RESEARCH

UK MARKET OUTLOOK JULY 2014

INDUSTRIAL – THE GREAT MISNOMER?

With the UK's economic recovery gaining real traction, commercial property also finds itself on an upward trajectory – undoubtedly in terms of capital value growth but also with regard to rental growth, albeit more modestly. But the relationship between the economy and property performance gets more complicated when we drill down to the sector level.

The market in a minute

All Property capital growth index rises to 1.1% in May m-on-m, up from 0.8% in April*

Industrial leads total returns for May at 1.7% for the month, and retail the lowest (1.4%)*

Latest consensus points to **All Property total returns of 13.7% in 2014****

Industrial returns expected to lead the main sectors over the medium term**

* IPD figures
**Based on IPF figures

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"The economy has been piggy-backed out of recession by the dominant services sector."

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The Bank of England is forecasting UK GDP growth to reach a very respectable 3.4% in 2014 – if borne out, that would be the strongest year for UK Plc since 2007. Meanwhile, on the property side, May's IPF consensus forecast points to All Property returns of 13.7% for the year – making 2014 the best calendar year for UK Property since the market rebound of 2010 and, before that, the peak of 2006.

It has also been well documented that the economy has been piggy-backed out of recession by the dominant Services sector, and this could be used to at least partly explain why Offices are currently leading the IPD Index, with returns of 21.4% over the 12 months to May, compared with 16.0% for All Property.

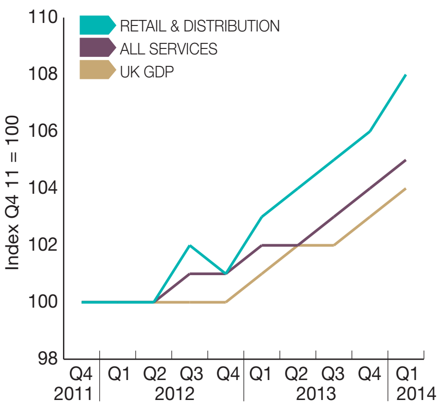
So far, so good. But the correlation between the main components of the economy with property sector performance runs into far muddier waters when we consider firstly, the retail sector and, secondly, the regional variation in performance within the core property sectors.

Retail and Distribution output – a sub-sector of Services – has been one of the UK's top performing economic sectors during the UK's recent recovery, with growth outpacing the overall Service sector and the economy as a whole (Figure 1). So much for political ambitions to rebalance economic growth away from consumption in recent years!

But this is not reflected in Retail property performance. According to IPD, UK Retail is the laggard of commercial property, with returns of 11.2% over the past 12 months (Figure 2). Retail capital values are rising, but at a slower rate than the other main sectors, while Retail is the only core sector where rental growth remains in 'bottoming-out' phase.

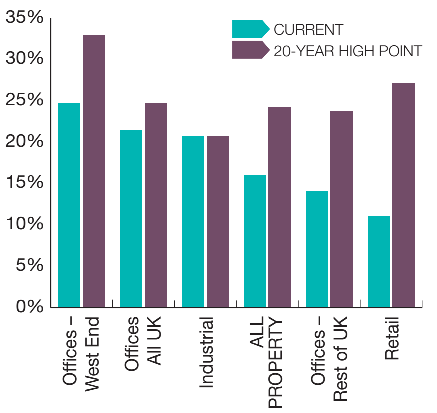
So, why the disconnect? The resilience followed by the resurgence of the UK consumer is arguably being better reflected in the strength of the IPD Industrial sector than Retail. The steady rise of e-tailing is changing the physical retail landscape and, to put it bluntly, there is an oversupply of retail space currently in existence.

FIGURE 1
Economic output
Index



Source: ONS

FIGURE 2
Total returns
12 months (%)



Source: Knight Frank / IPD

Before I am sent to Coventry by our retail agents, this is not to say that retail property is fighting a losing battle with online. Indeed, a physical and online presence are seen as complimentary, with platforms like click 'n' collect pointing to an evolution of the retail landscape rather than the death knell for the high street.

Landlords of good quality shopping centres and the most desirable or well-located retail parades have little to fear. The problem is that much of the poorer quality or marginally located retail space is becoming increasingly redundant, and evidence from Knight Frank's history on secondary and tertiary yields shows how investors are seemingly deterred by these riskier retail assets (Figure 3).

Regional variations in performance within sectors can also confuse matters. UK Offices may lead the core property sectors in terms of overall total returns, but, scratch the surface, and the reality is that Central London Offices are dominating the sector's performance overall, with annual returns running at 24.7% for London West End compared with 14.1% for the IPD 'Rest of UK' Offices (Figure 2).

If we take London Offices out of the equation, Industrial is quietly leading the three core sectors of UK commercial property. IPD's use of the term 'industrial' is certainly something of a misnomer. What it really refers to distribution property, designed to meet consumption rather than provide space for production. Regardless of what it's called though, investors are gravitating towards it.

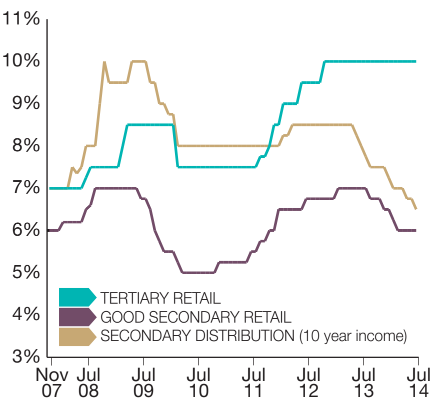
So long seen as something of a 'steady Eddie' of investment property, Industrial total returns currently stand at a 20-year high of 20.7% over the 12 months to May. All sectors are on the up, but no other can claim to be anywhere near its 20-year best (Figure 2). Furthermore, the latest IPF survey tips Industrial as the lead performing sector over the medium-term, with annual total returns of 9.3% p.a. up to 2018, vs 8.3% p.a. for All Property.

As well as sound long-term prospects linked to the steady rise of e-commerce, good quality supply is becoming increasingly tight in the Industrial occupier market, a trend which is expected to prompt a new cycle of rental growth in the sector. IPD figures show that Industrial rental growth edged up to 1.8% in the year to May – and while not sounding too exciting, equates to its strongest level in twelve years.

Investors are voting with their feet. An analysis of property investment trends shows that, historically, buying activity between High Street Retail units and Industrial have compared very closely. However, Industrial has moved ahead more recently, with investment volumes over the past two years at 19% above their long-term quarterly average, while High Street Retail stands 4% below its average (Figure 4).

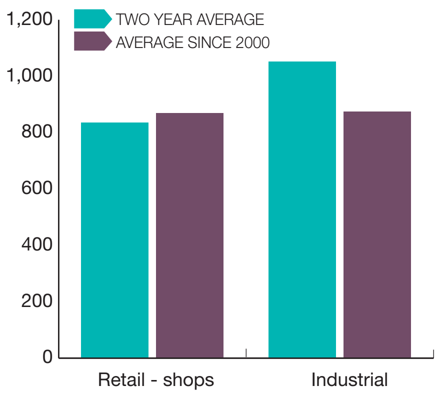
The recovery in the economy is undoubtedly taking UK commercial property with it, but to really understand sector-level performance, considerations of supply and underlying structural change are arguably much more fundamental.

FIGURE 3
Secondary yields
%



Source: Knight Frank

FIGURE 4
Quarterly investment volumes
£m



Source: Knight Frank / Property Data

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