RESEARCH

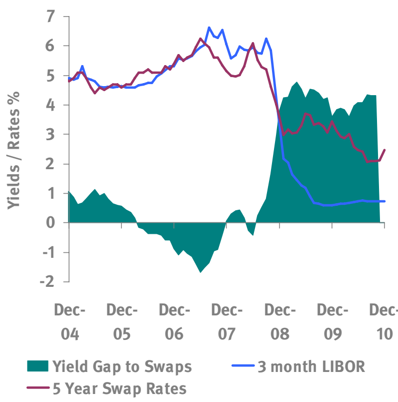
DECEMBER 2010
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- As the chances of QE2 in the UK faded, Gilt yields softened for much of October. They appear to have stabilised lately, but this may just be refugee money fleeing the Eurozone. Hot money rarely stays anywhere long in volatile times, so this respite may prove short-lived.
- Despite the fall for Gilts, Equities have had a bumpy ride. The FTSE 100 swung from 5,875 on November 9th, to 5,528 by the end of the month. Yet, at the time of writing it is above the 5,800 mark. Unsurprisingly, the Irish bail out has impacted sentiment.
- Inflation remains both above target, and outside of the 1%-3% band. With food commodity prices rising and the VAT rise to come, further increases are likely.

Economic outlook

- The latest consensus forecasts on the UK economy confirm that analysts see a chilly 2011 ahead. Though the underlying forecasts display a wide spread of opinion.
- More bearish commentators like Capital Economics see UK GDP increasing by just 1.0% next year. However, Citigroup and Schroders are predicting a racy 2.5%.
- There is a similar difference of opinion on inflation, with Capital Economics forecasting a plummet to 2.1% next year (from 3.2% currently). In contrast, Citigroup are expecting an increase to 3.5%.
- So rather than a consensus view we have a middle path through the wide range of opinion. The situation could easily go one way or the other, but thankfully the talk of double-dip recessions as dissipated lately.
- Perhaps worth noting is that back in January the consensus for 2010 was 1.4% GDP growth, which is now clearly too low. Perhaps we need to be careful of forecasts called during the dark, gloomy winter months.

Economic forecasts

	2010	2011	2012	2013	2014
GDP	1.7	1.9	2.1	2.4	2.5
CPI	3.2	2.8	1.7	2.0	2.2
RPI	4.5	3.5	2.6	3.0	3.3
B/Rate	0.5	0.9	1.6	2.4	3.0

Source: HM Treasury Consensus, November 2010

Property performance

Key performance indicators

Borrowing yield gap*		432 bps ↑
Risk yield gap**		370 bps ↓
Investment purchases (2010)		£26.89 bn
of which, from UK institutions		34% ↓
All Property void rate		9.8% ↓
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.4%	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 October 2010

- Capital growth remained positive in October but this indicator has clearly levelled off. Offices remain the best performer. Encouragingly industrial, having weighed on sector growth in August and September, is only just negative now (-0.1% in October).
- Rental Growth at -0.1% in now only just about negative, and may finally dip into positive territory in November. Retail is proving to be the drag on the all property measure, as both offices and industrial rents grew.
- IPD's Monthly Digest points to falling rents for regional offices and office parks, but with Central London offices offering a counterbalance. There is clearly an in-town / out-of-town dynamic to the office market.

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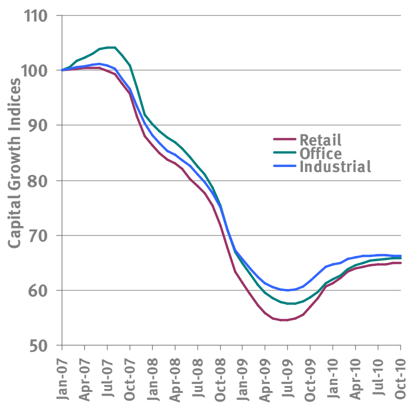
Standby for 2011

- So farewell to 2010. Though some features of the market appear hardly changed on the start of the year. Debt availability is low, buyer appetite is focussed on prime, there is not much confidence on the outlook for occupier markets; yet Central London appears to be exempted from these rules, and is viewed as a property micro-climate.

IPD Capital Growth Indices - 100 = Jan 2007

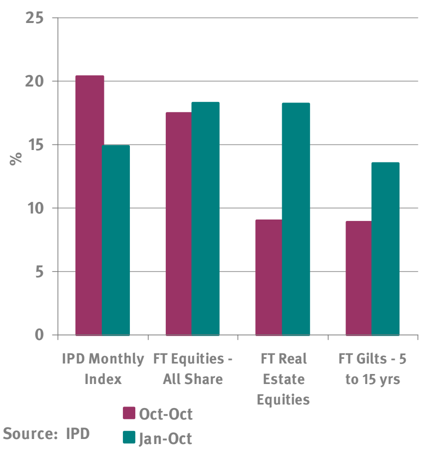


Source: IPD

- Of late the IPD Capital Growth indices for the three main sectors have levelled out. It is very easy to envisage a 2011 where this state of affairs continues; with growth for prime and favoured markets like London, counterbalancing price declines for secondary stock in the IPD portfolio.
- However, the further decline for secondary will not be about further deterioration of market conditions, but caused by the market slowly re-opening. As secondary gradually starts to trade again, the evidence emerges for the valuers to work with. In 2011 those holding secondary will get a better idea what it is truly worth.
- In theory this means losses that have already occurred will be booked, so pricing will not be getting worse per se. But in reality the losses being booked will push loans on some assets further into the realms of non-performance.
- So even the market re-opening again has a downside, which is not a cheerful thought. Yet, we see next year as one in which investors will increase exposure to real estate, due to pressures building in the wider economy, such as inflation, which make holding cash and low yield bonds unattractive. But will secondary take a significant share of this investment?
- A widespread re-opening of the secondary market in the next few months is hard to imagine. We will need to hear some better economic news, which kicks the ball further into next year. And even then it could only ever be a partial re-opening. The murkiest parts of secondary may have to wait for the next boom to have a realistic chance of trading.
- This points to a slow and phased re-opening of the secondary market, stretched over years. The consequence for a mixed bag of assets like IPD is that good and bad news may cancel each other out, sending the line on the chart sideways.
- This could draw attention to IPD's shortcomings as a benchmark index. Effectively the component assets in the basket of properties will probably be moving in wildly different directions, making the amalgam of less indicative value.
- Yet, as we all know property is a pickers market – it is all about the individual asset. Will 2011 be a good or bad year for commercial property investment? Depends on the asset, how much due diligence is conducted, whether there is scope for adding value, etc.

Relative Performance

Total Returns % Annualised



Source: IPD

- On an annualised basis, property has outperformed the other assets classes in the twelve months from October 2009 to October 2010. Time for three cheers?
- Well it is obviously good news. However, while on an October to October basis, IPD property outpaces the pack, on a January 2010 to October basis it drops to third place.
- The main difference is the January to October comparison brings the recent slowdown in capital growth into sharper focus.
- This is a reminder that statistics are a useful tool, but they need to be approached critically – a different start point can give you a very answer - and using one measure is never enough.

KNIGHT FRANK COMMENTS

A new year looms on the horizon, and some commentators are talking it down before it has even started. But there is the public sector spending cuts and the not so small matter of the Euro-zone crisis.

Yet while 2010 was hardly a great year, it certainly never matched the pessimism predicted for it around this time last year. That is why QE2 stayed in the dry dock, and given the inflationary pressures, it may never set sail. What is my prediction for 2011? Standby for lots of research notes on property in an inflationary environment.