RESEARCH

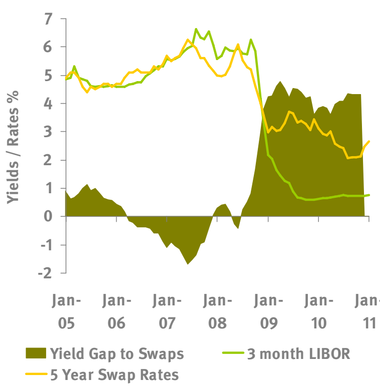
# APRIL 2011
# UK MARKET OUTLOOK

Commercial property review

Knight Frank

## Financial indicators

Lending rates and property yield gap




Source: Knight Frank Research, FT, IPD

- The European Central Bank increased its key interest rate by 25 bp to 1.25% in response to rising inflation. The move followed a rate increase by the Chinese Central Bank, as inflation becomes a global concern.
- The Bank of England left the UK base rate unchanged at 0.5%. Gilt prices suggest a 25 bp rise is expected in the coming months.
- The Pound declined against the Euro in anticipation of the ECB's rate hike. Brent Crude Oil cleared the $120 per barrel mark, drawing closer to its July 2008 peak of $144.
- The Bank of England's Credit Conditions survey showed a net balance of bankers questioned (-13.7%) reduced lending to commercial real estate in Q1. A net balance (-6.5%) plan to reduce further in Q2.

## Economic overview

- Inflation now stands at 4.4%, with rising commodity prices taking over from the VAT increase as the main inflationary drivers.
- The March budget contained a cut in corporation tax, although this was balanced with a further increase in the bank levy. Also some of the fuel tax burden will be shifted from consumers to oil companies.
- Consequently, the overall impact on the economy will probably be neutral at best. At worst it may encourage a view that the current UK government is hostile to business.
- The rate of unemployment continues to flat line at around the 8.0% mark, increasing concerns that we shall see a jobless recovery.
- The Markit PMI index for Services recorded improved activity for the largest sector of the economy in March. There is now a strong possibility that the GDP figures for Q1 will show a rebound for the economy.

Key economic indicators

| | % | Trend |
|---|---|---|
| CPI * | 4.4 | ↑ |
| Retail sales * | 1.3 | ↓ |
| Unemployment ** | 8.0 | → |
| Base Rate | 0.5 | → |
| £ : $ | $1.63 | → |
| £ : € | €1.14 | ↓ |
| FTSE 100 | 6,041 | ↑ |

Source: NS, FT, BoE.
All figures as at 6 Apr, except ** end Sept, * end Nov.
Currencies are the spot rate. FTSE is index value

## Property performance

Key performance indicators

| | | |
|---|---|---|
| Borrowing yield gap* | | 345 bps ↓ |
| Risk yield gap** | | 320 bps ↑ |
| Investment purchases (2011) | | £7.69bn |
| All Property void rate | | 10.0% ↑ |
| | Initial yield | 20yr average |
| Retail | 6.1% | 6.3% |
| Office | 6.3% | 7.3% |
| Industrial | 7.2% | 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 February 2011

- The IPD All Property capital growth index continues to drift sideways, recording an anaemic 0.2% month-on-month increase in February. The strongest performing sub-sectors were City Offices, Midtown and West End Offices, and Retail Warehouses.
- Rental value growth was unchanged for the seventh consecutive month, as an increase for Offices was counterbalanced by further declines for Retail and Industrial.
- The All property void rate increased for the first time in seven months, driven by higher voids for the Industrial and Retail sectors.
- Investment volume reached £7.7 bn for Q1 compared to £6.3 bn for the equivalent period in 2010. Continued interest in Shopping Centres had a significant influence on the figures.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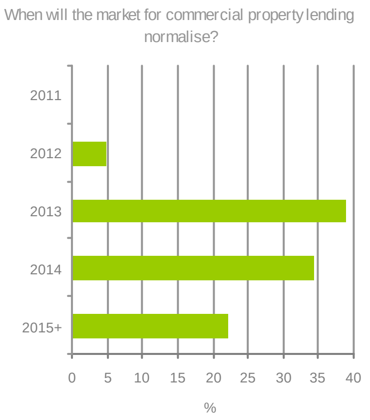
## Property Debt

