RESEARCH

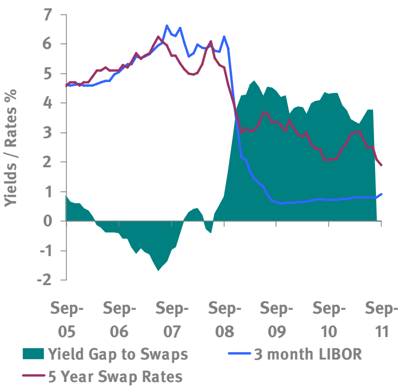
SEPTEMBER 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The base rate remained unchanged for yet another month, and market commentators have been speculating on whether the Bank of England will extend the QE programme.
- The last month has seen a flight of money to safe havens, as concerns grow on the impact of on-going sovereign debt crises on the balance sheets of certain Eurozone banks.
- The Swiss National Bank has declared a ceiling for the Franc, following an influx of money seeking a safe haven.
- Equity markets have tumbled, with the FTSE 100 Index dropping by 7.2% in August. However, the Summer is traditionally a 'soft' period for financial markets.

Economic outlook

- The August Markit PMI indices showed a deceleration in the rate of growth for services, manufacturing, and construction. This is just one month's figures, but they have fuelled concerns that the economy has experienced a marked slowdown in Q3.
- The Treasury's quarterly survey of City Analysts' forecasts for the UK economy reported a cut in expected growth this year to 1.2%, down from 1.5% back in May.
- The consensus forecast for 2012 was also down, to 2.0% versus 2.2% in the last survey.
- On a more positive note, unemployment at 7.9% is little changed on the start of the year. Analysts expected unemployment to increase significantly this year.
- Moreover, the UK workforce saw a 125,000 net increase in jobs in the first half of 2011.

August consensus forecasts (%)

	2011	2012	2013	2014	2015
GDP	1.2	2.2	2.3	2.3	2.3
CPI	4.4	2.6	2.0	2.01	2.1
RPI	5.1	3.4	3.1	3.3	3.2
Base Rate	0.6	1.0	1.8	2.8	3.6

Source: HM Treasury Consensus, Aug 2011

Property performance

Key performance indicators

Borrowing yield gap*		376 bps ↓
Risk yield gap**		368 bps ↑
Investment purchases (2011)		£19.9 bn
of which, from UK institutions		28.2%
All Property void rate		9.5% ↓
	Initial yield	20yr average
Retail	6.0%	6.3%
Office	6.2%	7.3%
Industrial	7.1%	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 July 2011

- The IPD Capital Growth index in July slowed sharply on a month-on-month basis, from 0.15% to 0.06%. Offices continued to grow, counterbalancing falling values for retail and logistics.
- Interestingly, on the three-month measure capital growth for offices increased for a fourth consecutive month.
- The Rental Growth index also points to growing momentum for offices. On the three month measure offices were up to 0.72% having dropped to half this level earlier in the year.
- This confirms that there is growing disparity between offices and the other two sectors.

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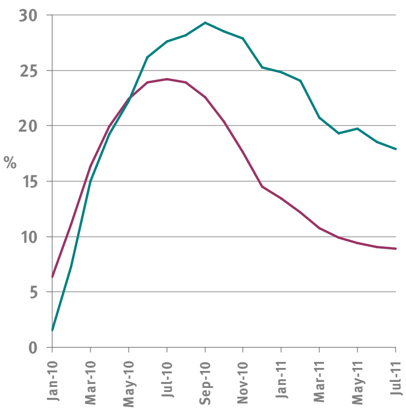
Time for Plan B?

- Earlier in the year the property market dared to hope it was through the downturn. Property, it was assumed, would benefit from a recovering global economy, with expanding companies buoying leasing market demand.

All Property 12 month Total Return vs City Offices

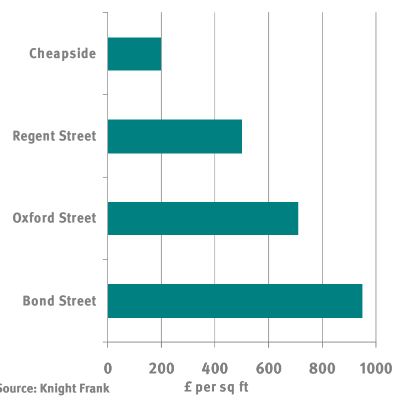


Source: IPD

- However, as the Summer draws to a close, the global economic recovery looks stalled, while central banks and governments appear wrong footed and buffeted by events.
- If riding on the coat-tails of a global economic recovery was property's 'plan A', then it is time to look at a 'plan B'. What would this consist of?
- For tertiary stock, and lower quality or poorly located secondary, economic recovery held out the prospect of rising demand for development sites. Outside of the capital, this seems a very distant prospect. There is not much development pipeline across the UK, but that is just as well.
- Therefore it is encouraging to hear the government voicing determination on reforming the planning process. There is a lot of dead wood that needs cutting from the commercial property stock, making conversion to residential a key component of 'plan B'.
- Moving beyond the most embattled parts of the market, 'plan B' may involve a reality check on the actual merits of the asset in question.
- Recent months have seen rapid price growth for a range of safe haven assets, such as Gold, Gilts, and Bunds. This has left investors casting around for places to deploy money.
- Such an environment will favour long-let property, due to the lure of steady rental income. The problem will be that buyers will want prime, understandably. Yet, in many markets most genuine prime assets have either traded recently, or the owner wants to keep the asset.
- So 'plan B' for the better quality end of the market involves the seller recognising that the buyer has problems too. Buyers do not want to move up the risk curve, but there is not much prime for sale.
- The next best option is good quality, well located secondary. Sellers need to honestly ask themselves: the buyer is choosing between my asset or bank interest, so which looks better? How happy you are with the answer is how hard you should negotiate.

The Changing face of Cheapside

Zone A Retail Prime Rents



Source: Knight Frank

- Cheapside is a thoroughfare in the square mile which ten years ago was lined with sandwich shops, mobile phone shops, and not much else.
- Following the arrival of a shopping mall at One New Change, reports suggest Cheapside is being considered by Apple for its first store in the City - a remarkable vote of confidence.
- The success of Cheapside relates to shifting lifestyles. For many City workers, due to work / life balance issues, the lunch hour has turned into a time to acquire a new shirt, training shoes, or a birthday present.
- Go look at the crowded Canary Wharf mall if you think bankers and brokers spend lunchtime at their desks. In the past shoppers went to where shops could be found, in today's tough retail environment the reverse now applies.

KNIGHT FRANK COMMENTS

In the space of a few months we have gone from the ECB raising interest rates, to extending its bond buying to Italy and Spain. Back in the Spring rising inflation was the cited threat, now we are hearing the phrase 'double-dip' in use again.

Without doubt it has been a miserable summer for the economy. Although just as the financial markets have quickly swung from bull to bear in a few months, there is no guarantee they will not do the opposite in an equally short space of time in the coming months. Property investors should pick up their 'Keep Calm, and Carry on" coffee mug and contemplate the logic.

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