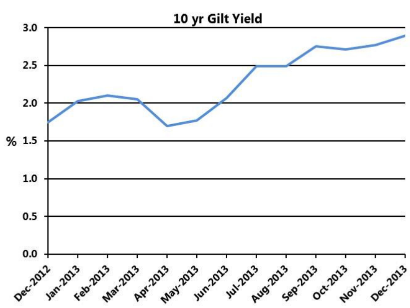
RESEARCH

DECEMBER 2013
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators



Source: Datastream

- At the time of writing ten year UK Gilt yields stood at 2.9%, having begun the year at just under 2.0%. Generally the prospect of economic recovery causes Gilt yields to rise; although equally important lately has been the level of ten year US Treasuries. For much of this year, Gilts have tracked the rise of Treasury yields.
- Recent comments by the Bank of England's Chief Economist, Spencer Dale, dampened speculation on an early rise in the UK base rate. Mr Dale in a speech said the Bank would need to see a "prolonged period of strong growth" before increasing rates.
- Sterling is on course to finish this year down 3.6% against the Euro and unchanged in comparison to the US Dollar. Against emerging markets currencies, the picture is mixed – down 2.6% versus the Chinese Renminbi, but up 14.5% against the Indian Rupee.

Economic outlook

- The figures for overseas visitors to the UK suggest the country has enjoyed a post-Olympics bounce in tourism and business travel. The number of overseas visitors to the UK was 28 million between January and October, compared to 26 million for the same period of 2012.
- UK construction output increased by 2.2% in October compared to September – the increase was 5.3% against October 2012. The sector, which was struggling last year, has been boosted by a surge in new housing projects.
- CPI inflation fell sharply in October to 2.2%, down from 2.7% in September. In part this was down to last year's hike in university tuition fees dropping out of the figures. RPI inflation fell from 3.2% to 2.6%.

Key economic indicators

	% / Value	Change
CPI **	2.2	↓
Retail sales (volumes) **	1.8	↑
Unemployment *	7.6	↓
Base Rate	0.5	→
£ : $	1.62	↑
£ : €	1.18	↓
FTSE 100	6,440.0	↓

Source: ONS, FT, BoE.
All figures as at 13th December, except * end September and ** end of October Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		454 bps ↑
Risk yield gap**		439 bps ↑
Investment purchases (2013)		£39.22 bn
All Property void rate		10.5% ↓
	Initial yield	**20yr average**
Retail	6.2%	6.2%
Office	5.7%	7.0%
Industrial	7.1%	7.7%

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 2013

- The IPD all property capital growth index recorded a punchy 0.9% month-on-month increase in November, up from 0.6% in October. This is the highest monthly increase since March 2010.
- All three sectors recorded expansion on the IPD measure. However, November saw offices overtaken by industrial as the sector recording the highest month-on-month capital growth. The industrial index grew by 1.6%, compared to 1.4% for offices.
- With over £39 billion of deals transacted at the time of writing, the UK property investment volume has more than exceeded in 2013 the £33.5 bn figure for 2012. Leisure property has seen an 88% rise in deal volume in 2013 to nearly £2.8 bn.

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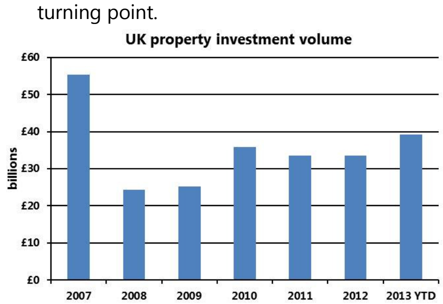
The year ahead

- 2013 was a good year for commercial property. The economic news beat all but the mostly bullish forecasts, which has drawn buyers into markets that previously struggled to draw attention. The Summer appears to have been something of a turning point.



Source: Property Data

- So far, so positive, but being December it is time for Knight Frank Research to give its tips for next year.

- *1. Office markets have led the recovery so far, but in 2014 we may see logistics competing for first place.*

- This is because recent years have seen each Christmas initiate yet more people into shopping online. In Christmas 2012, the internet accounted for nearly 11% of retail sales, and we expect this to exceed 12% this year. Online is still on an upwards trajectory, which will benefit sheds. Also, signs of improvement in the Eurozone and the US should improve exports, and increase demand for logistics property.

- *2. Retail remains the tail-end Charlie for commercial property in 2014, but we expect a significant polarisation.*

- Retailers are coming to terms with online; but some are adapting better than others. Also, towards the end of 2014 the possibility of rising interest rates in 2015 will reawaken concerns over tenant covenant. Nevertheless, retail does have its bright spots. Costa Coffee plans to open 300 new shops, while Inditex has opened 240 new stores around the world and enlarged another 100, suggesting on-going demand for 'fast fashion'.

- *3. Overseas (particularly Far Eastern) money will appear in unexpected places.*

- Last month a Chinese private equity firm bought an office tower on Birmingham's Broad Street. China needs to invest the proceeds of its huge trade surplus overseas; otherwise it will feed asset bubbles (and inflation) in China. Moreover, Asian developers are becoming bolder, searching widely for opportunities.

- *4. 3D printing will not have much impact on commercial property.*

- 3D printing will not undermine the market for sheds. Few people want to switch from drinking from glasses to plastic beakers. Even if one can 3D print all the parts for a watch at home, how many people have the skills to assemble them into a working time piece? Moreover, you would still need a logistics network to deliver all the raw plastic. We believe 3D printers will be favoured by hobbyists, not the general public.

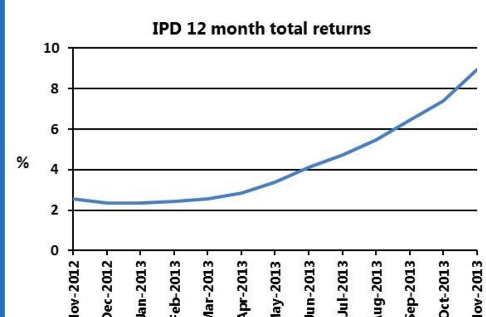
- *5. After years of releasing space into the sub-let market, in 2014 we expect the financial sector to grow as a source of demand for the office leasing market.*

- We see this as gradual increase not a sharp rebound, and it will be non-bank financials, probably fund managers and Fin-Tech leading the way. Nevertheless, a return of economic growth will mean more companies wanting to raise money via equity or debt, and more money flowing into unit funds. Moreover, our prediction of emerging markets investors playing a bigger role in property will also be true of other forms of investment, again creating business for the finance sector.

Knight Frank Research Comments

The UK property industry is finishing 2013 in better shape than it began the year, and arguably for the first year since 2007, we will begin 2014 without a major systemic threat (either at home or abroad) hanging over the economy. Next year it will important for property investors to avoid being lulled into a false sense of security, as there are still challenges ahead.

For the wider UK economy those challenges include bringing debt down much further, and decreasing the trade deficit; from 2015 the prospect of rising interest rates will loom. For commercial property it is a case of sorting the wheat from the chaff as activity moves further into the secondary market. As the more complicated assets with more potential negatives start to trade again, the chances of buying a lemon go up. Nevertheless, we finish the year with IPD's capital value index on a rising tide, to the backdrop of a growing economy. As Mrs Thatcher once said, "Rejoice at that news!"



Source: IPD

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