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Cambridge University  
Land Society

# Nature of Property Cycles: Past, Present and Future



Investment  
Property Forum

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# Nature of Property Cycles : Past, Present and Future

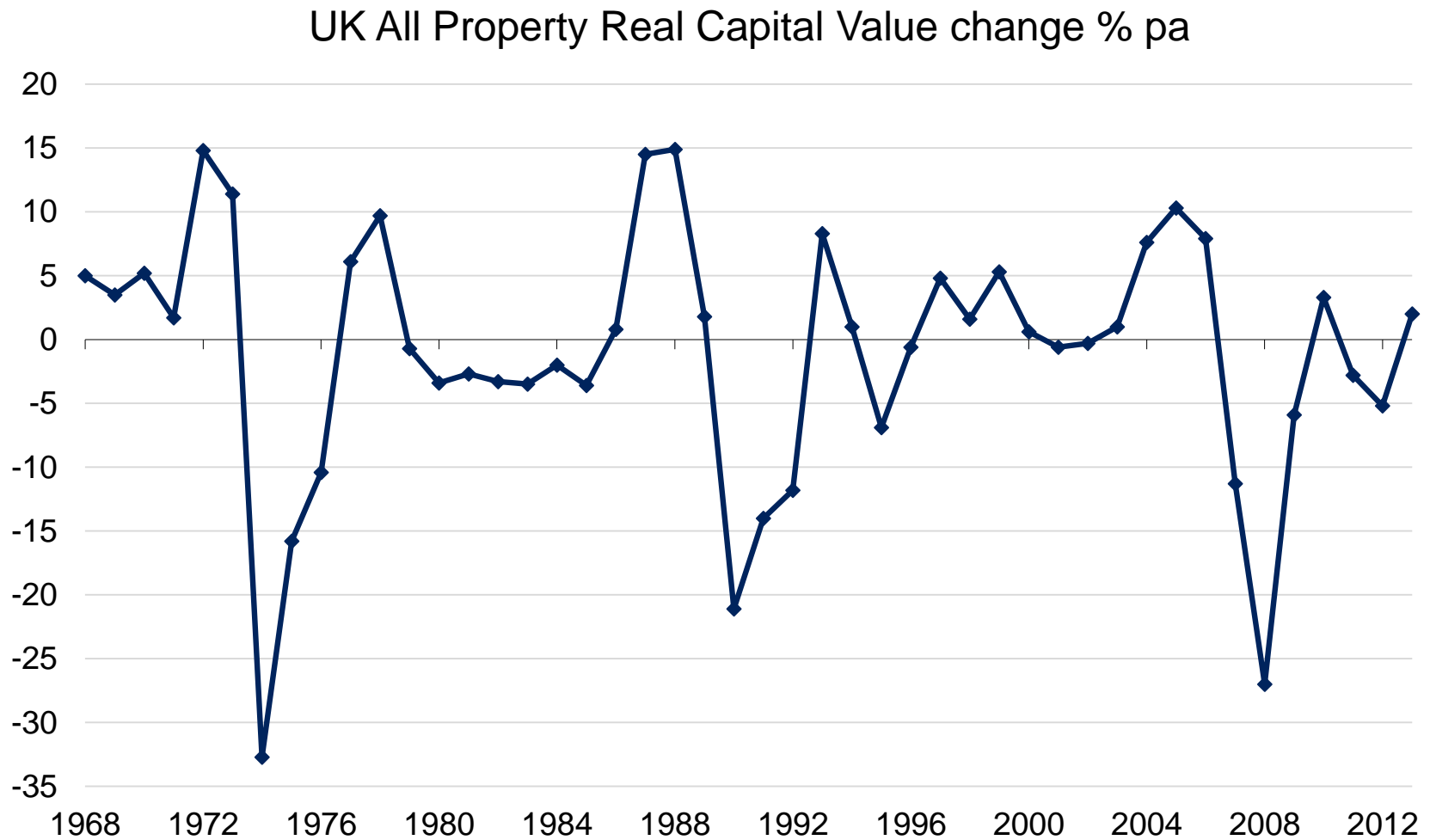
## Agenda

- The Past: pre-2014
  - Nature of Cycles in the UK and other Markets
  - Academic Literature
- The Present: 2014-Today
  - What is the nature of the current cycle?
  - Similarities and Differences
- The Future: The Next Decade
  - Understanding the causes of cyclicity - lessons learned
  - Can the Credit Cycle be tamed?
  - Conclusions and Forecasts

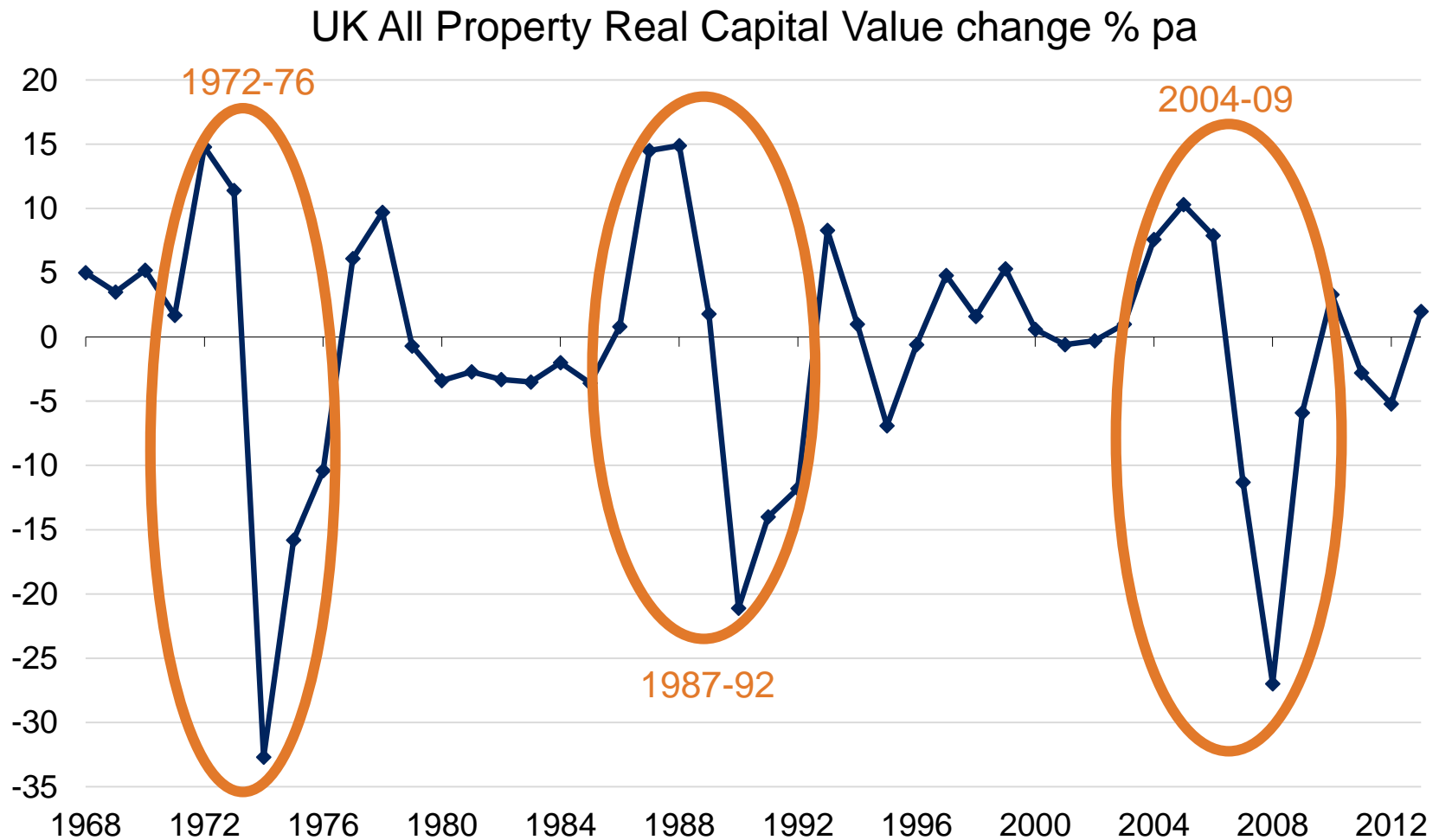
## The Past: (pre-2014)



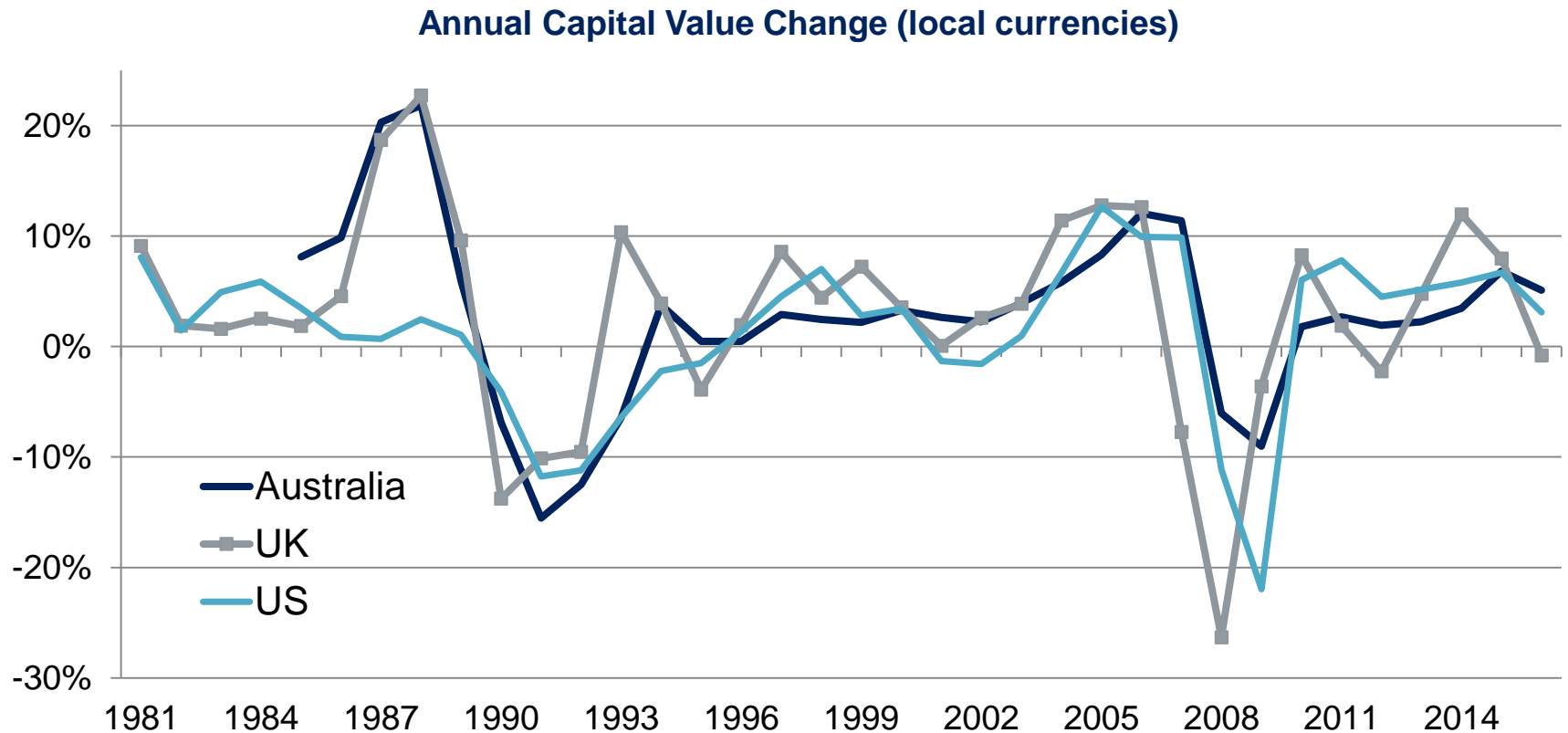
# UK Property 1968-2013: Three Significant Cycles