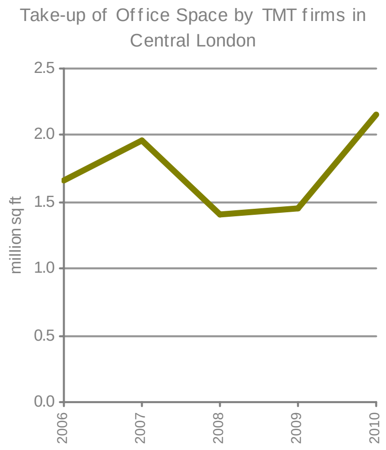
- Last week Knight Frank held a briefing for bankers with audience participation, via electronic voting pads, on a number of property market questions. The responses to the question, "when will the market for commercial property lending normalise?" were interesting.




Source: Knight Frank Post-Budget Breakfast

- Our expectation was that the majority would vote for 2015+. Surprisingly, 2013 proved the most popular choice with 39% of the vote, followed by 2014 (34%).
- The latest Bank of England Credit Conditions Survey showed that availability of debt for commercial property has started to shrink again, and will probably continue to do so in the next three months. However, this is referring to the here-and-now, and the world will probably be a different place by 2013.
- So the message seems to be that the property lending market may be retrenching now, but the bankers – at least the ones we spoke to – believe that credit will become more freely available in the medium-term.
- This contradicts current market wisdom, which holds the banks will be deleveraging for years to come, with Basel III set to make matters worse. How do we explain this disparity?
- In part, market share considerations may be weighing on minds. Insurers are entering the market, and new banking entrants will probably follow. Some banks may be concerned that holding back lending too long could leave them marginalised.
- A recent article in the *Financial Times* reported that Barclays executives now want to see more risk taking in order to support profit margins. After years of caution and retraction across the business world, companies are growing conscious of the need to invest and win market share.
- Moreover, there are precedents for the banks in other industries of existing players losing ground to new entrants during downturns. Apple took advantage of retrenchment by telecoms firms to grab a huge market share in smart phones, releasing four versions of the iPhone while other handset manufacturers slashed product investment. The banks doubtless would rather insurers did not mop-up the property finance market at their expense.
- We expect a strong drive to clear-up loan books in the next 24 months, with implications for corporate recovery. This is consistent with evidence that secondary pricing outside of London is softening again. The market has to get a bit worse in order to get better. However, the pain this time will be localised to lesser quality stock in certain parts of the country, and not the general pain seen in 2008.
- Whether banks want to start lending more from 2013, and whether they can are not the same thing. There are many factors influencing the deleveraging process that the banks cannot control. Moreover, there are still losses to be crystallised on tertiary properties whose true value can only be guessed at.

## Technology firms and offices




Source: Knight Frank

- New technology is often presented as a the Achilles' Heel of offices; the logic being that fewer work stations will be needed as more staff work from home via wifi, enjoying a better work life balance.
- However, currently some of the largest names in new technology, like Google, Apple, and Bloomberg, are in the process of expanding their office occupation in the centre of London.
- While individual workstations are typically getting smaller, most companies are adding break-out areas, cafés, and quiet rooms. So workplace practices are changing, but not reducing the overall need for office space in CBD locations.
- In fact, the technology is facilitating the rise of non-desk work areas, now the laptop can join you in the break out area. What about working from home? In fact, some people like to 'escape' to work and the big city.

## KNIGHT FRANK COMMENTS

Inflationary pressures are building in the global economy, but the strength of the recovery remains in doubt. Central Banks disagree on how to respond. Interest rate rises will not address the true causes of rising prices, so inflation will probably go unchecked for now.

Property investors are as split on strategy as the Central Bankers. Remaining in cash has little attraction, but finding someone to sell prime is hard, and buying secondary appears brave given the gloom surrounding the economy. Eventually we expect investors to conclude that it is time to take the plunge, as waiting for normality to return will become an exception in watching inflation eat your cash.