RESEARCH

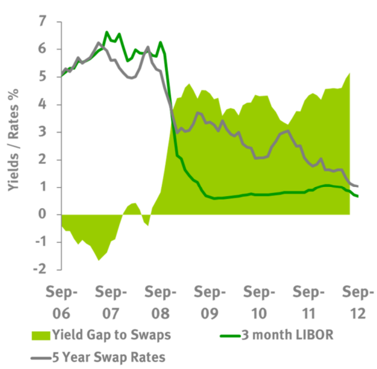
SEPTEMBER 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The ECB announced plans to make 'unlimited' bond purchases for countries who requested assistance. The bank added the purchases would be 'sterilised', so a proportional volume of other nations' bonds will be sold to prevent price inflation.
- Also, the German constitutional court approved the new ESM, suggesting progress is being made towards a Euro crisis solution. Yields on 'Club Med' Euro bonds have fallen.
- Global stock markets have rallied in recent months. In part this reflects the improved news from Europe. The FTSE 100 index has risen by over 200 points since the beginning of July. Oil prices are also edging upwards.

Economic outlook

- The second estimate of Q2 UK GDP saw the figure revised upwards from minus 0.7% to minus 0.5%. The ONS had overestimated the impact of the extra bank holiday in June on construction and production growth.
- The latest consensus survey of forecasts compiled by HM Treasury (August) showed analysts now expect GDP to contract by 0.4% this year, compared to the growth of 0.3% forecast in May.
- The consensus in our view is a step behind current debate, influenced by the poor first estimate of GDP but compiled before the higher second estimate. The inflation forecast also looks low considering the increase in July.
- Recent employment figures show that the labour market remains strong, with falling unemployment, and rising job creation. We see this as pointing to underlying strength in the economy.

August consensus forecasts (%)

	2012	2013	2014	2015	2016
GDP	-0.4	1.1	1.9	2.3	2.4
CPI	2.5	1.8	1.9	2.1	2.1
RPI	2.9	2.3	2.6	3.0	3.1
Base Rate	0.5	0.6	1.0	1.9	2.6

Source: HM Treasury Consensus, August 2012

Property performance

Key performance indicators

Borrowing yield gap*		516 bps ↑
Risk yield gap**		531 bps ↑
Investment purchases 2012		£21.2 bn
All Property void rate		10.3% ↓
	Initial yield	**20yr average**
Retail	6.1%	6.3%
Office	6.1%	7.2%
Industrial	7.2%	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 July 2012

- The IPD capital growth index confirmed that commercial property remains in a double-dip. Capital growth fell for a ninth consecutive month, with the all-property index down by 2.5% since it began to fall last November.
- Shopping centres have seen the greatest fall in value on a twelve month basis, down 8.5%, reflecting the broader problems facing the high street. London offices remain the strongest performer.
- January to August saw £19.7 bn invested in commercial property, according to Property Data. This is down from £21.9 bn for the same period of 2011, due to sharp fall in shopping centre investment. However, the volume invested in offices has risen to over £9.9 bn, compared to £8.0 bn a year ago.

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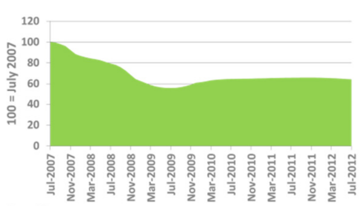
Time for a UK super fund?

- Sovereign wealth funds have been playing a bigger role in the UK property market, which highlights the role a strategic investor can play. This creates the question, does the UK need a similar 'big picture' investor?
- Like most Western nations a problem afflicting the UK is what John Maynard Keynes called the paradox of thrift. Investors and consumers perceive the outlook as negative, so they hoard cash, making the contraction of that cash-starved economy a near certainty.

IPD All Property Capital Growth Index – rebased to July 2007



Source: IPD

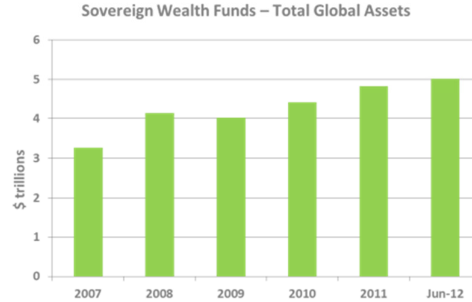
- Up until now the solution pursued by the Bank of England has been quantitative easing, which is meant to make Gilt yields unattractively low, thus flushing investors into racier forms of investment that generate growth. However, critics suggest that QE now needs to extend beyond buying Gilts to other assets to get money into the wider economy.
- The Bank may well diversify its range of purchases, but it is unlikely to begin making targeted investments to 'manage' a recovery – something that is beyond its mandate.
- Consequently, what is needed is a new investor or investors, who on receipt of the QE money will invest it, and in a targeted manner that considers long-term development objectives. Thus the paradox of thrift is broken, and money can be channelled into strategic areas that will generate future growth – not another house price boom.
- A UK super fund should be established, with a medium-term remit to drive economic growth and develop strategic infrastructure projects, and a long-term objective to fund education and offer venture capital to start-up businesses in growth areas like technology.
- The fund would issue bonds, which the Bank of England would buy with QE money, then invest in house building and infrastructure projects as a phase one.
- Phase two would be providing venture capital to start-ups in technology and renewable energy, R&D projects, and commercial property investment and development. This would be funded by bond issues on global capital markets once the Bank of England has ended QE.
- Commercial property would be added to the super fund's agenda for three reasons. Firstly, providing affordable and fit-for-use business premises is an important part of a growing economy. It would be a brake on growth for new companies if they face high property costs, or have to trade from sub-standard premises.
- Secondly, the long-term objectives of the fund to give something back to the taxpayer by funding higher education – possibly through grants or interest free loans to poorer students – will need to be backed by a steady income stream. The development of an extensive property portfolio with a low vacancy rate would help provide that income stream.
- Thirdly, the large stock of poor quality property in work-out with banks is also acting as brake on the economy, as it is part of the reason banks are not lending. To have a super fund come in and provide the capital to refurbish those properties and give them prospects in the open market could break the impasse.
- The Australians have their super annuation funds, the East its sovereign wealth funds, and the US its endowment funds. The UK similarly needs to introduce investment funds which are not plagued by redemptions and short-term considerations, and put wealth to work for the benefit of the wider economy.

KNIGHT FRANK COMMENTS

The entire investment world, including property, has been plagued by a reluctance to deploy funds this year, reflecting the largely gloomy economic news; crisis in the Euro area, slowdown in China, recession in the UK. Something is needed to break the cycle of pessimism and encourage investors that an inflection point has passed and it is time to buy. For Europe we have seen progress towards a Euro crisis solution, while China is now embarking on infrastructure projects to create growth. However, the UK is lacking a similar catalyst for growth.

We back the view that the Bank of England needs to move away from QE via Gilt purchases, which is just giving money to banks without a knock-on rise in lending. Moreover, there needs to be recognition that commercial property is part of the banks' problems. While property continues to fall in price, the banks will be focussed on work out and not lending. Policymakers need to move towards a managed solution to the financial crisis and recession which includes property.

Sovereign Wealth Funds – Total Global Assets



Source: The City UK

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