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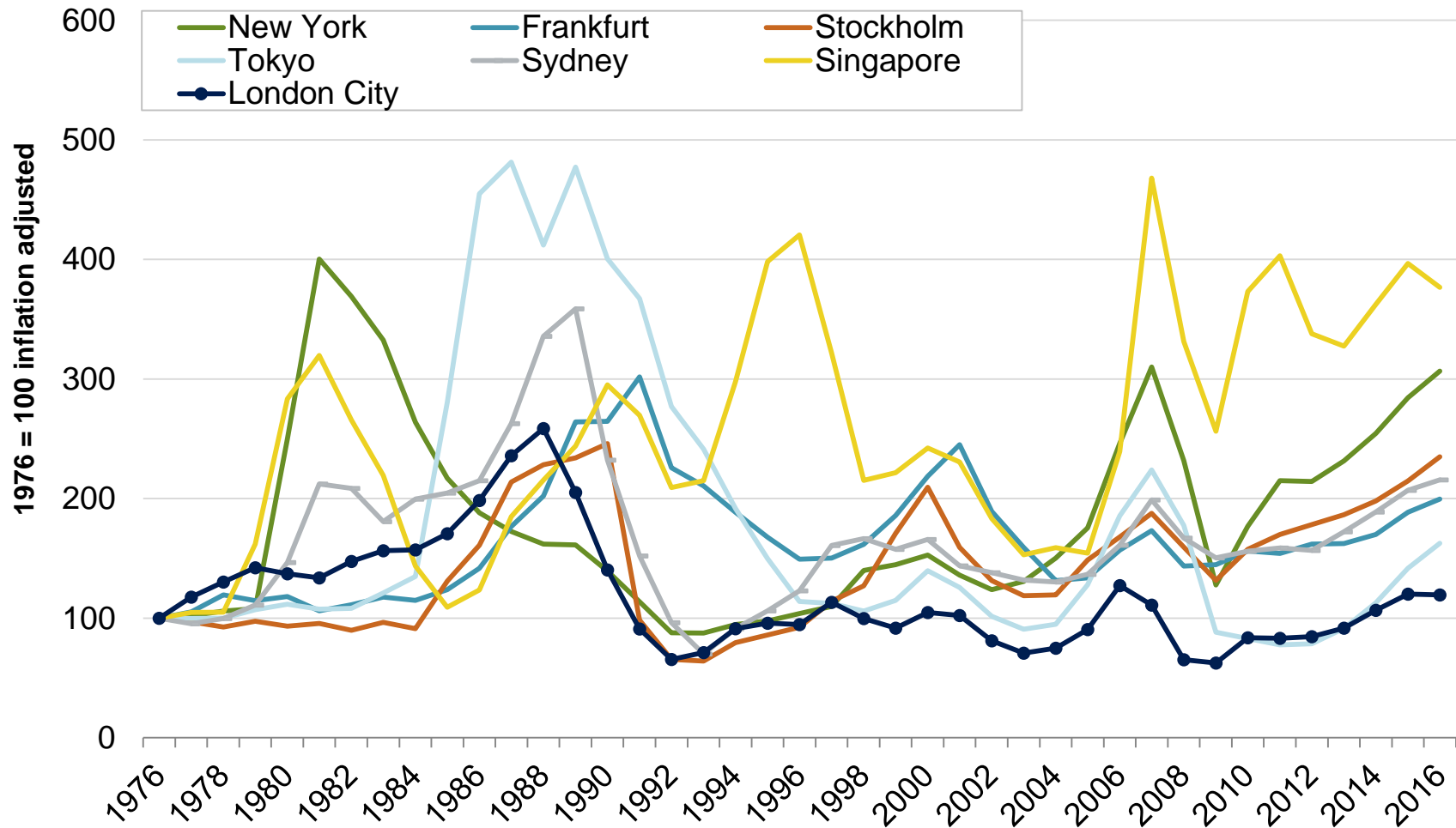


# Developed Markets show similar cyclical pattern 1980-2016



# All Real Estate Markets are Cyclical

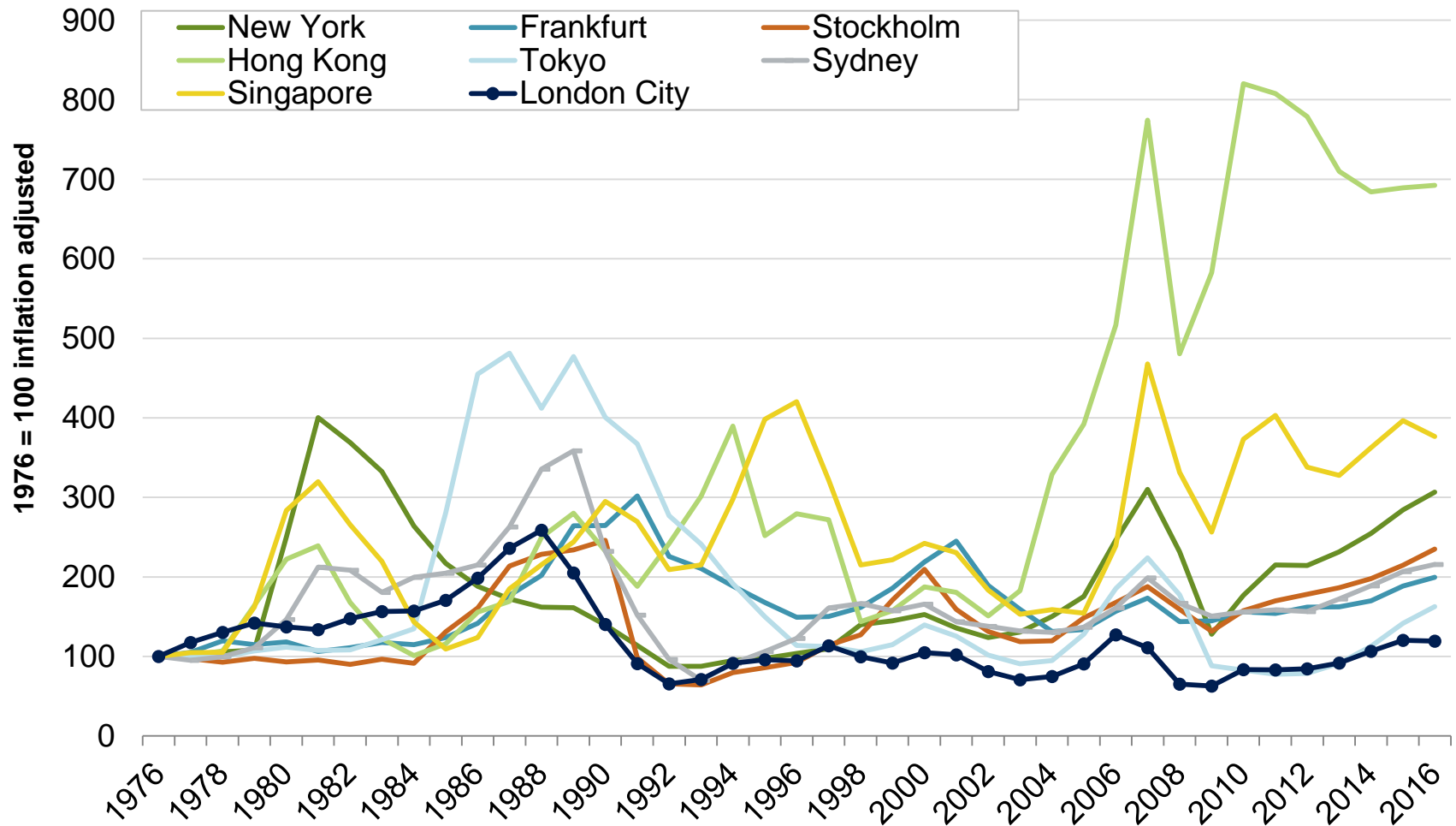
## Real Office Values in Major Global Markets



