion, a summit deal which seemed out of reach until the very last minute has now been announced. Whether these arrangements are sufficient remains to be seen.

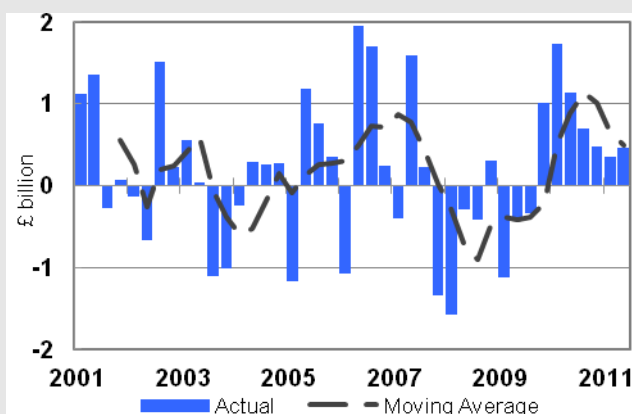
Investment in UK property Q2 2011 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts ¹	Total
Purchases	641	467	463	1,571
Sales	441	454	209	1,104
Net Investment	200	13	254	467

1. Includes Investment Trusts

In October, the PMI index constructed from surveys of the services, manufacturing and construction industries indicated that private sector economic growth picked up in September, with upturns in services and manufacturing offsetting stagnation in construction. The improvement lifts the prospects for GDP growth in the third quarter to as much as 0.4%. However, business confidence about the year ahead has slipped to its lowest since March 2009, when the UK was in its fourth quarter of recession, which suggests that activity may weaken in the final quarter of the year.

Net institutional investment in property



Source: National Statistics

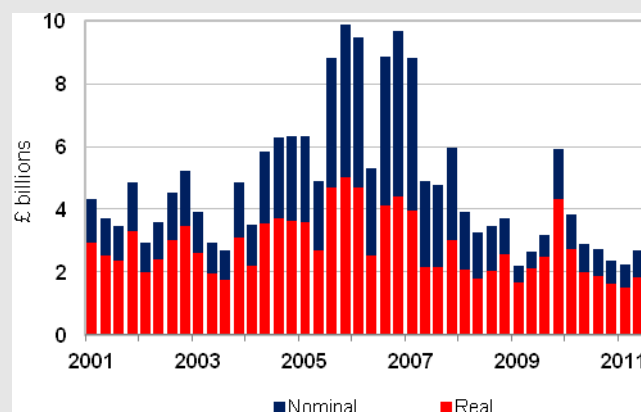
The commercial property market again weakened slightly over the course of Q3. Capital values as measured by the IPD Monthly index increased by 0.2% in Q3 compared to 0.4% in Q2. This is the lowest rate of growth since the recovery started in September 2009. Total returns decreased to 1.9% in Q3 from 2.1% in Q2. Total returns in the 12 months to September decreased to 8.7% from 9.1% in the 12-months to June.

In Q2 net investment in commercial property reversed its trend of the previous four quarters and increased as institutions acquired property assets worth £1.6 billion and recorded sales of £1.1 billion. As a result, net investment in Q2 was £467 million compared to £355 million in Q1. In the 12 months to

June, net investment by institutions amounted to £2.0 billion compared with net investment of £3.5 billion in the 12 months to June 2010.

In the second quarter, pension funds invested a further £200 million and have been net investors for the last seventeen quarters. Total investment by pension funds in the 12 months to June amounted to £1.5 billion compared to £1.8 billion in the 12 months to March and £1.7 billion in the year to June 2010. Life companies were net sellers for the third consecutive quarter. Net disinvestment in Q2 amounted to £76 million. Total disinvestment in the 12 months to the end of June amounted to £468 million compared to disinvestment of £86 million in the 12 months ending March and a net investment of £220 million in the year to June 2010. Property Unit Trusts were net investors for the seventh consecutive quarter in Q2 as the Association of Real Estate Funds continued to report net cash inflows. They invested £204 million in Q2 and £658 million in the 12 months to the end of June compared with a net investment of £782 million in the 12 months ending March and a net investment of £1.4 billion in the year to June 2010.

Property market liquidity



Source: National Statistics & Fletcher King

Total institutional investment grew by £15.6 billion in Q2 having previously grown by £22.1 billion in Q1. In addition to the net investment of £467 million in UK Property noted above, institutions also made net purchases in Q2 amounting to £7.0 billion of overseas equities and increased their holdings of cash and other short term instruments by £2.4 billion, while gilt holdings increased by £1.9 billion. However, sales of UK equities amounted to £1.8 billion.

Net institutional investment by asset type, Q2 2011



Source: National Statistics

Retailing, retailers and retail property

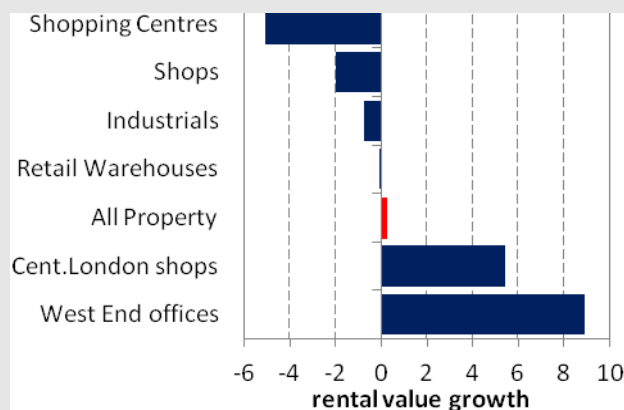
It is correctly perceived that the retail sector is struggling in the current economic climate. In Q3 the office and industrial sectors both posted stronger performance than Unit Shops, Shopping Centres and Retail Warehouses and all three retail segments generated less rental value growth than the all property average (see Chart 1). Rents at the all property level grew slightly in Q3 but shop and shopping centre rents shrank at the annualised rate of 2% and 5% while retail warehouse rents remained static.

