RESEARCH

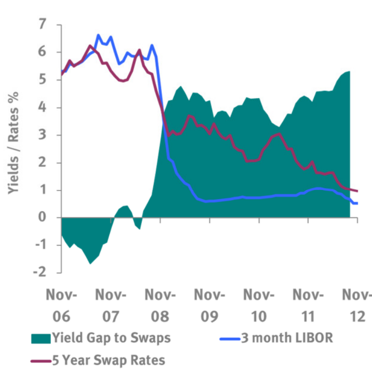
NOVEMBER 2012 UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England left the base rate on hold at its November meeting, and announced no further increase in the asset purchase (QE) programme. Better economic news and a rise in inflation probably deterred policymakers from introducing more stimulus.
- Following the late summer rally, the last month has seen global equity markets retreat. This reflects growing concerns over the US fiscal cliff, as well a renewed focus on the Greek debt crisis.
- Nevertheless, the Pound appears to have stabilised against the Euro, possibly reflecting less flight capital from the Euro area since the ECB pledge to intervene in bond markets if necessary.

Economic outlook

- The first estimate of UK GDP came in surprisingly strong at 1.0% for Q3, which may suggest future downward revisions will occur as more data comes in. The figures were boosted by the inclusion of the Olympics ticket sales.
- During a recent press conference, Mervyn King, the Governor of the Bank of England warned the economy may dip back into negative territory in Q4, as the international economy remains weak.
- Unemployment fell again in September to 7.8%, although the decline owed much to people joining government training schemes. Again this may reflect a fading of the Olympics economic boost.
- Inflation increased in October to 2.7% on the CPI measure, and 3.2% on the RPI index. This reduces the near-term likelihood of more Quantitative Easing, pending further data on GDP.

Key economic indicators

	% / Value	m-on-m Change
CPI **	2.7	↑
Retail sales (vols) *	0.6	↑
Unemployment *	7.8	↓
Base Rate	0.5	→
£ : $	1.59	↓
£ : €	1.25	→
FTSE 100	5,767	↓

Source: ONS, FT, BoE. All figures as at 13 Nov, except *Sept and ** Oct. Currencies are the spot rate.

Property performance

Key performance indicators

Borrowing yield gap*		531 bps ↑
Risk yield gap**		525 bps ↓
Investment purchases (2012)		£27.37 bn
All Property void rate		10.2% →
	Initial yield	**20yr average**
Retail	6.2%	6.3%
Office	6.0%	7.2%
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 September 2012

- IPD all property initial yields stood at 6.4% and equivalent yields at 7.4% at the end of September. This is substantially higher than the 10 year gilt yield at 1.7% at the end of September.
- Investment transactions in the first nine months of this year totalled £24.3 bn, which is similar to the £24.9 bn for the equivalent period of 2011, according to Property Data. However, whereas 2011 started strong then progressively weakened, in 2012 we have seen a gradual improvement in activity.
- Offices have accounted for 47% of deals this year by volume, up from 39% in 2011.
- The October transaction volume figures bode well for the Q4 outcome, as £2.5 bn worth of deals transacted, a significant improvement on the October 2011 figure of £1.4 bn.

Commercial Research
James Roberts Head of Commercial Research
+44 (0)20 7861 1239
James.roberts@knightfrank.com

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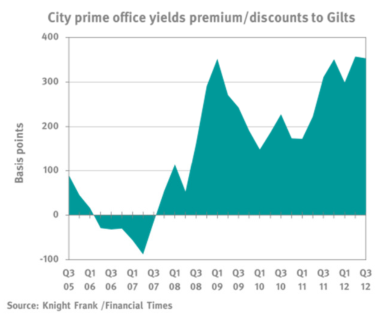
Property's risk premium

- It is easy with the power of hindsight to look back on 2006-2007, and wonder how the industry missed warning signs that a storm was coming. The warning signs were missed because the world looked different back then. The danger is we are today missing signals of another turning point.



- If one looks at government bonds for triple A nations, or the double A nations that command confidence, one is confronted by yields where 3.0% is considered high. Some of the safest nations, like Switzerland are around the 0.5% mark. This is significant if we benchmark against property yields.
- Some commentators say West End office prices are now back to pre-credit crunch levels because yields are at 4.0%, but this is incorrect. Back in 2006, West End office yields were 4.0%, but Gilt yields were 4.8% - 80 bps below the safe haven of government debt. Today, West End offices offer 230 bps over Gilts. By this comparison, at a time rents appear to be growing again, pricing appears sound.
- If one then looks at regional prime offices (6.0%-6.5%), or prime distribution warehouses (6.75%-7.0%), then the risk premium grows considerably.
- Arguably there is the security of income argument to justify pricing. However, as the chart shows, the spread between City of London office yields and Gilts is as wide now as in the aftermath of the Lehman collapse. Are the chances of the typical City office tenant going bust as great now as in early 2009? This seems like a significant overestimation of the risks landlords in the City face today.
- The criticism of the above argument is it relies heavily on London offices, one of the few commercial property markets in the world that is operating in relatively normal conditions. Moreover, it overlooks structural problems in certain markets, particularly standard retail.
- Nevertheless, and setting standard retail aside as special case (with the near certainty of January insolvencies), the current double-dip for commercial property is proving a tamer correction than 2008-2009, and closer in severity to 1994-1996.
- If we look at the underlying occupier market, the void rate for the IPD portfolio peaked in June at 10.7%, falling to 10.2% by September. This confirms we have seen less occupier distress in 2012 than in 2009, when the void rate reached 12.6%.
- The volume of property that has probably gone into work out this year, or will next year, justifies continued investor caution towards secondary and tertiary. Yet for prime, yields seem to be offering a risk premium so generous one has to wonder if we are currently in an anti-bubble; investors choose to hold cash in circumstances that call for taking a risk.
- Given the gloomy economic backdrop, we doubt if this situation will change suddenly. However, investment history is full of years where people look back and say, "I wish I'd bought then". Roll on 2013?

KNIGHT FRANK COMMENTS

Over the course of this year pricing for commercial property has steadily fallen outside of London, reflecting the gloomy economic news, and matching our general expectation 2012 would be a poor year. It is interesting that the transaction volume benchmarks well against last year, suggesting there is demand for long let property, with its bond-like steady income, and yields markedly higher than the safe haven of government debt. Leasing market indicators have held up reasonably well in the face of the double-dip recession, justifying the confidence of those who have invested.

However, with prime currently offering such high yields, there is remarkably little pressure on investors to branch into secondary. Until there is evidence of a sustained economic recovery, it is hard to see that situation changing suddenly. Nevertheless, the average yields reported by IPD are at a level where one wonders whether the threats justify eschewing such high returns. Any investment involves taking on some risk, and most commercial properties are let to tenants who will still be trading and paying their rent this time next year. The UK is not in the same boat as Greece or Spain and too often today UK property is being benchmarked against worst case scenarios.