RESEARCH

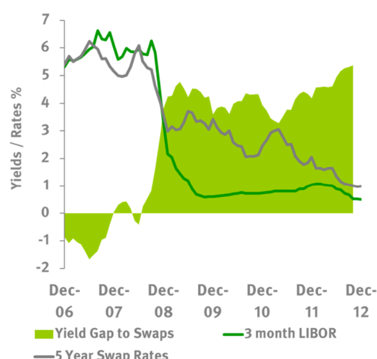
DECEMBER 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England finished the year with rates unchanged at 0.5%. While no formal QE was announced, many commentators are describing the Chancellor's acquisition of the asset purchase programme surplus as a form of QE.
- The Euro area crisis has seen an easing of pressures, as the troika approved the next tranche of Greek aid, and lifted the country's debt to GDP target. Plans for a new Euro bank regulator also won approval.
- The US Federal Reserve has pledged to hold official interest rates at historic lows until the unemployment rate drops to 6.5%, unless inflation rises above 2.5%.

Economic outlook

- The second estimate of Q3 UK GDP saw the figure left unchanged at 1.0%, defying expectations of a downwards revision to such a strong level of growth. The latest employment figures also showed the jobless rate down to 7.8%.
- The latest consensus survey of forecasts compiled by HM Treasury (November) showed analysts slightly more optimistic on near-term performance. The forecast for 2012 full year growth was minus 0.2%, up from minus 0.4% in August.
- However, the forecast figures for 2014 to 2016 are slightly more bearish, suggesting analysts are leaning towards a protracted period of slow growth.
- Interestingly, the inflation forecast has picked up, despite the cut in the growth rate, which coincides with a cut in the base rate forecasts. This suggests analysts expect central banks to target growth ahead of controlling inflation.

August consensus forecasts (%)

	2012	2013	2014	2015	2016
GDP	-0.2	1.1	1.7	2.0	2.1
CPI	2.7	2.3	2.1	2.2	2.2
RPI	3.1	2.7	2.5	2.9	3.1
Base Rate	0.5	0.5	0.7	1.4	2.0

Source: HM Treasury Consensus, November 2012

Property performance

Key performance indicators

Borrowing yield gap*		537 bps ↑
Risk yield gap**		511 bps ↓
Investment purchases 2012		£29.6 bn
All Property void rate		10.2% →
	Initial yield	**20yr average**
Retail	6.2%	6.2%
Office	6.1%	7.2%
Industrial	7.3%	7.8%

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 Oct 2012

- The IPD all property capital growth index showed a deceleration in the rate of fall, recording minus 0.3% in October, compared to minus 0.4% in September, on a month-on-month comparison.
- South East shops became the first retail sub-sector to record positive growth since the double dip began. However, the increase at 0.1% was marginal.
- Based on twelve month total returns, West End offices have been the best performing sub-sector in the year to the end of October.
- The UK investment volume for the year to date was just under £30.0 bn, which is in line with the same period in 2011, thanks to increased demand for offices.

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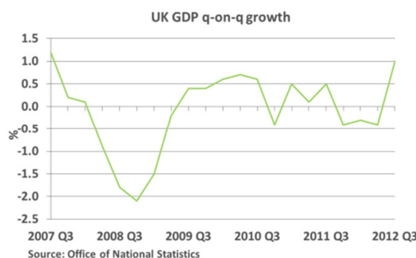
The chicken and the egg

- The Chancellor's Autumn Statement was broadly positive for commercial property. New developments gain an exemption from empty rates, and UK corporation tax will be cut to a competitive 21% by 2014. Finance will be provided for the Northern line tube extension to the Battersea Power Station site.
- This comes on top of the overhaul of the planning regulations announced in the Budget, back in the spring. So overall, 2012 has seen 11 Downing Street deliver some helpful measures for the property industry.



- However, this serves to highlight a problem with government policy on generating growth.
- When people have enough confidence in the economic outlook to develop new commercial buildings, the slimmed down planning rules, and empty rates exemption, will help build the business case. Nevertheless, the economic component remains central; people are unlikely to develop schemes because of a changed planning regime or a tax break.
- Similarly, the cut in corporation tax is an incentive for an Asian company who wants to ride a European recovery by establishing a presence in Britain rather than Germany. However, that Asian investor needs to feel that now, not later, is the time to starting investing.
- The problem for the UK is the Chancellor has delivered a series of measures that will grease a recovery which is underway. What we have not seen are the catalyst measures to get the economy moving. So effectively we have a chicken and the egg situation – we need the economy to improve before the cuts in tax and red tape start to take effect.
- So where might the catalyst for growth come from? John Maynard Keynes would have argued it should come from the Chancellor, with a stimulus package, but for political reasons that is very unlikely.
- The proposed small business bank could make some difference on the margins, but is unlikely to a have a major impact by itself. Shale gas has had a revitalising effect on the US economy, but for the UK this is distant horizon, and we have yet to establish whether the reserves are economically viable.
- On quantitative easing, the impact of QE2 has been disappointing compared to the rebound prompted by QE1. However, the Bank of England could adopt some ideas from the US Federal Reserve on QE, perhaps buying mortgage backed securities, or pegging it to unemployment or nominal GDP levels.
- The best remaining option is an outside intervention, in the form of a pick-up in world trade that brings out the advantages of the weakened Pound. We have already seen in the property market – particularly in London – the level of interest foreign money has in the UK. It is hard to envisage world trade rebounding suddenly, but there has been some encouraging news lately from the US and China. Let us hope it continues.
- Property investors should note that events abroad are increasingly dictating whether the UK economy expands. If growth must come from the outside world, then commercial property that plugs into world trade should be targeted. This favours logistics property near ports and airports, and large manufacturing hubs; and offices in centres of excellence for services. Note that the insurance district of EC3 is currently one of the bright spots in the London office market.

KNIGHT FRANK COMMENTS

Other than central London investment agents, few in the property industry will look back on 2012 with affection. A crumb of comfort is it could have been much worse; the Euro area stayed together, international property investors have compensated for the lack of domestic demand, and in the leasing market vacancy rates remain much lower than in the early 1990s recession. Moreover, 2012 was one of the CMBS expiries spike years, and while yields on secondary stock have edged up, they have not leapt upwards as occurred in 2008.

For 2013, there is little hope of a rebound, given the flat economic outlook, but there are good reasons to expect modest improvement. Compulsory enrolment will result in more money flowing into managed funds, and it would be surprising if property does not see any of this investment. Many of the systemic threats in the economy are easing, which should improve investor confidence. Also, interest rates are negative in real terms and set to stay that way. While hardly amounting to an epic improvement, we expect 2013 to better than 2012.

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