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

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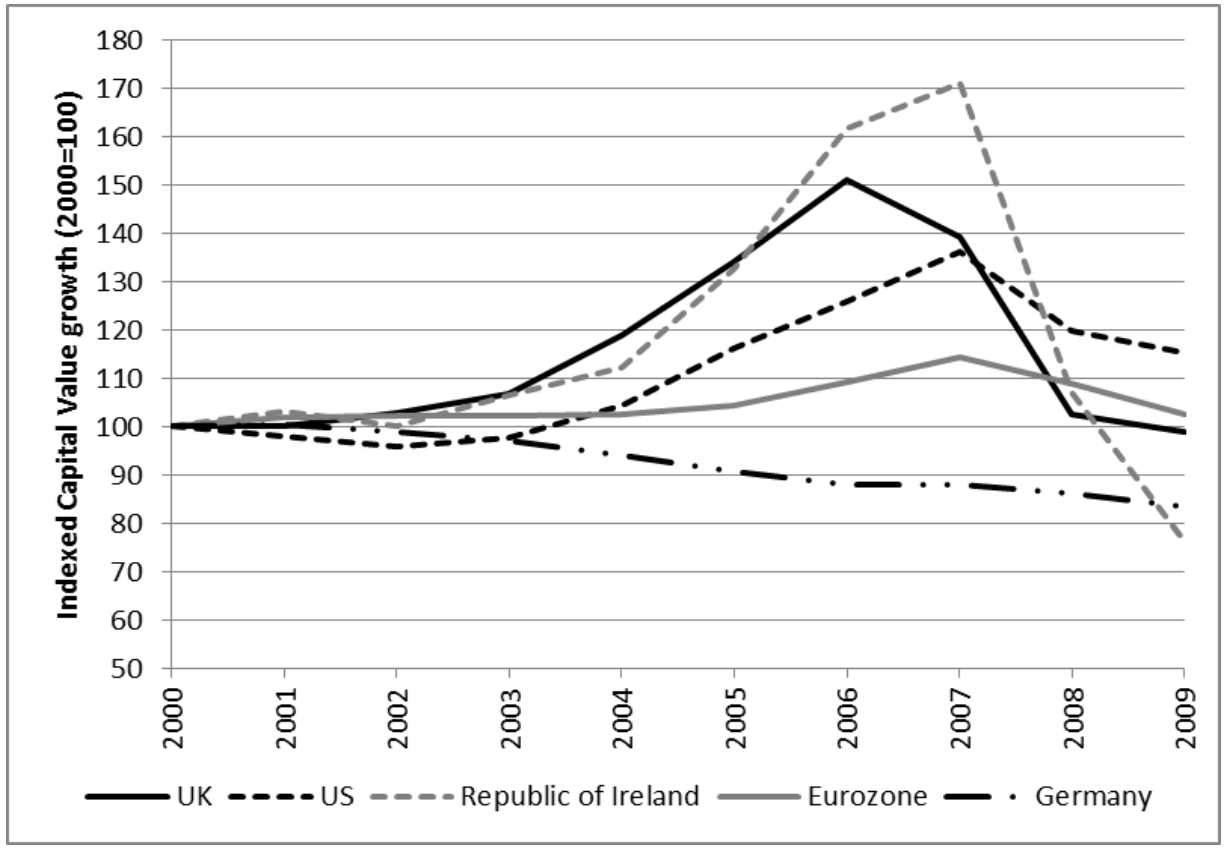
Introduction

