Rental volatility in commercial property markets economics essay

This Report has several aims and it sets out to explain what rental volatility is, the main causes of rental volatility, identify current annual changes in real estate, property market life cycles, Investment and Development markets and the wider Economy with the aid of up to date Statistics and Charts and ascertain the important drivers of the pricing of different lease terms in the UK property sector.

The research uses data derived from major databases maintained by IPD and various real estate service providers such as GVA Grimley, Ryden, Atisreal, JLL, CBRE, Drivers Jonas, Knight Frank, and DTZ. Along with the extensive online resources I will look towards lecture notes provided by Dr Michael White for guidance on the topic, aswell as relevant textbooks recommended to me in my course of study.

2. Risk

2. 1 Rental Volatility

Rental volatility is a measure of how high and low the Annual % Change in real Rents moves within a specified time period, usually displayed from the 1970 – Current obtainable statistical data. Several indicators have been developed over the years, such as Changes in GDP, consumer’s expenditure; service sector employment and industrial output are interlinked and impact on demand for commercial real estate. Although we will be focusing on Micro Economic factors in relation to Rental volatility, research shows that fluctuations in property markets, particularly, in the late 1980s, can be related to changes in the macro economy and to the property development sector’s ability to meet changes in demand for property.

2. 2 Factors causing Rental Volatility

Rental market volatility is significant and understanding it is essential to investing in real estate all around the world, so here is a list of the many Factors driving it.

2. 2. 1 Macro Economic factors:

Economic Growth

Gross Domestic Product (GDP)

Consumer's Expenditure

Unemployment

Supply and Demand

Cyclical Fluctuations

2. 2. 2 Micro Economic factors:

Historical Rents

Commercial Property Policies

Tax Ratings

Construction Costs

2. 3 Rental volatility in Different Sectors

2. 3. 1 Office sector

Volatility is displayed in commercial property markets and in the office market major cycles in rents occur in the early 1970s and again in the late 1980s. Most recent cyclical trough has displayed less excess supply than early 1990s, although it clearly shows a dip in the commercial rents in 2009 from the Credit Crunch with Office suffering the most dramatic decline followed by retail and Industrial least affected, this can be put down to the fact that office’s are usually affected by the Macro Economy in terms of service sector occupiers, but office rents have not changed considerably over the period 1970-2007, in spite of significant cycles.

Graph showing the Regional Office Rental growth from 1981 – 2008

2. 3. 2 Retail Sector

Retail markets are driven by consumer’s expenditure and this is affected by personal disposable income. Macroeconomic variables of interest rates, Tax changes, GDP, Monetary Fiscal policies and unemployment will impact on disposable income; this in turn will determine the public’s willingness to purchase products from the retail sectors. Another factor is Permanent Income; this is what the public expect to spend in the future in regards to Wage income and Asset income (Intertemporal Substitution) thus increasing their consumption of goods due to a higher asset wealth or expected higher wage prospects. In 2007; statistics show a high permanent income in regards to the Increase of house prices but in 2010 there is a massive decline and almost levelling out due to the 2009 Credit Crunch causing the public to reduce their expenditure and save more money.

2. 3. 3 Industrial Sector

Due to the Decline on Manufacturing in the industrial sector; especially in Developed countries like the UK; warehousing and logistics has become the largest occupier of industrial space and provides a vital support to the UK economy and support a wide range of spatial, economic and transport policy objectives, some cities in key locations may have long term structural advantages for warehousing/logistics and the key to a successful freight strategy is balancing the requirements of operators against impacts. As we see from the sector rental growth graph below, it clearly show that the industrial sector is far more stable than its counterparts, although still dipping in certain areas such as 1992 and the 2009 Credit Crunch; the changes remains less erratic and the lowest Percentage in 1992 was at -8% compared to

-20% of the office sector. This can be attributed to the fact that Industrial Warehousing will not be affected by the same factors as retail and office, whereas Retail considers “ Location” as the most important, warehousing is usually situated near transport networks such as motorways which leads to less planning restraints which in turn drives cost/risk down.

Sector Rental Growth: Main Case Forecasts Based upon 2009q2:

Latest Sector Rental Growth over three months: Based upon 2010 Q3:

All Property rental values are now -10. 5% lower than at their peak in April 2008 and are continuing to fall, but the rate of decline is slowing noticeably.

Over the three months to March, the IPD Monthly Index reports a decrease of -0. 5%, compared with a fall of -1. 2% in the last three months of 2009, with falls of -0. 7% in the retail and industrial sectors.

3. Commercial Real Estate Markets

3. 1 User Markets

Use, or potential use, drives property value and its investment value and a factor of determining rental value comes from demand and supply, shown below is a graph of the Change in lettings and availability. According to the latest RICS Commercial Market Survey with a balance of -10% of respondents reporting a fall in sales and letting activity. This reverses the modest rises reported over the previous two quarters and shows that demand remains fragile, with uncertainty resulting from the budget highlighted as a key factor, with a sharp drop in take-up in Q2 overturning the rises seen over the previous three quarters.