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

# All Real Estate Markets are Cyclical

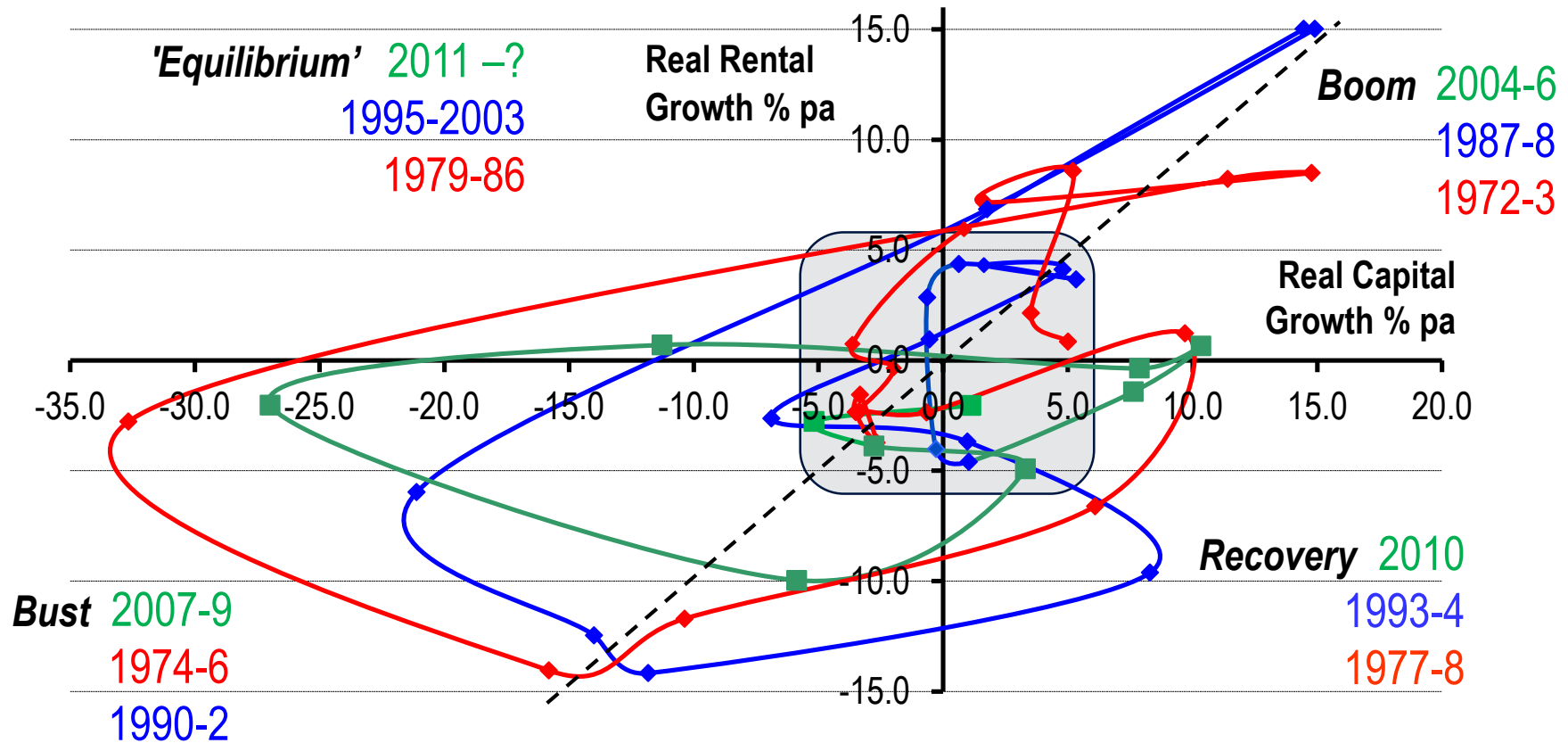
Real Office Values in Major Global Markets: Especially Volatile in Hong Kong!



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



# Example from UK: Property Cycles 1968-2013

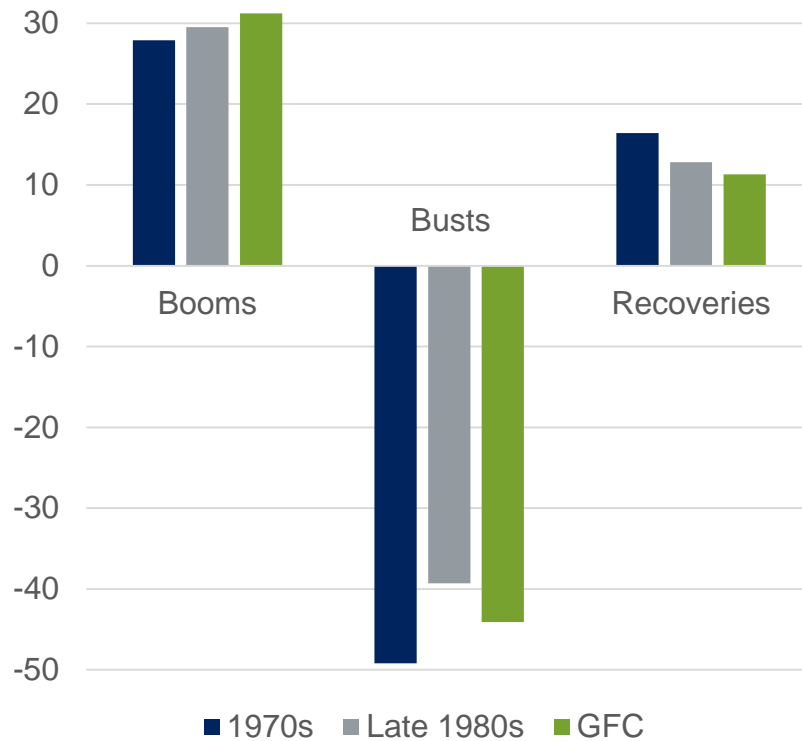


Sources: MSCI/IPD, LaSalle Investment Management

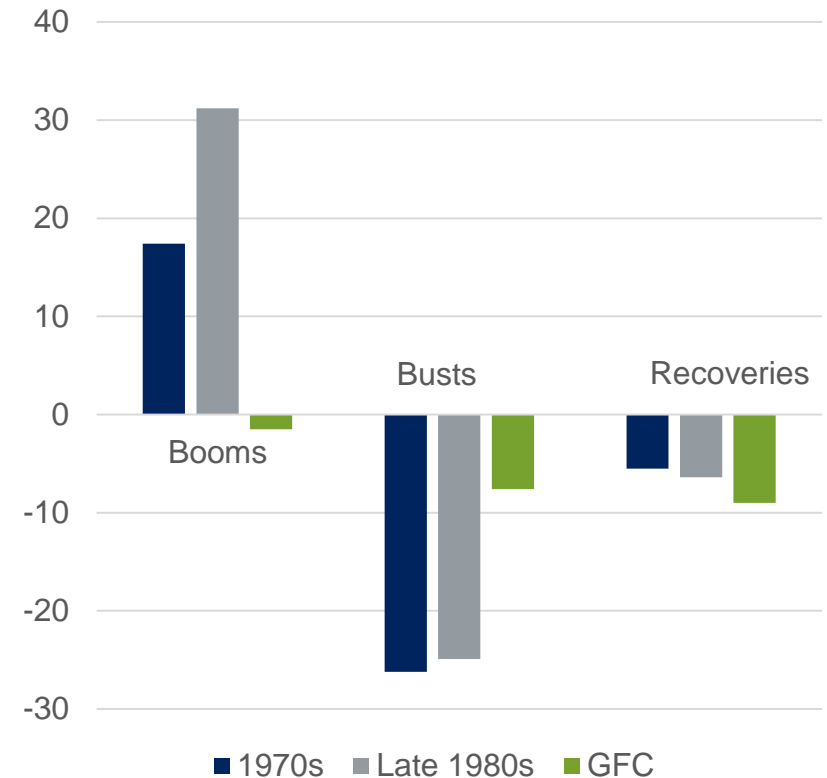
# Decomposing UK Property Cycles

## A Comparison of Three Cycles

Real Capital Value change %



Real Rental Value change %



# What else 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 - Foldvary 1997; 15-25 years in UK – Barras 2009)
  - Kondratiev Waves: 45-60 years – technological changes / financial manias?
- Cracking Stories:
  - Early 1970s – Plender, J (1982)
  - Late 1980s – Ross Goobey, A (1992)
  - GFC – ‘Big Short’ etc.(& World Economic Forum (2015))

