

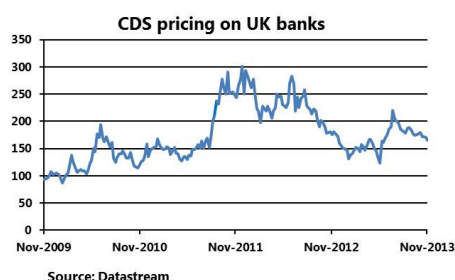
# NOVEMBER 2013

## UK MARKET OUTLOOK

Commercial property review

**Knight Frank**

### Financial indicators



- October saw a rally for equities, with the FTSE 100 rising by 4.2% during the month. This reflected further evidence of economic recovery, both in the UK and abroad, and the end to the US government shutdown. The S&P 500 US equity index rose by 4.5% during October.
- Ten year Gilt yields fell sharply during the US government shutdown, then rose after a budget deal was agreed. They currently stand at 2.72%. Of late, Gilt yield movements appear as much dictated by the level of US Treasury yields as by domestic factors.
- The price of credit default swaps on UK banks continued to slide, having peaked in late June – see graph above. Over the same period there has been a similar fall for CDS pricing for European and US banks. This suggests returning confidence in the stability of the banking sector.

### Economic outlook

- The first reading of Q3 UK GDP came in as expected at 0.8%, marking a third consecutive quarter of growth. As in the previous quarter, expansion was recorded in all the main industry sectors, pointing to a broad-based recovery. The strongest growth came from construction.
- Further good news came from the PMI index for UK services which hit a 16 year high in October of 62.5 – a reading of over 50 points to growth. The index was buoyed by rising levels of employment and new business.
- Inflation appears to have stabilised at 2.7%, which is inside the Bank of England's 1-3% band. This will reduce pressure on the Bank to raise the base rate for now. However, inflation remains well above the rate of pay growth.

#### Key economic indicators

	% / Value	Change
CPI **	2.7	→
Retail sales (volumes) **	2.2	↑
Unemployment *	7.7	→
Base Rate	0.5	→
£ : \$	1.61	↑
£ : €	1.19	↑
FTSE 100	6,741.7	↑

Source: ONS, FT, BoE.

All figures as at 6<sup>th</sup> November, except \* end August and \*\* end of September. Currencies are the spot rate. FTSE is the index value.

### Property performance

#### Key performance indicators

Borrowing yield gap*		437 bps ↓
Risk yield gap**		418 bps ↓
Investment purchases (2013)		£33.71 bn
All Property void rate		10.9% ↓
	Initial yield	20yr average
Retail	6.2%	6.2%
Office	5.8%	7.0%
Industrial	7.2%	7.7%

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 2013

- The IPD all property capital growth index rose by 0.60% month-on-month, its strongest rate of expansion since April 2010. This marks the fifth month in a row of rising capital values.
- Offices continue to lead the recovery with the sector's capital growth index recording an increase of 1.03%, followed by industrial at 0.72%. Retail saw its second consecutive month of capital growth – up 0.28% month-on-month.
- Year-to-date the UK investment transaction volume stands at £33.7 bn, according to Property Data, which is greater than the full year total for 2012. The figures have benefited from increased volumes for shopping centres, industrial and leisure property.

#### Commercial Research

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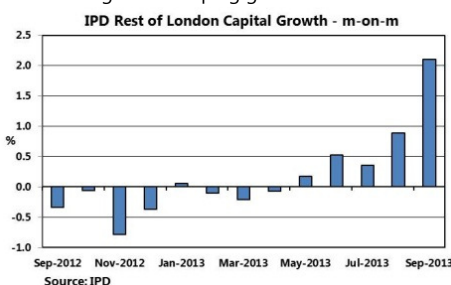
# OCTOBER 2013 UK MARKET OUTLOOK

Commercial property review



## The sleeping giant stirs

- September delivered an upbeat set of IPD capital growth figures, with the star performance coming from what IPD describe as the 'Rest of London', i.e. outside of the central London. This recorded a hefty 2.1% month-on-month increase, the strongest rise seen by this market in 19 years. Are these the first stirrings of a sleeping giant?



- The first instinct on seeing such a punchy number is to view it as a spike in the figures. There will be an element of this, but the previous month's increase was 0.9%, which suggests building momentum.
  - Also, Knight Frank's own research coverage of the M25 and M4 office market (which has a significant overlap with IPD's Rest of London) points to a market on a rising tide. The investment transaction volume in Q1-3
- was up by a hefty 72% compared to the same period of 2012.
  - Places like Hammersmith, Chiswick, and Heathrow are perennial locations in the UK economy. With extensive motorway connections, the world's largest airport, and lots of blue chip tenants, it would be odd if these districts did not sit high on buyers' shopping lists.
  - However, we would argue that changes occurring both within London, and comparable cities abroad such as New York, suggest investors may wish to cast their net wider in the Rest of London, not just along the M4.
  - In New York we have been seeing growing popularity for offices outside the traditional office districts, with more interest in Midtown South (which contains places like Greenwich Village and Tribeca) and Brooklyn. This move towards edgier locations reflects the rise in new start-up businesses, and enthusiasm for offices near to where many of the twenty-somethings in New York live.
  - Similarly in London, the popularity of Shoreditch is well known, and rent inflation looks set to displace start-ups into

surrounding Brooklyn-type areas – the E1 postcode, Camden, Hoxton and Hackney. Like New York, this is where many young professionals live. Ironically they are probably the off-spring of the early-1980s yuppies that popularised Battersea and Lambeth.

- Moreover, it is not just the jeans and t-shirt brigade looking into London's 'emerging markets'. Pre-let deals by the US and Dutch embassies at Nine Elms have prompted talk of a new diplomatic quarter for London.
- This coincides with pre-letting success at King's Cross Central, demonstrating demand for big floor plate office campus accommodation in an urban setting. This bodes well for future schemes at Battersea Power Station, Stratford, White City, and Wood Wharf.
- Like Hong Kong and Singapore, London combines a fast growing economy and limited geographic area. This problem went on a back burner during the recession. The new economic cycle will revive the need to accommodate future growth, and bring forward schemes in London's Brooklyn equivalents. The sleeping giant of Greater London is stirring.

## Knight Frank Research Comments

What a difference three consecutive quarters of GDP growth makes. A year ago the Investment Property Forum consensus of industry forecasts showed analysts expected a fall in capital values this year, now the opposite outcome appears certain. Commercial property investors have been quick to respond, and have displayed greater flexibility than expected. International buyers, who it was widely assumed would only be London-focussed, have quickly moved on prime regional stock. Investors need to look widely for opportunities in this context.

For the new cycle, property investors need to consider the huge changes which have occurred in how people interact with property. Shoppers now see retail as a mix of online and real estate. Working from home never took off, but break-out areas and cafes in the office have flourished. Young professionals want work and home to be nearby, and they often prefer the edgy part of town. This will open up new property markets, often in locations previously seen as fringe.

