RESEARCH

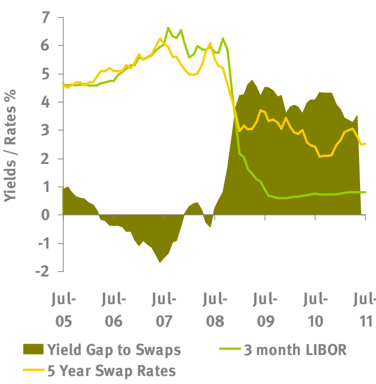
JULY 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- July again saw no change to the Bank of England base rate - which has been at 0.5% for 28 months - or any new QE measures.
- Whilst inflation remains well above target, the weakness of recent economic data will likely mean that any interest rate rise is pushed back even further – possibly into 2012.
- Indeed, the tone of the latest MPC minutes suggests that rates are less likely to rise in the short term, with more members of the MPC actually raising the possibility of additional QE to support the economy.
- Long term UK gilts trended down in recent weeks, apparently benefitting from the turbulence in the Eurozone – although the Euro strengthened against Sterling.

Economic overview

- The June consensus forecasts for GDP growth published by the Treasury have softened slightly to 1.5% for 2011, although the 2012 figure remains unchanged at 2.1%.
- The latest Markit PMI surveys reflect the general sentiment that the recovery is losing steam. Whilst the manufacturing, services and construction sectors are still expanding, the June surveys indicated a reduction in the rate of growth.
- Inflation is outpacing wage growth – reinforcing the squeeze on consumers – and is leading to expectations among the general public of faster price rises in the coming year.
- Following an improvement in consumer confidence in recent months, the very latest surveys show that April's "feel good" factor seems to be wearing off – with further negative implications for consumer spending going forward.

Key economic indicators

	%	Trend
CPI *	4.5	↑
Retail sales(vol)*	1.3	↓
Unemployment **	7.7	→
Base Rate	0.5	→
£ : $	$1.59	↓
£ : €	€1.11	↓
FTSE 100	6,012	→

Source: NS, FT, BoE.
All figures as at 7 July, except ** April, * May.
Currencies are the spot rate. FTSE is index value

Property performance

Key performance indicators

Borrowing yield gap*		351 bps ↑
Risk yield gap**		341 bps↑
Investment purchases (2011)		£14.96bn
of which, from UK institutions		28.7%
All Property void rate		9.8% ↓
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.2%	7.3%
Industrial	7.1%	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 May 2011

- Offices continue to outperform the rest of the market – driven mainly by Central London – with retail and industrial still turning in a lacklustre performance.
- Whilst rents are now more stable, total return expectations are falling; the rate of yield compression has slowed and rental growth is being seen only in selected areas, such as Central London offices.
- Indeed, the rate of annual growth in capital values slowed to just 2.3% in May – down from a healthy 13.5% a year ago.
- Q2 investment activity was down sharply on Q1, with Property Data reporting just under £5.2bn of transactions, compared with £9.7bn in Q1. Quoted property companies, the institutions and overseas investors continue to be the main net buyers.

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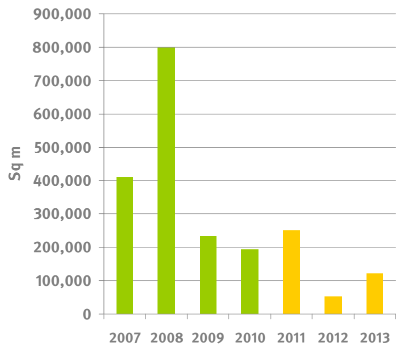
Slow recovery in shopping centre development

New Shopping Centre Floorspace by Year



Source: Knight Frank

- The pace of shopping centre development has fallen sharply during the last two years - along with rents and capital values - with the onset of the credit crunch and subsequent "real" recession. Whilst yields have recovered on the back of strong investor demand and prime rents have now bottomed out, development activity remains at low levels.

- The amount of new space delivered in 2009 was around 30% of its 2008 peak and 2010 saw a further decline. With an extremely limited pipeline in prospect for the next three years, shopping centre development activity is beginning to pick up tentatively, but should accelerate as this year progresses and developers start to plan for a more sustained economic recovery.

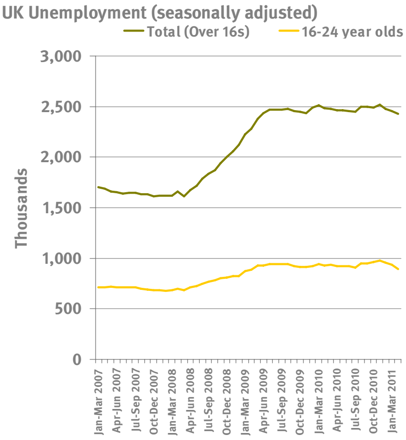
- In the short term, however, development is expected to focus on extensions to existing schemes, rather than new build. In part this is due to the continuing caution among occupiers, but also to greater constraints on funding for new development which is still viewed as being higher risk in the current economic climate.

- Looking to the medium term, developers will take some comfort from the fact that occupiers will struggle to find enough good quality "right size, right configuration" units. That said, vacancy rates in many high streets and weaker schemes will remain high for the foreseeable future.

- As the graph shows, 2011 is forecast to see only around 250,000 sq m of new shopping centre space, a significant proportion of which is accounted for by the Stratford City scheme set to open in East London. Even less space is expected in 2012 and 2013, although this may change – depending of course on the strength of the occupier market, developer confidence and funding availability.

Mixed news on unemployment

UK Unemployment (seasonally adjusted)



Source: ONS

- Against some forecasts that unemployment would exceed three million during the recession, the recent data looks positive to say the least. Indeed, the unemployment numbers have been one of the bright spots amongst the generally gloomy economic backdrop.

- However, headline figures can often mask a more mixed underlying picture and this is the case with the unemployment figures. On the surface, the recent trend appears positive, with total unemployment falling by 88,000 in the three months to April – equating to a fall in the unemployment rate from 7.9% to 7.7%. But this says nothing about the sharp increases in the number of young people going in to higher education, or people taking part-time work.

- May data also showed that the number claiming Jobseekers Allowance actually rose by 19,600 compared with April. Whilst much of this is due to changes in the benefit rules, the claimant count measure of unemployment is seen as more reliable than the headline measure (which is survey-based) and the May increase follows a similar rise in April.

- On a positive note, the economy is still creating more jobs than it is losing and, so far, job creation in the private sector has exceeded the job losses in the public sector. Indeed, in the first quarter, the number of public sector jobs fell by 24,000 to 6.16 million, against a rise in the number of private sector jobs by 104,000 to reach 23.08 million. Let's hope this continues to be the case.

KNIGHT FRANK COMMENTS

With occupational demand still weak or at best cautious in many areas, it looks like the UK market will see a supply-led recovery. Indeed, one of the main features of the recent downturn has been a dramatic reduction in the amount of new development coming through across all sectors.

While more developers are beginning to dust down mothballed proposals, speculative development has yet to make a significant return to any part of the market. As a result, falling supply is already leading to a hardening of incentives for prime regional offices, with rents in the best high streets, retail parks and shopping centres also expected to come under increasing upward pressure, as the supply-demand balance tips more in favour of landlords.