RESEARCH

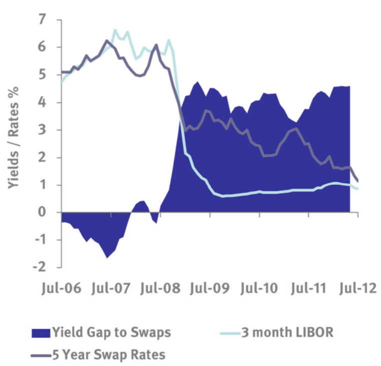
JULY 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Early July saw a flurry of activity by central banks, with rate cuts in the Euro area, China and Denmark, and more QE for the UK. The Bank of England, increased its asset purchase programme by £50 bn to £375 bn.
- Interestingly, while the ECB reduced is deposit rate to zero, the Danish central bank reduced its equivalent to minus 0.2%. So banks will receive no interest if they place money with the ECB, or pay to hold funds at the Danish National Bank.
- Consequently, we may be moving into a new phase of the credit crunch where central banks begin taking action to compel banks to lend. In contrast to the recent anti-risk taking rhetoric, it appears too much caution is being viewed as the main threat to the global economy.

Economic outlook

- The third revision confirmed Q1 2012 UK GDP contracted by minus 0.3%. The dilemma for the UK is that Sterling has strengthened in 2012, which has brought inflation under control, but also hit exports, and in turn dampened growth.
- A problem facing the UK is that in the past financial services funnelled work to the associated business services sector. While there are signs of progress in shifting the UK away from finance, it is not apparent that new industries are providing new work to business services at the rate finance did pre-recession.
- Both official and business survey data suggest that the manufacturing and construction sectors have contracted in recent months, and services industries achieved little or no growth. On a positive note unemployment continues to fall.

Key economic indicators

	% / Value	Change
CPI *	2.8	↓
Retail sales (volumes) *	1.4	↑
Unemployment *	8.2	↓
Base Rate	0.5	→
£ : $	1.57	→
£ : €	1.27	↑
FTSE 100	5,664.5	→

Source: NS, FT, BoE.
All figures as at 11th Jun, except * end May.
Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		460 bps ↑
Risk yield gap**		517 bps ↑
Investment purchases (2012)		£16.3 bn
All Property void rate		10.4% →
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.1%	7.2%
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 May 2012

- The IPD capital growth index fell by 0.5% month-on-month, due to a sharp fall for retail property. All three sectors are now experiencing falling values, with retail the worst performer (-0.75%) and offices holding up the best (-0.26%).
- The deterioration for capital values took retail total returns into negative territory for the first time since 2009. The retail total return index fell by -0.23% month-on-month. Offices and industrial total returns, however, remained in positive territory.
- There was a 7% quarter-on-quarter increase in UK investment transactions in Q2 to £8.0 bn. Volumes were also up 14% on Q2 2011. Demand was supported by an increase in office deals, which compensated for declining volumes for retail and industrial stock.

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Britzerland?

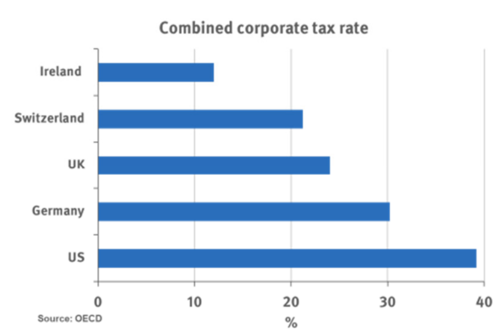
- Growing in popularity among commentators is the idea of 'Britzerland'. Just as Switzerland sits out the wars and chaos that periodically tear Europe asunder, so is true of London which is held to be similarly removed from the economic problems availing the rest of the UK.

- To some extent this is the media playing catch-up on what the property industry has known for fifteen years. Frankfurt never came close to overtaking London as Europe's main financial market place. Most of the US tech firms who opened offices in Dublin opened London ones as well. Even those London firms who shifted their headquarters abroad often only sent a brass plate overseas; as shown by the many Lloyds insurers who are listed in Bermuda but operate in the City.
- London has displayed a surprising resilience in the face of the double dip recession, as evidenced by the growth of the technology and media cluster in the Northern City. Skype recently acquired 88,000 sq ft at 2 Waterhouse Square, and take-up of City office space by TMT firms doubled in the first half of this year.
- The City office market is also benefiting from insurance firm requirements, reminding us that the square mile does not just consist of banks and brokers.
- This is no reason for complacency. In 2008, the London office market responded quickly and negatively to the big bank failures of that year. Rather than being a safe haven from distress, London is very plugged in to the global economy, and if a crisis reaches systemic level the capital will feel the pain. That was the experience of 2008.
- It is also true that London rebounded sooner and faster than most other property markets in 2009 and 2010. This is the phenomenon that pundits are alluding to with 'Britzerland'. Yet, the cautious investor knows that 2008 had to be survived in order reach 2009. In 2012 there is an on-going European sovereign debt crisis, and it would be foolish to think we can overlook the present crisis by declaring London immune. On the Euro crisis it is fairer to say London is closer to being a spectator, whereas in 2008 it was centre stage.
- The idea that 'Britzerland' and the rest of the UK are disconnected also needs challenging. Some City law firms now operate what is known as a 'Mexican wave' system, whereby jobs are won by rainmakers in London, then passed to junior solicitors in regional offices. Other London industries also plug in to the regions – insurers with back offices along the M4 for instance.
- We are starting to see a similar working arrangement appear among some technology firms, although sometimes with Dublin at the other end of the 'Mexican wave'. This is a concern for UK PLC, as it risks undermining the development of tech hubs elsewhere in the UK. Moreover, the recent fall in value of the Euro versus Sterling could encourage more London firms to look at a Dublin back office.
- Rather than a new Switzerland, we believe a better analogy for London would be 'New Hong Kong'. London acts as an 'on ramp' for the UK economy to access the global economy, and vice versa; which is similar to the relationship between Hong Kong and China.
- There is, however, the danger the rest of the UK fails to spot this; with lower corporation tax luring tech jobs to Dublin for instance. The emerging trend is that foreign firms are prepared to pay more tax to be in London, but when it comes to the wider UK, the tax issue looms larger in decision makers' thinking.

KNIGHT FRANK COMMENTS

The Olympics is almost upon us and London, which normally attracts far more of the world's attention than other UK regions, is going to move even further to the front. The capital's strengths as business location are well known, and the logic for investing there remains compelling, but this should not blind us to opportunities elsewhere. The South East boasts four major airports, scientific centres of excellence at Cambridge and Oxford, and the logistics hub at Heathrow. The regional city centres offer many of the same occupiers – PwC, Ernst & Young, HSBC – as London.

One consequence of the Euro zone crisis though is that the UK must consider the appeal of Dublin. In many ways London and Dublin are building a complimentary relationship, with many of the same occupiers taking office space, just for different parts of the business. Policymakers need to consider that this could be at the expense of the UK regions. Tax is a big issue.



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