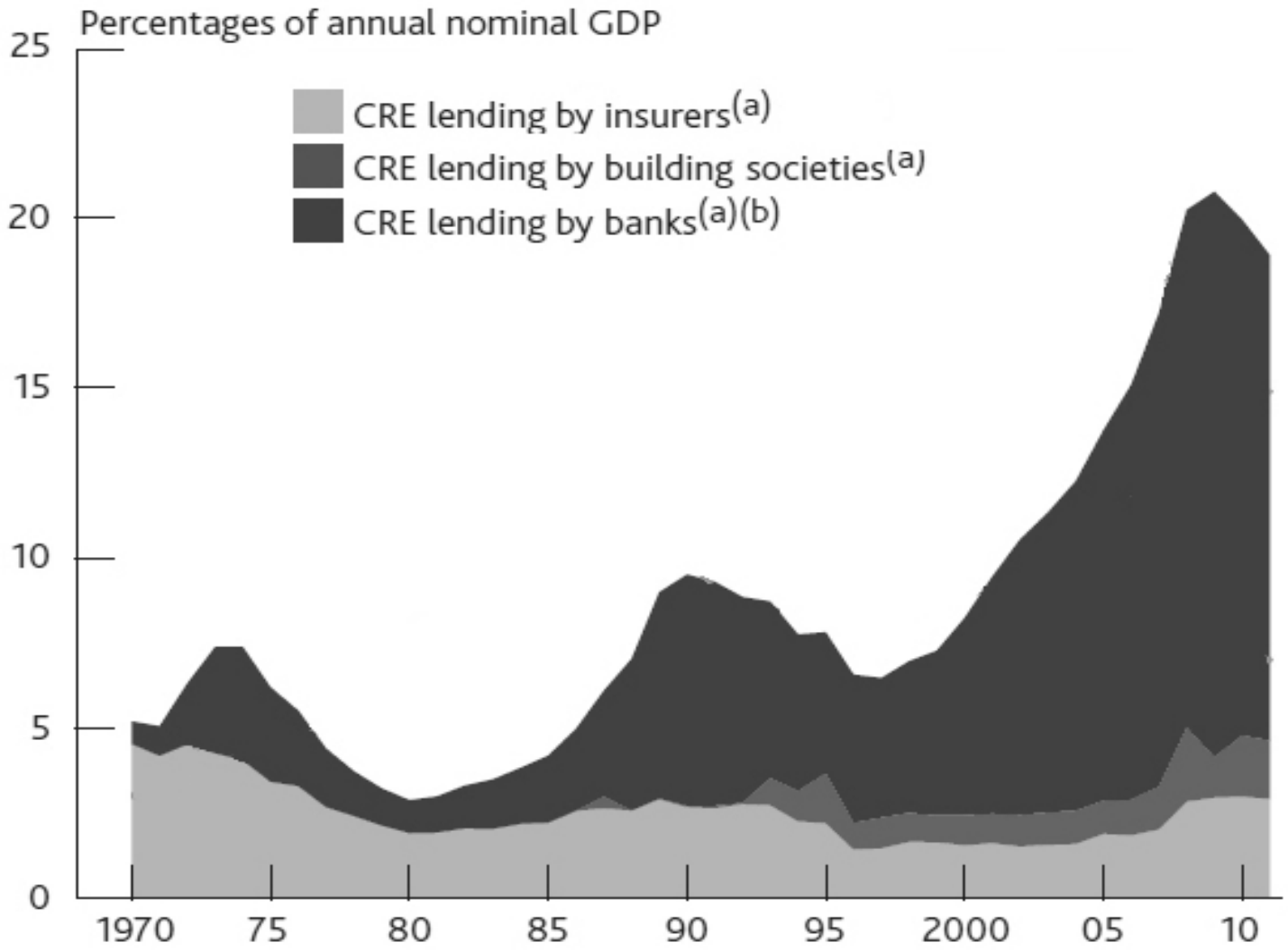
- A critical analysis of models of commercial property cycles and a reappraisal
- Based on the experience of the noughties boom and bust
- Core of empirical analysis is the dynamics of the upswing and downside of the UK commercial property market
- Draws on data from MSCI/IPD on investment and capital values and from Property Data of transactions

Noughties Boom

Commercial Property Capital Growth in Selected Countries 2000-2009



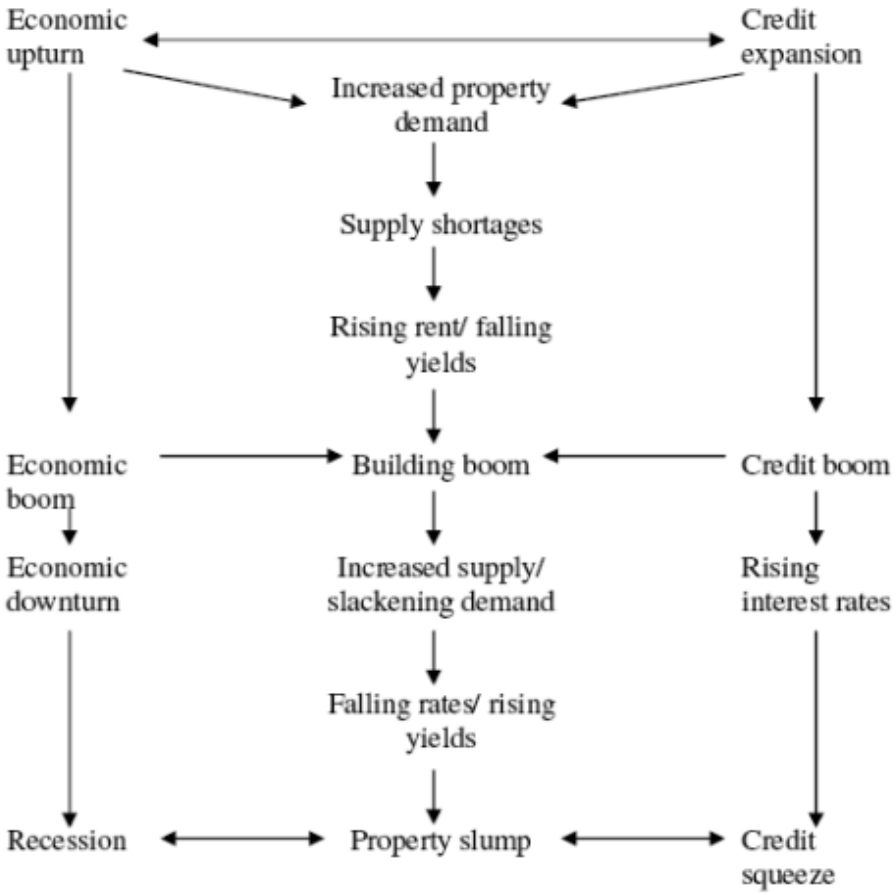
Commercial Real Estate Lending as a Percentage of Annual UK GDP 1970-2011