UK 2010 Q2:

UK 2010 Q3:

3. 2 Investment Markets

Latest statistics provided by GVA Grimley suggest a downward yield movement that has driven the strong performance of prime and good quality secondary property over the last year appears to be coming to a halt. The All Property equivalent yield fell very marginally from 7. 57% in May to 7. 53% in June. As yields have begun to level off, so capital value growth has slowed noticeably. Falling rental values detracted just -0. 4% from capital value growth in the three months to June compared with -2. 7% a year ago. Although capital growth is now slowing, the year-on-year figure has continued to rise sharply, reaching 15% pa in June compared with 7. 6% pa in March. However, the level of transactions is now reducing, largely in response to a significant reduction in available stock, although a cooling in investor demand has also had an effect. As a result, we expect to see a lower level of transactions to be reported in Q3. With the downward movement that has occurred over the last year, property yields have moved back to a level broadly in line with the average over the last 15 years. Taking into account the subdued outlook for rental growth across most of the market, a further significant downward movement in property yields looks hard to justify.

With the subdued outlook for the economy and rental growth, yields for good quality secondary property could well come under increased pressure to move upwards. At the same time, there could also be some further selective downward move in prime yields.

UK 2010 Q2:

UK 2010 Q3:

3. 3 Development Market

The definition of the Development market usually means land or property that may possess to have development potential whenever a degree of latent value may be released by the expenditure of capital upon that land or property. Within the development process there carries a certain amount of complexities in the development process and these include site acquisition, obtaining planning permission, transaction costs and arranging finance for short term/long term, within the development cycle, consider a adjustment lags and interaction between development, the real economy and the monetary sector. The diagram below shows the relationship between Investment and Development Markets and allows us to further understand the relationship.

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DiPasquale-Wheaton's Model

Examines user, investment and development and provides a graphical illustration of these relationships.

3. 4 Wider Economy

Data from Global Market Perspective October 2010 – Jones Lang LaSalle shows that the global economy continues to expand, although the pace of growth is slowing, leading the IMF to lower its projections marginally for the coming year. The US is showing Uncertainty in economic recovery; this is due to the diminishing impact of fiscal stimulus as well as the end of the inventory bounce having combined with a weak housing market. In Europe, there is mounting evidence that the relatively strong Q2 bounce has weakened. News that the tally for rescuing the Irish financial sector could run to over 55% of Irish GDP (or around €50 billion) the Irish rescue Loan causing Corporation tax to rise but not helping raise Growth in the Irish economy, combined with recent credit rating downgrades for Spain and Ireland, have resurrected concerns about European sovereign debt. However Germany has shown remarkable resilience, with a sharp fall in unemployment, growth in exports and strengthening domestic demand boosting German business and consumer confidence.

Global Real Estate Health Monitor:

Commercial Real Estate Return Performance – A Cross-Country Analysis:

Mean Annualized Return (%)

Commercial Real Estate Return Performance. jpg

Volatility (Risk) (%)

3. 5 Property Market Life Cycles:

The Barras's Model Identifies the relationship between the property market, economy and the credit market and shows interaction between Property Markets and the Macro economy.

The Process:

If there is a strong economic upturn coinciding with relative shortage of space. Demand for space â†', rents â†', yields â†", capital values â†'. Profitability of development rises, so new buildings are started.

If credit expansion also occurs, interest rates fall reinforcing economic growth and banks begin to fund speculative developments. The building boom will be underway but little new supply on market due to time lags.

In macro economy, inflation will have risen at this stage in the cycle, interest rates rise to control inflation, then the macro cycle moves into a downswing.

New space supply reaches the market as demand levels off so rents and capital values fall.

Demand is now falling (in the recessionary phase) so rents fall further, vacant stock increases, property development companies go bankrupt so the next upswing in property will be demand driven, the supply overhang from the previous boom/bust will discourage speculative development leading to volatility of previous cycle to be avoided.

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Barras (1994) illustrates how a building boom is generated by the interaction of the business cycle, the credit cycle and the long cycle of development in the property market.

4. Conclusion:

I believe Investment in the UK in the next few years will be a viable and good worthy investment; this is due to the continuing upward shift in growth throughout the Rental markets in Retail, industrial and office Sectors. I advise that if investment were to be made, the Industrial Sector seems to be low risk in regards to the other sectors; remaining very stable in past years and almost levelling out and rising slightly in the 2010-2012 Forecasts. The most risky investment would be the office market, this mainly due to the 2009 Credit crunch has caused a massive dip in rental values and vacant stock, the problem is that if investment were to be made in this sector; the economy might fall into another recessionary period causing a double dip and won’t make you any returns on your investment.