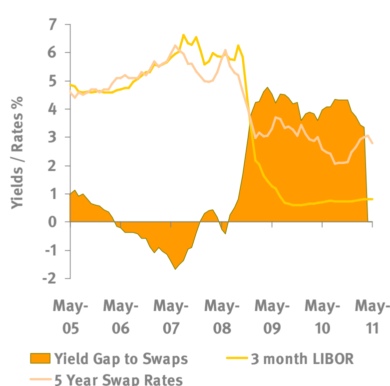
RESEARCH

MAY 2011
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 shied away from increasing the base rate in May, as concerns grow on the strength of the economic recovery. Gilt pricing suggests the markets now believe the chances of an increase this year are falling.
- The sharp drop in commodity prices will help ease inflationary pressures, albeit after a time lag, and assuming there is not a rebound.
- With the base rate on hold, the Pound continued its decline against the Euro – it currently trades at €1.12, compared to €1.19 a month ago. Against the Dollar the Pound is gaining ground, reflecting concerns on the US deficit.

Economic overview

- The first estimate of Q1 GDP at 0.5% was in line with expectations, but nevertheless sluggish. FBS was the main growth driver, with output increasing by 1.0%.
- The Markit PMI survey indices suggest the pace of growth may have slowed in April. All three indices (services, manufacturing, and construction) recorded slower growth, but were still positive.
- Inflation edged back in March to 4.0%, although the decline may prove to be a one-off. Debate is growing on how much spare capacity there is in the economy, with some suggesting that the level may have been overestimated.
- Encouragingly, despite the sluggish growth figures, unemployment appears to have stabilised at just below 8%.

Key economic indicators

	% / Value	Change
CPI *	4.0	↓
Retail sales (volumes) *	0.2	↑
Unemployment *	7.8	→
Base Rate	0.5	→
£ : $	1.64	↑
£ : €	1.12	↓
FTSE 100	5,920.0	↓

Source: NS, FT, BoE.
All figures as at 5 May, except * end Mar. Figures for currencies and FTSE are the value

Property performance

Borrowing yield gap*		336 bps ↓
Risk yield gap**		317 bps ↓
Investment purchases (2011)		£10.9 bn
of which, from UK institutions		14%
All Property void rate		10.1% ↑
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.3%	7.3%
Industrial	7.1%	8.0%

Key performance indicators

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 March 2011

- The IPD capital growth index did pick-up slightly in March, but as will be discussed overleaf, the general trend has been slow growth for some time now.
- The rental growth index turned negative, with all three sectors recording a month-on-month decline. Industrial was hardest hit (-0.9%).
- Transaction volumes for January to April totalled £10.9 bn, up from £8.3 bn for the equivalent period in 2010. Shopping Centres were the main driver of growth. However, note the very low market share for UK institutions – just 14%.

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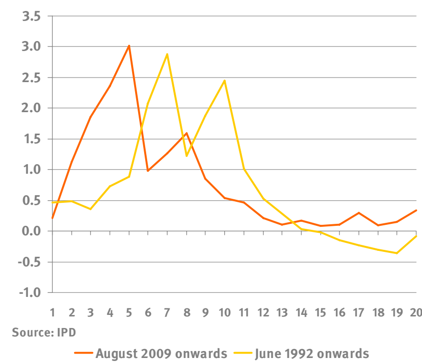
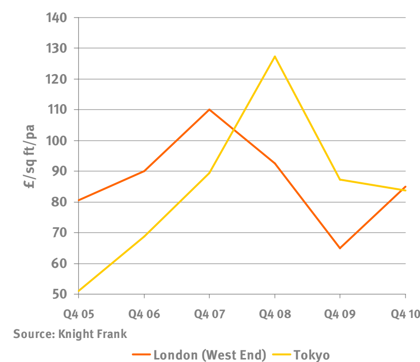
Capital growth – no double-dip

- Does history ever repeat itself? Property market analysts thought it would do a year ago, when the rate of capital growth began to decelerate.



- In June 1992, the IPD capital growth index returned to growth, only to tumble back into negative territory 15 months later. April 2010 saw a rapid slowdown for the capital growth index, prompting forecasts that a similar double-dip was occurring.
- However, as the chart shows, rather than plunging into the red, capital growth has levelled off at slightly above zero growth.
- This is better than a double-dip, but with the index so close to zero, a sudden adverse turn of events could quickly turn growth into contraction.
- There are two possible candidates for that potential 'adverse turn'. The first is a surge of losses on poor quality assets not yet realised impacting the IPD figures as the owners take the hit.
- The risk of this happening is impossible to quantify. And rather than a surge, it is perhaps more likely that the re-pricing of poor quality assets occurs piecemeal, as the tertiary market is only expected to re-open slowly. Therefore, the impact on the IPD index could be negligible.
- The other possibility is a major economic shock. However, we note that the current period of low growth has coincided with a volatile geo-political situation – with the debt crisis in the Eurozone, and Middle East unrest – but capital growth has remained positive.
- So for now we expect the index to remain just about positive. A broad-based re-emergence of rental growth is needed to pull capital growth reassuringly clear of the zero mark. This remains some way off.

The Comeback Kid



- Knight Frank's latest Global Report confirmed London's West End had reassumed the title of the world's most expensive office market.
- Some West End landlords will be unhappy with this ranking. Being labelled 'expensive' is hardly a positive, and the £90.00 per sq ft prime rent applies to the core of Mayfair and St James's. Beyond the core, rents are more affordable.
- The top core rents are often on a small unit of space, usually let to a financial firm with deep pockets. The tone for prime in the media districts of Soho and Covent Garden is in the low to mid £50s.
- Yet, as Sam Goldwyn said "Any publicity is good publicity". Even outside the core, most West End tenants like to think their offices are in the exclusive part of town.

KNIGHT FRANK COMMENTS

The economy in 2011 has got off to a slow start, but that is what everyone expected to be the case back in January. Fortunately, some of the bad news – the VAT increase, the Japanese tsunami – are one-offs, but others – the Eurozone crisis, public sector cuts – are on-going.

That IPD capital growth is managing an anaemic rise is quite respectable given the frosty economic backdrop. In part this is due to a distortion of the market - the managed release of assets by the banks, preventing an over supply. However, there is evidence of more buyers looking beyond Central London, in search of higher yields. The pace is slow, but the recovery continues.

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