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THE PROPERTY INVESTMENT PEOPLE

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2014 – Recovery Set to Spread from the Capital

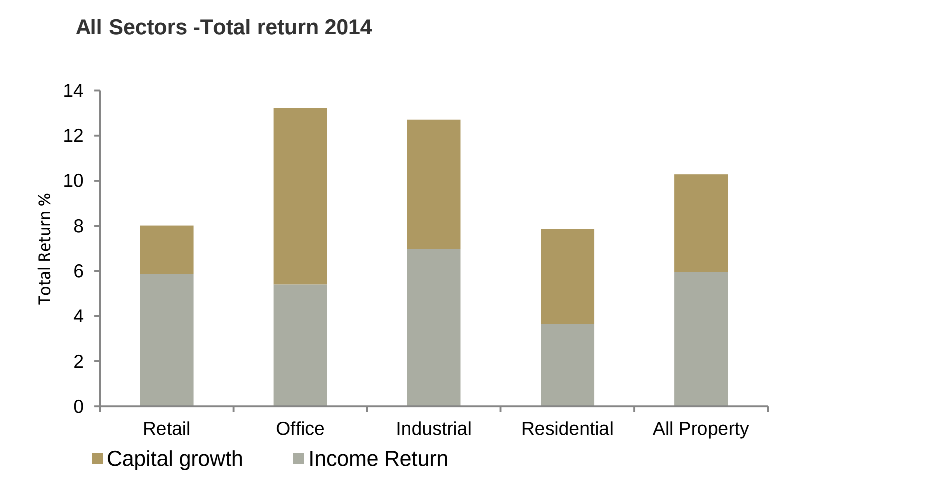
Returns hit 3-year high as regional recovery starts to take hold

A long-awaited resurgence in UK commercial property finally came through last year as 2013 showed signs of a sustained economic recovery.

Real estate returns came second to those for equities in 2013, which returned 18.5% (MSCI UK), but outperformed bonds, at -5.2% for the year (JPM 7-10 year).

A recovery in regional property values during the closing months of last year helped property returns hit 10.52% in 2013, according to IPD. Commercial property fared particularly well with offices being the strongest performer at a total return of +13.61%.

Improving business and consumer sentiment in core cities such as Manchester, Birmingham, Edinburgh and Leeds, coupled with the continuing strength of London and the South East, has helped All Property capital values grow by 4.3% for the year (2.9% during the last quarter).



Source: IPD UK Quarterly Digest Q4 2013

Whilst London property has prospered due its safe-haven status and the wall of money that continues to flow into the UK from overseas investors, property performance outside London has been muted since the financial crisis.

According to the IPD UK Quarterly Property Index, commercial real estate values have risen in Central London by 26% since December 2010, but have fallen by 4% in the rest of the UK.

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When we look back on 2013, we may well see it as the year that the property recovery became broader based. Capital values for the UK excluding London rose by 2.2% in Q4, not far below the national average, with the biggest winners, Aberdeen, Brighton and Cambridge, all seeing property values rise by more than 3.5% during the fourth quarter, and total capital returns in excess of 5.0%.

While momentum within the property sector is continuing to build, a concentration in demand for prime properties and a likely rise in gilt yields mean that investors are looking increasingly to secondary, regional assets to boost returns.

The discounting of UK regional assets has made them very competitive, with values on average 21% lower than their 2007, pre-recession peak, and income yields in excess of 6.4% in many areas, over a third higher than the Central London average.

UK property investment surges to 6-year highs

Last year marked a six year high in commercial property investment across the UK, driven by increases in regional markets and the continued inflow of capital into Central London from overseas investors.

A total of £44.75bn of transactions was completed across the UK in 2013, two-thirds of which were made in London and the South East of England.

Whilst there was a significant increase in investment into London, +38.5%, the percentage increase in investment into regional markets was far higher at 60.8%. Much of this increase was seen over the second half of 2013 and for the large part, was driven by UK institutions who generated 39% of all deals, according to CBRE, the property advisory group.

The increase in investment levels was seen across the majority of the UK's regions, with the biggest rises recorded in Wales, East Midlands and North East (investment more than doubled in each region).

According to Deloittes, "institutional funds, which had largely retrenched into core South East and London markets until mid-2013, are now bidding on, and winning higher-risk assets across the UK, as greater optimism amongst wealth managers translates into an increasing allocation of capital to real estate."

