RESEARCH

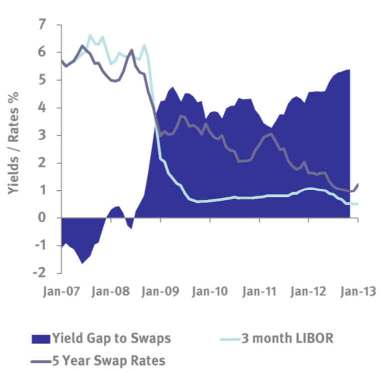
# JANUARY 2013
# UK MARKET OUTLOOK

## Commercial property review

**Knight Frank**

## Financial indicators

**Lending rates and property yield gap**




Source: Knight Frank Research, FT, IPD

- The Bank of England left the base rate unchanged at 0.5%, and the asset purchase programme at £375 bn. The UK monetary policy at present appears to be on holding pattern, possibly awaiting the next GDP figures.
- UK Gilt yields have risen in early January, mirroring an increase for US Treasuries. The yield on 10 year gilts increased from 1.7% at the end of December to just over 2.0% at the time of writing.
- The Pound Sterling is currently trading at around €1.21, having peaked at nearly €1.28 in mid-August. In part this reflects growing confidence that the Euro area will stay together, although concerns are growing over the UK's poor economic growth in 2012, and the size of the trade deficit.

## Economic outlook

- The third reading for Q3 GDP saw a downwards revision from 1.0% to 0.9%, although this is still a robust figure. However, the latest PMI services index pointed to weak growth in December, which has raised concerns over Q4 GDP.
- Unemployment remained steady at 7.8%, while the number of people in employment reached a record high of 29.6 m. However, the number of people on government training schemes increased, while the growth rate for part-time jobs was greater than for full-time roles.
- Despite the weak economic back drop, CPI inflation remains above the target levels of 2.0%. At 2.7%, inflation was well above average pay increases at 1.3% - pay growth fell markedly in September and October.

**Key economic indicators**

| | % / Value | Change |
|---|---|---|
| CPI * | 2.7 | → |
| Retail sales (volumes) * | 0.0 | ↓ |
| Unemployment ** | 7.8 | → |
| Base Rate | 0.5 | → |
| £ : $ | 1.61 | → |
| £ : € | 1.21 | ↓ |
| FTSE 100 | 6,121.6 | ↑ |

Source: NS, FT, BoE.
All figures as at 11th Jan, except * end Nov. ** end Oct. Currencies are the spot rate. FTSE is index value.

## Property performance

**Key performance indicators**

| | | |
|---|---|---|
| Borrowing yield gap* | | 539 bps ↑ |
| Risk yield gap** | | 510 bps ↓ |
| Investment purchases (2012) | | £32.8 bn |
| All Property void rate | | 10.3% ↑ |
| | Initial yield | 20yr average |
| Retail | 6.3% | 6.3% |
| Office | 6.0% | 7.2% |
| Industrial | 7.3% | 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 November 2012

- IPD 12 month total returns fell to 2.6% in November based on the all property index, their lowest level since December 2009. Month-on-month total returns were zero, partly due to a decline in the capital growth index for retail.
- The all retail capital growth index fell by minus 0.8% in November, compared to minus 0.4% in October. This was mainly due to falls for shopping centres and retail warehouses.
- Total investment in UK commercial property was £32.8 bn in 2012, down from £33.6 bn in 2011. Offices defied the gloom, recording a 21% increase in volume to £15.6 bn. Shopping centres saw a recovery in activity in the second half – particularly in the fourth quarter.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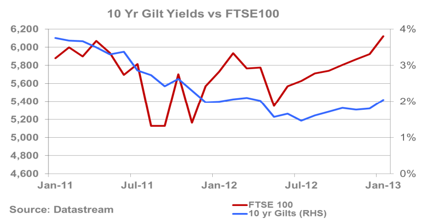
## 2013 – the year of managing risk

- The New Year begins with some tentative signs that investors are looking to increase their exposure to risk. Major equity indices have rallied to pre-Lehman collapse levels, and safe haven government bonds are seeing yields creep upwards.




- Negative real interest rates are making cash in the bank a painful option, and this search for higher returns we expect to migrate to commercial property this year. However, deploying money requires risk management – and for this recovery that risk is going to be higher and need more managing.
- Under normal circumstances property investors would manage risk in the early cycle stages by acquiring safe product – prime – then move up the risk curve as evidence of a recovery emerges. The problem with prime today, however, is that the supply of property that genuinely fits the description is dwindling for two reasons.
- Firstly, we have built little new stock in the last five years, while which was built pre-2007 has inevitably aged; reducing its prime credentials. Both pressures are shrinking the overall pool of prime assets. Secondly, much of the stock that does fit the prime definition has traded lately, further reducing the pipeline of quality assets coming to market.
- Given this, many property investors who want to acquire may have to start buying on the second or third rung of the risk ladder – good or medium quality secondary. This is a nervous experience for investors, as it involves immediately moving to medium risk assets when we have yet to see evidence of a recovery in the statistics.
- Moreover, certain areas of property still have on-going, and indeed structural, problems. There is an over-supply of grade B office space outside of city centres, the retail market is having to adjust to seismic changes, and certain regional markets have big exposures to a retrenching public sector.
- Buying into the risk is an integral part of the investment game. It was even true in boom years; buyers just failed to see or under-estimated how great the risks were.
- 2013 will be about managing those risks, something the property industry has always been much better at than we care to admit. If the vacancy rate for the City of London office market is 8.4%, that means 91.6% of offices are earning a rent.
- Risk management will take many forms. Some investors will decide covenant is key, and compromise on lease length, choosing certainty of a rent cheque and hoping for lease renewal at expiry. Others will favour the old mantra location, location, location – buy a property that will quickly re-let if the tenant does go bust. Then there are the investors who will ‘stick to what we know’, relying depth of knowledge of a sub-sector.
- None of these approaches are ‘better,’ the important factor being that there is a strategy for managing the risk. Once this is in place, investors can capitalise on the pockets of opportunity that exist in any market, whatever stage the cycle is at.

## KNIGHT FRANK COMMENTS

We view 2013 as a year in which the rules of the game of property investment are about to shift. 2012 was mostly about caution – prime and London were in, secondary and regional were out. A shift in a attitude towards risk is occurring as certain systemic economic threats have failed to materialise – the Euro has held together, the US did not go over the fiscal cliff – and investors are again looking beyond the safe havens for opportunities.

Nevertheless, the economy is lacking that big new game changer that could drive a rebound, the way the internet did in the mid-1990s, and as China and easy debt did in 2005-2006. Given both these booms ended in busts, perhaps we would be better off it is just a gradual recovery not a rebound. A slow recovery is the more probable forecast, so we would direct investors to seek the pockets of opportunity. They are out there, from Midtown offices, to CBD coffee shops, to light industrial units let to local firms with long track records.