RESEARCH

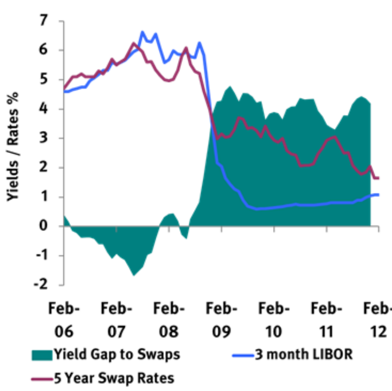
FEBRUARY 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- As was widely expected, the Bank of England's MPC sanctioned the release of a further £50 bn of Quantitative Easing. The Bank plans to widen the range of gilt maturities it will purchase, perhaps reflecting a constrained market for 10 to 15 year bonds.
- UK 10 year gilt yields are just under 2.2%. This is slightly up on earlier this year, when anticipation of QE and the situation in Europe briefly pushed them sub-2%. Even with the uptick, gilt yields are still very low by historic standards.
- The FTSE 100 has gradually edged upwards in recent weeks, perhaps in anticipation of QE pushing investors towards risk.

Economic outlook

- The first estimate of UK GDP showed the economy had contracted marginally, by 0.2%. Manufacturing, energy supply, and mineral extraction were the main drags on performance.
- However, the PMI indices for UK services and manufacturing suggest the economy has seen improvement in January; with both sectors recording increased activity.
- Inflation fell to 3.6% on the CPI measure, as the effect of the VAT increase in January of last year dropped out of the figures. Further near-term falls are expected due to lower energy costs.
- CPI inflation is still significantly above target at a time when a large amount of QE is being released into the economy, creating long-term inflationary risks.

Key economic indicators

	% / Value	Change
CPI **	3.6	↓
Retail sales (volumes) #	-0.4	↓
Unemployment *	8.4	↑
Base Rate	0.5	→
£ : $	1.58	↑
£ : €	1.19	→
FTSE 100	5,905.7	↑

- Source: NS, FT, BoE.
- All figures as at 13 Feb, except * end November, # end of December, and ** January. Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		418 bps ↓
Risk yield gap**		475 bps ↑
Investment purchases (2012)		£1.97 bn
All Property void rate		9.7% ↑
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.0%	7.3%
Industrial	7.1%	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 December 2011

- The IPD Capital Growth index recorded its second month-on-month decline, falling by 0.07% in December. The decline was due to falls for retail and industrial stock, as offices remained just about positive, with 0.06% growth.
- The offices capital growth index is relying heavily on central London offices for support, and we expect all three property sectors to be declining in value on the IPD measure by the spring.
- The declines we are seeing are marginal, and within the basket of IPD buildings there will be considerable differences in performance depending on the quality and geographic location of the asset.

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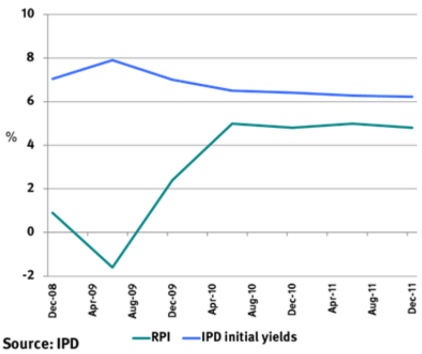
The printing presses roll (again)

- The first phase of Quantitative Easing began in March 2009, when the UK was completing its fourth calendar quarter of recession. The government was intervening to save banks, and deflation had commenced on the RPI measure. QE1 smacked of defibrillator shocking the economy back to life.

RPI inflation vs IPD initial yields



Source: IPD

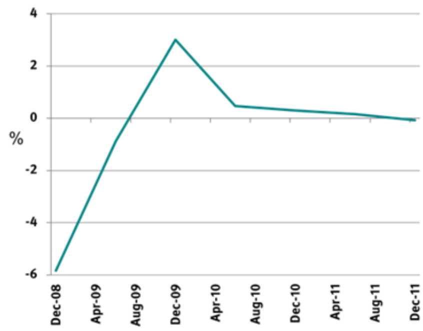
- We are currently five months into the second phase of QE; with £75 bn already released and a further £50 bn on the launch pad. Yet, opinion is divided on whether we will actually see a technical recession this time around – the CBI says no.
- There is clearly uncertainty in the banking world again, and credit availability is tightening. However, the Greek crisis is hardly comparable to the financial meltdown of late 2008 / early 2009. The gap between the base rate and three month Libor was 100 to 140 basis points in March 2009, it is under 60 points today.
- Inflation is falling, but at 3.9% RPI / 3.6% CPI it is hardly low – the equivalent figures in March 2009 were -0.4% RPI / 2.9% CPI – and in the long-term we expect a revival in inflationary pressures.
- The argument runs that the Bank of England is this time acting pre-emptively. However, the PMI Markit surveys point to a growing service sector, while December's trade figures showed rising exports. The risk is that the MPC are tackling a crisis that passed its peak in October / November.
- What will all this mean for commercial property? The safer areas of the market will be in demand as investors seek steady income, i.e. prime city centre offices, central London, M4 corridor, dominant regional shopping malls, and modern South East industrial.
- QE will keep Sterling at its comparatively low levels, thus drawing in foreign investment. It should also keep gilt yields low making property attractive. We see this drawing more pension fund interest towards property – a sector that may play a bigger role in the coming years, given the approaching surge of retirements.
- However, more foreign money does not bode well for IRR buyers hoping to deploy funds in early 2012. Pricing should push them towards secondary, but many would want evidence of a new economic cycle before buying lesser quality stock, which is normally a recovery play.
- So what are the chances of seeing that new economic cycle for secondary to ride in 2012 – perhaps initiated by the QE money? Initial economic indicators for 2012 have been better than the gloom-mongers led us to expect, but not to the point one would recommend entering the riskier parts of the property market just yet. This is particularly the case for secondary that is bordering on tertiary. The slow year continues.

KNIGHT FRANK COMMENTS

The economy and the property market have entered a period where speaking in generality is dangerous. The official statistics have the economy shrinking in Q4, but a range of indicators suggest stirrings of life from mid-Q4. This makes reading too much into the disappointing GDP figures an overreaction. Reading too much into superficial bad news is equally unwise in regard to property. On the face of it the IPD figures recorded a second month of falling capital values (on the volatile monthly measure), although as the graph left shows, the decline is marginal. Bargain hunters will struggle to persuade those holding prime assets to slash asking prices.

The poor economic indicators partly reflect structural changes in UK PLC – the decline of North Sea oil, for instance. This is why a contraction in national GDP has coincided with relatively upbeat figures for the service sector. Property has a similar mismatch between the headline figures and micro-market performance. There is little doubt a fundamental resizing of the high street is occurring, for instance, which is impacting the headline IPD numbers. Yet commercial property plugged into the more buoyant parts of the service sector – upmarket retail, or offices in districts popular with new tech firms – faces a very different outlook. The opportunities are in the detail.

IPD one month capital growth



Source: IPD