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


Economic upturn
Credit expansion
Increased property demand
Supply shortages
Rising rent/ falling yields
Economic boom
Building boom
Credit boom
Economic downturn
Increased supply/ slackening demand
Rising interest rates
Falling rates/ rising yields
Recession
Property slump
Credit squeeze

Bubbles

- Term “Bubble” describes booms and imply excessive price rises
- Prices divorced from ‘fundamentals’
- Potential in property mkt because of inefficiences – 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?

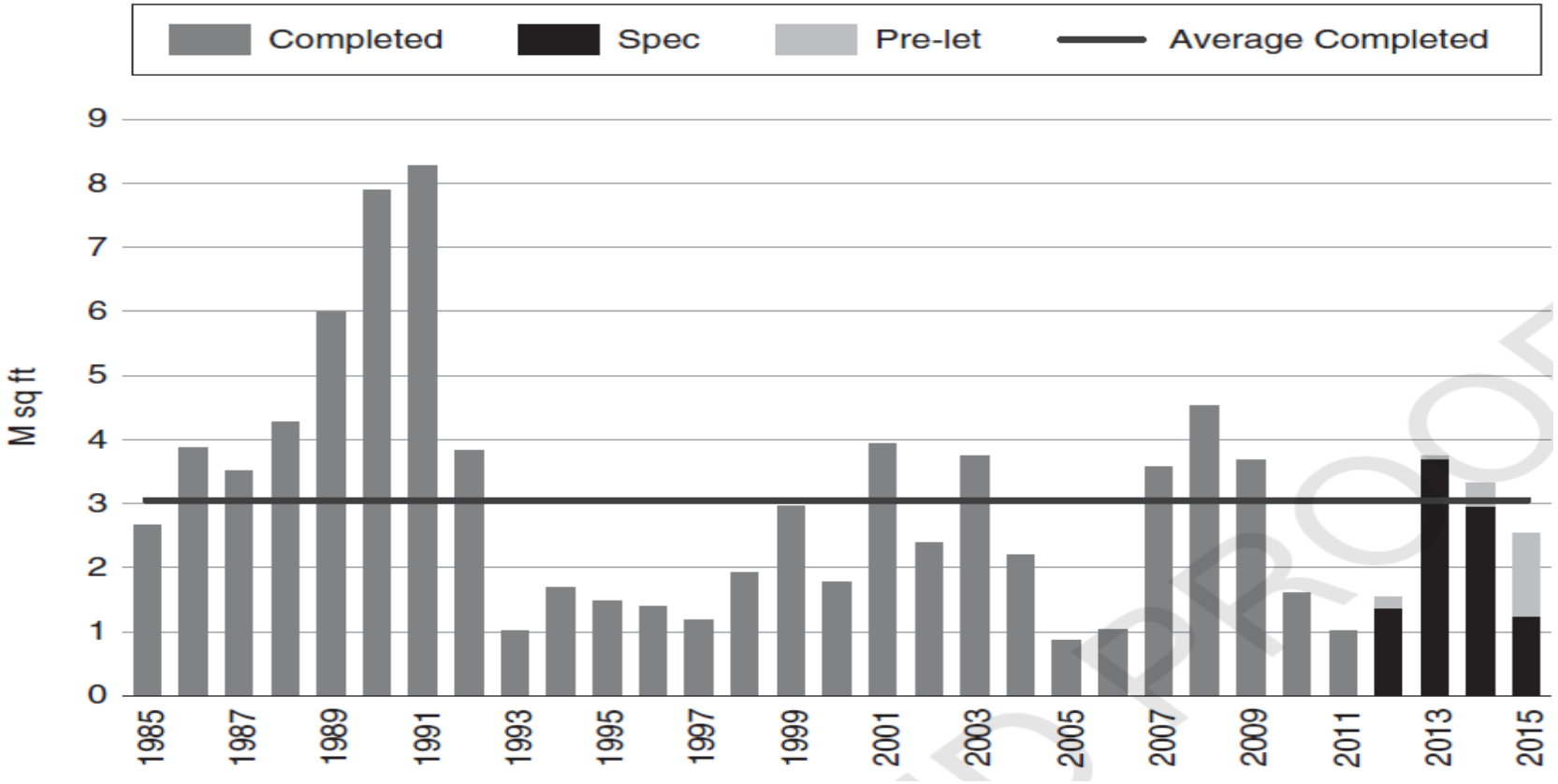
- Initial shock(s) instigate price increases that encourage further demand through adaptive expectations
- Shiller argues -> rational causes of this irrational exuberance
- Property mkt processes contribute to an overshooting of price fundamentals creating a bubble
- Bubbles = overshooting cycles

