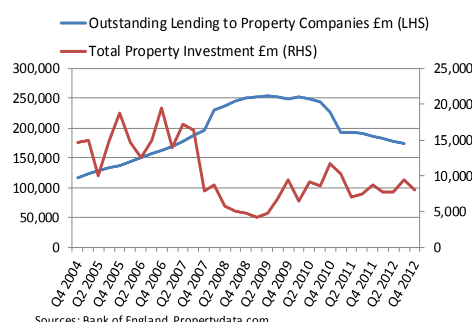
FEBRUARY 2013
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators



Sources: Bank of England, Propertydata.com

- Unsurprisingly, the Bank of England left the base rate unchanged at 0.5% in February, and the asset purchase programme at £375 bn. It appears that there will need to be a significant deterioration in the economic outlook for the Bank to pursue additional QE.
- While the rally in equities has recently faltered, the general shift out of bonds in late 2012/early 2013 reflects a more "risk on" attitude among investors. UK 10-year gilts ended last year at 1.83% but had risen to 2.1% by early February.
- The Pound has continued to weaken against the Euro and, in mid-January, fell below the €1.20 level for the first time since April 2012. The recent weakness reflects investors' concerns about the UK's AAA rating and the country's position within the EU. In addition, the systemic risks posed by the sovereign debt crisis in the Euro area appear to have eased – although have not completely dissipated.

Economic outlook

- The initial estimate for Q4 GDP showed a 0.3% contraction in the economy. There was a 1.4% decline in manufacturing, while construction saw a 0.3% rise and the service sector was flat. However, GDP would have fallen by just 0.1%, had it not been for a fall in production caused by disruption to North Sea oil and gas operations. Moreover, the January PMI survey rose to a four-month high, which bodes well for modest economic growth in Q1.
- Unemployment remains on a downward trend, falling by 37,000 to 2.49 million between September and November, against the previous three months. This equates to a rate of 7.7% - its lowest level in 18 months.
- CPI inflation stood at 2.7% in December - unchanged since October - although pay growth remains subdued at just 1.8% (3-month average growth to October).

Key economic indicators

	% / Value	Change
CPI *	2.7	→
Retail sales (volumes) *	0.3	↑
Unemployment **	7.7	↓
Base Rate	0.5	→
£ : $	1.57	↓
£ : €	1.17	↓
FTSE 100	6,228	↑

Source: NS, FT, BoE.
All figures as at 7th Feb, except * Dec. **Nov.
Currencies are the spot rate. FTSE is index value.

Property performance

Key performance indicators

Borrowing yield gap*		536 bps ↓
Risk yield gap**		503 bps ↓
Investment purchases (2012)		£35.5bn
All Property void rate		10.5% ↑
	Initial yield	20yr average
Retail	6.2%	6.3%
Office	6.0%	7.2%
Industrial	7.3%	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 December 2012

- Based on the IPD December monthly digest, all property total returns in 2012 were 2.4%, led by offices (4.2%) and industrial (3.7%). Retail generated a total return of just 0.4%, although south east retail performed strongly.
- Property capital values declined for the fourteenth consecutive month in December, taking the annual decline to 4.2%. Retail continued to suffer falls in capital values across the board, particularly shopping centres.
- Updated figures from Propertydata.com suggest that total commercial property investment amounted to £35.5bn in 2012, a near 6% increase on 2011. Q4 saw a flurry of deals across all the main sectors, taking the annual total close to the 2010 figure.

