RESEARCH

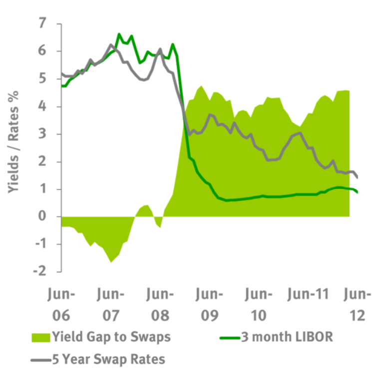
JUNE 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Spain will formally request a bailout to support its banking sector once an independent audit has been completed, although it is not yet clear as to which fund the money will come from and what the terms will be.
- Global stock markets initially reacted positively to the news, although many of the early gains were pared back by the lack of detail on the bail out and Spanish bonds spiked as high as 7.0%.
- Cyprus also looks set to request a bail out before the end of June and, now that Spain has decided to seek assistance, attention is expected to focus on Italy - whose bond yields also remain under upwards pressure.

Economic outlook

- Despite concerns that the initial Q1 GDP estimate was out of line with a number of more positive surveys, the second estimate was actually revised down to -0.3% from -0.2% - thereby confirming that the UK is back in recession. While service sector output was flat, manufacturing and construction have been weak.
- The latest consensus forecasts from HM Treasury (May) are more pessimistic about the outlook for GDP, with growth for 2012 and 2013 expected to come in at just 0.3% and 1.8% respectively.
- There are a number of relative bright spots in the economy, however. Unemployment has continued to stabilise at 8.2% and inflation is back on a downwards trend, with CPI falling to 3% in April. Business investment – which will be key to driving the recovery – amounted to £30.8bn in Q1, the highest quarterly figure since Q1 2009 and a rise of 14.2% year-on-year.

May consensus forecasts (%)

	2012	2013	2014	2015	2016
GDP	0.3	1.8	2.2	2.5	2.4
CPI	2.8	2.1	2.3	2.3	2.4
RPI	3.2	2.6	3.4	3.7	3.9
Base Rate	0.5	0.7	1.4	2.3	3.2

Source: HM Treasury Consensus, May 2012

Property performance

Key performance indicators

Borrowing yield gap*		458 bps ↓
Risk yield gap**		459 bps ↑
Investment purchases 2012		£12.3 bn
All Property void rate		10.4% ↑
	Initial yield	**20yr average**
Retail	6.0%	6.3%
Office	6.0%	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 April 2012

- The IPD April digest recorded a sixth consecutive monthly fall in capital values (- 0.3%). As in March, Retail showed the sharpest fall (-0.4%), followed by Industrial (-0.26%). The rate of decline capital values for Offices accelerated to -0.23%, as a result of weakness in markets outside London.
- The latest IPF forecasts (May) meanwhile showed a further decline in total return expectations for 2012, with the consensus falling from 1.6% to 1.4% at the All Property level. This is based on continued expectations of falling capital values and a reduction in income returns. The forecast for rental growth has also weakened marginally to -0.9%.
- For 2013, a further marginal fall in capital values is expected, with rental growth just about in positive territory.

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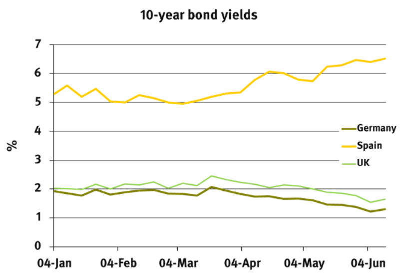
The Euro zone crisis

- Today the Euro crisis has become the overarching influence on the business world, to the point that discussing anything else is effectively ducking the point. So what are the forward scenarios for UK commercial property?



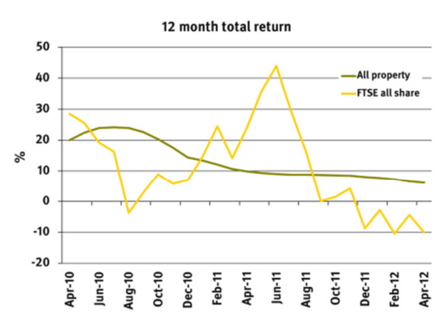
Source: Financial Times

- There has been much talk of the importance of achieving a 'managed' rather than a 'messy' exit for Greece in the event of it leaving the Euro. We believe the Grexit debate is a Trojan horse. Any exit scenario is pre-destined to be presented as 'messy' by pundits and the media, prompting more speculation on which nation may leave next.
- Given the high level of associated risks in the above scenario, we doubt if it will come to this. If Greece is to leave the Euro it would need to be at a time when there is a low risk of another nation being dragged out with it.
- That said, it is surprising in retrospect that Lehman Brothers was allowed to collapse, but it was, and Europe's politicians may similarly miscalculate the systemic risks. If the Greek election delivers an anti-bail out government there may be little choice.
- In a 'messy' scenario, events following the Lehman collapse offer our best historic precedent on what comes next for property. IPD capital values dropped 26% between September 2008 and July 2009 when the market finally found the floor.
- However, to attribute all of that fall in value to the Lehman collapse would be incorrect. Commercial property was already experiencing a sharp correction prior to September 2008; the Lehman collapse just greased the slide.
- Values for prime, and good quality secondary assets in London and the South East, are stable at present, and owners would be more likely to sit out any Euro storm than sell in our view.
- This is because investors would view the Grexit as 'a storm', i.e. something that will blow over. In 2008 the UK was in the thick of the crisis, whereas on this occasion it is on the margins. In fact, the London market has benefited from refugee money from the continent lately.
- In the medium-term we may also see a recovery where UK commercial property benefits from a perception among foreign investors that the Euro Area is too focussed on its internal squabbles to provide a business friendly investment environment.
- We see the Euro zone crisis as exaggerating previous trends in the market. Demand for high street retail in towns with high unemployment was cool before the crisis, but now this section of the market is in deep winter. Mayfair property remains in demand, and will probably only experience a quiet period in the event of a Grexit.
- Where the crisis is having the most impact is in demand for lesser quality secondary assets. Buyers were tentatively starting to re-enter this market a year ago, but now activity is thin and restricted to safer locations. Critically this means we are back to a market where the buyer has to almost guess the value now there is so little transaction evidence to benchmark against.
- This makes buying lesser quality secondary outside of favoured markets, like London, a higher risk option than a year ago; and across the economy investors are avoiding risk. For the harder to value assets, the turning point is disappearing further over the horizon.

KNIGHT FRANK COMMENTS

Commenting on the market just days before the Greek election is problematic. Someone reading this a week from now may be living in a world where the economic landscape has undergone an earthquake-like change. Overlooked at the moment is the possibility that change can be for the better rather than the worse. Governments and central banks may have to action before investors once again have a 'glass half full' view of the world.

The Euro crisis has exaggerated on-going trends in the UK property market. Good quality stock still trades. Poor quality stock is firmly out of favour, and the definition of what constitutes 'poor' is expanding. Nevertheless, the darkest hour is often before the dawn. Leasing availability has not spiralled upwards to the levels some predicted back in 2008, and investment deals are still happening. When no deals happen, that is the time to really worry.



Source: IPD