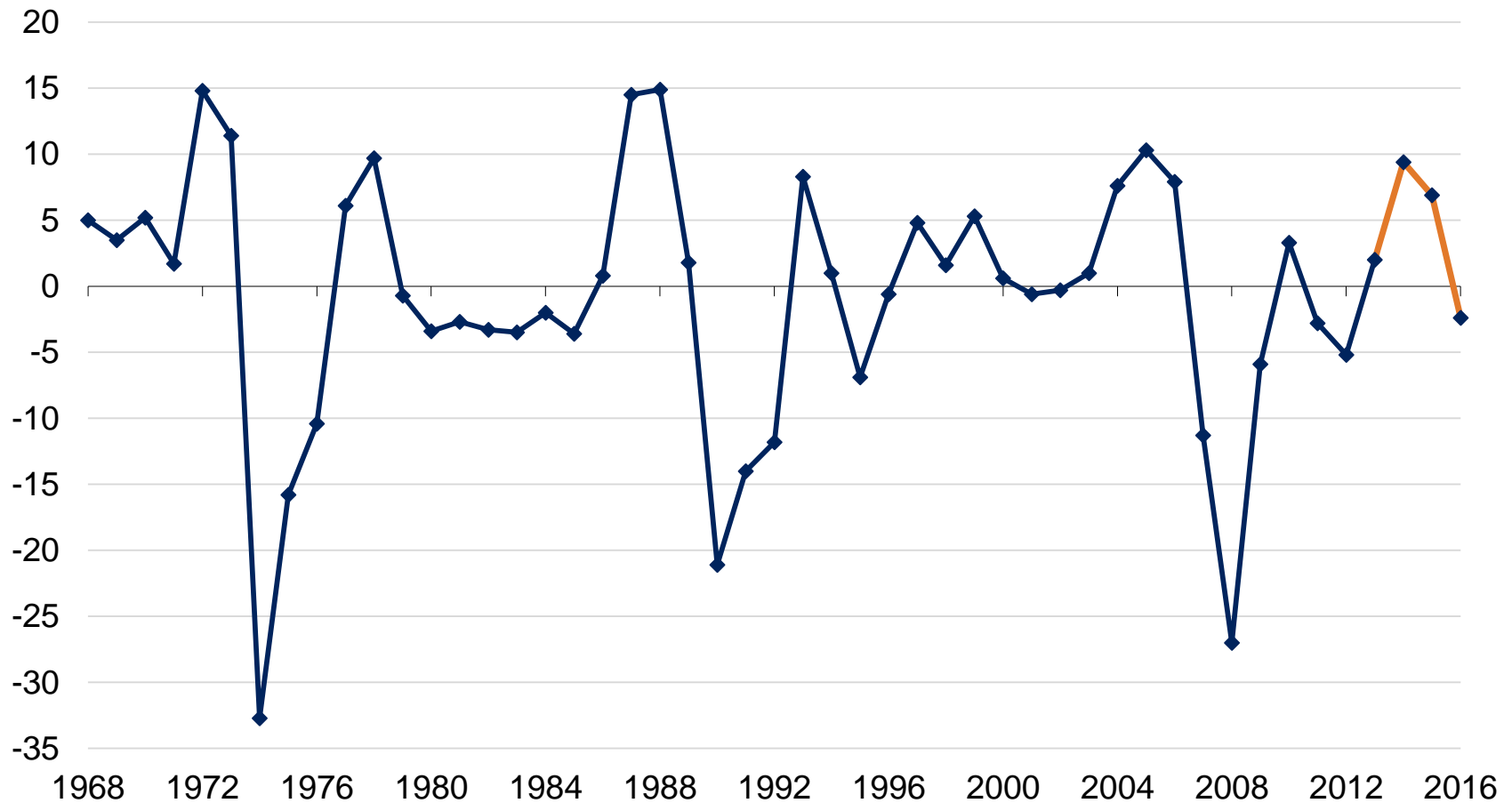
## The Present: 2014 - Today



# UK Property 1968-2016: The Present

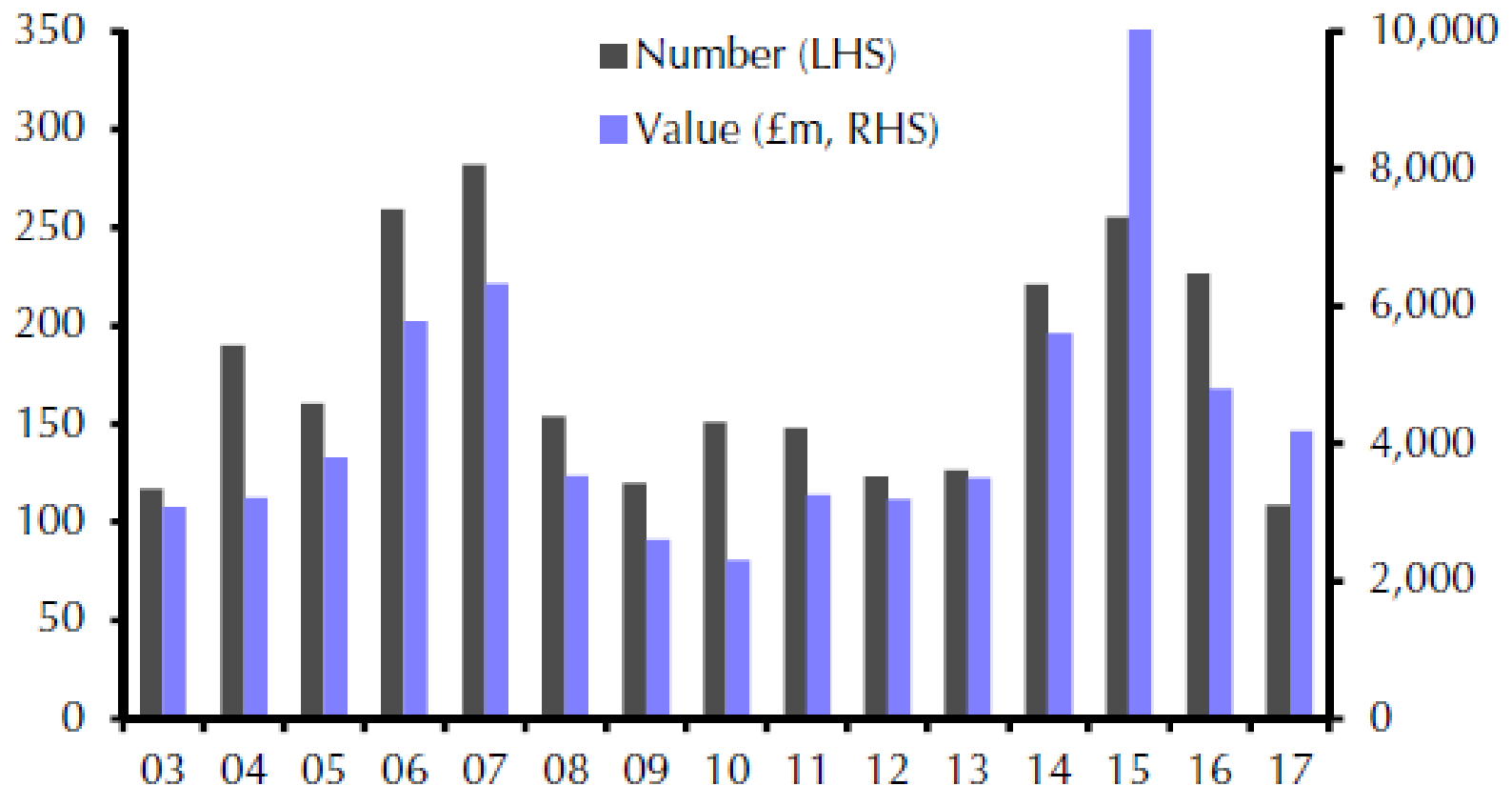
Did we experience a Boom in 2014/15 so are we now about to have a Bust?

UK All Property Real Capital Value change % pa



# UK Property Transaction Volumes: The Present

The Pattern of Transactions looks suspiciously like 2005/07

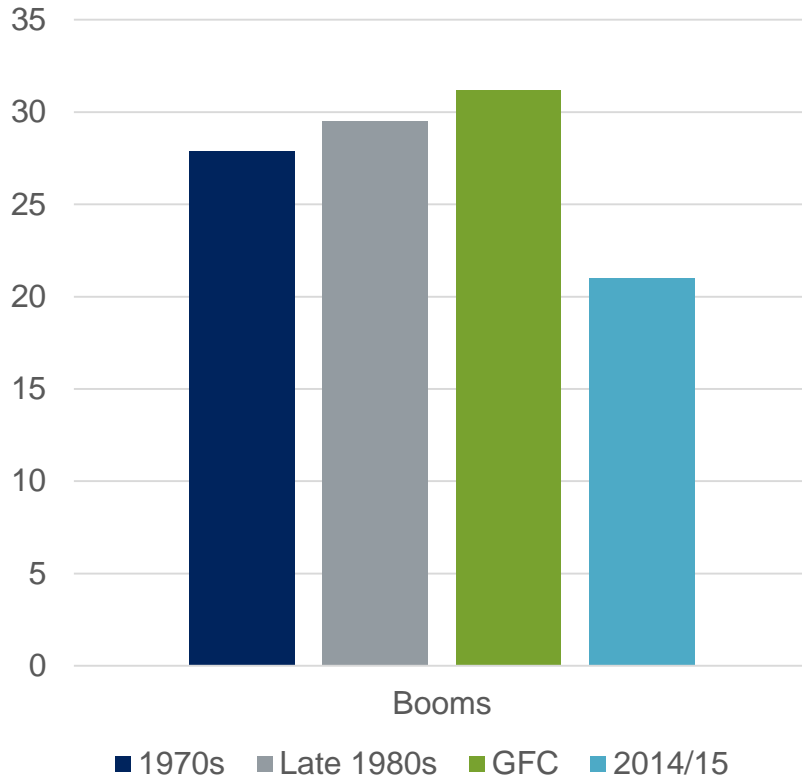


Value and Number of Commercial Property Deals in March of Each Year  
Sources: Property Archive, Capital Economics

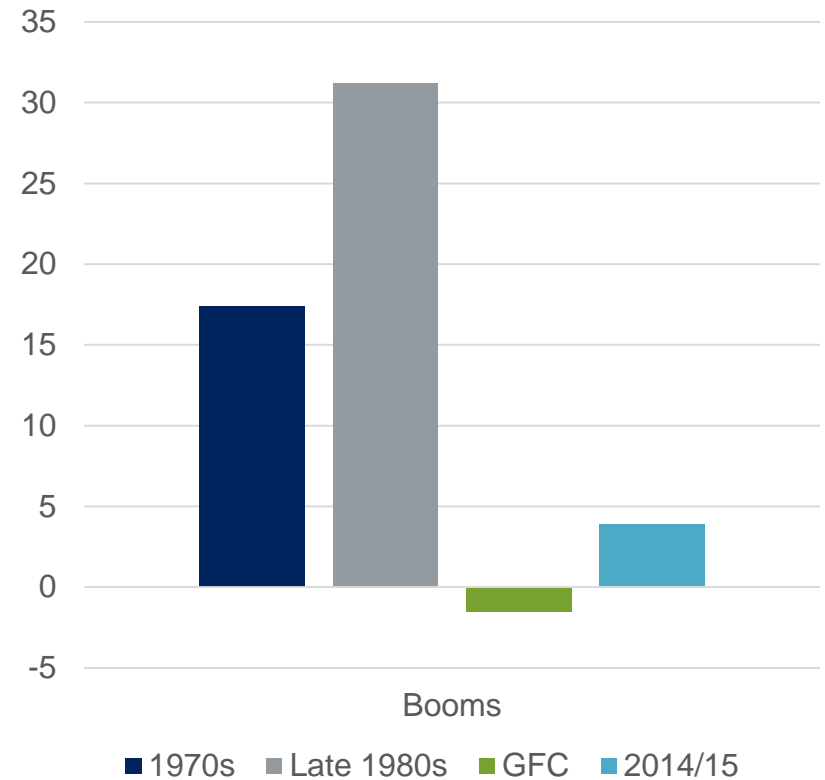
# Decomposing UK Property Cycles

Capital Gain in 2014/15 not sufficient to be a 'Boom'

