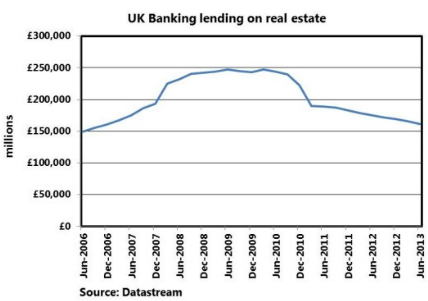
RESEARCH

OCTOBER 2013
UK MARKET OUTLOOK
Commercial property review
Knight Frank

Financial indicators



- Financial markets have experienced a volatile month, as the difficulties of emerging markets and concern over the US government shutdown have impacted confidence. UK ten year Gilt yields have fallen to 2.74%, having cleared 3.00% during the summer.
- This has made the markets more comfortable with the Bank of England's guidance that a rise in interest rates is some way off. Talk of an increase in the base rate in 2014, which was commonplace a month ago is now relatively unusual.
- The banks continue to deleverage and reduce exposure to UK real estate. According to the latest Bank of England figures at the end of June, UK banks had £161 bn of real estate loans on their books; down from £166 bn in March, and £170 bn at the end of last year.

Economic outlook

- A number of international commentators including the IMF and the OECD have upgraded their 2013 forecasts for UK economic growth. This coincided with official figures confirming that GDP grew by 0.7% in the second quarter.
- The latest PMI index showed the UK services sector expanded strongly in September. The index read at 60.3, compared to 48.3 in September 2012. A reading of over 50 equates to growth.
- However, the August UK index of industrial production recorded a 1.1% month-on-month fall in output. This came as a surprise as economists had been forecasting an increase. The figure may be revised upwards as more data is released, as the fall is at odds with the manufacturing PMI index.

Key economic indicators

	% / Value	Change
CPI **	2.7	↓
Retail sales (volumes) **	2.1	↑
Unemployment *	7.7	↓
Base Rate	0.5	→
£ : $	1.60	↑
£ : €	1.18	↓
FTSE 100	6,507.7	↓

Source: NS, FT, BoE.
All figures as at 14th October, except * end July and ** end of August. Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		443 bps ↓
Risk yield gap**		433 bps ↓
Investment purchases (2013)		£31.37 bn
All Property void rate		11.4% ↓
	Initial yield	**20yr average**
Retail	6.2%	6.2%
Office	5.9%	7.0%
Industrial	7.2%	7.7%

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 August 2013

- The IPD all property capital growth index increased month-on-month by 0.36% in August, compared to the 0.23% rise recorded in July. This is the fourth month in a row that the index has increased.
- Encouragingly, the all retail capital growth index returned to the black in August, up 0.13% month-on-month. This was partly thanks to a surprise burst growth for regional standard shops. The all office and all industrial indices both increased by 0.6%.
- Around £31.4 bn of commercial property sales have been transacted in the year to date, compared to £25.8 bn for the same period of 2012. The market benefited from a surge in office sales in Q3.

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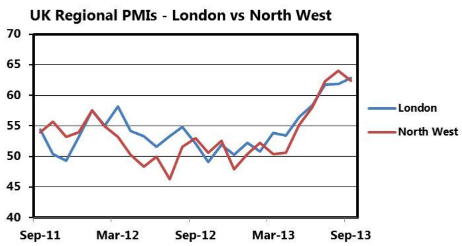
Regional offices await their cue

- The August IPD figures brought some good news for regional offices. A few months after the all property capital growth index turned positive, IPD's "rest of UK" office index – which is Britain outside of London and the South East – found the floor after 37 months of decline.



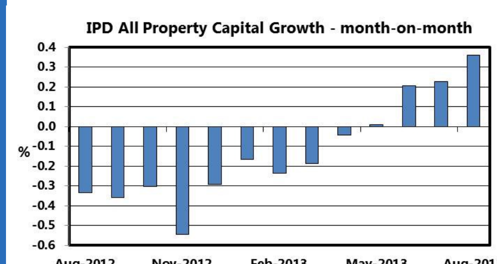
Source: Markit

- Hopefully the September figures will show a move into growth, and not a resumption of the downswing. However, much already depends on which part of the "rest of UK" a property is located in. If we look at the four underlying indices that make up "rest of the UK", a three tier pattern emerges.
- Top of the pops is 'Wales and the West Midlands', which actually moved into the black in August, registering 0.3% month-on-month growth. Still in the mire are Scotland (minus 0.2%) and the South West (minus 0.5%). While in the middle sits 'Rest of England', effectively the North West and North East of England, on zero growth.
- Nevertheless, we believe that IPD's rest of UK office index will establish itself in a new growth cycle in the coming months.
- Investors are focussing on the improved economic news flow, observing that the South East office market is experiencing a new wave of activity, and rationalising that the regions are the next logical domino in the row.
- So far, so logical. Certainly when Knight Frank releases its ROMP family of regional city centre office market research notes at the end of the month, we expect to report hardening prime yields in several regional city markets.
- Economic indicators are also painting a picture of a recovery spreading into the regions. The September regional break down of the UK PMI index showed a rapid increase in business activity outside of London and the South East. Indeed the North West has in recent months been giving London a run for its money (see graph).
- However, the latest edition of *The Economist* carries a message of caution for property investors targeting the regions, with its article "Rustbelt Britain". This discusses the problems of those smaller cities – often satellites of the bigger regional business centres – which have struggled to adapt to the post-industrial world.
- The underlying suggestion within the text is some of these 'cities' may need to shrink to town-size.
- Regional cities are in the wings awaiting their cue for the new UK property cycle, but it is major city centres with large service industries, high technology and media tenants, and leading universities, that will be at the top of buyers' wish lists.

Knight Frank Comments

There is a popular saying in property that, "the turning point is either six months away or six months behind us". People rarely call the exact moment, and often find themselves re-entering a market place that is quickly filling again with interested buyers. Now is a time of opportunity, but this will not be 2004-2005 all over again when the catalyst of an unfolding debt boom created an unexpected and (ultimately) unsustainable surge in performance.

The economy since 2009 has followed a stop-go pattern, and careful asset selection will be the best insurance against any future unexpected stop. City centres are growing in popularity – young professionals want to live near work, tech firms are shifting from business parks to city offices, and new leisure and retail offerings are emerging to match the trend. Investing in cities today means buy the 'Bright Lights'.



Source: IPD