Bubbles or Cycles

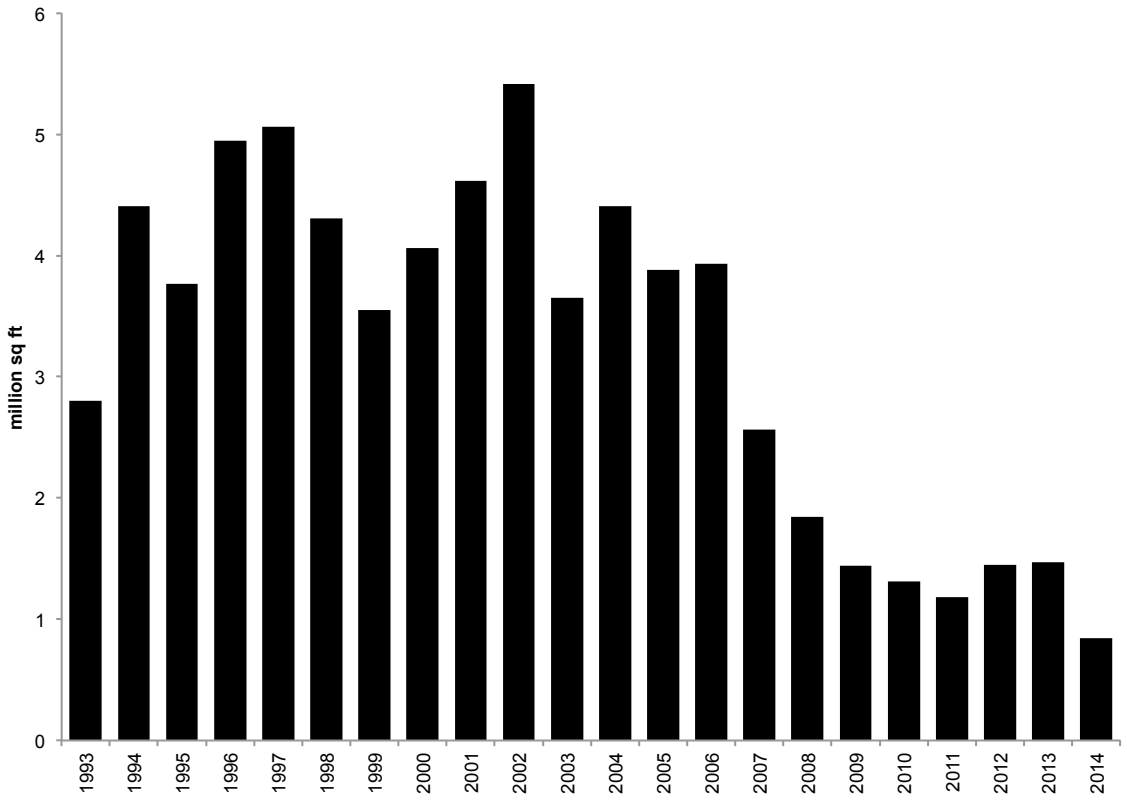
- Bubble=stimulated by positive exogenous shock but eventually bursts when prices deviate too far from fundamentals
- Reach unsustainable/unaffordable point
- But is this abnormal or normal part of a cycle
- Many authors view bubble as abnormal
- Bubble processes in a cycle

