RESEARCH

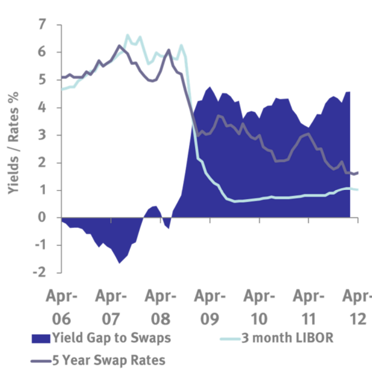
APRIL 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England left the base rate on hold at 0.5% in April and maintained the current level of QE at £325bn. The ECB also left rates unchanged at 1.0%.
- Debate is growing on the Bank of England's next move on QE, with recent improved economic indicators increasing the likelihood that the MPC will now end QE2. Much will depend on the strength of the Q1 GDP figure, which is released later this month.
- The FTSE 100, following a strong start to the year, has come under pressure in recent weeks, possibly through profit taking plus the reduced likelihood of further QE. The benchmark index has shed over 250 points since peaking in mid-March.

Economic outlook

- The third revision saw Q4 2011 UK GDP growth revised downwards to minus 0.3%. However, the debate has moved onto the Q1 2012 figures, following the OECD's forecast of a minus 0.1% contraction in Q1 – thus forming a technical recession.
- Critics, however, point to improving survey evidence, with the PMI Markit indices for all three sectors of the UK suggesting growth occurred in March. Markit suggested the economy may have seen as much as 0.5% growth in Q1.
- The latest trade figures showed the current account deficit narrowed in the final quarter of 2012. Rising exports to non-EU countries and investment income more than counterbalanced a fall in demand from the Euro zone.

Key economic indicators

	% / Value	Change
CPI **	3.4	↓
Retail sales (volumes) **	-0.8	↓
Unemployment *	8.4	→
Base Rate	0.5	→
£ : $	1.59	↑
£ : €	1.21	→
FTSE 100	5,703.8	↓

Source: NS, FT, BoE.
All figures as at 4th Apr, except * end January and ** February. Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		458 bps ↑
Risk yield gap**		463 bps ↓
Investment purchases (2012)		£6.28 bn
All Property void rate		9.9% ↑
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.1%	7.2%
Industrial	7.0%	7.9%

Source: IPD, FT, Property Data, Knight Frank Research
*5 yr Swap rates to All Property initial yield
**Gilt redemption yield to All Property equivalent yield
IPD and matching data as at end February 2012

- The IPD capital growth index continued its move into double dip, with a month-on-month figure of minus 0.3%. Retail remains the worst performer, recording a fall of minus 0.4%. According to Local Data Company the UK retail vacancy rate stands at 14.6%.
- IPD all property total returns, on a twelve month basis, are currently 7.3%, compared to 12.1% this time last year. Offices, at 8.6%, are holding up the all property figure, with retail at 6.2% and industrial at 7.1%.
- The government slimmed down planning guidance dramatically, with the new 50 page National Planning Policy Framework. Key features included a town centres first policy, and the controversial presumption in favour of sustainable development.

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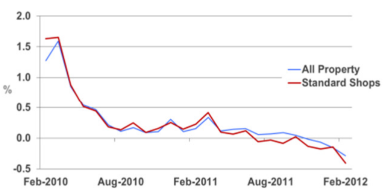
The high street soldiers on

- The Prime Minister's foreword to the government's response to the Portas review reads as inadvertently ironic. Mr Cameron pledged £12.5 m for investment in the UK's high streets via various schemes, which is a negligible sum given the scale of the problem. Local Data Company estimates that 14.6% of the 530,000 shops they monitor are vacant.

IPD month-on-month capital growth



Source: IPD

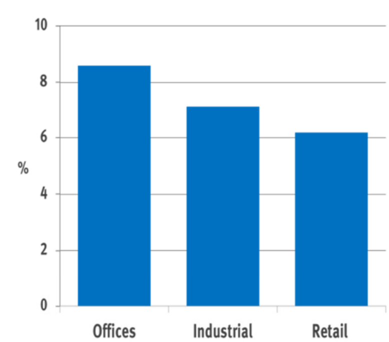
- To be fair on the government, it does not have the money for a significant investment in the high street. Recent cuts in corporation tax in the budget had to be counterbalanced by an increase in the banking levy. So the high street must be content with gestures, like a national market day, so we can have a growing corporate sector to pay the salaries that might be spent on the high street.
- 'Might' is the operative word as the alternative places to shop have the upper hand. Reversing the social and market forces that have seen consumers migrate from the high street to retail parks, mega-malls, super stores, and web sites, is clearly impossible. This is why the government was right to reject the proposal that large out-of-town development schemes be referred to the secretary of state.
- The government should not try to force people to shop on the high street, but to manage its enrolment into a 24-7 / internet driven society, which no longer requires so many shops within walking distance of home.
- Therefore, plans to make space above shops easier to convert into flats are welcome, but the government should have been gone further. Entire buildings in the low footfall peripheries of high streets should change use. Without the frequently empty units on the margins, high streets would lose some of the embattled air that boarded up windows and 'To Let' signs create.
- However, we are not supporters of the darker analysis on the outlook of high street retail. The high street will not die, as it does have a role. The supermarkets are opening 'local' or 'express' outlets, bringing footfall back to small retail parades. There is also the army of coffee shops, which continued their steady advance through the recession; plus the rise of the tanning booth / nail bar / garra fish shops.
- The credit easing plans to extend more finance to SMEs will also help the high street. Retailers were facing substantial change even without the credit crunch, but it was the turning off of the debt tap which made the situation critical.
- Our view is that the future of standard high street shops lies with specialist retail that will complement the supermarket 'local' offering. So service offerings like tanning booths, luxury / niche products one would not expect to buy in the supermarket, such as delicatessen produce, plus takeaway outlets. While sandwich and coffee shop chains will continue to expand in CBD areas.
- We would also view gaming and bookmaking outlets as also being part of the high street's future. At present some are talking of controlling this aspect of the high street, but you cannot have it both ways. Throughout history people have always found ways to gamble, and if we do not want boarded shops we need to look at what forms of distribution work on the high street.
- So Portas will probably make little significant difference to the high street's future, which will be dictated by the market. Policymakers should facilitate the changes in retailing, which are happening because consumers wish to shop in many different places.

KNIGHT FRANK COMMENTS

The global economy, Euro zone aside, appears to be moving into a new cycle. The US economy is adding jobs and delivery growth, China has successfully engineered a soft landing, and in the UK survey evidence and official figures point to growth in the services sector, which accounts for 75% of GDP. Trade figures show the UK is increasing its exposure to non-EU markets, and reducing the deficit. Also, UK corporation tax in the budget fell to an attractive 24%. Fundamentals are falling into place to achieve a sustainable export-driven recovery.

A picture is emerging of a new UK economy in the next cycle which is pro-business and export driven; away from house price and consumer booms. For commercial real estate, this favours offices and industrial – probably in that order as the UK runs a surplus in invisible exports and deficit in visibles. Retail has a tough road ahead, and Portas has not changed the outlook. But think big picture, in the future we will still shop just via a range of distribution channels.

IPD 12 month total returns



Source: IPD

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