Real Capital Value change %

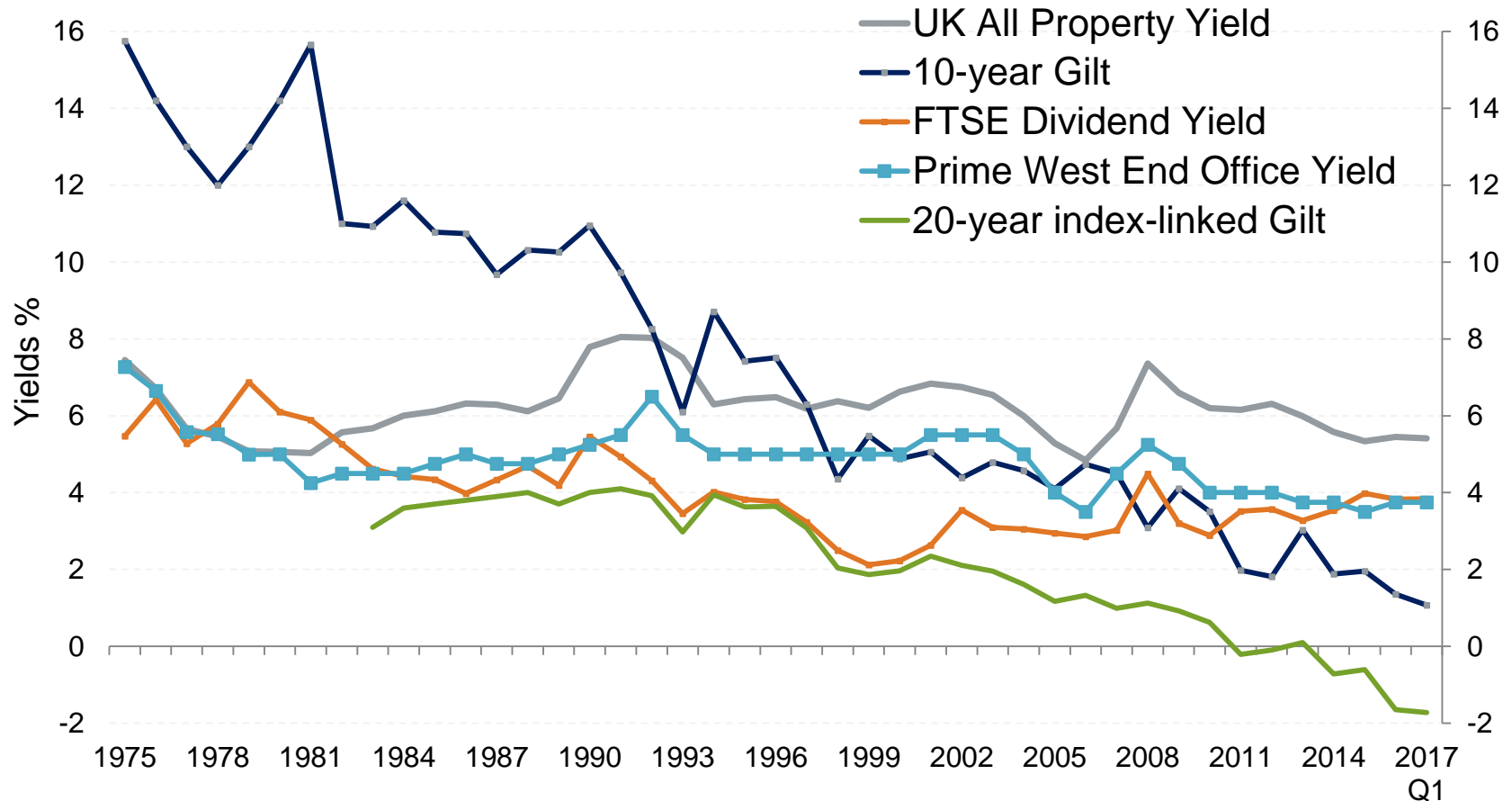


Real Rental Value change %



# UK Asset Class Yields 1975-2017 Q1

Spread between Property & Gilts has never been wider

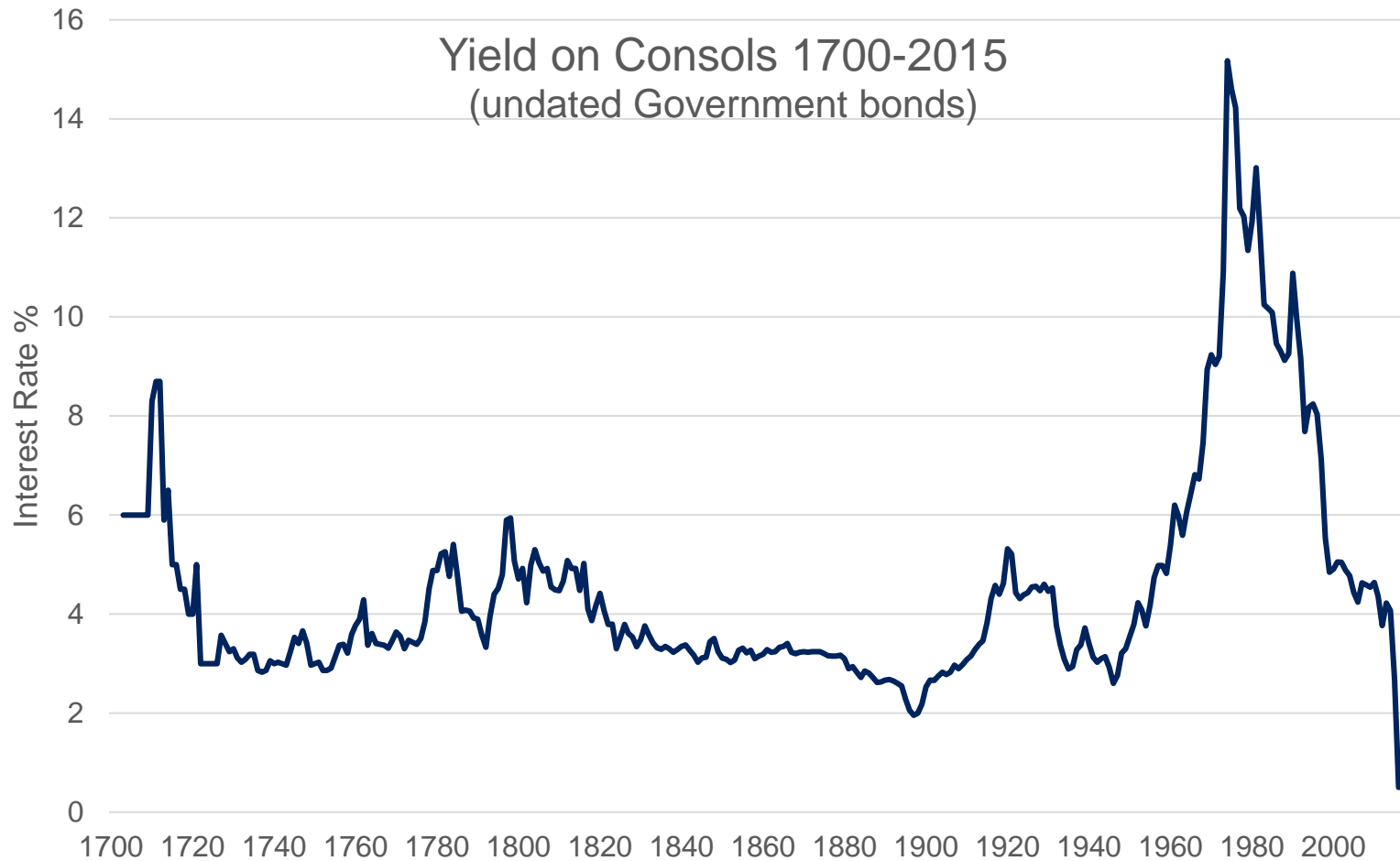


Sources: Thomson Reuters (Datastream), CBRE, LaSalle Investment Management



# But the Post-War period is an Aberration relative to history

## What is a 'normal level' for the Risk Free Rate?



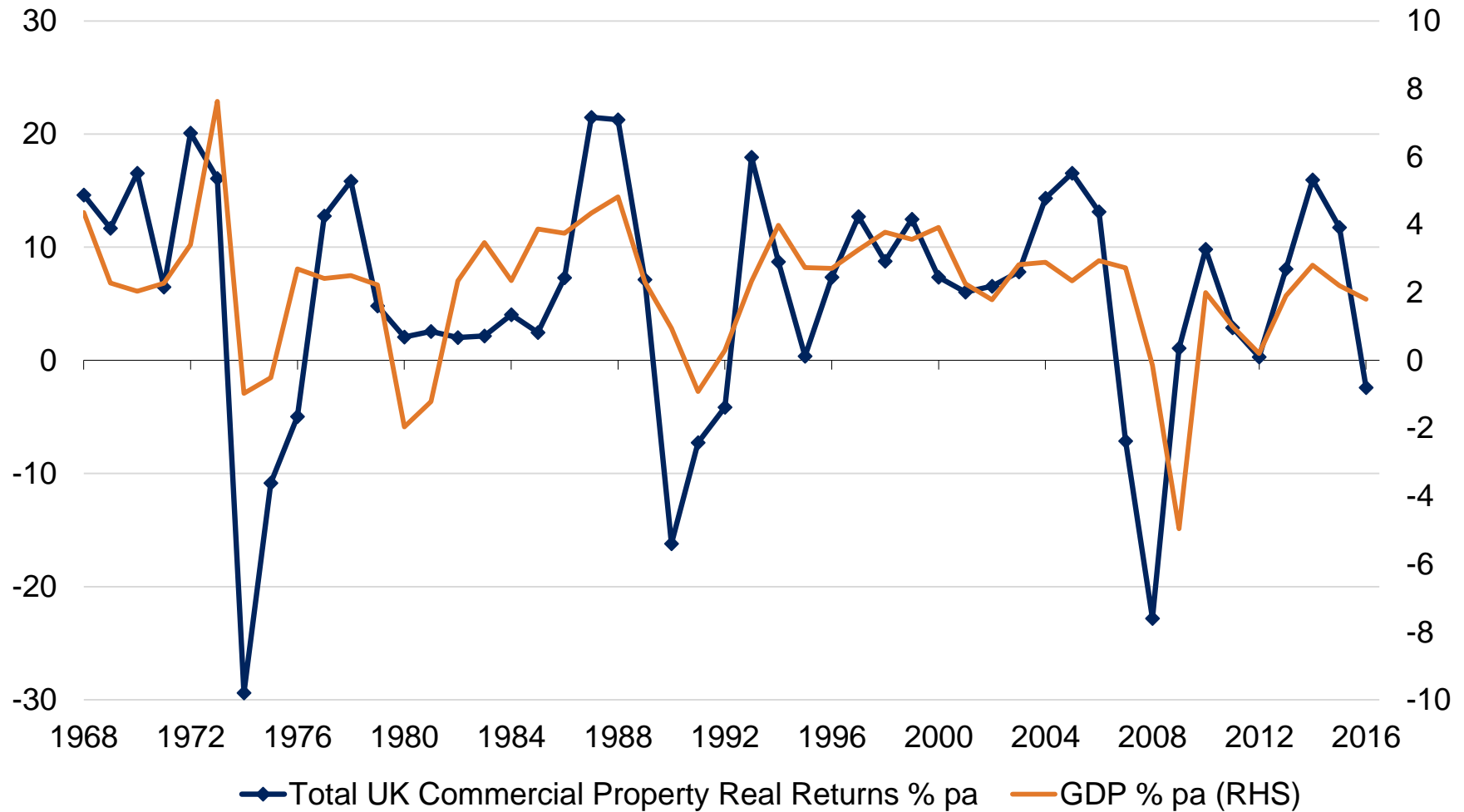
# The Future

What drives Property Cycles



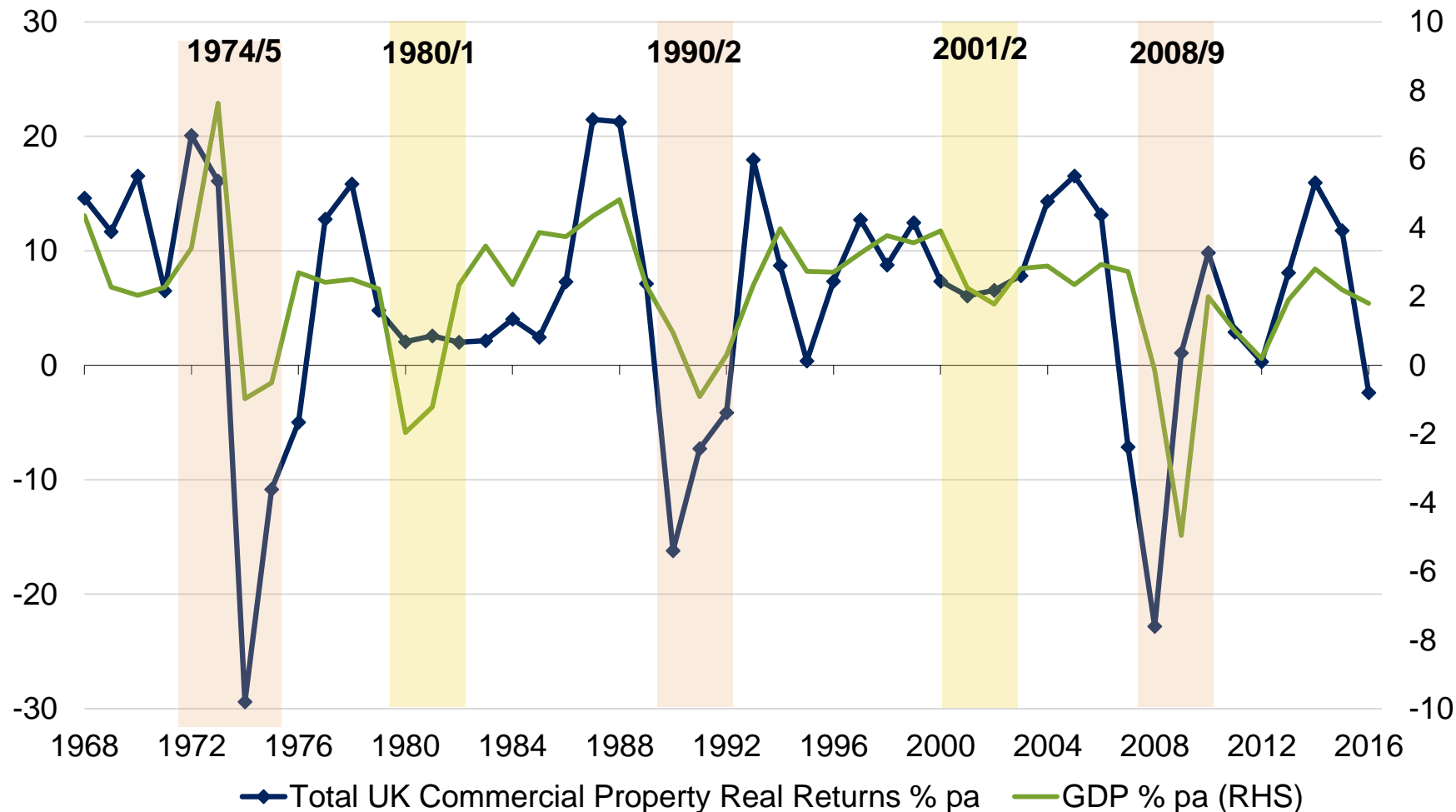
# UK Property Cycles 1968-2016: Three Significant Ones

## Strong relationship between Property Returns and Economic