Research report

EPMR

Economic & Property Market Review

Q1 2012

Economic trends

The eurozone is suffering from a marked lack of effective decision making which is prolonging the crisis. Leaders are muddling through and moving slowly towards a tighter and more centrally controlled fiscal policy (needed for the euro to survive). But in the short term what is urgently needed is a much larger rescue fund to resolve the banking and sovereign debt crisis and an effective economic growth strategy. This delay, coupled with austerity programmes in many countries, is pushing the euro zone back into recession.

These concerns have affected UK business confidence and, together with high inflation, negative real income growth and our own severe austerity programme, have caused a **UK GDP decline of 0.2% in Q4**. This compares with an increase of 0.6% in Q3, as the first chart shows. Growth in 2011 overall was a very weak 0.9%, compared to 2.1% in 2010.

The weakest sector in **Q4 was Production (-1.2%)**, followed by **Construction (-0.5%)** and the **service sector (zero overall growth)**. Within services the largest relative slowdown was in business services and finance where strong growth of 1.2% in Q3 reduced to zero in Q4. The one services sub-sector that saw growth in Q4 was, surprisingly, Government and other services, where output increased by 0.4%.

Unemployment increased by 118,000 in the three months to November bringing the rate up to 8.4%, as the economically active population rose more than total employment. Encouragingly for the property market, **employment growth moved into positive territory** in the three months to November, although the increase was by only 12,000, but this was a noticeable improvement from the steep declines a few months ago.

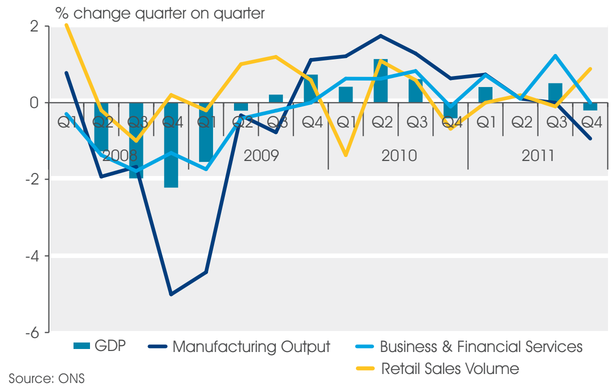
Other mildly positive news was that **retail sales volumes recovered in December** and in Q4 showed growth of 0.9%, as the first chart shows. But this was mainly down to aggressive price discounting, off-setting worsening consumer confidence. A concern for the retail property market was the growth of on-line sales, which in December accounted for nearly 11% of total retail sales, a huge 28% increase over the previous 12 months.

Inflation was down to 4.2% in December, from over 5% in September. Further large declines are almost certain as the effect of last year's VAT increase and higher oil prices drop out of the annual comparisons. This will lessen the decline in real income growth experienced in 2011, which is better news for consumer spending.

The economic outlook in the short term is inevitably poor in the UK and in Europe as the second chart shows. However, the IMF forecasts for the UK are better than for the euro area as a whole and slightly better than for Germany and France. On a more positive note the US economy has been improving in recent months and is forecasted by the IMF to show nearly 2% growth this year and next.

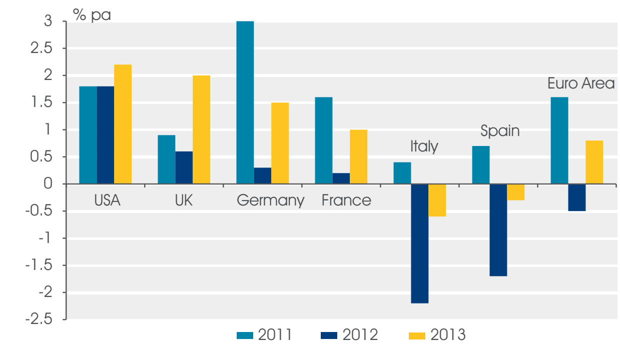
If Q1 2012 shows a further decline in UK output, which seems likely, we will technically be in a recession, albeit a mild one. But some improvement is expected thereafter with (weak) positive growth for 2012 overall of 0.6% (IMF) or 0.4% (latest Consensus forecasts), and then a stronger improvement to a just below trend 2% in 2013, assuming that the eurozone crisis doesn't worsen further. Occupier property demand will clearly remain weak in 2012, but should slowly improve thereafter as the third chart shows.

