A Reappraisal of Models of Commercial Property Cycles in the light of the Noughties Boom and Bust

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Introduction

• A critical analysis of models of commercial property cycles and a reappraisal
• Based on the experience of the noughties boom and bust
• Core of empirical analysis is the dynamics of the upswing and downside of the UK commercial property market
• Draws on data from MSCI/IPD on investment and capital values and from Property Data of transactions
Noughties Boom
Commercial Property Capital Growth in Selected Countries 2000-2009
Commercial Real Estate Lending as a Percentage of Annual UK GDP 1970-2011
Theory of Booms and Busts
Theoretical Basis for a Property Cycle

- Property cycle developed by Barras centres on the role of development time lags
- Incorporates interaction between business cycle, credit cycle and property market
- Starting point = strong business upturn
- Coincides with shortages in available supply of property after period of low development activity in previous business cycle
- Rents and capital values begin to rise
- Series of stages
Bubbles

• Term “Bubble” describes booms and imply excessive price rises
• Prices divorced from ‘fundamentals’
• Potential in property mkt because of inefficiencies – information constraints, heterogeneity, diversity, localised markets
• Possible capital values rise so much cannot be justified on affordability basis or meaningful rates of return
Overshooting Cycles?

- Initial shock(s) instigate price increases that encourage further demand through adaptive expectations
- Shiller argues -> rational causes of this irrational exuberance
- Property mkt processes contribute to an overshooting of price fundamentals creating a bubble
- Bubbles = overshooting cycles
Bubbles or Cycles

• Bubble=stimulated by positive exogenous shock but eventually bursts when prices deviate too far from fundamentals
• Reach unsustainable/unaffordable point
• But is this abnormal or normal part of a cycle
• Many authors view bubble as abnormal
• Bubble processes in a cycle
Anatomy of Noughties
Boom and Bust
Office Development in London 1985-2011

![Bar chart showing office development in London from 1985 to 2011. The chart includes bars for completed, speculative, pre-let, and average completed office space.](image-url)
Annual Retail Warehouse Space completed 1993-2014
Annual Completions of Town Centre and Out-of-Town Shopping Centres 1965-2014
Long Term Capital and Rental Value Growth Patterns 1975-2015
Annual Contributions to Capital Growth 1981-2007

The diagram illustrates the annual contributions to capital growth from rental value growth, residual, and yield impact for the years 1981 to 2007.
Net Quarterly Institutional Investment into Commercial Property 2001-2009
The Value of Commercial Property Transaction Volumes 2000-2009
Reflections

• Commercial property boom of the noughties one in which investors saw dramatic returns supported by banks willing to lend more and more to them
• High returns were partly down to the substantial gearing in a rising market
• Not just individual investors who were heavily geared but also the property investment stock as a whole
• Funds chasing a stock that was virtually static
• Capital values increased without a concomitant level of rental growth
• Unsustainable process as investors joined the bandwagon
Conclusions

• Previous property booms such as in the 1980s were also linked to substantial development as a response to rising rents and occupational demand

• Development contributed only a modest addition to the commercial property stock

• Returns were all yield driven and not supported by rental growth

• Arguably first commercial property boom that was driven predominantly by investment speculation and irrational exuberance