RESEARCH

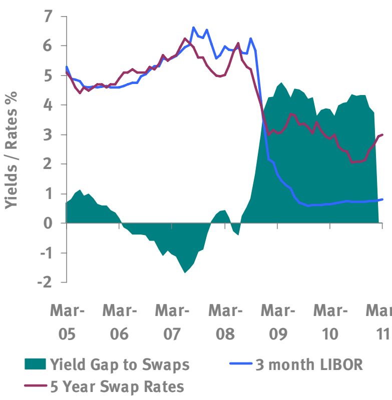
MARCH 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- While the base rate remained on hold in March, the continued rise in inflation – which is certain to increase further on higher fuel costs – is prompting discussion on when the Bank of England will begin tightening policy.
- Mixed signals from the economy suggest there is limited scope for a sharp increase in the base rate. However, three MPC members voted to increase rates in February, suggesting at least a token 25 bp rise is drawing closer.
- Key OPEC nations have now upped production in response to high crude oil prices. Concern is growing that high energy prices could slow the global economic recovery.

Economic outlook

- The revised Q4 GDP figures suggested a worse than expected finish to last year, with the economy contracting by 0.6%, not 0.5% as previously thought.
- The latest Markit PMI index suggests the key Services sector is expanding again, but not adding jobs. This has been the case for some time, and bodes ill on redeploying public sector redundancies.
- Given the wintery backdrop, consensus forecasts for the UK economy make encouraging reading. See table below.
- However, the 'consensus' is an amalgam of very different views. The analysts have polarised into bulls and bears.
- On a positive note, the UK saw an improvement in its net trade position in January, as the effects of the cheap pound filter through. This is encouraging given exports will be key to the UK's recovery.

February consensus forecasts

	2011	2012	2013	2014	2015
GDP	1.7	2.1	2.5	2.5	2.5
CPI	3.6	1.8	2.0	2.0	2.0
RPI	4.2	2.9	3.0	3.0	2.8
Base Rate	0.6	1.4	2.7	3.4	3.7

Source: HM Treasury Consensus, February 2011

Property performance

Key performance indicators

Borrowing yield gap*		374 bps ↓
Risk yield gap**		314 bps ↓
Investment purchases (2011)		£5.19 bn
of which, from UK institutions		23.3%
All Property void rate		9.8% →
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.3%	7.3%
Industrial	7.2%	8.0%

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 January 2011

- Capital growth remains just about in positive territory, with a 0.1% month-on-month increase in the IPD all property index in January.
- The rental growth index dipped slightly back into negative territory, with further declines for Retail and Industrial outweighing continued growth for Offices.
- The IPD indicators suggest a flat market, with little momentum either upwards or downwards.
- According to Property Data, Shopping Centres have recorded a strong level of transaction volume in recent months. Over £1.8 bn in stock has traded so far this year, compared to £536 m for Q1 2010.

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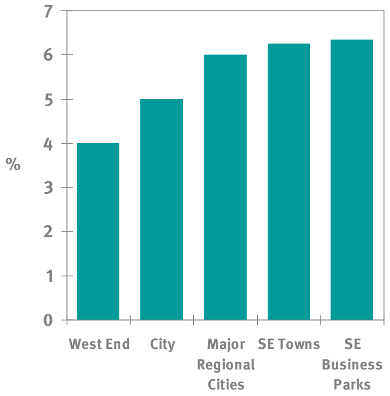
The World beyond London

- A recurring theme in this note has been the disparity between the performance of London's property market and the rest of the UK. In recent months commentators have begun to query whether the gap is deserved.

Prime Office Investment Yields

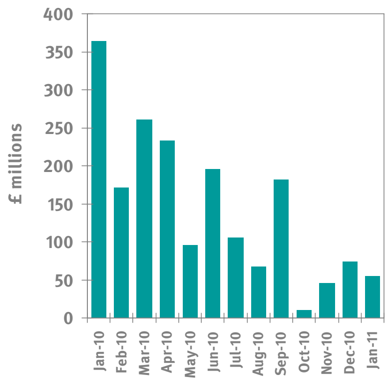


Source: Knight Frank

- To date, the statistics back the bias to the capital – no other office occupier market can point to such robust rental growth. While West End retail seems oblivious to the fact the economy is struggling.
- However, statistics tell us where we have been, not where we are going. The gap between Central London prime yields and those available elsewhere appear on the face of it attractively wide.
- Appearances can be deceptive though. West End prime office yields are 4.00%, but that refers to freeholds in Mayfair and St James's – a small and very exclusive part of the market. Higher yields are available in the West End. A half share in the long leasehold on Google's HQ in Victoria sold at nearly 6.00% recently, reflecting the tenure and out-of-core location.
- London's investment rebound has been largely driven by foreign money. Some foreign buyers are now looking at the South East market, but others seem content to buy secondary or development sites in London – preferring to go up the risk curve in the capital.
- To drive a sustainable recovery, the Regions need to see a significant return of investment from the UK institutions and prop cos. In this respect we have seen mixed messages. Fund industry figures show net inflows into UK property funds, but at low levels. Some property companies are bargain hunting, with Shopping Centres an area of interest.
- These are tentative stirrings, not the blast of the start whistle. The key missing ingredient is some punchy news on the UK economy. Eyes will now turn to the Chancellor's budget for growth.
- Talk of enterprise zones and less red tape are encouraging, but these would deliver upside later rather than sooner. Tax cuts or breaks would be welcome, but the Chancellor has little room for manoeuvre in that regard.
- Consequently, for the UK regions there is upside ahead, but it will be a long march back, not a rebound.

Property Fund Investment

Net Retail Sales for UK Property Funds



Source: Investment Management Association ©

- Recent figures from the Investment Management Association show a pick-up in retail sales for UK property funds in December and January, after having dropped off significantly in October.
- The recovery is a positive sign, but it is worth noting that compared to the rebound recorded a year ago, the recent increase appears subdued.
- The figures suggest that investment from the UK funds is not about to rebound suddenly. But given the challenging economic backdrop, at least we are not seeing redemptions.

KNIGHT FRANK COMMENTS

Property market indictors are mostly moving sideways at the moment. Still, better sideways than downwards.

The market always used to thunder one way or the other – reaching for the sky in 2005-2006, plunging to earth in 2008-2009. Yet lately we see gradual change – hence the statistics flattening out. This probably reflects the banks drip feeding stock back to the market, plus a general reluctance to sell by those holding prime. For now, it is difficult to see what will change this situation. Some better economic news would help though.