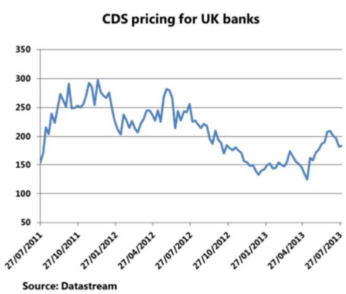
RESEARCH

AUGUST 2013
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators



- The minutes for the July Bank of England Monetary Policy Committee (MPC) meeting showed all committee members were opposed to more QE. The UK base rate was again left unchanged at 0.5% at the August MPC meeting. Better economic news and rising inflation has significantly reduced the chances of further QE.
- In recent days 10 year Gilt yields have increased to 2.4% reflecting the improved economic situation. Equities markets have rallied in the last month, after the volatility seen in May and June.
- Pricing for credit default swaps on UK banks fell back in July (see graph above), having risen sharply in May and June. The Bank of England recently introduced new capital rules requiring banks to hold reserves equal to 3% of lending. Some UK banks are now raising additional capital to comply with the new rules.

Economic outlook

- The first reading for Q2 UK GDP came in at 0.6%, which is encouraging although this initial estimate is based on just 44% actual data, with computer models filling in the gaps. Nevertheless, the figures are consistent with recent business surveys that point to increased activity.
- With growth picking up, inflation is starting to gather pace. CPI inflation increased to 2.9% in June, drawing closer to the 3.0% ceiling of the Bank of England's target band. Upwards pressure came from petrol, clothing and footwear.
- Bentley Motors, part of Volkswagen, is planning to invest £800 m in its Crewe factory in order to produce a new upmarket sports utility vehicle there. Bentley is to add 400 posts at its plant, with a further 600 jobs expected to be created among its UK suppliers.

Key economic indicators

	% / Value	Change
CPI *	2.9	↑
Retail sales (volumes) *	0.2	↓
Unemployment **	7.8	→
Base Rate	0.5	→
£ : $	1.52	↑
£ : €	1.14	↓
FTSE 100	6,621.1	↑

Source: NS, FT, BoE.
All figures as at 31st July, except * end June and ** end May. Currencies are the spot rate. FTSE is the index value.

Property performance

Key performance indicators

Borrowing yield gap*		514 bps ↓
Risk yield gap**		451 bps ↓
Investment purchases (2013)		£21.03 bn
All Property void rate		11.9% ↑
	Initial yield	**20yr average**
Retail	6.2%	6.2%
Office	5.9%	7.0%
Industrial	7.3%	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 June 2013

- The IPD all property capital growth index moved further into positive territory in June, rising 0.21% month-on-month. This is the second consecutive month of growth for the index.
- Confirming established trends, the rise was driven by growth for offices and industrial property. The retail index declined in June, led downwards by retail outside of London and the South East. However, shopping centre investment volumes have increased significantly this year, so the fall in values could reflect assets being priced to sell.
- UK property unit funds recorded net sales of £140 m in June, their highest level since June 2011, according to figures from the Investment Management Association. This takes net sales for Q2 2013 to £350 m, up from £97 m in Q1.

Commercial Research
James Roberts, Head of Commercial Research
+44 (0)20 7861 1239
james.roberts@knightfrank.com

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Heathrow and commercial property

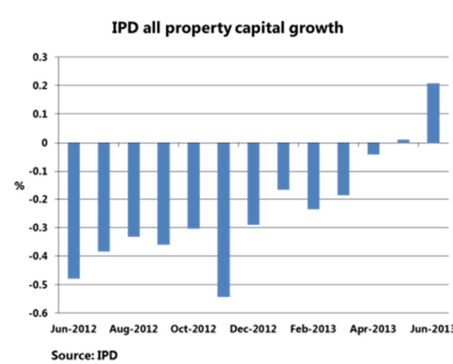
- The debate over expansion of London's airport infrastructure is dominating the headlines. Heathrow is at 98% capacity and 60% of arrivals find themselves in holding pattern before landing there, according to the air traffic control service, NATS.

- Various proposals – a third runway at Heathrow, expansion of Gatwick or Stansted, and even a new Thames estuary airport – have been discussed. From a commercial property perspective we see Heathrow expansion as the best solution.
- The advantage of Heathrow is that all the elements needed to support a successful business hub are already in place. The workforce, the warehouses, the business parks, the motorways, and the rail links. Indeed, with Crossrail, transport capacity is about to be strengthened.
- This is the undoing of the Thames estuary airport proposals, as the supporting infrastructure would have to be built from scratch. Once the expense of new rail and road links, plus a new Thames flood barrier, are taken into account, this is the most expensive of the airport proposals.
- Knight Frank Research data shows that in the surrounding area to Heathrow there is 28.7 m sq ft of office stock (which is more than Birmingham and Leeds city centres put together). Promis estimate the warehouse stock in the immediate area at 21.9 m sq ft.
- For the Thames Estuary airport all this commercial property would need to be newly developed, probably exacerbating the opposition from locals and environmental groups.
- For Gatwick the local commercial property stock would require major expansion. We estimate the office market at just under 6.0 m sq ft. Promis places the warehouse stock at 5.2 m sq ft.
- The Stansted airport web site reports 3.2 m sq ft of "commercial accommodation" at the airport, although this includes hangars and airline lounges. Interestingly, passenger numbers at Stansted are down 27% on 2007, although cargo tonnage is up by 4% over the same period.
- However, looking at commercial property in the immediate Heathrow area understates the volume for business space demand the airport generates. There are firms along the M4 from Reading to Chiswick who require proximity to Heathrow. A new hub airport elsewhere will necessitate building the supporting commercial property, as well as homes for workers, and transport links to the new warehouses and office parks.
- There is also the issue of expanding the commercial stock to match future growth arising from the airport. For Gatwick and Stansted this means seeking planning permission for green field development. For Heathrow, due to the large volume of local stock, there is room to redevelop existing sites to greater densities.
- Heathrow is more than an airport, it is a major economic hub and a gateway for the UK into the global economy. Inevitably a large commercial property hub has grown in tandem. Moving it somewhere else would be a huge, disruptive, and expensive undertaking. Expansion in property is best achieved by building on something which is already there, as you are not seeking planning consent on green fields. Britain should continue to back a winner.

Knight Frank Comments

The UK Market Outlook research note began life in the Summer of 2008, and consequently has had a lot of bad news to report. Of late it has made for a more upbeat read, with the IPD capital growth index emerging from the double-dip, and the economic news having improved. Offices and industrial are leading the recovery for commercial property, but there are signs of life in retail if we set aside the particularly embattled local high street.

The property market historically has gravitated between extremes of bullishness and bearishness in the last 15 years. We expect the path ahead to be something which will require a more measured mind set, i.e. a slow recovery, where corporate recovery sales dampen the upside from an improving economy. In this context, the UK needs to avoid any economic own goals, like excessive Euro-phobia or talk of closing Heathrow. These growth-threatening policy proposals are luxuries the UK today can ill afford.



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