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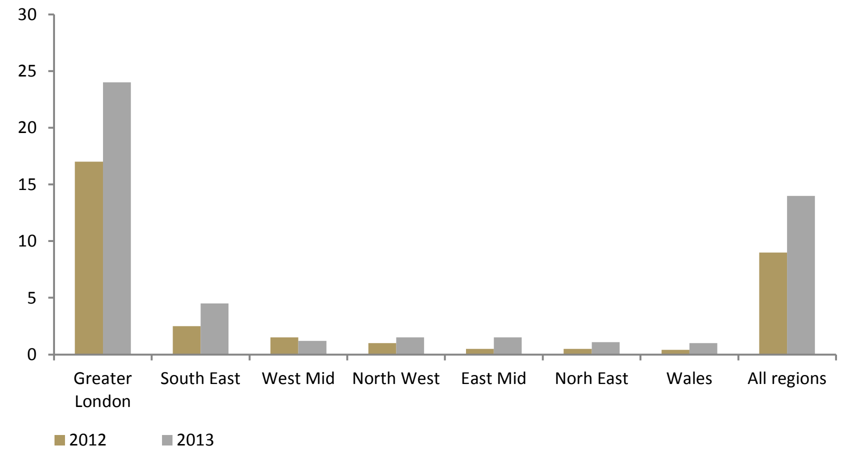
Regional Investment Volumes £bn



Source: Lambert Smith Hampton: Transactions Bulletin Q4 2013

Overseas inflow finding its way into the regions

Overseas buyers, who for the moment remain focused on London, were the second largest investors outside of London. A third of these (overseas buyers) were from Asia.

Inflows into the UK market from Chinese investors were particularly significant due, partly, to China's financial regulator relaxing overseas investment rules last May, allowing insurance companies to buy foreign real estate. The regulator also doubled the proportion of capital that Chinese insurers can place into real estate assets, from 10% to 20%.

In a positive sign for the regions, Chinese investor interest has started to find its way outside of London; major deals included Gingko Tree's (China's State Administration of Foreign Exchange) joint purchase of One Angel Square in Manchester and Beijing Construction Engineering Group's joint (£650m) investment.

Improving occupier demand and signs of rental growth

2013 has seen the highest take-up across the regional markets for over 5 years and 2014 is likely to see momentum maintained.

The pick-up in occupier demand across key regional office markets was very noticeable over the second half of 2013. As the economy continues to improve,

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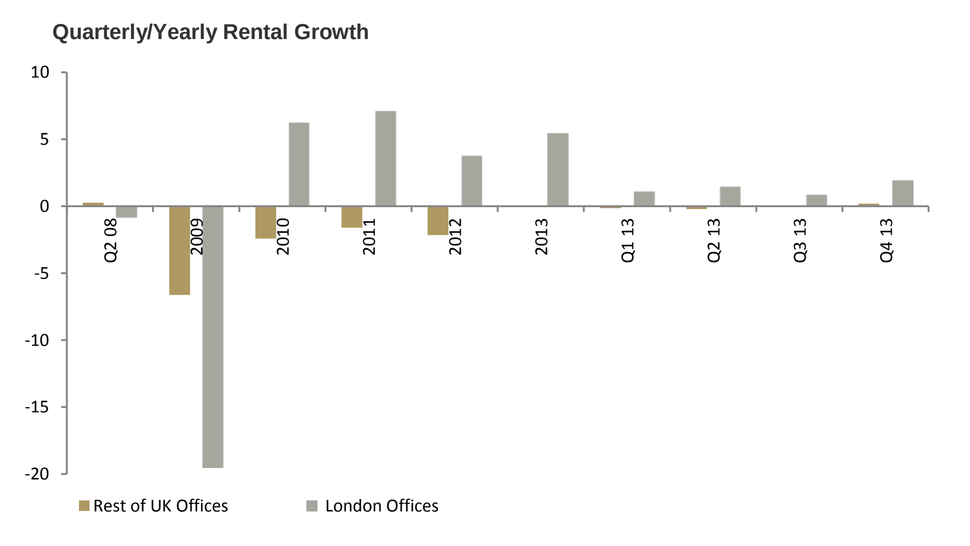
businesses will have a greater confidence in implementing decisions that were previously on the back burner, with regards to their future expansion (space) requirements and thus pushing leasing volumes higher. This increased confidence in the occupier markets provides a compelling case for value growth.

Demand is strengthening for well-located assets outside the capital, and due to a lack of grade A office supply (resulting from a lack of new developments since 2008) we would expect rental increases over the coming year.

