ST. BRIDE'S MANAGERS

Half-Year Report 2014

Is the Property Market in 2014 going to be a game of two halves?

July 2014

Half-Year Report 2014

Dove and Hawk are treating themselves to a well-earned holiday in South America. Having taken in England's World Cup matches in Brazil at the same time, they definitely need the break! In their absence, Bull and Bear have been deputised to present the half-year report on the UK Property Market.

Bull: Although we didn't do very well in Brazil, we have a very young side. There's lots of potential. Roll on Euro 2016!

Bear: Yeah right. And this is from the very same person who said we were a shoo-in for at least a semi-final spot.

Bull: Okay... but back here in the UK, it is gold stars all round. The economy is booming and property is blasting its way back. It's great to be alive!

Bear: I don't want to spoil your moment in the sun Bull, but if Hawk was here now, he'd roll off his well-honed list of impending catastrophes... Government debt, housing shortages....

Bull: Doom! Doom! Doom! That's all he can talk about! What's his problem? Surely he can see that it's now Boom! Boom! Boom!

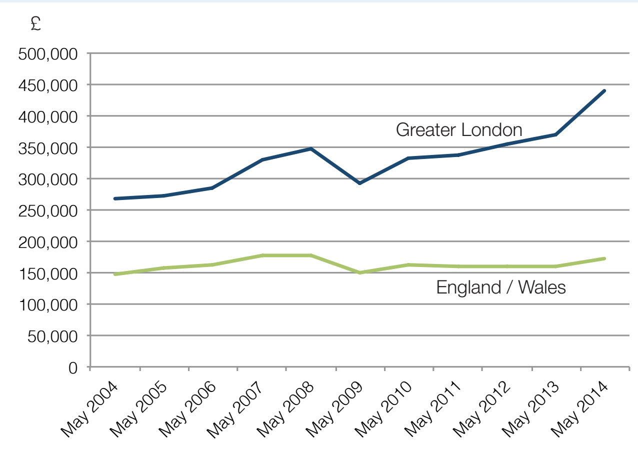
GDP is going gang-busters, unemployment is down, inflation is well under control, interest rates are low... it's party time!

Bear: If things are so great how come you haven't had a pay rise for 6 years? And unless I am mistaken, inflation is up by over 18% since then. So you're actually a whole load worse off than you were.

Bull: Okay. But according to the Land Registry, my house in London has gone up in value by 18% since last year alone.

Bear: Yes. I understand why that might make you feel wealthier. But remember average house prices (£172,035) across England and Wales are still below their level in May 2007 (£176,974). So a lot of people are still in negative equity territory.

Average House Prices 2004 - 2014
(seasonally adjusted)



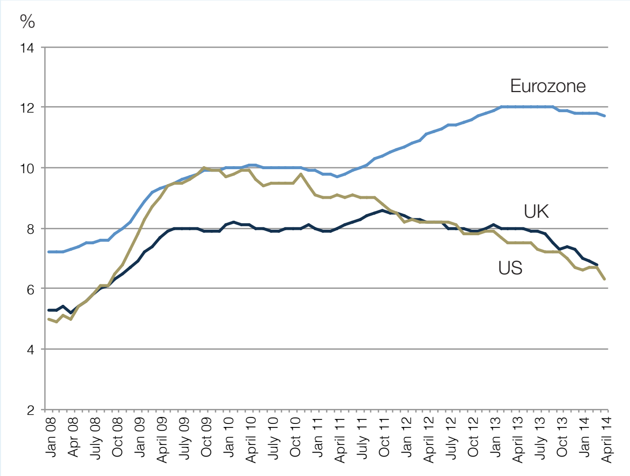
Source: Land Registry

Bull: But let's not get too gloomy about it. With the unemployment rate racing down it is only a matter of time before my boss will be begging me not to leave and pumping up my pay. And it will be the same right across the UK.

Bear: Dream on! In April 2008 just before Mr Lehman and his brothers upset the apple-cart, the UK unemployment rate was 5.2%. That compares to 6.8% now... which includes a significant degree of part-time and zero hours contract employment.

Bull: The continental Europeans may be better at football than us, but they do have an employment problem, don't they?