Growth



# Economic Downturns don't have to cause a Property Bust

## Big Cycles have occurred every second Economic Downturn



# Too much office development can also be problematic

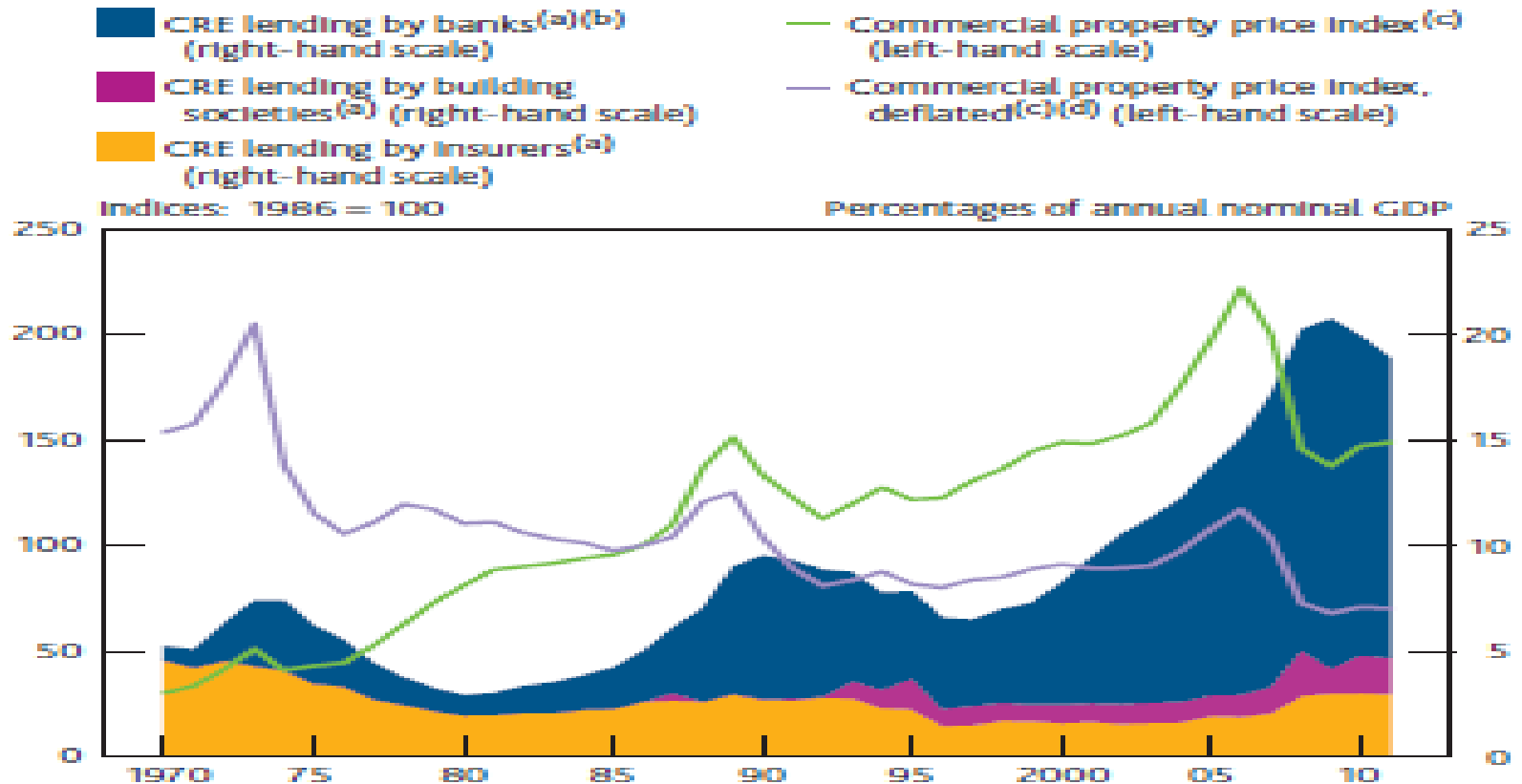
## UK Office development 1980-2016



Sources: LaSalle, BCIS, ONS

# UK Lending to Corporate Real Estate

## Highly correlated with the 3 Cyclical Peaks



Sources: Association of British Insurers, Bank of England, Building Societies Association, Investment Property Databank, ONS and Bank calculations.

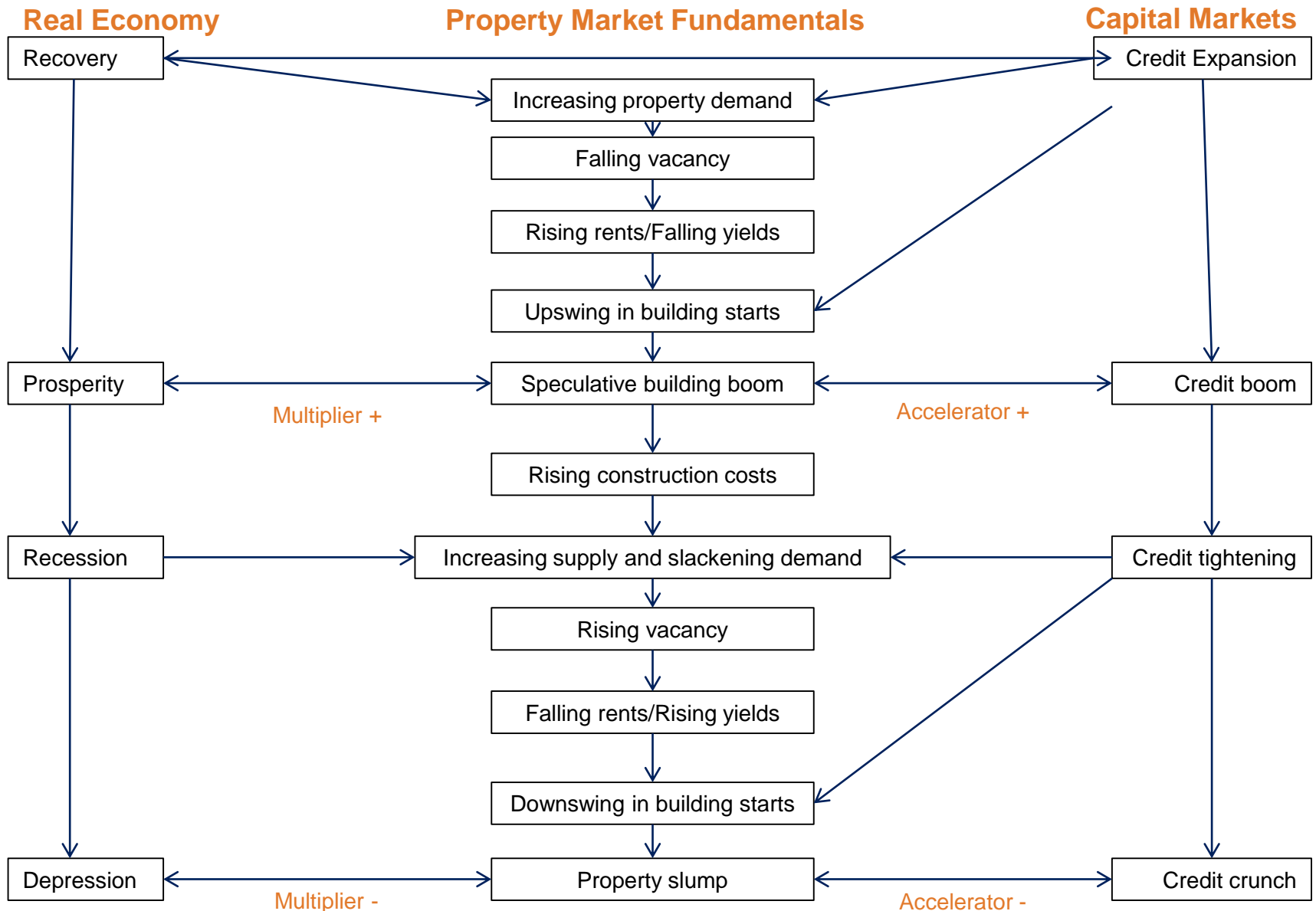
(a) End-year stock of outstanding lending.

(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.