UK Output growth



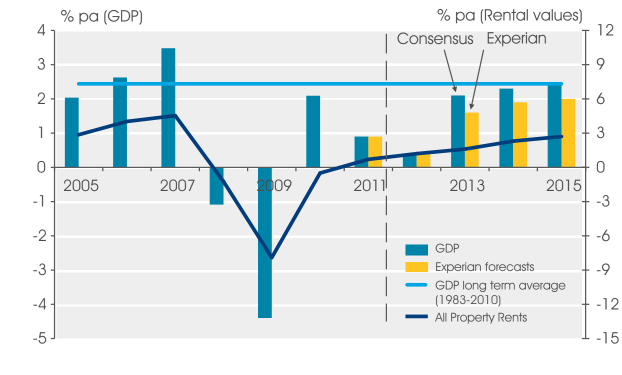
Source: ONS

Economic growth in Europe and the USA



Source: IMF

Economic output and all property rents



Source: ONS, IPD, REF Ltd, GVA

Latest Consensus Forecasts, January 2012

	2011	2012	Long-term average
Economic growth (GDP)	0.9%	0.4%	2.4% pa (1983-2010)
Private Consumption	-0.7%	0.2%	
Employment growth	0.2%	-0.5%	0.4 - 0.6% pa
Bank base rate (Q4)	0.5%	0.5%	
CPI – Inflation (Q4)	4.6%	2.1%	
RPI – Inflation (Q4)	5.1%	2.7%	
House Price Inflation (Q4)	-0.6%	-0.3%	

Source: HM Treasury (compilation of forecasts), GVA

Commercial property market

Recent occupier market trends

Occupier demand is understandably subdued across most of the commercial property market, as underlined by the RICS UK Commercial Market Survey. This suggests a fall in occupier demand in both Q3 and Q4 2011 (balances of -12 and -13 respectively, compared with positive balances in Q1 and Q2).

Construction activity remains in the doldrums and has weakened slightly during 2011 from an already historically low level. The value of new construction orders in real terms for retail, office and industrial property during the year to Q3 2011 was a third of the level seen at the peak in 2007.

The supply picture varies considerably. The lack of development activity means shortages of prime space are beginning to emerge in certain markets, but there are significant overhangs of secondary space.

Average rental levels across the commercial market as a whole held steady during the last three months of 2011, and there was little change during the year as a whole – the IPD Monthly Index reports a rise in all property rental values of just 0.1%. But there is significant variation by sector as the first chart shows.

Central London offices have been one of the few sectors to see above-inflation rental value increases over the last two years. But the rate of growth now seems to have peaked.

Central London take up in Q4 2011 was in line with the five year quarterly average, although the figure for the whole of 2011 was one third down on 2010. Across the largest nine regional office centres, take-up held up reasonably well in Q4, at 1.5 million sq ft, just 4% below the quarterly average. Recent office take-up trends are illustrated in the second chart.

Take-up in the distribution market in 2011 was down considerably on 2010 levels, with occupier demand focused around the food retailers, discount retailers and internet operations. However, good quality speculative space is becoming increasingly in short supply.

