RESEARCH

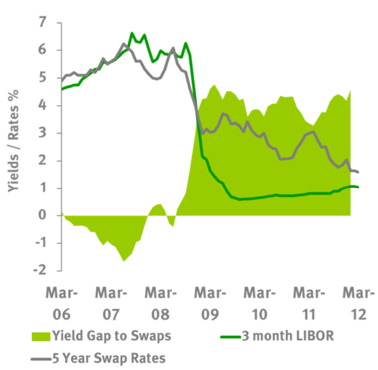
MARCH 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Greece cleared the final hurdle to its second bail out after 95% of private bond holders approved a swap deal involving a substantial write down in value.
- UK gilt yields ticked upwards, partly reflecting the ebbing of concerns on a Greek default. Moreover, better than expected economic indicators have reduced the likelihood of further QE.
- According to Dealogic, 2012 has seen a surge in junk bond issuance, responding to investor demand for high yielding securities.
- The FTSE 100 has been clinging to the 5,900 mark in recent weeks, perhaps suggesting that equity investors view recent better economic news as now priced in.

Economic outlook

- The latest consensus of UK GDP forecasts (see table below) indicates expectations for 2012 remain remarkably bearish. Growth of just 0.5% is expected this year, but with a rebound in 2013 predicted. On a more encouraging note, the consensus for inflation is to fall to just 2% next year.
- Nevertheless, the forecasts are notoriously volatile, and we believe the recent improvement in indicators has not yet filtered through to the consensus. The UK PMI indices so far for 2012 point to growth for services and manufacturing.
- Certainly, news like Porsche announcing a 22% profit increase and 18% rise in sales is not consistent with an economic slowdown. Yes, it is a German company, but Porsche is a global trader and one would not expect a luxury carmaker to be doing so well if the economy was as embattled as some would claim. Coincidentally, UK car exports increased markedly in January.

February consensus forecasts (%)

	2012	2013	2014	2015	2016
GDP	0.5	1.8	2.2	2.4	2.3
CPI	2.6	2.0	2.1	2.2	2.3
RPI	3.2	2.6	2.9	3.3	3.7
Base Rate	0.5	0.8	1.4	2.3	3.2

Source: HM Treasury Consensus, Feb 2011

Property performance

Key performance indicators

Borrowing yield gap*		457 bps ↑
Risk yield gap**		479 bps ↑
Investment purchases 2012		£4.57 bn
All Property void rate		9.8% ↑
	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 January 2012

- The IPD all property capital growth index fell for a third consecutive month on the volatile month-on-month measure. This suggests the long-anticipated double-dip for capital values has finally arrived, but so far is following a shallow trajectory.
- However, a shallow dip can turn into a steep decline with remarkable speed, and recent distress in the retail industry will probably exert downwards pressure on the IPD index in the coming months.
- The remarkably long gap between the present dip and that of 2008-2009 is worth noting – some commentators were predicting the second dip to commence last summer. In part, this reflects the severity of the first dip, which bodes well for a shallow second dip, as considerable downside is already priced in.

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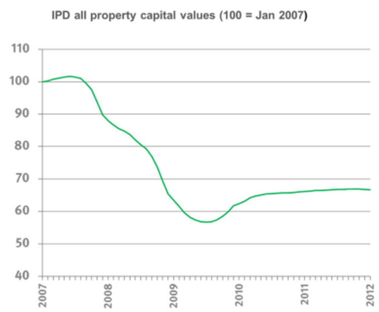
A game of two halves

- July 1994: Brazil won the FIFA World Cup, Tony Blair became Labour Party leader, and Wet Wet Wet were number one with "Love is all around". However, in the property world love was thin on the ground as capital values moved into a double dip that would last for 2 years. With the IPD index recording its third month of minute decline, the historic comparison with the mid-1990s is worth considering.



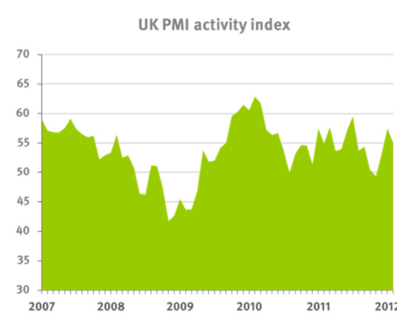
Source: IPD

- Peak to trough, the 1994 to 1996 double-dip saw the all property capital value index fall by 6%. Offices in the City of London led the market into downturn, as IPD values had peaked in April 1994 then fell by 8.5%. Offices in the neighbouring West End saw the shallowest downturn – dropping by just 0.7% in value, so more of a paddle than a dip.
- Central London retail only recorded the odd month of falling values, and largely defied the downswing with a 13% increase in its capital value index between July 1994 and July 1996. The all retail warehouses index fell by just 1.7% from peak to trough. Regional shops took a bigger hit, falling by nearly 5.8%.
- The historical similarity between the current double dip and 1994-1996 in our view will be superficial. Central London retail may well defy gravity as in the mid-1990s, but it would be very surprising if secondary regional retail did not face a tougher double dip this time around. Average pay is increasing at 2% per annum when inflation is 3.6%, highlighting the squeeze on consumer incomes.
- In contrast, City offices have already defied the historic record. In January the City was the only sub-sector to record an increase in its IPD capital value, although the rise was minute.
- The City will probably join the general IPD slide in the coming months, but in contrast to 1994-1996 we believe the decline will be far less than the all property index. Leasing availability is 14% lower today, and there is the potential upside from the growing tech cluster in the northern City.
- We expect the present double-dip for property to reflect changes within the UK economy. The pre-2007 reliance on the consumer to drive the economy was unsustainable, and we will not shop our way out of recession as in the 1990s. This counts against secondary retail.
- A sustainable economic recovery involves reweighting towards trade and export-led employment. This primarily means office-based knowledge industries, where the UK has comparative advantage and a trade surplus in invisible exports. This favours offices.
- There will also be upside for prime logistics, partly through improvement for the manufacturing sector and the rise of internet commerce.
- So 1994-96 in our view is of limited value in judging the year ahead, given the very different economic challenges facing UK PLC compared to the mid-90s. Different sectors of the economy will lead the recovery, and the relevant property sectors will be in demand.
- However, the one similarity with the mid-1990s will be the disparities between different sub-sectors – some hard hit, and others riding the waves.
- Recent years have seen remarkable contrasts in performance, and let us not forget the late 2009 rebound (largely driven by central London) took the market completely by surprise. Like the 1994 World Cup final, which went to penalties, the final score for commercial property in 2012 is hard to guess. The economic news is gradually improving, which could change the direction of the game.

KNIGHT FRANK COMMENTS

Currently the economic news and property indicators have parted company. Survey evidence, like the PMI Markit indices, point to improvement in the UK private sector economy since November, while the situation in the Euro zone appears to have stabilised (let us hope this lasts). In contrast, the IPD capital growth index has turned negative, and property market sentiment is more bearish than a year ago – but, interestingly, not as bearish as before Christmas.

Property is a lagging indicator; the global economic recovery will need to notch up some more miles before it reaches UK real estate. This is especially true for poorer quality stock and those regions that have historically been dogged by high unemployment. Our view is the darkest hour for the economy has passed, with stirrings of a new cycle appearing in the private sector. However, remember the time-lag – the good news will take time to reach commercial property.



Source: Markit

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