Unemployment Rate in the UK, US & Europe



Source: ONS and Central Government Statistics

Bear: Yes. Certainly on the periphery anyway, if less so in Germany. That makes it all the more bizarre that Spanish (2.68%) and Italian (2.74%) 10 year Government bonds are near enough the same as US Treasuries (2.53%) and UK gilts (2.68%). And can you believe it... Irish bonds are the lowest of them all at 2.37%. Mr 'Whatever it takes' Draghi has certainly captured the market's attention.

Bull: You wouldn't get me buying bonds at those prices. Give me something that is "as safe as houses"... er... like houses, any day.

Bear: Well! Well! Here we are... only on page 3 and I am actually agreeing with you on something.

Bull: Yep. Top-end London resi. You can't go wrong with it. Make your fortune and retire to... well, Spain or Italy.

Bear: No! No! No! Those nice chaps at St Bride's predicted in January that demand for prime London residential would wane by the end of 2014. In fact, it looks as if the brakes have already been put on. Moreover, Mr Carney has been given new powers to cool the market, if he needs to.

But that doesn't negate the overriding case for residential as an institutional asset class. It's all about the UK's growing and changing demographics.

Bull: Not that old chestnut again!

Bear: Bull, I am going to harp on about this until you finally get it. The UK's population is expected to grow by 11 million between 2010 and 2035 to 73.2 million. That's an 18% increase. And according to the ONS, the population grew by 400,000 in 2013 alone. These addtional people will need to live somewhere. And everyone knows that we just aren't building anywhere near enough homes to meet this demand.

Bull: It would help if they sorted out our planning system. It used to be the best in the world. Frankly, now it is an embarrassment. They are under-staffed, under-paid and bombarded by NIMBYs. Someone has got to get a grip of it.

Populations By Age Groups

Age Group	Category	UK %	US %
65+	Swing Generation	16%	13%
46-64	Baby Boom	24%	25%
32-45	Baby Bust	19%	18%
14-31	Baby Echo	24%	27%
0-13	Generation Z	17%	17%

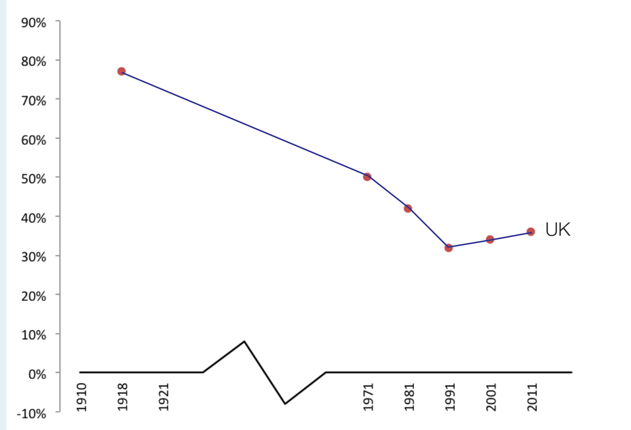
Bear: Now that's two things I agree with you about. But it isn't only about *more* people, it's their age too. It is remarkable that the shape of our population is almost exactly the same as in the US. The key political, economic and social challenge for both of us here in the UK and America is that in 20 years' time a huge part of our populations will be in retirement.

Bull: Won't they all have left for Marbella or Florida for sun, sea and sangria?

Bear: No – they are going to be heading back into our city centres where they can find mix-aged communities, accessible medical care and be close to their kids (Baby Echoes) and grand-kids. And they will want to rent rather than own.

Bull: That's ridiculous – everyone wants to own. And the baby boomers have the dosh. Whatever happened to 'A man's home is his castle'?

UK % Rented v Owner Households



Source: ONS, Government Statistics

Bear: Few people realise that at the end of World War I, 77% of the UK population rented their homes. The tables were then completely turned and by 1991, 32% rented and 68% owned. Since then though, the number of renters have started to rise again. Trust me. The tide has turned.

Think about it – mortgage tax relief was withdrawn in April 2000, people are getting married later, jobs are less secure and everyone has to be more willing to move to where the work is.

At the same time successive governments have seen the folly of rent controls, allowing buy-to-let investment to flourish. And at long last we are seeing the institutions getting involved. If the current momentum is sustained we could get to 40-50% renting within the next couple of generations – much like Germany is now.

