RESEARCH

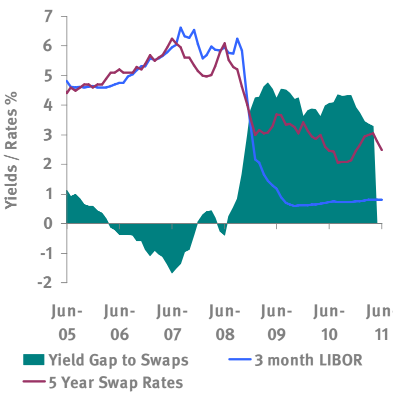
JUNE 2011
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Base rate remained unchanged for yet another month, as the economy has yet to display strong and consistent growth.
- Given the Chancellor rejected calls for a 'plan b' on fiscal policy, we believe the Bank of England has little room to increase rates for some time to come.
- Sentiment on the direction of interest rates has swung wildly. In Autumn 2010, there were predictions of QE2 for the UK; a few months ago some were forecasting rates to have risen by now.
- Despite a correction in early May, commodity prices – a major driver behind the recent surge in global inflation – rebounded. Brent crude oil hit $117.85 a barrel on 7th June.

Economic outlook

- The revised Q1 GDP figures were unchanged at 0.5%, which is consistent with a general view that the economy is growing, but at a sluggish pace.
- The latest Markit PMI indices showed a deceleration in the rate of growth for the key services sector, and also manufacturing. Construction, however, saw a pick-up in activity, perhaps reflecting the arrival of warmer weather.
- In general, confidence has ebbed on the strength of the recovery, the latest consensus of forecasts show City institutions and economic consultants have reduced their expectations for growth this year.
- In February the consensus was for 1.7% GDP growth in 2011. The figure has now dropped to 1.5%.
- That said, expectations for 2012 have improved slightly – up from 2.1% in February to 2.2% in May. Inflation expectations have also risen.

May consensus forecasts (%)

	2011	2012	2013	2014	2015
GDP	1.5	2.21	2.4	2.5	2.5
CPI	4.2	2.3	2.1	2.1	2.1
RPI	5.1	3.6	3.4	3.4	3.1
Base Rate	0.7	1.5	2.5	3.2	3.8

Source: HM Treasury Consensus, May 2011

Property performance

Key performance indicators

Borrowing yield gap*		328 bps ↓
Risk yield gap**		331 bps ↑
Investment purchases (2011)		£12.8 bn
of which, from UK institutions		27.8%
All Property void rate		10.0% ↓
	Initial yield	20yr average
Retail	6.1%	6.3%
Office	6.3%	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 April 2011

- Capital values continue to record marginal growth, as has been the case for almost a year now. The all property index increased by just 0.1%, driven mainly by offices.
- The rental growth index managed a negligible rate of growth (0.01%), again with offices as the main contributor.
- The IPD indicators confirm the property market is going through a slow patch. Yet, the figures have stayed positive despite the disappointing economic backdrop.
- According to Property Data, transaction volumes slowed in Q2. Sales totalled £1.8 bn in May, compared to £1.5 bn in April, and £2.8 bn for March.

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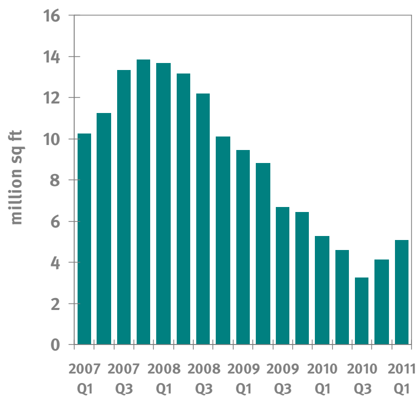
UK MARKET OUTLOOK

Commercial property review

The Prime dilemma

- The economic news is far from encouraging, and the latest Lloyds Banking Group commercial property survey reports rising cautiousness. The temptation grows to target the safest assets - prime.

Central London Office Space Under Construction

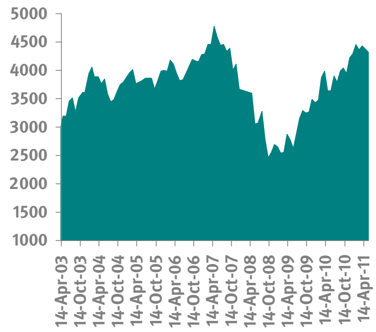


Source: Knight Frank Research

- The logic behind such a defensive move in a slow market is very apparent, but it is perhaps easier said than done. There is growing constraint upon the market for prime.
- We are now almost four years on from the onset of the credit crunch in the Summer of 2007. That period has seen the commercial property development pipeline slow to a crawl. Consequently the new supply of prime assets to trade has shrunk.
- Given that all completed buildings are depreciating, a combination of few development completions and ageing stock mean the pool of prime assets is getting smaller.
- This is leading to 'prime creep', whereby investors respond to the difficulty of finding genuine prime by stretching the definition.
- Once only a lease of over ten years was acceptable. Yet, now we have moved on from the dark days of early 2009, eight or seven years on the lease will do. Until eventually assets that would have been dismissed as secondary two years ago are being seriously considered by 'cautious' investors.
- There are signs that the development situation is improving now, but building starts in 2011 will not reach completion until 2013 or even 2014. Also, the signs of a revival in development activity are tentative. With so little finance available, it is hard to envisage a rebound.
- In the next two years genuinely prime assets which come to the market will meet with competitive bidding. However, prime supply is shrinking as demand looks set to increase. Good secondary is moving onto buyers' radar screens.

Media flexes its muscles

FTSE Media Shares



Source: FTSE

- Shortly after Google took 155,000 sq ft of expansion space in the Central St Giles office building in London's Covent Garden, comes news that Expedia are under offer on c.82,000 sq ft in Derwent London's Angel Building in trendy Clerkenwell. The space they are leaving in Covent Garden is under offer to Facebook.
- This rise in media demand tallies with recent news from across the Atlantic. In Manhattan, Condé Naste (the publisher of Vogue) has signed on 1.0 m sq ft at One World Trade Center. Omnicom, the advertising giant, has taken an extra 147,000 sq ft in its building, One Hudson Square.
- The rise of wifi, smart phones, social media, and tablet computers has energised the media sector. Media is therefore one to watch for occupier demand, though note that stronger growth appears to be coming from 'new' media rather than 'old'.

KNIGHT FRANK COMMENTS

The Commercial property market continues its unremarkable journey through 2011. After a correction as severe as 2008-2009, a gradual recovery was inevitable, but many of the worst case scenarios have failed to materialise, thankfully.

To date there has been little debate on what will drive the next cycle. The gloom-mongers would retort that talk of a cycle upswing is premature, but historic experience is the new driver emerges during the lean years – desktop computers in the late-70s, the internet in the early-90s. Now is the time to look around for opportunities.