Anatomy of Noughties Boom and Bust

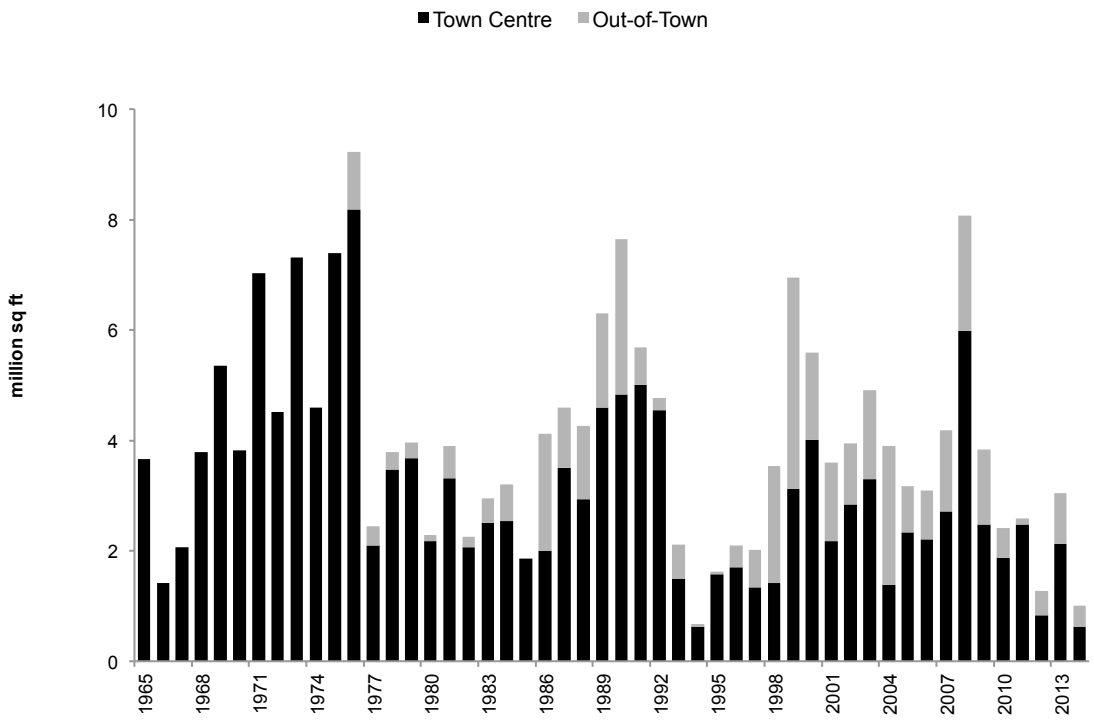
Office Development in London 1985-2011



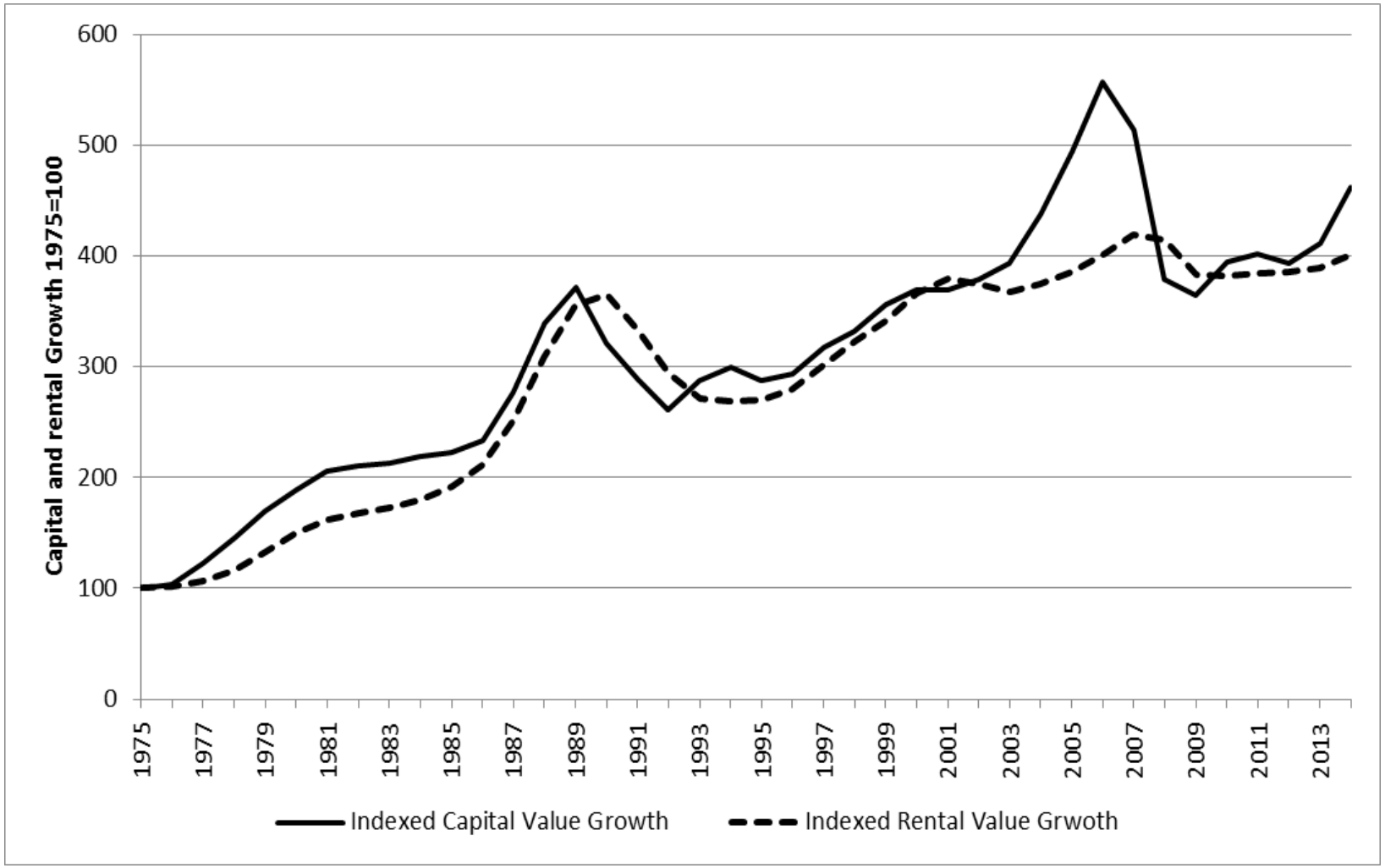
Annual Retail Warehouse Space completed 1993-2014



