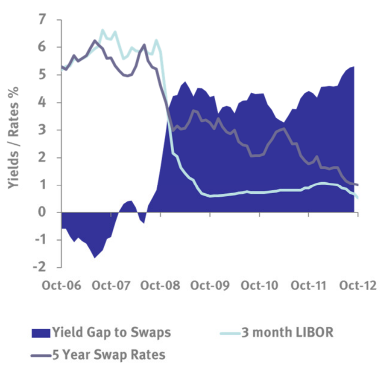
RESEARCH

OCTOBER 2012
UK MARKET OUTLOOK
Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- The Bank of England and the ECB left policy rates unchanged at their latest meetings. This probably reflects a recent easing of some of the tensions in the financial markets since the ECB opened its bond buying scheme to European governments.
- Interestingly, Greek government bonds have declined in the last month, helped by the first monthly rise in industrial output for the Hellenic Republic since 2008.
- With better news emerging from the Euro area, the Pound has declined against the single currency. In mid-October the rate was €1.24 to the Pound, compared to circa €1.27 in mid-August. Against the Dollar, Sterling is currently trading at $1.60, down slightly on a month ago.

Economic outlook

- UK GDP for Q2 was revised upwards on the third reading to minus 0.4%. The first estimate back in July was minus 0.7%, reminding us of the dangers in reading too much into initial estimates of GDP.
- The number of people in employment in Britain reached its highest level since May 2008. There are currently 29.6 m people in employment. The unemployment rate is 8.1%, down from 8.3% at the start of the year.
- The employment figures point to a mixed jobs market. On the one-hand there has been a fall in the number of people holding a second job, which should indicate a strengthening employment market. On the other hand, there are rising numbers of temporary jobs, suggesting jobs are struggling to find permanent roles.

Key economic indicators

	% / Value	Change
CPI *	2.2	↓
Retail sales (volumes) *	-0.2	↓
Unemployment **	8.1	↓
Base Rate	0.5	→
£ : $	1.60	↓
£ : €	1.24	↓
FTSE 100	5,805.6	↑

Source: NS, FT, BoE.
All figures as at 15th Oct, except * end Sept. ** end Jul. Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		531 bps ↑
Risk yield gap**		525 bps ↓
Investment purchases (2012)		£25.3 bn
All Property void rate		10.2% →
	Initial yield	20yr average
Retail	6.2%	6.3%
Office	6.0%	7.2%
Industrial	7.3%	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 September 2012

- September saw IPD totals return fall to 3.5% on a twelve month basis, their lowest reading since December 2009. This is significantly lower than total returns for equities (17.2%) and gilts (8.8%).
- West End offices continue to report the highest twelve month total returns of the IPD sub-sectors (10.8%). All shopping centres remains the worst performer (minus 1.8%). Falling capital values is the main pressure on total returns.
- Figures from Property Data show that the third quarter saw a rise in investment volume. Total investment reached £9.1 bn in Q3 2011, compared to £7.4 bn for Q2 and £7.5 bn for Q3 2011. Offices accounted for nearly half the total volume, at £4.5 bn – a quarter-on-quarter increase of 16%, and a year-on-year rise of 50%.

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UK MARKET OUTLOOK

Commercial property review

Property heads into Autumn

- Property is what people in the financial markets refer to as a 'risk on' investment – it performs well when sentiment is positive. Given this, it is unsurprising that 2012, with its global economic storms, has been a year of further price falls.

- Generally we are cautious of reading too much into historic comparisons – there is no reason why the future should not be completely different from the past. Nevertheless, there some interesting similarities, and contrasts, between the current double-dip for property, and that recorded in the mid-1990s.
- The mid-1990s double-dip saw the IPD All property capital growth index fall for 22 months, losing 6.2% of its value. So far this time, the index has been negative for 11 months and has lost 3.2% of its value. The capital growth index is certain to fall further, although there are a few encouraging signals in the economy to give us reason to suppose we will see a turning point in the medium-term.
- Therefore, a 6%-6.5% fall in value over 20 to 24 months seems a credible forecast for this double-dip. So far, so roughly similar; but looking below the headline figures reveals several contrasts.
- In the mid-1990s downturn, retail was the best performing sector. The all retail capital growth index fell by minus 4.5% during the 1990s double-dip. This time around it is the worst performing sector – having already declined by 4.6%, with further falls probably ahead.
- Last time around, the pain was greatest for standard shops, which fell by 6.3%. This time it is shopping centres leading the decline, with their capital value index down 10.5% to date. In the mid-1990s downswing, shopping centre capital values fell by just 3.3%.
- There are, however, two similarities for retail today with the mid-1990s double-dip. Retail warehouses are performing better than most other retail sub-sectors, but like shopping centres and standard shops, they have already fallen further in value than in the mid-1990s – minus 3.3% so far, compared to minus 1.8% in the previous double-dip.
- Also central London retail has continued to grow, which is similar to its mid-1990s experience – just two months of falling capital growth, recording a negligible minus 0.2%.
- In contrast, both offices and industrial appear to be experiencing gentler double-dips comparative to the mid-1990s. After nine months of decline, the all office capital growth index has fallen by 1.9%, versus 3.3% in the first nine months of the 1990s double-dip. Similarly, the all industrial capital growth index is down 3.1% after seventeen months of double-dip. This compares to a 7.5% for the equivalent period of the mid-1990s.
- The current double-dip has been hardest on the consumer facing retail property sector; but this perhaps points to a future recovery built on firmer foundations. The long-boom for the UK economy of 1992 to 2007 was characterised by an over-reliance on consumers and easy credit. A UK economic cycle that is drawing growth from enterprise should have deeper foundations and greater resilience.
- That said, we must not write off retail – people will still shop in the future. Also, the geographic disparities – London and the South East versus the rest, have been too frequently a point of analysis in this note. Policymakers need to think more about how growth can be spread wider within the UK economy. 'Risk on' property investors will want to hear more about growth for the UK economy in order to be tempted out of London.

KNIGHT FRANK COMMENTS

The double-dip for UK commercial property continues to unfold, and there is no reason to expect any sudden rebound. The comparison with the mid-1990s double-dip, which would suggest we are around half way through, is tempting; but this is not a re-run of that downturn, as this double-dip has its own characteristics. Offices and industrial are holding up better than retail, and we expect that to remain the case as retail still has an overcapacity issue; while offices and industrial should benefit from an improvement in trade when the global economic cycle turns upwards.

Geographic differences in performance within the UK were features of previous property market and economic downturns. This time they are particularly stark, as much of the good news in property (and the economy) today relates to overseas investment, which tends to focus on London and the South East. Moving the growth around the country is now a major issue.

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