Bull: Yes. I see now. And it isn't just going to be blocks of flats is it? We will have to build to cater for every age bracket and every socio-demographic group. There should be money in that. Bring it on!

London - Still Fair Value?

London continues to attract record numbers of overseas investors which is hardly surprising given that it is the Number One World City. But at current prices, does it still offer fair value?

Bear: According to the IPF, the UK commercial real estate investment universe last year was valued at £364 billion. Critically, 24% of it is owned by overseas investors. Ten years ago they owned just 15%.

Bull: Wow!

Bear: Exactly. But look what has happened to the institutions' contribution. Not only is it down in absolute numbers but their share of the total pot has fallen from 34% to 24%. I suppose I can concede that they have been the backbone of support for collective schemes too, but still... it's pretty disappointing isn't it?

UK Commercial Investment Property Universe

Investor Type	Mid 2003 £bn	Mid 2013 £bn	Mid 2013 Share
UK Insurance Cos, Pension Funds, Charities and Landed Estates	£98	£87	24%
UK Collective Investment Schemes	£29	£59	16%
UK REITS and Listed Prop Cos	£42	£52	14%
UK Private Prop Cos	£50	£50	14%
UK Private Investors	£8	£10	3%
UK Others	£15	£18	5%
Overseas	£42	£88	24%
Total	£284	£364	100%

Source: IPF

Bull: I find that a bit mystifying. After all, the income return being generated off (All UK) property is way higher than any other regular investment. Currently it is 5.9% pa which is more than 3% higher than 10 year gilts.

Bear: Clearly overseas investors have spotted it, albeit their focus has been mainly on London and yields there have been driven down pretty hard lately through strong competition. However, I still think there's value if you invest carefully.

Bull: What! Am I hearing right? Are you feeling okay Bear? I was expecting you to say that the market is completely over-bought.

Relative Income Returns

Asset Type	Income Returns % pa	Difference to Property
All Property (IPD)	5.90	-
FTSE 100	3.44	2.46
Gilts (10 year)	2.68	3.22
Inflation (CPI)	1.80	4.10
SWAP (10 years)	2.68	3.22
Base Rate	0.50	5.40

Source: FT, IPD, ONS

Bear: No. Not a bit of it. The trouble is that everyone converts everything back to historic norms. And in any event, why should fair values be set by the UK institutions? Particularly as they are less and less influential. London is the Number One World City. The whole world seems to recognise that. But our own institutions, at best, have 10-15% of their property holdings in the Capital. It's weird. No. It's just wrong.

Bull: Wow Bear. You're really worked up about this aren't you?

Bear: Of course. The trouble is they are too close to it to see London's phenomenal potential. And I suspect there are local jealousies too.

Bull: I agree. All my overseas clients love the place. Of course, they all have very different reasons for investing there. You can broadly categorise them into three groupings.

Firstly, the 'Grown-Ups'. Here I would include, for instance, the Canadian, Norwegian and Singaporean Sovereign Wealth Funds who already dominate their own (rather small) home markets and really have to diversify to spread their real estate risk. But they 'get it'.

Then you have 'The Fearful'. These are investors who may be worried about the financial and / or political stability in their own back-yards and where having part of their wealth off-shore makes sense. By way of example, they incude the Ukranians, South Africans and increasingly the Chinese.

And thirdly, 'The Egotists'. These are the investors who are simply collectors of fine art, fine cars, fine wine, football teams and fine buildings. I am not knocking them. It's just that they have no need to price property in the same way that our domestic pension funds do. They have their own pricing criteria.

Bear: And they are not only investing in London, are they?

Bull: No they're not. They are investing all over the world.

Bear: Well, I just hope that they are taking full note of St Bride's Top 20 World Cities. In fact, the chaps have just re-run their model. The order has moved around a little bit, and Vancouver has come in for the first time at Number 16 at the expense of Berlin, but fundamentally it hasn't changed too much since 2011.