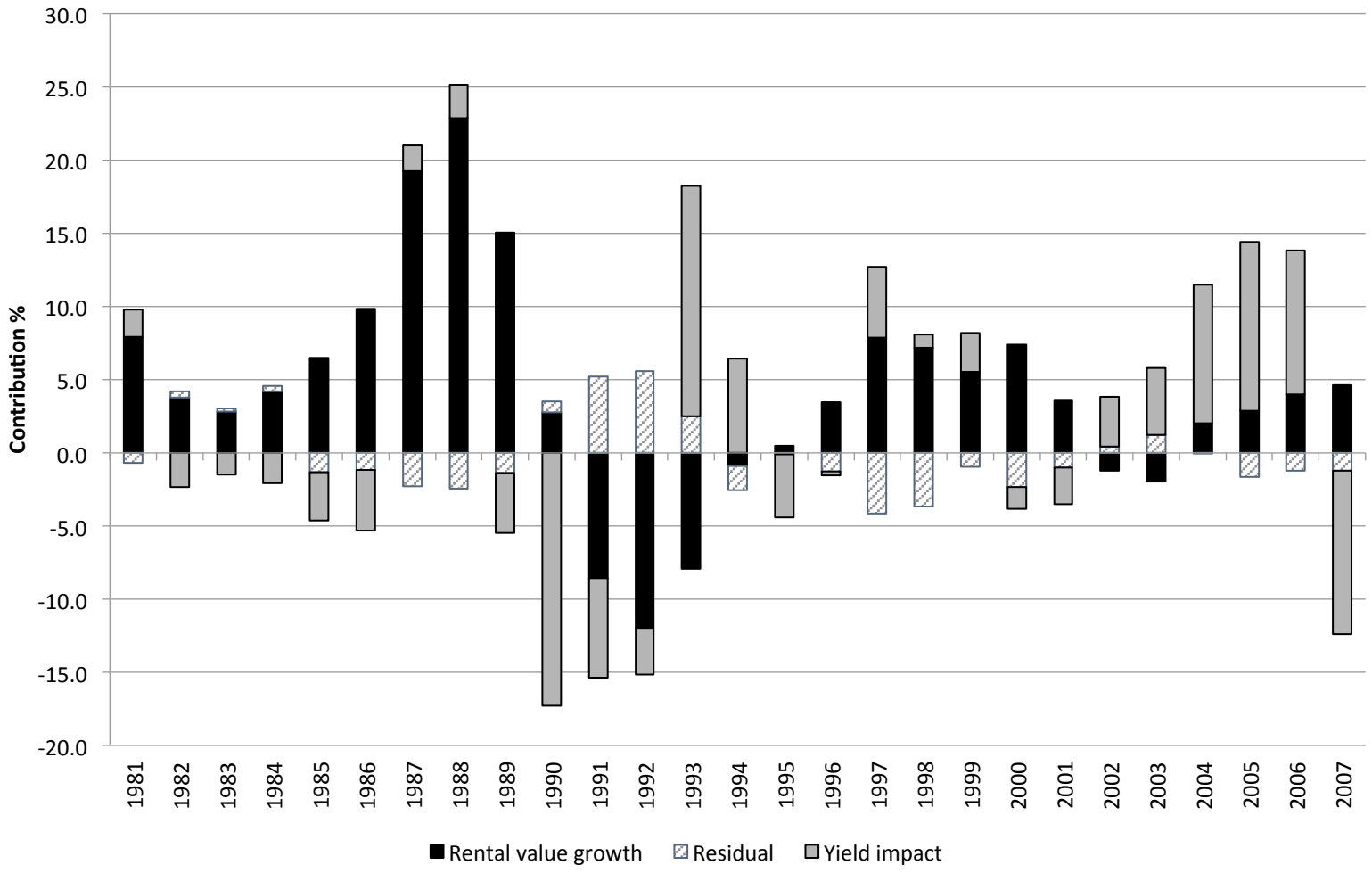
Annual Completions of Town Centre and Out-of-Town Shopping Centres 1965-2014



