How property markets work: some lessons learned over three cycles

Professor Robin Goodchild MA PhD FRICS
International Director - Global Research & Strategy & University of Aberdeen Business School
Office values in major global markets: a volatile story

Source: PMA, Wheaton & Barranski, Vallis, Devaney, Turvey, RICS
Bjorklund & Soderberg
Office values in major global markets: a volatile story
Especially with Hong Kong

Source: PMA, Wheaton & Barranski, Vallis, Devaney, Turvey, RICS
Bjorklund & Soderberg

Property Market Analysis
Sources: LaSalle, IPD, ONS
Example from UK: Property Cycles 1968-2013

Sources: IPD, LaSalle Investment Management
What does this tell us?

• 2008/09 was not exceptional in real estate terms (at least in the UK)
• 16-18 years between cycles – is that just a coincidence?
• Types of economic cycles:
  – Kitchin: 3-5 years – inventories
  – Juglar: 7-11 years – fixed investment (business cycle)
  – Kuznets: 15-25 years – infrastructure investment
    (18 year US property cycle - Hanke 2010)
  – Kondratiev Waves: 45-60 years – technological changes / financial manias?
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• Explanations:
  – GDP growth
  – Behavioural economics – balance of *Greed & Fear*
  – The role of memory
UK Property Cycles 1963-2013: Three Big Ones

Sources: LaSalle, IPD, ONS
Economic Downturn doesn’t have to cause a Property Crash

Developed World Recessions

1974/5  1980/1  1990/2  2001/2  2008/9

UK All Property Total Real Return pa

Sources: LaSalle, IPD, ONS
UK Lending to Corporate Real Estate
Highly correlated with the 3 Cyclical Peaks


(a) End-year stock of outstanding lending.
(b) In 2010 and 2011 this includes an adjustment to include CRE loans transferred to the Irish National Asset Management Agency.
(c) Based on end-year data.
(d) Deflated using GDP deflator.
Why is CRE lending so cyclical?

Write-off rates on lending to UK businesses

Sources: Bank of England and Bank calculations.

(a) Lending by UK monetary financial institutions. The series are calculated as annualised quarterly write-offs divided by the corresponding loans outstanding at the end of the previous quarter. The data are presented as four-quarter moving averages and are non seasonally adjusted. Lending in both sterling and foreign currency, expressed in sterling terms.
Economic Downturn doesn’t have to cause a Property Crash

Developed World Recessions

UK All Property Total Real Return pa

-40 -30 -20 -10 0 10 20 30

Real GDP % pa
-6.0 -4.0 -2.0 0.0 2.0 4.0 6.0 8.0 10.0
1974/5 1980/1 1990/2 2001/2 2008/9

Bankers learn a new way to lose money every other recession

Sources: LaSalle, IPD, ONS
Too much office development can also be problematic
Much more so in 1989/90 than in 2007

Sources: LaSalle, BCIS, ONS
Some lessons from three big Property Cycles

- Debt is the principal fuel that drives real estate markets
- Contradiction between prudent lending and building a market leading banking business in commercial real estate
- Too much development is also dangerous
- ‘Greed and Fear’ rule - pay attention to Behavioural Economics
- Property looks a very easy business in a Boom
- Beware managers in senior positions who have not experienced a big cycle
- Commercial property values should not increase by over 5-6% real pa (This may vary by market. Numbers quoted are for the UK)
- Ways to exploit property cycles
  - ‘Catching the falling knife’ - buy in the Bust to exploit the Recovery bounce
History shows that pricing recovery has been rapid: buy in 2009 for 2010/11 recovery as equity in the wings re-enters market (written in October 2008)
Example:

Retail warehouse purchased in March 2009

Distressed seller (property unit trust)

Yield at purchase 10%+

Income increased during ownership

Sold December 2009 at yield <7%: 70% capital gain in 9 months

Source: IPD Monthly Index
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  - ‘Catching the falling knife’ - buy in the Bust to exploit the Recovery bounce
  - Long term investing between big cycles selling into the next Boom
Benefit of investing between big cycles in US & UK

UK
- Long-run real average 4.2% pa
- 1977-1988 8.0%
- 1978-1988 7.6%
- 1979-1988 6.8%
- 1993-2006 9.9%
- 1994-2006 9.3%
- 1995-2006 9.4%

USA
- Long-run real average 5.4% pa
- 1978-1988 6.6%
- 1979-1988 6.8%
- 1980-1988 6.4%
- 1994-2007 9.3%
- 1995-2007 9.7%
- 1996-2007 10.2%

Source: IPD, NCREIF, LaSalle Investment Management
Contact details: Robin Goodchild PhD FRICS

E-mail robin.goodchild@lasalle.com

References:


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