St Bride's 20 World Cities (London = 100)

Rank	City	Score
1	London	100
2	New York	99.4
3	Singapore	89.4
4	Tokyo	88.2
5	Paris	85.1
6	Hong Kong	85.1
7	Chicago	79.5
8	Los Angeles	79.3
9	San Francisco	78.6
10	Sydney	78.0
11	Toronto	76.7
12	Boston	76.0
13	Washington D.C.	75.1
14	Geneva	74.9
15	Amsterdam	74.6
16	Vancouver	73.6
17	Seoul	72.9
18	Melbourne	72.8
19	Stockholm	72.6
20	Munich	72.5

Source: St Bride's Managers

Bull: The six US cities do well in the model don't they? But won't investors get stung by high tax leakage if they invest there?

Bear: St Bride's reckon that it may impact returns by about 0.5% pa, but if the US market continues to do as well as it has in the past, (which my Compliance Officer catagorically wants me to stress is not a guide to the future), you can afford to take the hit.

In fact, according to IPD, whilst the UK has been creditable, the US has been the star performer over the past 10 years.

Total Returns % pa to December 2013

	1 Year	3 Years	5 Years	10 Years
US Direct Property	11.4	12.2	6.0	8.4
UK Direct Property	10.7	7.3	8.0	6.3
Pan-European Property	1.5	1.7	-1.5	n/a

Source: IPD

Bull: So just run it past me one more time. Why exactly are our institutions so reticent about investing in London?

Bear: I guess they may have been scared off by the sharp (rise and fall) cycles in the past. But I so wish they would practice what they preach - ***long term*** liabilities require ***long term*** assets... and as St Bride's Model screams... there is no better place on the planet than London for ***long term*** investment.

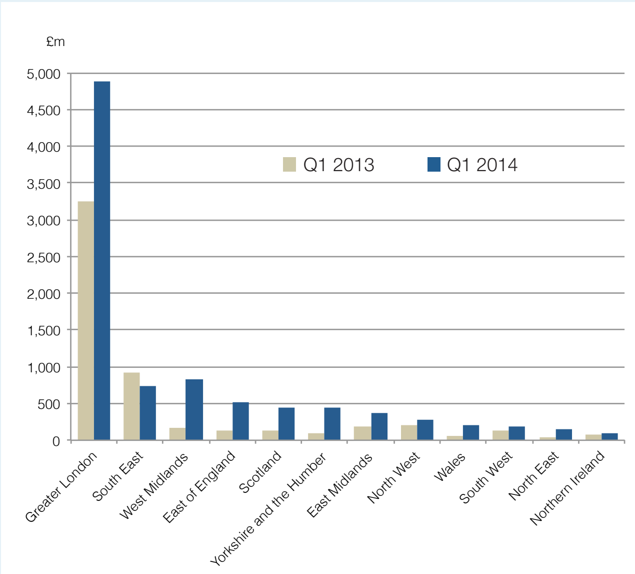
And if prices are a bit hot for them just now - okay. But that doesn't mean that they are too hot for everyone else. We really have something to celebrate here. We may not have the Number 1 World Football Team, but we do have the Number 1 World City.

Regional Markets

After 7 years in the doldrums, the UK Regional property markets are recovering. Domestic investors are attracted by their higher income returns, but with barely any rental growth, do they really offer fair value?

Bull: You've been pretty bearish on the regions recently haven't you Bear? Well, it's pretty obvious that no-one is taking a blind bit of notice of you, since investment volumes have just absolutely taken off. They were up 50% in 2013 and 2014 is going to be another good year.

Investment Volumes



Source: LSH

Bear: I must admit I have been taken a bit by surprise. There is still a lot of oversupply and most of the occupiers I talk to are happy to cram a few more people into their existing space until they are really comfortable that their local economy (and the national one) isn't going to double-back on them.

Let's face it, regional high streets are still in distress and virtually every office out of London is over-rented. It is going to take years to recover properly... and that assumes that the economy remains on track.

Bull: And why shouldn't it?

Bear: Firstly, interest rates are only going one way and "could happen sooner than markets currently expect".