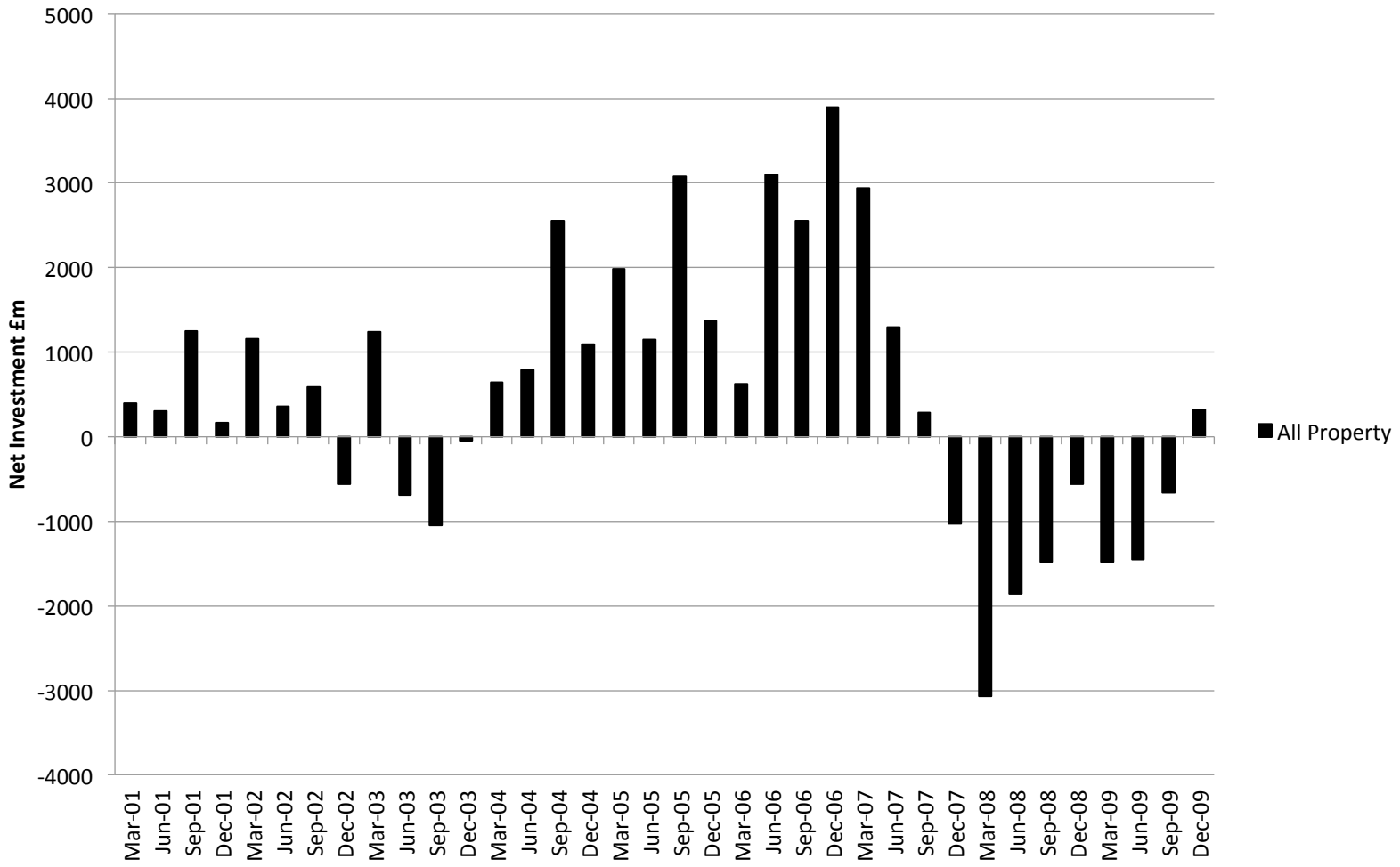
Long Term Capital and Rental Value Growth Patterns 1975-2015



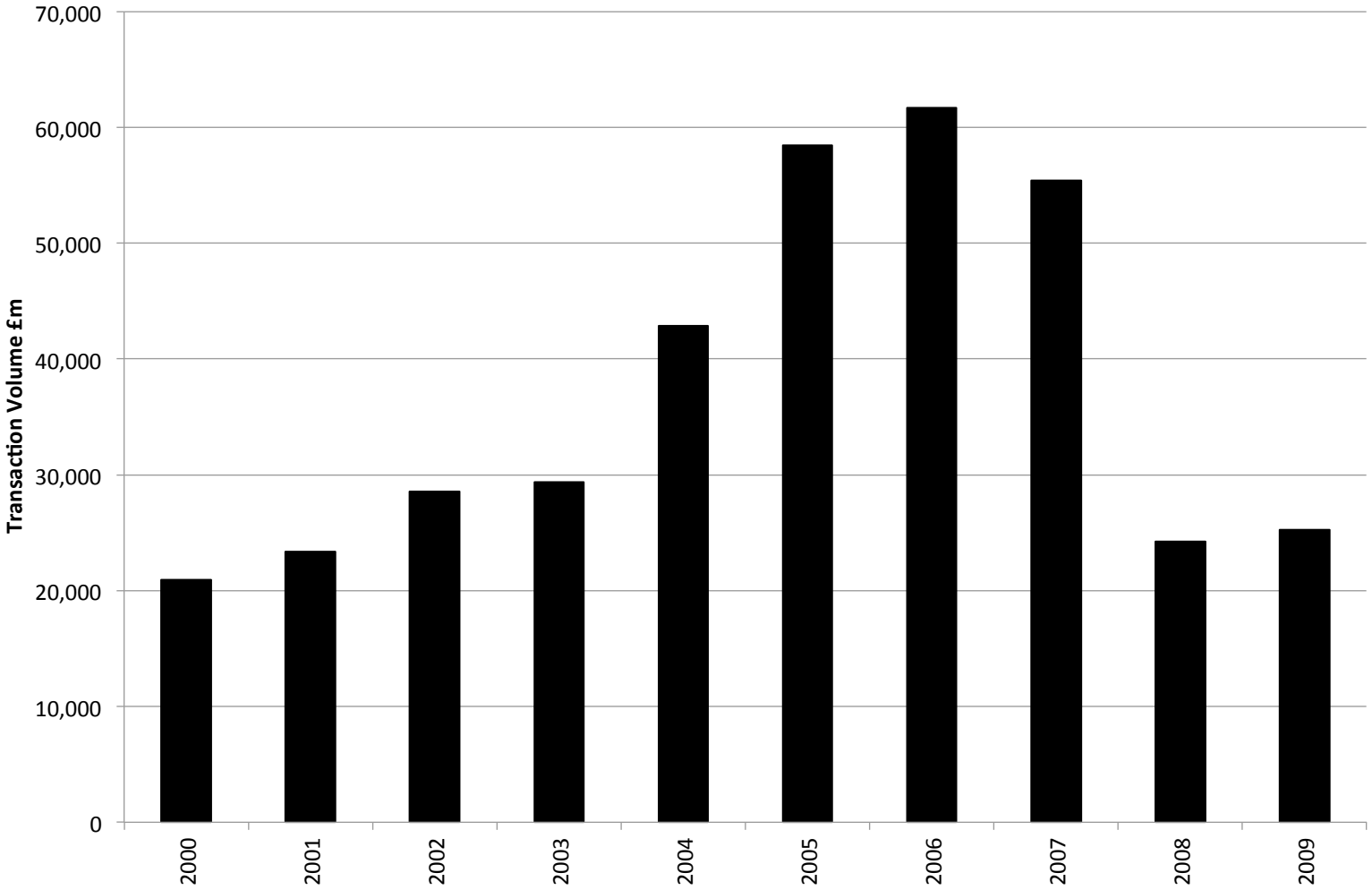
Annual Contributions to Capital Growth 1981-2007



