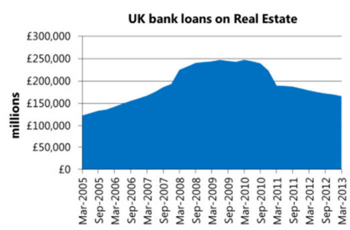
RESEARCH

JULY 2013
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators



Source: Datastream

- Mark Carney's first Monetary Policy Committee (MPC) meeting statement convinced financial markets that the new Bank of England governor sees the base rate staying at its current level for some time to come. The MPC described the pricing in of upcoming interest rate rises as "not warranted".
- Nevertheless, ten year gilt yields have continued to rise to 2.4% currently, compared to 2.2% a month ago, and 1.7% back in April. While some are predicting more QE to come, there is also a growing school of thought that believes bond yields are ultimately destined to drift steadily upwards.
- The UK banks continue to work down their property debt burden, albeit at a gradual pace. The volume of outstanding lending was £166 bn at the end of Q1, although this is comparable with Q1 2007 levels, which coincides with the final stages of the last market boom.

Economic outlook

- The third reading confirmed Q1 GDP at 0.3%, and erased the double dip. It also increased the severity of the 2008-2009 recession, and moved the UK further away from returning to its pre-recession peak.
- This in theory suggests there is spare capacity in the economy – hence the elevated level of unemployment. However, the situation may not be that straight forward if those unemployed do not have the skills to man the industries driving new growth in the economy. This could be an issue for the UK given the recent transition from finance to new technology industries.
- The latest PMI indices for the UK have made encouraging reading, particularly the services index. UK services read at 56.9 June, up from 54.9 in May.

Key economic indicators

	% / Value	Change
CPI *	2.7	↑
Retail sales (volumes) *	1.9	↑
Unemployment **	7.8	→
Base Rate	0.5	→
£ : $	1.49	↓
£ : €	1.16	↓
FTSE 100	6,505.0	↑

Source: NS, FT, BoE.
All figures as at 10th July, except * end May and ** end Apr. Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		539 bps ↓
Risk yield gap**		492 bps ↓
Investment purchases (2013)		£16.74 bn
All Property void rate		11.8% ↓
	Initial yield	**20yr average**
Retail	6.3%	6.2%
Office	5.9%	7.0%
Industrial	7.2%	7.8%

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 April 2013

- The IPD capital growth index moved into positive territory in May, but by a tiny margin (0.01%). A dip back into the red in the near-term is certainly possible, but we now expect the index to move permanently out of the double-dip in the coming months.
- Nevertheless, within the index there remain significant disparities in performance. At minus 0.3%, rest of UK standard shops remain in a downturn, whereas City of London offices recorded their third consecutive month of growth.
- Year to date, the UK commercial property market has seen £16.7 bn of investment, compared to £15.1 bn, for the same period of 2012, according to Property Data. However, the volume fell by 21% quarter-on-quarter to £7.4 bn in Q2, after the strong start to the year.

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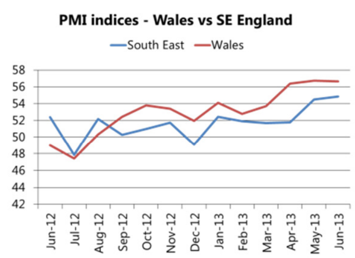
The Regions strike back

- PMI Markit's indices that cover the UK regions showed a surprising resurgence of business activity outside of London in June. This has implications for property investors, many of whom will be looking to deploy funds, but are possibly priced out of the central London market.



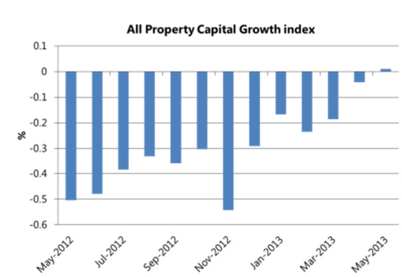
Source: Markit

- For those unfamiliar with the PMI indices, companies are polled on a monthly basis on a range of aspects of their business, e.g. employment levels, new business volumes, prices, etc. The results are compiled into an index, for which the reading of over the 50 mark indicates growth.
- For the mainland UK regions, all were above the 50 mark for June. This is the second month in a row that all were greater than 50, so let us hope this is not a blip. Moreover, all bar two (East Midlands and the North East) were above their ten year average level. In the case of the East Midlands, it was only just shy of average.
- London, unsurprisingly, had the highest rating but only just. London came in at 58.3, followed by the North West on 58.1, then Scotland on 57.0.
- Interestingly, Wales has had a good year so far, reading 56.7 in June, compared to a ten year average figure of 53.0. This is in marked contrast to this time last year when the principality was at 49.0, i.e. contracting. However, in the last twelve months it has outperformed the South East of England (see graph).
- From a commercial property perspective, this is encouraging for a number of reasons.
- Firstly, this evidence that the regions are strengthening coincides with the IPD all property capital growth index returning to growth after 18 months of contraction. Even if the index turns negative again in the coming months, we expect a permanent exit will occur soon.
- Secondly, the news comes at a time when a range of factors are pushing investors to consider where to deploy money. The economic news has improved lately, bond yields are moving upwards, and the Bank of England has stated its determination to keep real interest rates negative for some time to come.
- Moreover, concerns are growing on the outlook for emerging markets, which is switching the focus of investors back to developed countries, like the UK.
- As we have discussed before in this note, much of the good news in the IPD index lately tends to come from central London. However, the Rest of UK industrial capital growth index stabilised in June, following a run of good news for the car industry.
- This suggests we need to see more than two months of improving economic indicators for the regions before we see the benefit transmit through to commercial property. However, it is encouraging to think that an end to the long winter for regional property may be just over the horizon.
- Based on London's recovery pattern, we believe cities with a track record for technology and media industries, and a strong base of professional workers will be best positioned in the new cycle. This would favour Bristol, Birmingham, Cardiff, Leeds and Manchester.

Knight Frank Comments

It is a sign of the times that Knight Frank Research are today releasing a note discussing when the recovery will begin for regional commercial property, in contrast to our 'London, London, London' message of the last three years. The recovery is turning into a UK phenomenon, not just the capital tugging the rest of the nation behind it. The economic news has improved and with a six month time lag, we expect to see regional property markets benefiting.

This comes with a caveat, however, as the recovery will be uneven and bumpy. High street shops in the regions remains an embattled market unless the asset is prime, and regional office parks face tough conditions. There is too much commercial stock in the slower growth UK regions, and given the housing market is sluggish in those regions, conversion to residential will not offer a quick solution. Nevertheless, the worst appears to be behind us.



Source: IPD

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