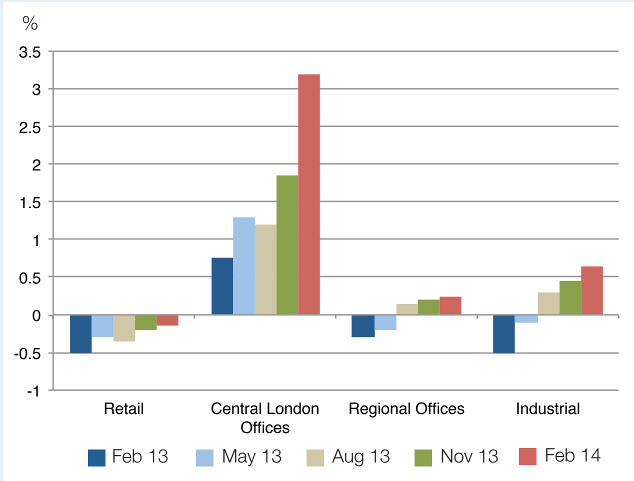
Bull: Don't you think that with inflation staying well below the Bank of England's 2% target, they will keep rates down a bit longer?

Bear: Not really. The latest view is that they will start ticking up towards the end of this year. And secondly, there's a General Election next year and there's no telling what will happen after that.

Bull: Well I think we should be filling our boots in the Regions. There are already early signs of rental growth.

Bear: Only for absolutely Grade A space in the top cities. And anyway Bull, you already have 85% of your portfolio there and unless I am mistaken quite a lot of it is still in distress, isn't it? Why on earth would you want more?

Average Quarterly Rental Growth



Source: IPD

Bull: Yeah, yeah, yeah. I know what you're going to say now – I should be more diversified - 33% Regions, 33% London and 33% World Cities.

Bear: That's right, but if you are looking to be a bit more adventurous, how about substituting Birkenhead for Barcelona, Maidstone for Madrid or Sunderland for Seville? You can buy much better assets there and there's still bags of value to be extracted.

Bull: Now that sounds fun.

Bear: I thought you would like that. But I am being serious. Be really careful. There are some smashing places to invest in the UK Regions, but against that many of the 'traditional' markets really have gone way past their 'sell-by' dates.

Bull: Birkenhead or Barcelona? Hmmm! That's a difficult one. Where's my suitcase?

Bear: The trouble with you Bull, is that you are all mouth and no action. If you are going to do it... then just do it. Otherwise stop drooling!

Of course, the challenge is to buy at the right price, whether you're investing in London, the UK Regions or elsewhere around the world. And that hangs on the prospects for rental growth. Get that right and you won't go too far wrong. So I've prepared a really simple table for you, which should help you to get your timing right. Remember lower yields are okay provided you are positioned to capture upside rental growth and / or you are able to engineer additional performance from active management. Otherwise... watch out!

Anyway, I promised Dove and Hawk that I would send them an Action List following our discussion. Are you happy with this?

Bull: Yes sir!

	Three Phases of Pricing		
	Phase 1	**Phase 2**	**Phase 3**
	High Yields + No prospect of Rental Growth	Medium Yields + Prospect of Rental Growth in 2/3 years + 'Engineered' Growth	Low Yields + Actual / Imminent Rental Growth
2009-10	London UK Regions Spain US Gateways		
2011-12	UK Regions Spain	London US Gateways	
2013-15		UK Regions US Gateways (some) Spain	London US Gateways (some)
2016-18 (projected)		Spain (some)	London UK Regions Spain (some) US Gateways

Source: St Bride's Managers

St Bride's Managers Action List	
1.	Do buy property. There really is still value to be found.
2.	Do invest (selectively) in wider London, even at current prices. It is the Number 1 World City and rents are rising.
3.	Do take the opportunity of the stronger UK regional investment market to sell out of "yesterday's assets" and reinvest in "tomorrow's".
4.	Do invest in the top World Cities for the long term. The UK is a great place, but there are other countries / cities with even better prospects.
5.	Do invest in UK Residential. We need more homes and demand is likely to exceed supply for many years to come. But beware of top-end residential in London for the moment.
6.	Do think Barcelona rather than Birkenhead... and not just for your summer holidays. You will be favourably surprised.
7.	Do keep an open mind as to ***how*** you invest. Debt and Securities (REITs) are perfectly valid avenues to follow both here and abroad.
8.	Don't think for a moment that the UK's embedded catastrophes have gone away. They are just not headline news at present.
9.	Do come up with some decent ideas as to how we can really 'up' our game on the International Football stage and send them to Roy Hodgson (or his successor!)
10.	Do have a smashing summer, but remember, when we get back to the office in September, it will be only a couple of weeks before the Scottish Referendum and 8 months to the General Election.

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