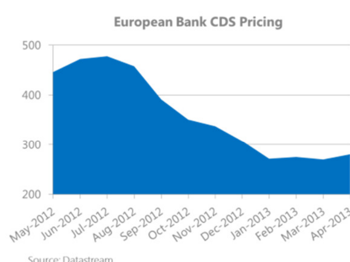
RESEARCH

Knight Frank

MAY 2013
UK MARKET OUTLOOK
Commercial property review
Knight Frank

Financial indicators



- The Bank of England left the UK base rate unchanged at 0.5% in May, a move that puts it at odds of with many other central banks around the world. This month has seen interest rate cuts in Australia, the Euro area, India and South Korea.
- UK 10 year Gilt yields have softened moving above the 1.7% mark, possibly reflecting the better-than-expected Q1 GDP figures. Nevertheless, yields are still lower than back in January when they were trading above 2.0%, and remain negative in real terms.
- Pricing of credit default swaps on European bank debt edged up marginally in April (see graph above), but is still down dramatically in comparison to last year. In early May, Portugal returned to the bond markets with its first issue since seeking a bail out – a further sign of normalisation in the Euro area.

Economic outlook

- The UK has avoided a triple dip recession, with the first estimate of Q1 GDP reported as 0.3%. The figures benefited from growth in services and a rebound for North Sea oil and gas production. This compensated for weak construction and manufacturing output.
- The PMI index for UK services rose further in April, reaching 52.9, up from 52.4 in March. A reading of above 50 indicates growth. The manufacturing index came in just short of expansion at 49.8, suggesting the economy is struggling to rebalance.
- The number of company insolvencies in the UK fell during Q1 2013. The first three months of this year saw 3,619 company liquidations; down 5.3% quarter-on-quarter, and 15.8% below the level seen in the equivalent quarter of 2012.

Key economic indicators

	% / Value	Change
CPI *	2.8	→
Retail sales (volumes) *	-0.5	↓
Unemployment **	7.9	↑
Base Rate	0.5	→
£ : $	1.55	↑
£ : €	1.18	↑
FTSE 100	6,557.3	↑

Source: NS, FT, BoE.
All figures as at 7th May, except * end Mar. ** end Feb. Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		526 bps ↑
Risk yield gap**		506 bps ↑
Investment purchases (2013)		£11.39 bn
All Property void rate		12.2% ↑
	Initial yield	20yr average
Retail	6.2%	6.2%
Office	5.9%	7.1%
Industrial	7.3%	7.8%

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 March 2013

- The IPD capital growth index is seeing a deceleration in the rate of decline. The index fell by 0.19% month-on-month in March, compared to minus 0.54% back in November. The rate of decline has been least for industrial (minus 0.07%) and greatest for retail (minus 0.29%).
- While the IPD rental growth index for retail continued to fall, the equivalent industrial index appears to be bumping along the bottom – alternating between growth and contraction. The office rental growth index has continued to grow marginally for the last eleven months.
- Total investment in UK commercial property has been £11.4 bn year to date, compared to £10.3 bn, for the same period of 2012, according to Property Data. Stronger sales for leisure property and shopping centres buoyed the figures.

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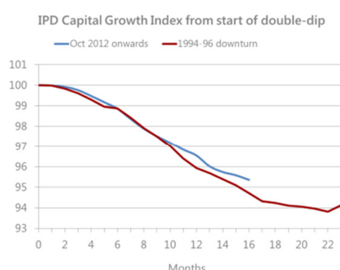
Light at the end of the tunnel

- During the opening phase of the current double-dip for commercial property, capital values closely tracked the double-dip that occurred in 1994-1996. However, in recent months the similarity has broken down – see graph below. This double-dip may now prove to be shallower than that of the mid-1990s.

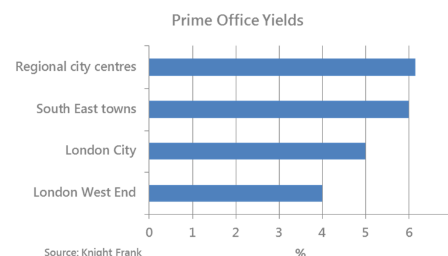


- While the IPD all property capital growth index is still falling, the rate of decline has slowed markedly. In the second half of last year the fall (month-on-month) for the all property index averaged minus 0.4% a month. This year, it has been minus 0.2%.
- Our forecast is that around September or October the index will turn positive again – having fallen around 5.5%, rather than the 6.0% drop seen in the mid-1990s double-dip.
- A slow recovery thereafter is expected, not a rebound, as there are more corporate recovery sales to come; and while debt may be slightly more available, it is still thin on the ground.
- Nevertheless, overseas investors have squeezed many UK institutions out of the central London market. With interest rates negative in real terms, and compulsory pension enrolment being launched, the UK funds could find themselves under pressure to deploy money later in the year, with the regions offering the higher yields they typically seek. This should help spread the recovery broadly across the country.
- While we are now confident to predict a time when the recovery may move from its present London-bias to a national phenomenon, we still see growth as remaining patchy across the sectors.
- Retail will in our view be the last of the main property sectors to exit the downturn, as it is addressing structural not just cyclical problems. We see retail as best suited in the next cycle to those prepared to actively and imaginatively manage the asset, possibly as part of a mixed use strategy, incorporating leisure and hotels.
- In contrast offices we see leading the upswing. For the last twenty years they have been the focus of gloomy predictions that the internet and homeworking would reduce the need for office space. However, there is clear evidence that the opposite has occurred.
- This year we have seen Yahoo's CEO ban homeworking, and Google has purchased a site to develop an 800,000 sq ft campus in London (nearly a 60% increase in floor space on its current office occupation). The online world has created a wave of programmer and developer jobs that did not exist twenty years ago, which are mostly office-based.
- We believe that later this year the property market will move into a period of recovery and geographic broadening for investment activity. However, disparities will exist between sectors, which will be greatest at the sub-sector level.

Knight Frank Comments

The UK economy has dodged the bullet of the triple-dip recession, and some commentators are even debating whether future data revisions will erode the double-dip. In the property world, the double dip for pricing is losing momentum, and some sub-sectors never even saw values fall. Fairly soon we will be writing about "the downturn" in the past tense, but this is not the time to become bullish. There are several factors that will lead to a slow recovery, such as the debt legacy, structural change in retail, and a sluggish global economy.

For property investors it is tempting to approach the early cycle defensively, favouring safe assets, but prime (thanks to a lot of foreign investment) looks expensive, particularly in the capital. Higher yields mean taking on more risk, seeking the pockets of opportunity in the regions, and selecting properties with asset management opportunities. If the recovery is to be a slow one, assets with potential to generate uplift are an opportunity worth exploring.



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