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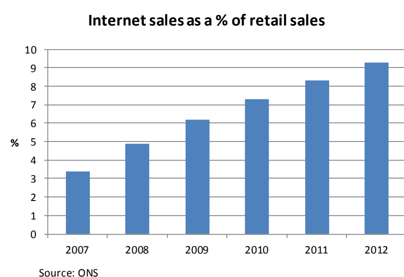
The internet juggernaut rolls on

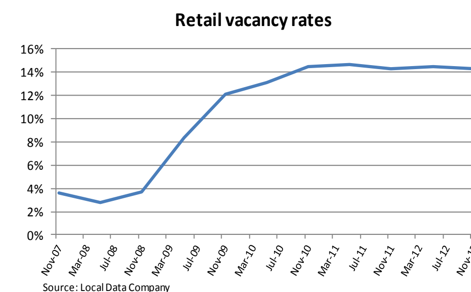
- The gradual consumer shift to online shopping is turning the existing retail landscape on its head, creating both winners and losers. Indeed, the weeks either side of Christmas saw more major retailers - Comet, HMV, Jessops and Blockbuster - end up in administration.



- The sectors in which all these retailers operate are those which are facing the strongest challenge from the Internet, namely offering products which can be easily researched and bought online. Digital now accounts for the majority of music sales for example and the number of book shops in the UK has halved in the last eight years.
- While total retail sales rose by just 0.3% (year-on-year) in December, Internet sales have continued to increase sharply. Sales were up 15.5% (year-on-year) in December and accounted for 10.6% of total retail sales for that month. But while the Internet has inevitably had an adverse impact on some retailers, others with the ability to invest in their online offering have benefitted significantly.
- Indeed, retailer feedback to the Office for National Statistics suggested that the Internet accounted for a much higher proportion of overall sales than expected, with John Lewis and Debenhams reporting 40% plus growth in online sales over the Christmas trading period.
- An integrated and consistent multi-channel approach has also paid dividends for some. Argos for example generated 42% of its sales online, but around 90% of those were via “click & collect” in store. At Dixons meanwhile, almost 20% of sales are now online, although the majority of transactions involve the internet at some point in the process.
- The line between clicks and bricks continues to blur and pure internet retailers are looking at maximising opportunities through an increased physical presence. Amazon for example has established a network of collection lockers and has suggested it may open stores in the future.
- An increasing number of consumers are turning their backs on many traditional shopping locations. Data from the British Retail Consortium/Springboard show that high street footfall declined by 3.3% in 2012. The Local Data Company meanwhile was quoting a national average retail vacancy rate of over 14% at the end of last year, with the level of empty shops in some of the worst affected towns now exceeding 30%.
- It appears that some high streets are unlikely to be saved as retail locations in their current form without radical restructuring. Others are salvageable and there are examples of local high streets such as Harrow which have bounced back as a result of investment in the public realm, improved facilities and events designed to attract people back in to the town centre. Harrow’s vacancy rate had fallen from 7% to around 4% by the end of 2012, against a London average of just over 10%.
- But for many other high street locations the future is bleak; a very high percentage of empty shops are simply obsolete. There are potential alternative uses but pop up shops are temporary by their nature; some say there are already too many charity shops; galleries do not generate huge footfall; residential is often quoted as a possible option, but there are already a million empty houses in the UK.
- Looking forward, if we are not to raze poorly performing high streets up and down the country, we need to look at areas where there are supply-demand imbalances, such as residential and care homes, for possible conversion. However, given the poor state and fragmented ownerships of many high streets, there are no easy or quick solutions to the empty shops problem, so don’t expect the vacancy rate to fall any time soon.

KNIGHT FRANK COMMENTS

The economy will bounce back at some point so, in terms of retail, we should be more focused on the structural changes taking place in the sector. The starting point is that retailers need significantly fewer stores than they used to and an integrated multi-channel offer is now standard. So, which locations will be the winners and losers at the end of all this upheaval? Essentially, we are seeing a division in to locations where people either really *want* to go, or really *have* to go. Everything else is losing ground. Critical mass is very important for retail locations and, generally, retail is moving towards bigger and better, whether for shopping centres, retail parks or cities, although some smaller self-contained towns will continue to do well. Ultimately, the winners will be the places where people want to live, work and play, with leisure becoming an increasingly important part of the mix, as consumers seek out ever increasing value - not just in terms of money, but also time.



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