Our view was reinforced by IPD data, which showed rental growth of 0.5% across all sectors during the fourth quarter, and 0.2% for assets outside London - their first quarterly increase since September 2008.



Source: IPD UK Quarterly Digest Q4 2013

Brighter outlook for regional debt finance

In the years following 2008 what little financing remained was only readily available for prime property, specifically in London. However, debt markets and property finance have seen a considerable change over the last 18 months. Conditions are now a long way from the “frozen” markets that existed in the aftermath of the 2008 crisis.

According to the UK's largest property lending survey produced by De Montfort University (DMU), lending in the commercial property sector is on the increase and confidence is slowly returning to the market. Thanks to an improving economic

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environment and a significant increase in the number of lenders, investors can now benefit from an historical low “all in cost” of debt.

Interest rate margins across all sectors have continued the decline that began in 2012 (the first such decline recorded by DMU, since 2006) with the steepest fall over the first half of 2013. The average margin for loans secured by prime office, for example, decreased from 323.8 bps in year-end 2012 to 280.3 bps at mid-year 2013.

Average equivalent yields, relative to long-run norms, reflect cash flow risks. Only Central London office and retail demonstrate low yields, driven by overseas capital and demand for assets. Elsewhere the risk premiums built into average market yields should give lenders some comfort that collateral values for reasonable quality stock should not experience significant further decline.

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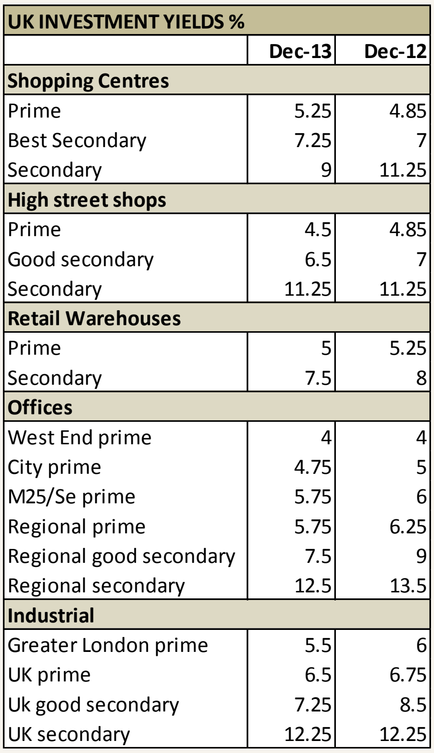
Prime property yields showed continuing signs of hardening; however it is the contraction of secondary yields that indicate that we may have reached an inflection point over the second half of 2013.



UK INVESTMENT YIELDS %		
	Dec-13	Dec-12
Shopping Centres		
Prime	5.25	4.85
Best Secondary	7.25	7
Secondary	9	11.25
High street shops		
Prime	4.5	4.85
Good secondary	6.5	7
Secondary	11.25	11.25
Retail Warehouses		
Prime	5	5.25
Secondary	7.5	8
Offices		
West End prime	4	4
City prime	4.75	5
M25/Se prime	5.75	6
Regional prime	5.75	6.25
Regional good secondary	7.5	9
Regional secondary	12.5	13.5
Industrial		
Greater London prime	5.5	6
UK prime	6.5	6.75
Uk good secondary	7.25	8.5
UK secondary	12.25	12.25

Source: IPD UK Quarterly Digest Q4 2013

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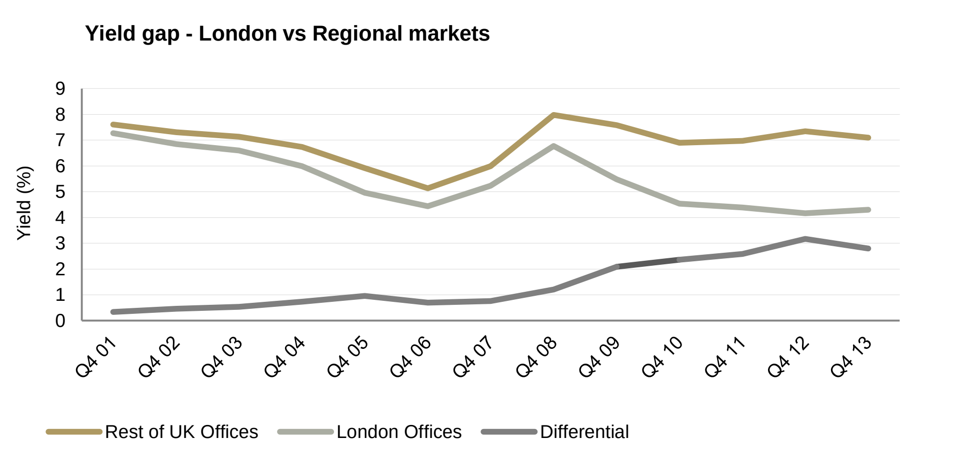
Prime holdings (typically characterised by good locations and long secure leases) have continued to command higher premiums, buoyed by their limited supply. However, in a recent report, DTZ noted that secondary property is expected to outperform prime on a total return basis from 2014 onwards.

