RESEARCH

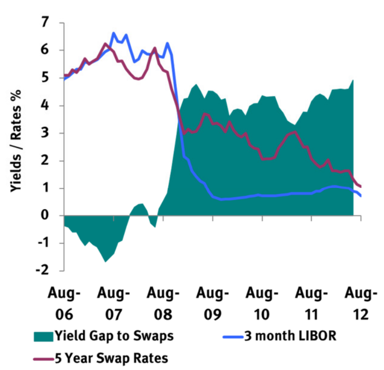
AUGUST 2012
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England and the ECB both left interest rates on hold in their latest policy meetings. However, in the subsequent press conference ECB President, Mario Draghi, said they 'may consider' further bond purchases, but only linked to countries seeking assistance from the EFSF.
- On a twelve month comparison, Sterling appears to be rising against the Euro (up 10%), but falling against the US Dollar (down 4%). The fall against the Dollar probably reflects poor growth prospects, the rise against the Euro may be due to flight capital.
- Despite the Euro crisis and global economic slowdown, gold has only seen a marginal rise in price in recent months, and is currently just over the $1,600 mark, having peaked last year at $1,877 per troy oz.

Economic outlook

- The first estimate of UK GDP was worse-than-expected at minus 0.7%. However, it is possible we will see an upwards revision, as the figures assumed industrial production would fall by 3.3% month-on-month in June, but subsequent figures show a 2.4% decline.
- In response to the poor GDP figures, the Bank of England cut its forecast for UK economic growth to zero for this year. During the press conference, Mervyn King drew attention to the new funding for lending scheme, suggesting later in the year we may start to see impact in the economy.
- Unemployment fell and the number of people in work increased in May. The unemployment rate was 8.1% compared to 8.4% at the end of last year. So far this year 225,000 jobs have been created.

Key economic indicators

	% / Value	m-on-m Change
CPI **	2.4	↓
Retail sales (vols) **	1.6	↑
Unemployment *	8.1	↓
Base Rate	0.5	→
£ : $	1.57	↑
£ : €	1.27	↑
FTSE 100	5,841	↑

Source: ONS, FT, BoE. All figures as at 8 Aug, except *May and ** June. Currencies are the spot rate.

Property performance

Key performance indicators

Borrowing yield gap*		492 bps ↑
Risk yield gap**		505 bps ↓
Investment purchases (2012)		£18.5 bn
All Property void rate		10.7% ↑
	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 June 2012

- The IPD June figures showed capital values declined again on a month-on-month basis, with the all property index falling by 0.5%. Retail remains the worst performing sector (-0.7%); within this sector shopping centres saw the biggest monthly fall.
- The all property capital values index has fallen for seven consecutive months now, with values down 2.1% since entering the double-dip. During the mid-1990s double-dip, the index fell for 21 consecutive months, and declined by 6.2%.
- Investment activity in the UK totalled £14.9 bn in the first half of 2012, which is markedly down on the £17.3 bn for the same period of 2011. Greater London accounted for 57% of activity in H1 2012, compared to 46% in H1 2011, suggesting investors are again focussing on the capital.

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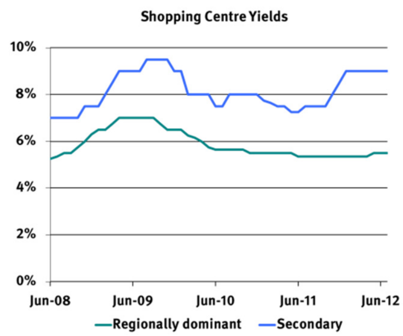
The iPad economy

- When commenting on retail property the analyst first needs to ask the question, what sort of retail are we discussing? On the one hand Lend Lease is going for planning on an extension at Bluewater. Also, the vast army of coffee shops continues to expand across the country.



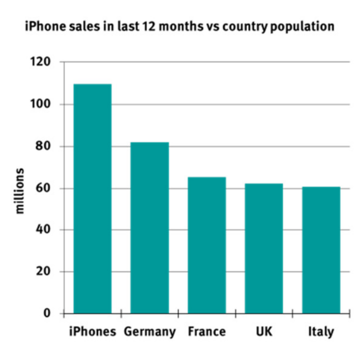
Source: Knight Frank Research

- On the other, retail is the worst performing sector of the IPD universe. Knight Frank data shows yields on secondary shopping centres have softened to circa 9.0%; widening the gap with big regionally dominant malls.
- Then there is the electronic challenge. Amazon now sells 114 e-books on Kindle devices for every 100 hard copy books. Ten years ago big book stores were a rising force in retail.
- This is also an example of e-commerce impacting the other side of the retail property equation. When there is no physical product, there is no need for a shed for storage and distribution.
- Technology and consumer habits are changing how much real estate is needed in retailing. The nature of the retail product being sold is also a factor, and products can be divided into three – intellectual, physical, and lifestyle enhancing.
- Intellectual product (i.e. media output) takes perfectly to electronic distribution. There are people who were avid buyers of books, DVDs, music, and newspapers, who now purchase all this content via their iPad or Galaxy. These devices have spawned a new retail category – the App.
- In property, the winner has been offices, accommodating a new wave of tech companies. Take-up of office space by technology and media firms in the City of London doubled in the first half of this year.
- Physical product has a complicated relationship with electronic media. Groceries work well in the iPad economy, but still require sheds. Nor does e-grocery shopping negate the need for a store front, due to trips to the supermarket 'local' store to buy what we forgot to purchase on-line.
- Fashion on-line often requires confidence that the size is correct, which favours trying on in a store then buying online. So the iPad economy allows the shopper to deal direct with the shed, but still has a role for the shop front (albeit reduced).
- Lifestyle enhancing product can involve intellectual and physical products, but does so in a semi-leisure context – which explains the on-going success of big shopping malls and coffee shops.
- For some people shopping is a leisure activity. One meets friends at the mega mall; have a look around the shops, then go for sushi or a movie. When waiting for friends, the iPad or Galaxy is utilised for watching a movie or reading a novel in a coffee shop. Effectively retail is providing a social space, where shopping is a by-product of leisure.
- The iPad economy is changing retail property, by shifting the dynamics – less demand for standard shops, more for mall space, offices and sheds. The challenge for investors is keeping pace with the changes.

KNIGHT FRANK COMMENTS

One of the advantages of the Olympics being in town is it is diverting attention away from the gloomy economic news. It is hard to say much positive about the near-term; in fact the financial markets appear to respond to most news from the Euro area by selling. This suggests confidence has broken and it could be a long process restoring faith in the EU grand plan. For Downing Street to push ahead with the austerity programme completely unchanged seems almost economic and political suicide. The latter point will speak to the politicians, and a delay in the austerity programme is a growing possibility.

However, let us not forget there are signs of life. Smart phone, tablet, and app sales have mushroomed, and the property implications of the digital revolution are huge. We still need shops in the iPad economy, but not as many; poorer quality offices are back in play in a world where start-ups just bolt a wi-fi box on the wall and switch on the lap tops. Business practices and product lines are changing to meet the digital revolution. The same will be true of property.



Source: Apple and Wikipedia

Commercial Research www.knightfrank.com