The challenges facing the sector are large. A squeeze on real take home pay and a public sector pay freeze have resulted in the first sustained fall in real earnings since the 1920's. Falling house prices and increased levels of unemployment have accelerated the decline in consumer confidence. But it is all too easy to sound like Private Frazer in Dad's Army. The retail sector is not doomed.

It is the case that there have been a number of high profile retail business failures in 2011. Focus DIY, Habitat, Homeform Group, Jane Norman, Odbbins and TJ Hughes have all gone into administration. BDO Stoy Hayward predicts that the squeeze on disposable incomes is likely to lead to a 12.5% rise in the number of retail failures to 3,104 in 2011 from 2,759 in 2010. But given that there are 180,000 VAT registered retail businesses in the UK, failures are likely to represent 1.7% of the total retail business stock. Dunn & Bradstock calculate that the probability of a "high" risk tenant defaulting is between 2.2% and 4.0%.

The major retailers see the current conditions as challenging but are still managing to grow their sales. In the first quarter of 2011/12 UK sales at M&S were up 2.7% and like for like sales were up by 1.7%. In the first half of 2011 sales at John Lewis were up 2.5% and like-for-like sales were up 1.0%.

Chart 1; Property sector rental value growth Q3 2011



Source: IPD & Fletcher King

Luxury brands trading on a global scale are thriving. LVMH, the high quality products group, recorded like for like sales growth across Asia, Europe and the United States during the first nine months of 2011 of 15% compared to the same period in 2010. Similarly, Burberry, announced that retail revenue in the first half of 2011 had increased by 45% in total and 20% excluding China led by sales in the Americas and the Emerging Markets

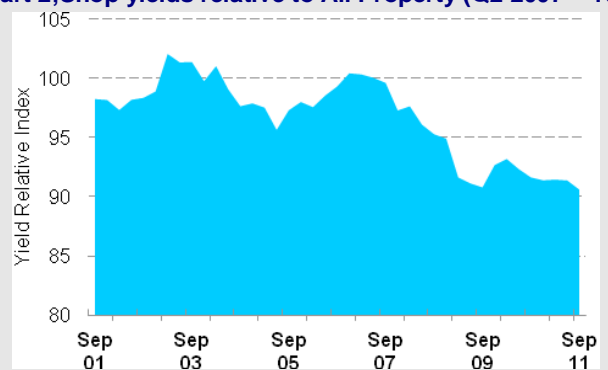
The growth of global luxury brands has helped Central London shops to become the strongest performing segment of the commercial property market. Rents on New Bond Street rose by 32% in 2010 and the "Zone A" is now in excess of £1,000 per sq ft. In Q3 Central London shop rents grew by 5% and produced total returns of 16% on an annualised basis. This trend is likely to continue for the foreseeable future as there remain a large number of unsatisfied retail requirements.

Across the UK, however, Shop vacancy rates are high. In September, the Local Data Company (LDC) reported a 14.5%

vacancy rate across the UK representing a near threefold increase on the average vacancy rate in 2008 when the last recession started. In presenting their report LDC said that, Great Britain has too many shops in the wrong locations and of the wrong size. Many of the vacant units are the smaller town centre units in peripheral locations that multiples no longer consider fit for purpose.

The major retailers continue to open new stores. In the first half of 2011, John Lewis opened 16 new shops; compared to 9 last year, an increase of 220,000 square feet of new space. Next have acquired more additional clothing space through extending and re-locating stores. So far in 2011 Next store numbers have increased from 6.07million sq. ft. in 525 stores to 6.256 million sq. ft. in 532 stores.

Chart 2; Shop yields relative to All Property (Q2 2007 = 100).



Source: IPD & Fletcher King

Long lease lengths in the retail sector remain a key attraction for investors. At the end of Q2 2011, IPD reported that the average lease length across all sectors of the property market was 11 years. But whilst industrial and office leases had an average unexpired term of 8 years, retail leases had an average term of 12 years. Unit shop leases had 14 years unexpired, shopping centres 12 years and retail warehouses 10 years. This may partly explain why standard shop yields are at ten year lows relative to the All Property average (see Chart 2).

On-line retailing continues to grow. According to the British Retail Consortium's October Retail Sales Monitor, UK retail sales were just 0.3% higher on a like for like basis from September 2010. But September's figures from the IMRG Capgemini e-Retail Sales Index revealed online sales growth of 15% year-on-year.

Conventional retailers have successfully faced up to the challenge posed by the internet. Six of the ten biggest e-retailers by site traffic are conventional high street retailers. They are Argos, Tesco, Next, M&S, Apple, B&Q and John Lewis. The only e-retailers in the list without a high street presence are Amazon, Play.com and Easy Jet. Johnlewis.com has seen sales growth of 27% in the first half of 2011. This has been achieved through increasing the number of products and brands sold online, investing in distribution and developing the 'Click and Collect' option which allows customers the choice of picking up their online purchases from existing stores. Next also offer a service allowing customers to collect on-line purchases from a nearby store. Next Directory sales were up 15% in the first half of 2011 compared to the previous year. M&S Direct sales grew by 13% in the first quarter of 2011.

The outlook for the retail sector continues to be uncertain. Trading conditions are set to remain challenging through the rest of this year. However, there are early indications that retail headwinds are likely to ease as we move into 2012 if as expected there is little or no further inflation in retail costs and other inflationary pressures also ease.