RESEARCH

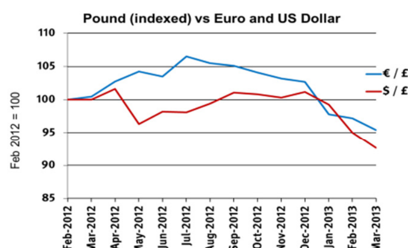
Knight Frank

MARCH 2013
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators



Source: Bank of England

- The Bank of England left the policy rate on hold and announced no additional QE. This confounded speculation that the Bank would release more stimulus, as the minutes of the previous meeting showed three committee members voted for more QE in January.
- The Pound is currently trading at $1.49, compared to $1.58 a year ago and $1.62 at the start of January. The credit rating downgrade, concerns over weak GDP growth, and the prospect of more QE weighed on Sterling.
- 10 year Gilts are back above the 2.0% level – last Summer they fell below 1.5%. With relative calm having returned to the Euro area, the UK has lost some of the 'safe haven' appeal it enjoyed last year.
- Equity markets, however, continue to move upwards, driven by QE speculation and confidence in the wider global economy's growth prospects. The FTSE 100 is trading above 6,500 – approaching pre-recession levels.

Economic outlook

- The second estimate for Q4 GDP was unchanged at minus 0.3%. Output from services sector was revised downwards from zero growth to minus 0.1%. However, an upwards revision for construction sector output acted as a counterbalance.
- At 29.7 million the number of people in employment is now at an historic high. This takes the unemployment rate to 7.8%, down from 8.3% a year ago. Encouragingly, full time jobs saw the greatest level of increase in the three months to December, while the level of part-time employment fell.
- The biggest rise in employment was in London (up 5.1% year-on-year). Interestingly, the capital continued adding jobs after the Olympics (up 1.2% since September).
- CPI inflation stood at 2.7% in January – the fourth month in a row this indicator has remained unchanged.

Key economic indicators

	% / Value	Change
CPI *	2.7	→
Retail sales (volumes) *	-0.6	↓
Unemployment **	7.8	→
Base Rate	0.5	→
£ : $	1.49	↓
£ : €	1.14	↓
FTSE 100	6,511	↑

Source: NS, FT, BoE.
All figures as at 12th Mar, except * Jan. **Dec.
Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		509 bps ↓
Risk yield gap**		483 bps ↓
Investment purchases (2013)		£4.5bn
All Property void rate		11.4% ↑
	Initial yield	20yr average
Retail	6.2%	6.3%
Office	5.9%	7.2%
Industrial	7.4%	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 January 2012

- The January IPD Monthly Index showed all property total returns unchanged at just below 2.4%. A further decline for the all retail index was counterbalanced by rises for the all office and all industrial indices.
- Interestingly the rental growth index for offices saw a marked increase in January. In the twelve months to January the index rose by 1.4%, compared to 1.1% in December.
- This increase was largely generated by London offices, although it should be noted IPD is based on valuations so the index is reflecting rental uplift coming through at review. On the open market, London office rents have been steady for some time, the growth having been recorded in previous years – so IPD is playing catch-up.

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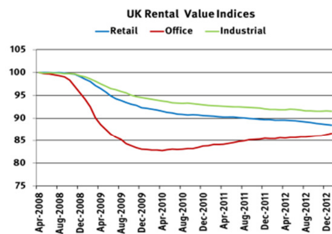
Offices on the road back

- When the property market first moved into downturn over five years ago, inevitably people looked back to previous downswings for clues as to what was ahead. History has proved to be an unreliable guide; something that is proving to be good news for some office landlords.



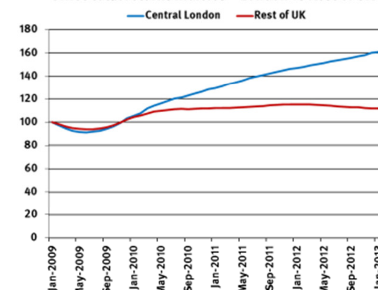
Source: IPD

- The early 1990s downturn was harder on offices than retail and industrial. The IPD all offices rental value index plunged 38.5% from peak to trough, and the time span of the correction was more than five years.
- In contrast the IPD rental index for retail fell by 6.4% over the space of three and a half years. The retail rents index was firmly established in recovery by the time the office rents index started to grow again.
- However, as the graph shows, this time it is different and startlingly so. Despite falling further than retail, the IPD offices index has long since found a floor and appears established on an upwards trend. Moreover, retail is still falling and showing little sign yet of finding a floor – chronologically, by this stage in the early 90s downturn the retail index was rising.
- The recovery for offices is almost entirely down to London, and characteristics of the IPD indices. The data from IPD is based on valuations, and rent reviews are now incorporating the rental growth that central London enjoyed in 2010 and 2011.
- The catch for offices is that central London market rents flat-lined in 2012, so we should expect a brief levelling out of that recovery at some point in the near future.
- Nevertheless, vacancy rates in the capital are low by historic standards, and when the economy does pick-up again we expect more rental growth in London – probably towards the end of this year.
- That job creation in London (see previous page) is increasing at a faster pace than other UK regions gives us additional confidence to forecast further rental growth in the capital. London added 45,000 jobs after the Olympics left town, which is a remarkable statement of economic strength.
- However, for retail the comparison with the early 1990s is unflattering. Having already declined 11.5% to date, the retail rental index appears set to fall more than double the level it saw between 1990 and 1993. Today average pay rises are well below the rate of inflation, making a consumer-led recovery unlikely.
- The rise of internet shopping (10% of UK retail sales today) means that even when the new cycle begins, retail property will share its market progressively more with logistics stock.
- Turning to industrial, while there have been some encouraging signs from the car industry, official statistics report manufacturing as a whole is struggling.
- The weak pound and the rise of internet shopping give us confidence that industrial property will see rents level out before retail. However, in the last decade industrial has experienced flatter rental cycles than offices and retail, which leads us to expect less upside in the recovery phase.
- Consequently, offices continuing to lead the recovery looks the most likely outlook for the next two years. The rising IT and media firms are office-based, and the UK needs to see activity shift beyond London. This is another rebalancing of the UK economy that needs to be worked on.

KNIGHT FRANK COMMENTS

Commentators are debating whether the Q1 GDP figures will show that the UK has entered a triple dip recession. Now we are seeing better news come through abroad – from the US and China in particular – it is becoming harder to accept the idea that Britain's economic woes are mostly due to international factors. With better growth to be found abroad, property investors will favour the parts of the UK that have the most international exposure, which favours London and the South East, and parts of the Midlands.

Within the UK economy there are clear differences in performance evident between various industries. The output figures for the services sector have held up better than those for production industries, with office-based occupations like IT, telecoms and media as bright spots. This will push investors towards offices in the South of the country, or towns and cities with strong technology connections.



Source: IPD

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