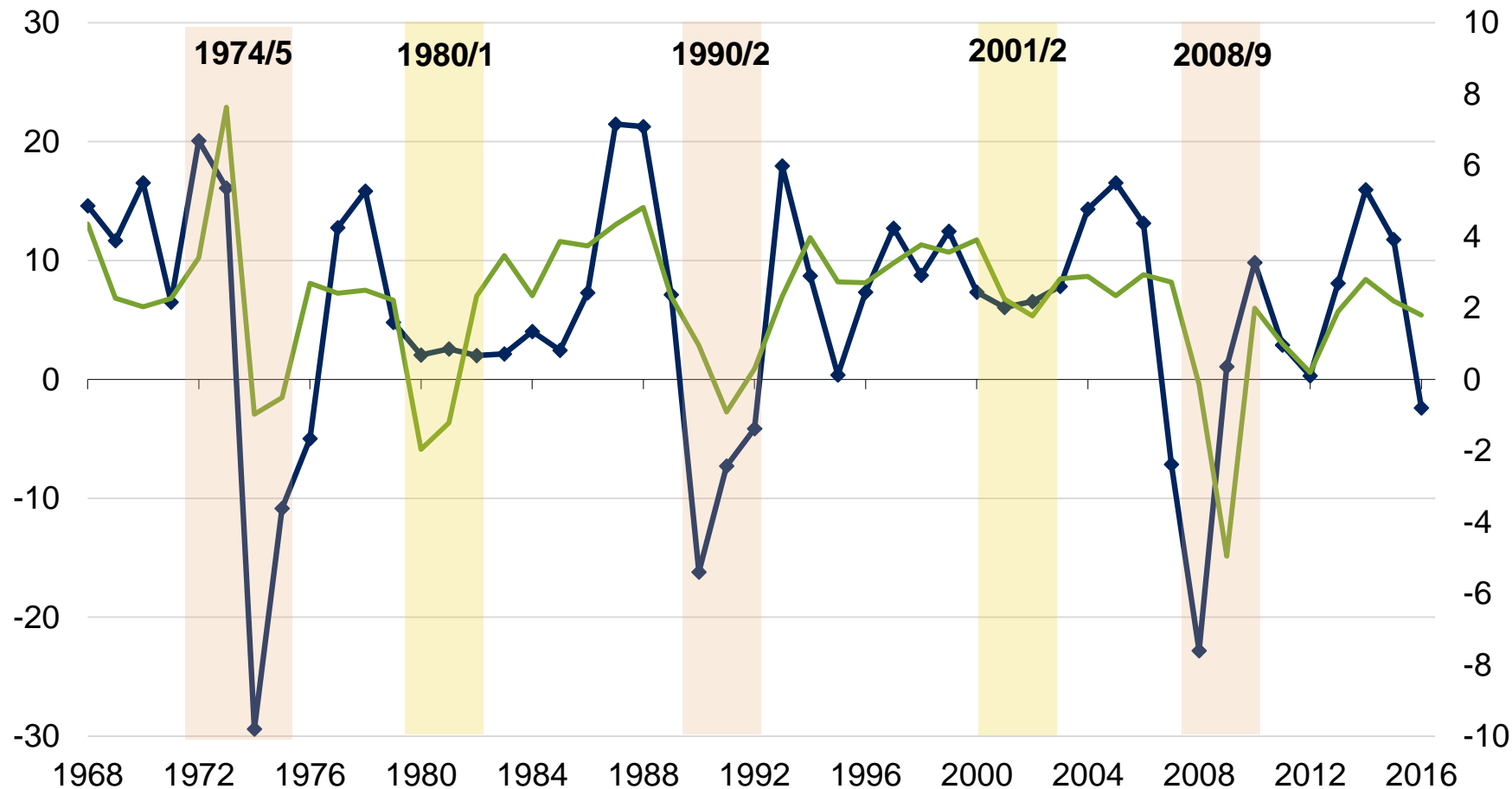
(d) Deflated using GDP deflator.

# How the Building Cycle works



# Economic Downturns don't have to cause a Property Bust

## Big Cycles have occurred every second Economic Downturn

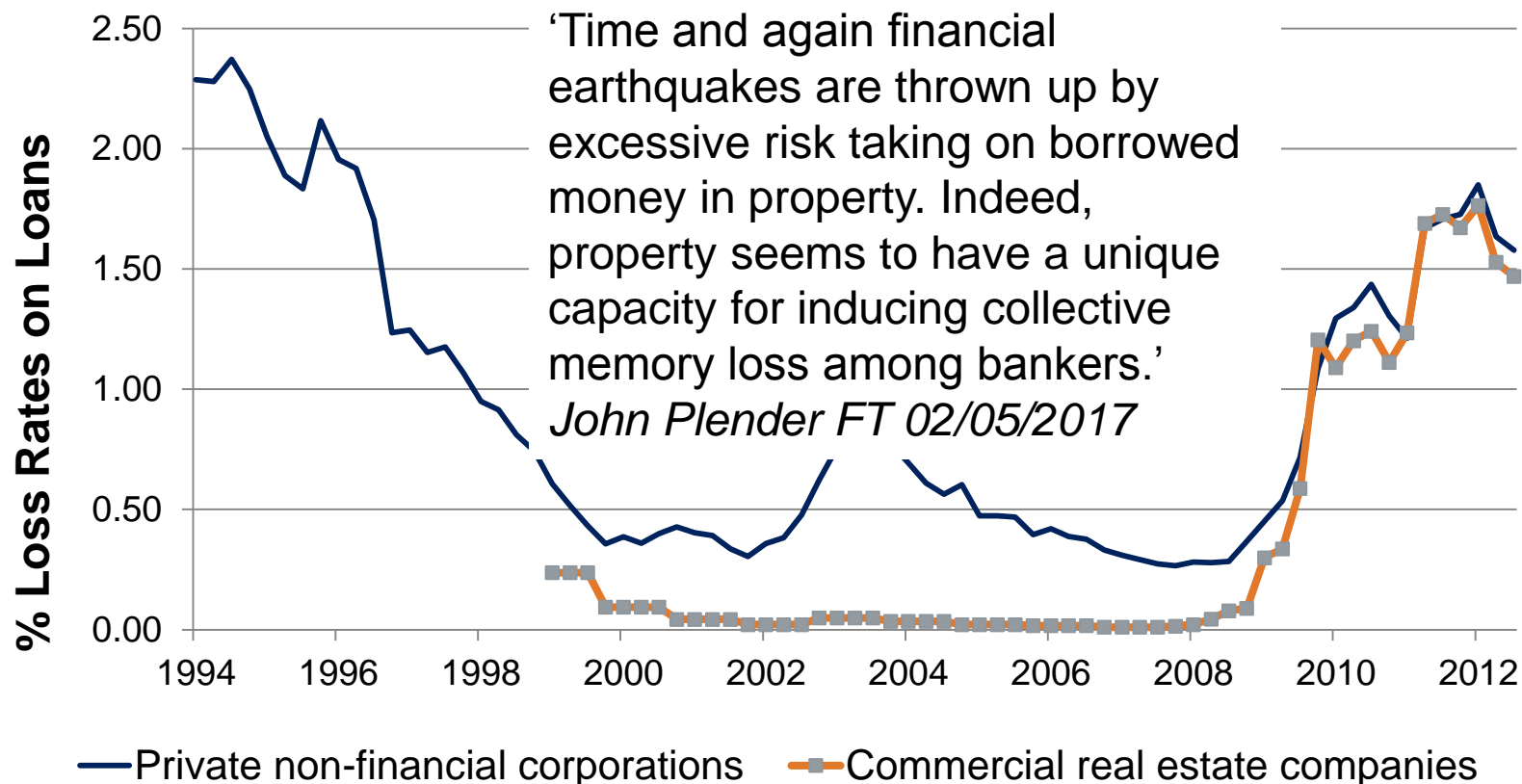


***But no accident that worst recessions usually coincide with the Busts***



# Why is CRE lending so cyclical?

## Write-off rates on lending to UK businesses

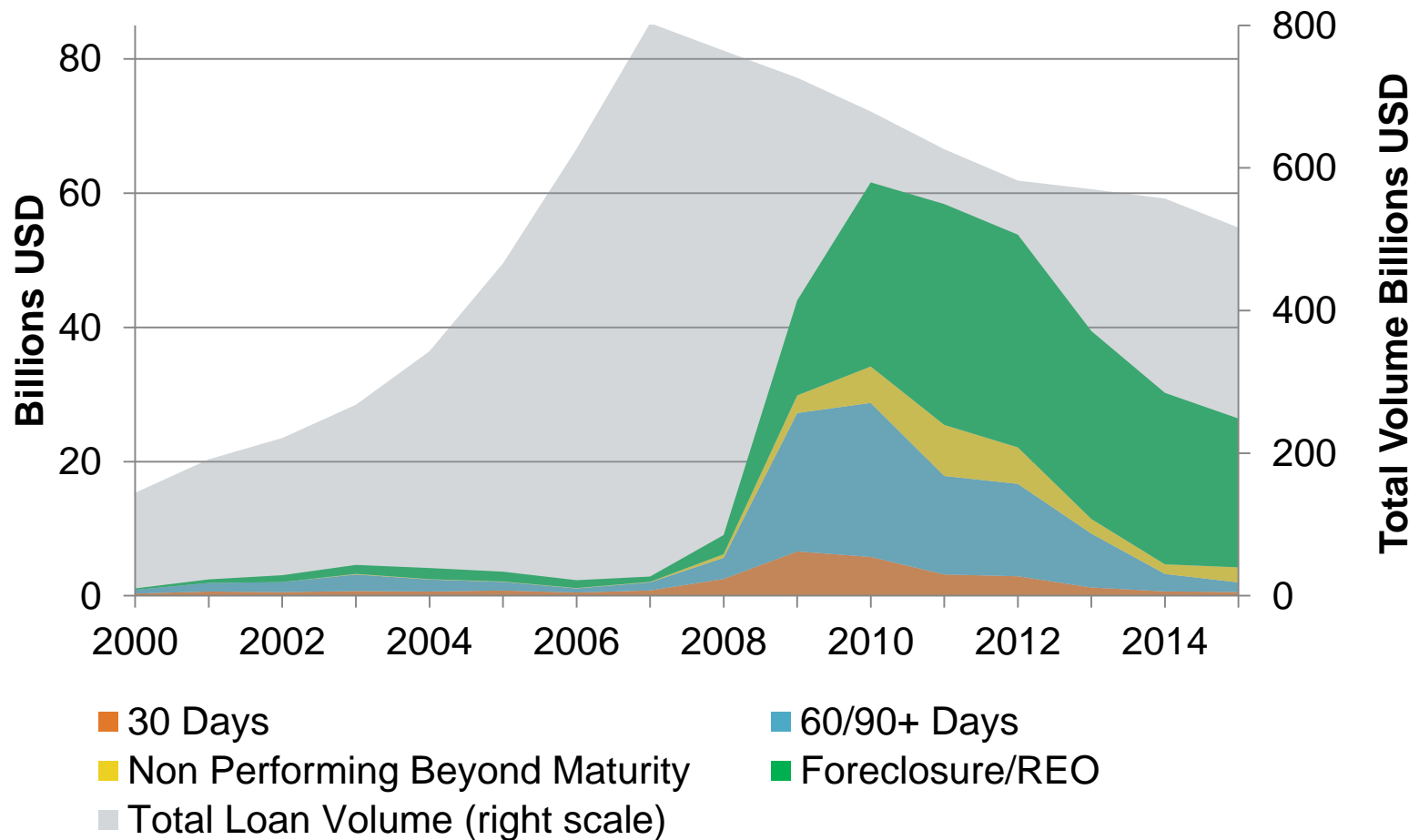


Lending by UK monetary financial institutions. The series are calculated as annualised quarterly write-offs divided by the corresponding loans outstanding at the end of the previous quarter. The data are presented as four-quarter moving averages and are non seasonally adjusted. Lending in both sterling and foreign currency, expressed in sterling terms.