Net Quarterly Institutional Investment into Commercial Property 2001-2009



The Value of Commercial Property Transaction Volumes 2000-2009

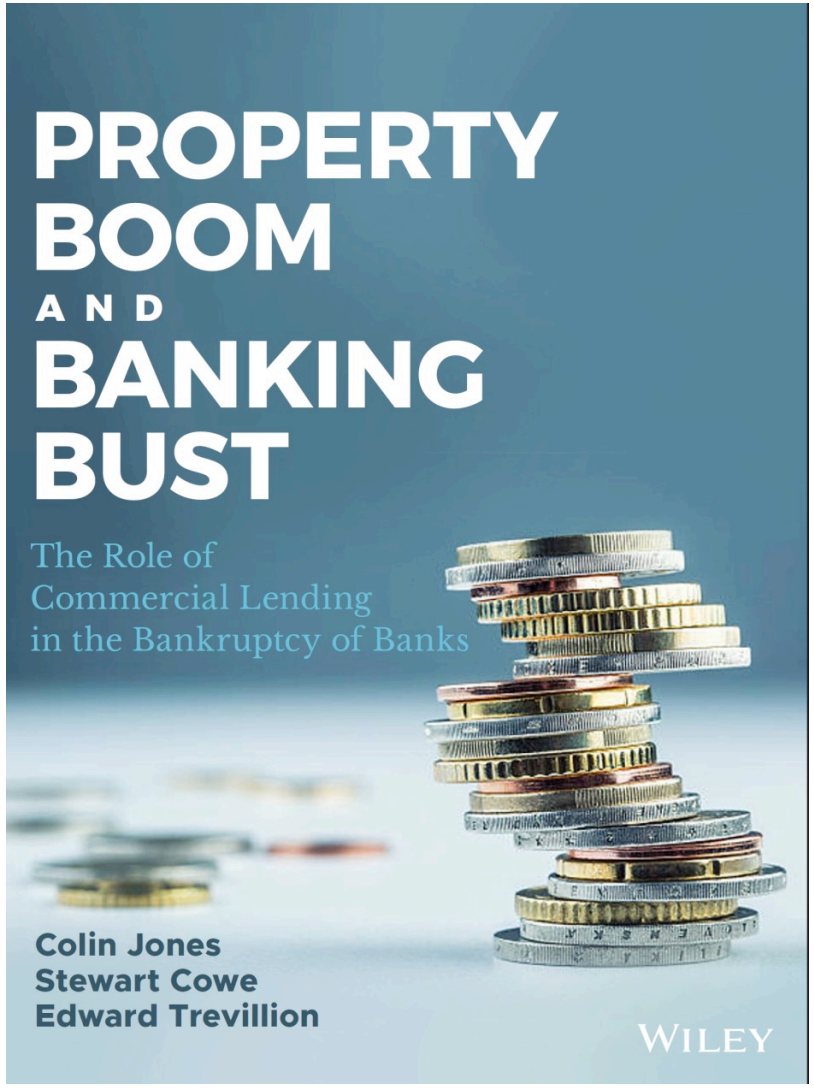


Reflections

- 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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