RESEARCH

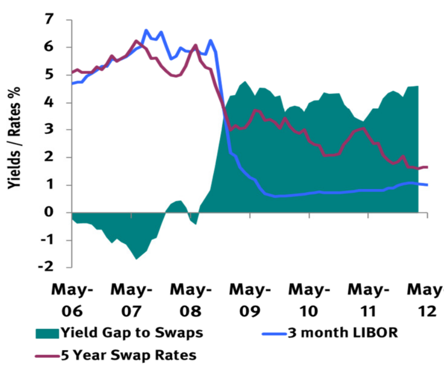
# MAY 2012
# UK MARKET OUTLOOK

Commercial property review

**Knight Frank**

## Financial indicators

**Lending rates and property yield gap**




Source: Knight Frank Research, FT, IPD

- The UK is technically in recession again, following a second successive contraction in GDP in Q1 (-0.2%). However, May saw no changes to the base rate (0.5%) and no new QE measures (currently £325bn).
- The combination of weak GDP data and a marginally higher March CPI figure make the next decision on QE more difficult, but the Bank of England has paused its asset purchase program for now.
- The Bank is minded to keep an eye on inflation - which may fall more slowly than anticipated. However, it faces a difficult balancing act between supporting a weak economy and not wishing to increase inflationary pressures through additional QE.

## Economic outlook

- The sovereign debt crisis in the Eurozone is continuing and its political impact is now being increasingly felt. The Netherlands remains without a government and recent elections in France and Greece show growing opposition to austerity measures.
- The disappointing GDP figure was largely due to weak production and construction data, although the latter tends to be revised. The latest figure also runs contrary to key surveys which indicated that business activity was accelerating and some analysts are questioning the reliability of the data.
- Nonetheless, the IMF recently revised its UK 2012 forecasts marginally upwards and the consensus remains that growth will pick up later this year - although notable downside risks remain.

**Key economic indicators**

| | % / Value | Change |
|---|---|---|
| CPI ** | 3.5 | ↑ |
| Retail sales (vols) ** | 3.3 | ↑ |
| Unemployment * | 8.3 | ↓ |
| Base Rate | 0.5 | → |
| £ : $ | 1.61 | ↑ |
| £ : € | 1.24 | ↑ |
| FTSE 100 | 5,544 | ↓ |

Source: ONS, FT, BoE. All figures as at 10 May, except *Feb and ** March. Currencies are the spot rate. FTSE is index value.

## Property performance

**Key performance indicators**

| | | |
|---|---|---|
| Borrowing yield gap* | | 460 bps ↑ |
| Risk yield gap** | | 452 bps ↓ |
| Investment purchases (2012) | | £10.0 bn |
| All Property void rate | | 10.1% ↑ |
| | Initial yield | 20yr average |
| Retail | 6.0% | 6.3% |
| Office | 6.0% | 7.3% |
| Industrial | 7.0% | 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 March 2012

- The IPD digest recorded a fifth consecutive monthly fall in All Property capital values, which declined by 0.3% in March. Retail again showed the sharpest fall (-0.5%), followed by Industrial (-0.2%). Offices were the most resilient, with a fall of just 0.1%, supported by Central London.
- Total returns are also declining. For March, the All Property annual total return amounted to 6.6%, a marked fall on February and the lowest since February 2009. Most parts of the market are weakening, although annual returns for Central London retail and offices are still in the double-digits.
- Q1 property investment volumes amounted to £7.3bn, buoyed by a couple of large portfolio deals, although the figure was almost 30% down on an annual basis.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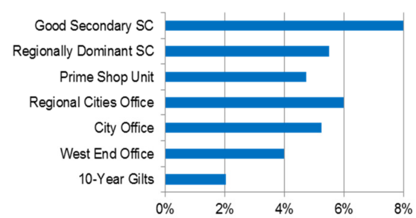
## A look at the regions

- The outlook for property and the economy remains uncertain, particularly outside London. However, despite this, we believe it is important to consider the wider UK as part of a diversified investment strategy. Our view is that, provided you buy the right assets, there are some excellent opportunities in the regions.
- The investment case for property remains strong. With interest rates at record low levels, investors are looking for income and property offers higher, relatively attractive yields compared with bonds and equities. In this context, prime regional offices look good value, with the best yields currently offering a 396 bps premium over UK gilts (6% versus 2.04%).

Prime Office & Retail Yields



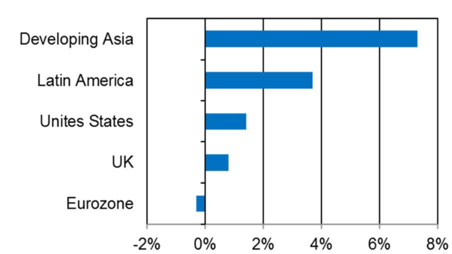

- Moreover, the typical yield range of 6-7% for regional offices also provides a degree of cushioning for capital values in the event of a further outward yield shift, if the economy does take a turn for the worse.
- Office rents have fallen in most regions since the downturn, but are now stable - certainly for prime stock. Over the longer term, regional offices have delivered a consistent, if unspectacular, rental growth of 2-3% per annum, against a more cyclical London market.
- Looking forward, while growth in headline rents for regional offices is expected to be limited in the short term, incentives are hardening and net effective rents in many areas are expected to face upward pressure by the year-end.
- A major driver of this trend is the steadily decreasing amount of supply. The supply of available Grade A office space in the top 11 regional cities has fallen by over 40% since the end of 2009. The lack of supply in some cities is very acute – which has prompted more speculative development starts in recent months.
- Making the investment case for retail in the regions is more difficult, with press headlines tending to focus on empty high street shops. However, the regions are home to some of the most successful shopping centres in Europe – namely the likes of Merry Hill, Meadowhall and the Trafford Centre.
- Retailer demand is generally gravitating towards bigger and better centres and most of these schemes have low vacancy rates. They are also being tracked increasingly by international capital and a number of significant recent deals have involved international investors – indicating that there is overseas interest in prime assets outside London.
- In summary, our view is that the regional office markets offer good value for prime assets, given their relatively high yields and stable rents. The availability of Grade A office space continues to fall and little new development is emerging. For regional retail, secondary yields are looking increasingly attractive, but the more secure income streams tend to be in the larger, more dominant cities/shopping centres and current yields reflect this.

## KNIGHT FRANK COMMENTS

Just when we thought things had settled down, the Eurozone crisis has reignited, leading to renewed nervousness among property investors and business generally. The Greek and French election results will have done little for investor confidence. Indeed, while Greece struggles to form a government and may be edging further towards a Eurozone exit, M. Hollande's pre-election proposal to impose a 75% tax levy on incomes in excess of €1 million has reportedly sparked an upsurge in enquiries to UK wealth managers from his compatriots. Moreover, with the Netherlands still without a government, Spain's banks under renewed pressure and the country's bond yields spiking again in recent days, the Eurozone remains in a state of flux.

In pure economic terms, it is clearly in the UK's interests for the Eurozone to resolve its issues so that stability and growth can resume. However, for UK property, the continuing turbulence in the Eurozone is likely to maintain the strong level of international investor interest in the market, which we expect will ripple out increasingly from London over the coming months.

GDP Growth Forecasts for 2012




Source: IMF