Source: Bank of England and Bank calculations

# Similar data for USA show GFC explosion in Loss Ratio

## Delinquency Levels for US CMBS loans 2000-15



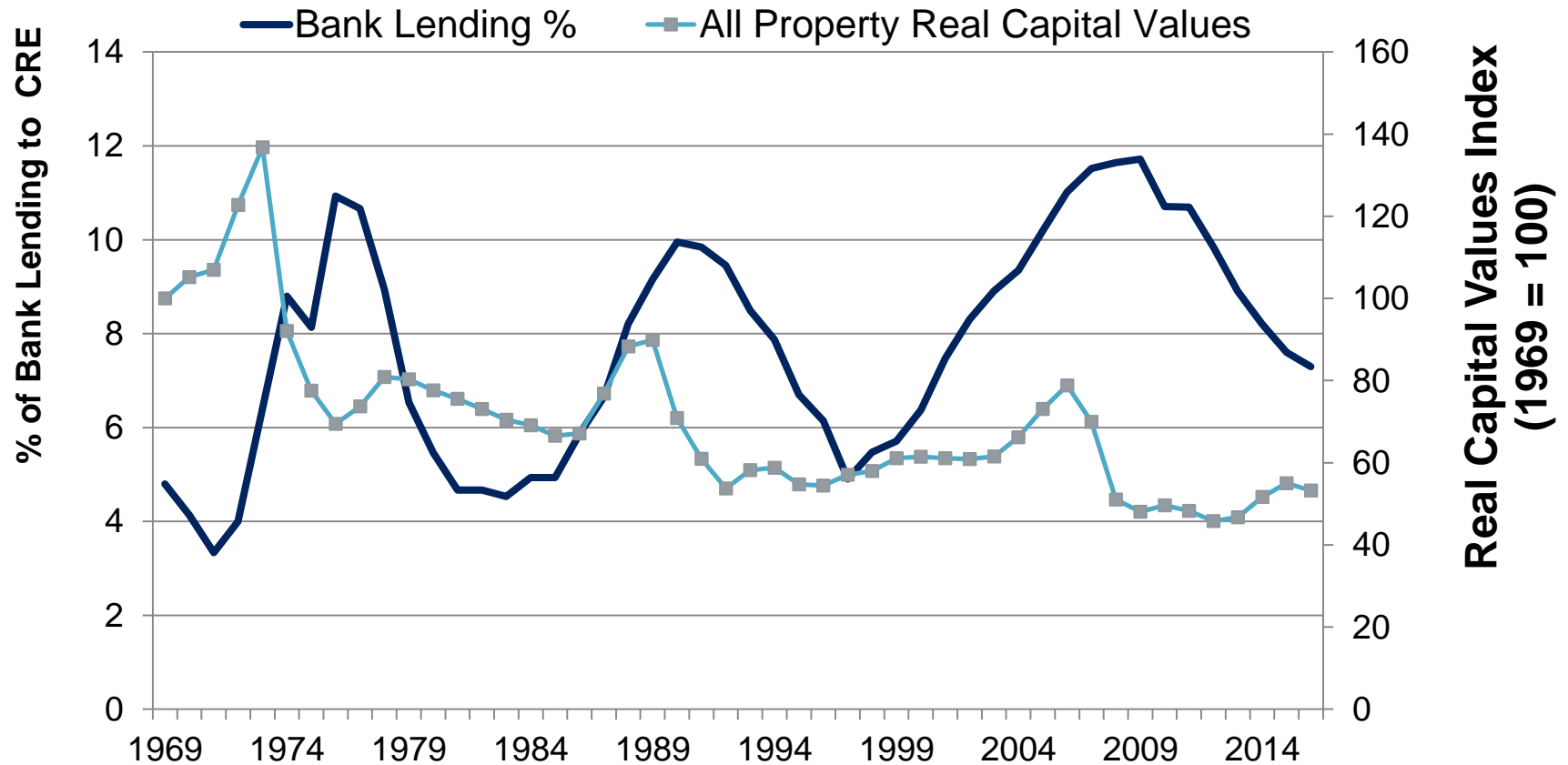
# Some lessons from three big Property Cycles

- Debt driven real estate markets are dangerous
- 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
- If commercial property values increase by over 25% real (in a 2/3 year period) - there is a very high probability of a Bust
- Ways to exploit property cycles
  - 'Catching the falling knife' - buy in the Bust to exploit the Recovery bounce
  - Long term investing between big cycles selling into the next Boom

# UK Commercial Real Estate (CRE) Lending 1969-2016

The current situation looks comfortable, i.e. mid-cycle

## Bank Lending to CRE as a % of all Lending



# So: When will the next Big Cycle occur?

*circa 2025 or some other date*

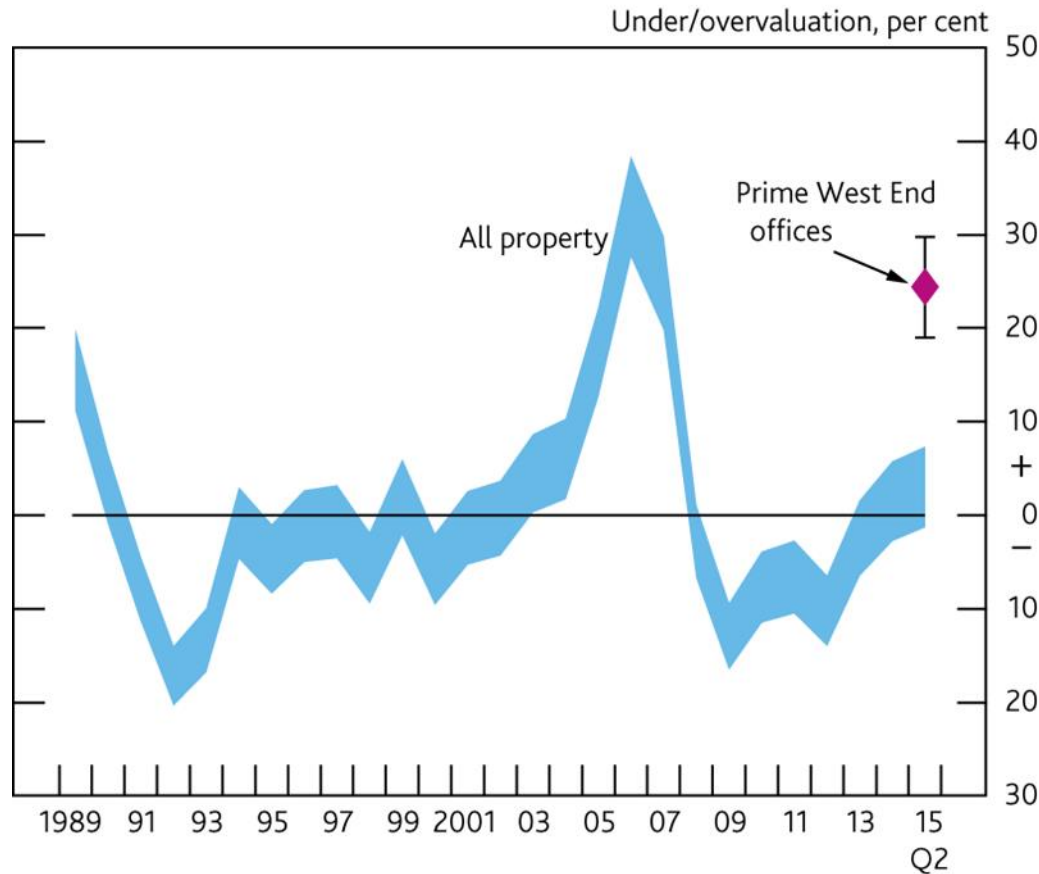
## **Pros**

- 16-18 years from 2007/8
- Time for professionals without experience of a Big Cycle to reach positions of seniority
- Debt market is attracting new players who may not have any institutional memory
- Bank of England will not be sufficiently brave to remove the punch bowl in time (as in 1986/7 and 2005/6)

## **Cons**

- The 2008/09 crash was so devastating that its effects will stay longer in corporate memories
- Better information about real estate markets will prevent a recurrence:
  - Property Vision report recommendations:
    - 'Long term' valuations
    - Loan data
- Recovery from the GFC will be so muted that there is not enough confidence to generate a Boom (cf. recovery from 1930s)
- Better education – CULS, IPF and SPR achieve their mission

# Bank of England's Investment Valuation Approach (Q2 2015)



Sources: Association of Real Estate Funds (AREF), Bloomberg, Investment Property Forum, MSCI and Bank of England calculations.

Investment valuations are based on assuming property is held for five years with the cash flows from the rent and sale discounted. It is assumed that the property is sold at a rental yield (in line with long-run averages fifteen years). The sale proceeds and rental income are discounted by the ten-year gilt yield plus a risk premium. The swathe represents varying assumptions on the average through the cycle risk premium, given the inherent uncertainty in measuring it; the lower end of the range is from a survey of investors from AREF and the higher end is a risk premium derived from the long-run relationship between gilt yields and property yields. For more details see Crosby et al. (2011),

# Nature of Property Cycles : Past, Present and Future

## Conclusions and Forecasts

- The Past: pre-2014
  - Property Cycles have a very long history
  - Four market phases – Boom, Bust, Recovery & Equilibrium
  - Key causes:
    - Combination of Economic, Debt Availability, Excess Development and ‘Memory’
- The Present: 2014-Today
  - Strong Equity Driven upswing but not a Boom
  - Market likely to remain in Equilibrium, i.e. no Bust
- The Future: The Next Decade
  - A Big Cycle around 2025 is not inevitable but .....

## Final Thoughts: Hope over Experience

“Whenever the [new cycle] starts, there will be new participants, who will be less constrained by the experience of this recession than those who lived through it. They will repeat many of the mistakes of the 1980s, as many of the companies repeated the mistakes of the 1970s. The market will then be driven to levels which will prove unsustainable.”

Ross Goobey, A (1992)



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