RESEARCH

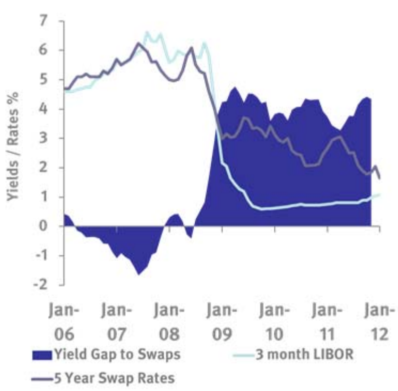
JANUARY 2012
UK MARKET OUTLOOK

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 January and maintained the current level of QE at £275bn, although more QE is expected in the coming months.
- In the Eurozone meanwhile, the ECB's provision of €489bn of cheap three-year loans to Eurozone banks seems to have averted a short term credit crunch and resulted in key interbank lending rates falling to a 9-month low in early January.
- However, the potential for sovereign default in the Eurozone remains. Indeed, last week saw S&P cut the AAA credit ratings of nine countries in the Euro area. These included France, a significant contributor to the European Financial Stability Fund.

Economic outlook

- A year ago the GDP forecasts for 2012 looked much brighter, but the latest consensus has now fallen to just 0.6%, with more bearish predictions suggesting an outright contraction in the economy.
- However, recent economic data has been mixed, with weaker figures on unemployment and manufacturing, whilst the trade and inflation figures improved.
- Christmas retail trading could have been worse, although sales were heavily driven by discounting. As the adage goes, "turnover is vanity, profit is sanity" and more retailer casualties are expected in 2012.

Key economic indicators

	% / Value	Change
CPI **	4.8	↓
Retail sales (volumes) **	0.7	↑
Unemployment *	8.3	↑
Base Rate	0.5	→
£ : $	1.52	↓
£ : €	1.21	↑
FTSE 100	5,636.6	↓

- Source: NS, FT, BoE.
- All figures as at 13th Jan, except * end October and ** November. Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		434 bps ↓
Risk yield gap**		450 bps ↑
Investment purchases (2011)		£31.4 bn
of which, from UK institutions		27.7%
All Property void rate		9.6% ↓
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.0%	7.3%
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 November 2011

- The IPD Capital Growth index for November showed just a 0.25% rise over the year, meaning that commercial property values were broadly flat in 2011.
- With yield compression all but over for now, income will be the key driver of returns in 2012. However, whilst prime yields should remain relatively stable, rising secondary yields turned the capital growth index negative in November.
- Property investment volumes amounted to £31.4bn in 2011, down 8% on 2010, indicative of increasing investor caution on the outlook for the economy, the continuing lack of debt, and a shortage of prime assets for sale.

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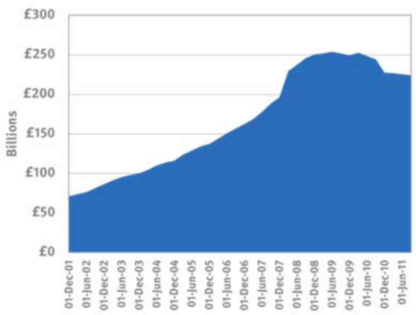
The Columbo market

- Unique among the genre of TV detective programmes is the 1970s series, Columbo. Unlike the standard murder mystery, the viewer discovers at the very beginning how the crime was committed and by whom – the mystery is in how Detective Columbo is going to solve the crime. Much the same is true of the market for secondary and tertiary property assets today.

UK Bank Loans to Real Estate Companies



Source: Bank of England

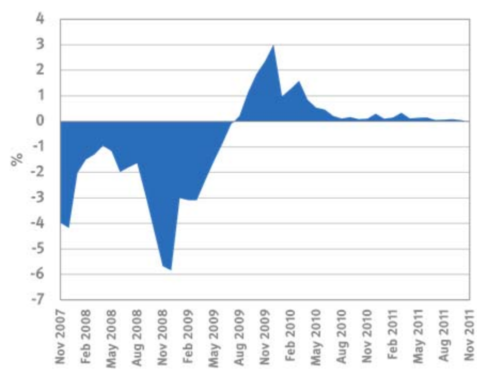
- It is common knowledge that a very large number of assets (although no-one has an up-to-date figure on how many) are with the banks, or eventually will be. Also, there was a spike in CMBS issuance in 2006-2007, suggesting a rise in maturities in 2012, which common sense dictates will add to the stock of distressed assets. This has made investors nervous of entering the market for lesser quality property, and the economic slowdown is pushing back further the day when confidence may be restored.
- However, issuing a prognosis on the impact of debt work out on the property market is dangerous territory for a real estate analyst. A fire sale of distressed assets has been predicted every year since 2008, and so far it has failed to occur.
- That the economy is struggling and the debt markets are freezing up again perhaps supports a prediction of 'this year it will finally happen'. Yet, in early 2009 the last rites were being read on property only for the patient to climb out of his death bed a few months later.
- So the existence of the problem is known, but like the viewer watching Columbo, what we do not know is how the mystery will be solved, i.e. how will the bank stock be returned to the market without causing an oversupply.
- It is fair to assume a mix of drip feed sales, asset management, and kick the can down the road, will be involved. However, a lack of hard facts on the balance between the three component parts heightens the uncertainty.
- However, arguably, our approach of becoming more nervous about recovery stock when the economy and property market become frosty is disingenuous.
- The banks and NAMA embarked on scaling the corporate recovery mountain when the property world was at its darkest, and underwritten by national governments. The assumption back then was it would be a long-haul not fire sale.
- Consequently, it is rebounds like the one we saw in 2010 that are more likely to encourage the bankers to step up sales; more bad news will push them towards asset management and kick-the-can.
- The corporate recovery shadow will hang over the market for some time – this will be a very long process. However, like people who live on the San Andreas Fault in Detective Columbo's California, property investors need to develop a Gallic shrug to the corporate recovery stock, not don the tin foil hat.
- To avoid the secondary market for years to come would be to surrender opportunities to competitors, particularly regarding well located assets. Poor asset selection is a greater threat to an investor than bank stock, and sensible asset management can mitigate other risks.

KNIGHT FRANK COMMENTS

A new year begins and the market is viewing 2012 with trepidation; and rightly so. The IPD capital growth index dipped slightly into negative territory at the end of last year, and it will certainly go further into the red this year, weighed by the troubles of retailers and a shrinking manufacturing sector. This will revive talk of a repetition of the double-dip for capital values that occurred during the 1994-1996 period, although similarities are relatively superficial.

In June 1993 the IPD capital growth index turned positive, then moved into a double-dip 14 months later. From August 2009 the IPD index stayed positive for 26 months. The IPD portfolio has seen values hold up better this time around thanks to pockets of good news, such as central London offices and shops, and steady demand for prime, particularly big shopping centres. The debt freeze remains, but this bad news is priced in, and relative to other assets pricing appears reasonable. A tough start to the year is inevitable, but there will be opportunities for those who do not judge all of 2012 based on a gloomy January.

IPD Capital Growth Index – month-on-month



Source: IPD

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