Narrowing of the yield gap

The widening of the yield gap between primary and secondary property has been a key feature of the UK property market since 2007/08. Having stabilised at a high level, the gap has now started to narrow as investors' appetite for higher risk secondary assets has improved.



Source: IPD UK Quarterly Digest Q4 2013

While the gap between prime and good quality secondary is narrowing, poorer quality secondary or tertiary property will continue to struggle as structural shifts mean that vacancy rates will remain high along with long void periods.

OUTLOOK

2014 – Widespread recovery

With the recovery in the UK economy becoming more deep rooted, the IMF raised UK growth forecasts for this year from 1.9% to 2.4%- a bigger upgrade than for any other nation. The renewed optimism on the UK marks a shift from a year ago when the IMF's chief economist warned that the UK Chancellor was "playing with fire".

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Confidence in the UK economy has increased markedly over the last few months, with unemployment falling, the manufacturing sector and retail sales recording strong growth, and inflation back at the government's 2% target rate.

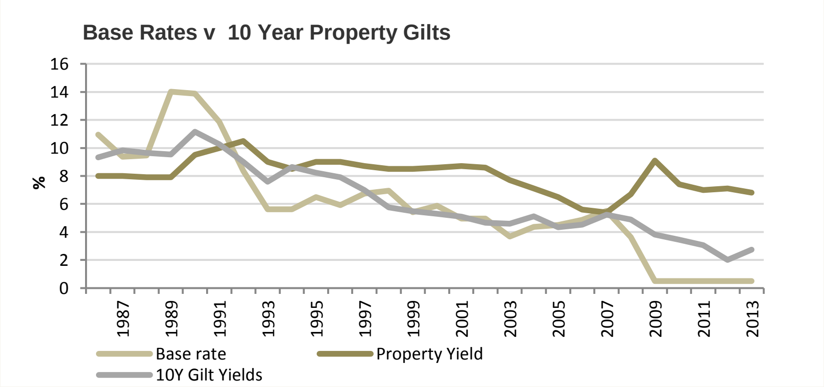
2013 was the year in which the recovery showed concrete signs of sustainability and with business confidence improving, demand for all commercial property in London was strong. The UK commercial property market started to turn around in 2010; however this was only really seen in prime markets until Q3 last year, when positive signs were also evident in the regions. As the recovery widens to key regional cities and investors appetite for risk returns, 2014 could well be the year in which secondary markets outperform.

Transactional volumes have started to pick up significantly outside of London and conditions remain in place for this momentum to continue. Strong investor demand will place downward pressure on yields over the next 12-18 months. The performance of good quality secondary property will be driven by yield spreads narrowing over a sustained period.

The lack of supply of new investment stock and the weight of money finding its way into London has meant that investors have started to move up the risk curve in order to take advantage of the yield arbitrage that exists between London and the regions. Allied with low interest rates the Yield gap (secondary yields – primary yields) will see more investors turn to the regions and we expect the search for yield to pick up momentum in 2014.

We remain in an ultra-low interest rate environment and despite UK unemployment levels approaching 7%, rates are not expected to rise until late 2015 at the earliest.

UK gilt yields did rise over 2013, however the gap that still exists between gilts and property remains significant. As gilt yields start to rise bond holders will suffer capital losses and commercial property, in particular regions outside London, could well benefit as capital is reallocated.



Source: IPD UK Quarterly Digest Q4 2013, Bank of England

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We look forward to the new year with a great deal of optimism. Whilst the yield gap between London and secondary markets has started to narrow, London will continue to draw investors given its allure to foreign buyers. **As a result the gap will remain wide enough to provide investors with the opportunity to acquire good quality secondary properties at competitive prices.**

2014 will also see the focus return to property fundamentals (occupational market growth and income sustainability) as opposed to yield levels and short term growth. This provides opportunity for the good asset manager to seek out potential and maximise the value of assets to achieve above-market returns.

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