Outlook for occupier market performance

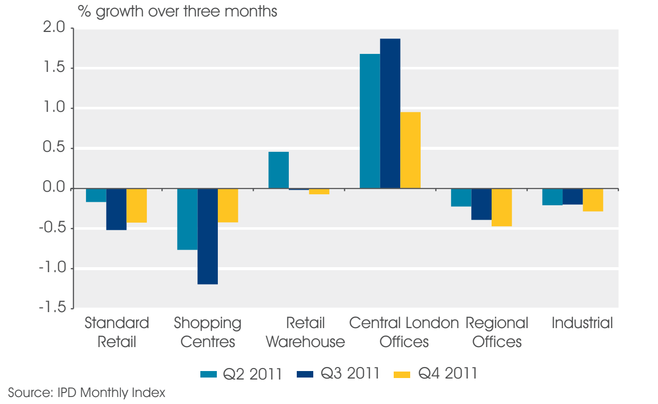
Occupier demand should remain robust in the central London office market this year, where employment growth will be focussed, and central London retail should continue to see healthy occupier interest. But these markets are driven as much by global economic conditions as the domestic economy.

Outside London, the retail market will face strong headwinds, particularly on the high street, where the recent Portas Review has served to highlight the problems of a structural oversupply. Several major UK retailers did not survive intact in 2011 and 2012 will doubtless see more failures as household disposable incomes are squeezed further and internet sales make further inroads into the high street market. But the rise of the internet should bolster demand for distribution space.

At the all property level, we forecast a rise in average rental values of 1.2% in 2012, only a very modest increase from the 2011 rate. Growth is likely to stay below 3% throughout our five-year forecast period, as the table shows. We also expect the rate of increase to remain below RPI inflation, meaning further falls in real terms.

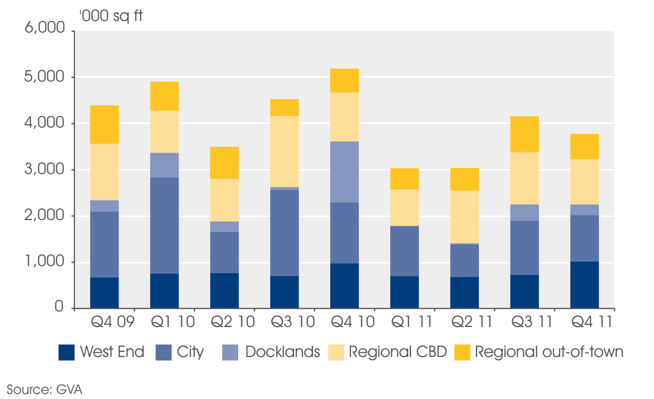
As the bottom chart illustrates, there should be a rebalancing of rental performance, as the relatively strong rate of rental growth in central London starts to slow and the regional markets begin to see a small rise in rental values (in nominal terms at least).

Average rental growth by sector



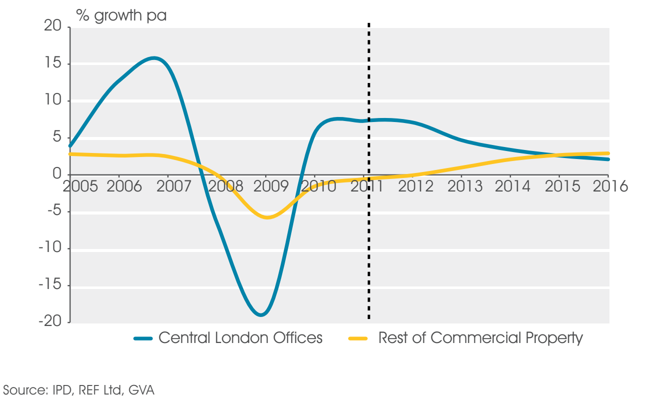
Source: IPD Monthly Index

Office take-up - central London and key regional centres



Source: GVA

Average rental growth forecasts



Source: IPD, REF Ltd, GVA

All property rental growth forecasts

	2012	2013	2014	2015	2016
Consensus (November)					
Maximum	2.2%	3.6%	-	-	-
Minimum	-2.2%	-1.0%	-	-	-
Average	0.6%	1.7%	-	-	-
GVA (December)	**1.2%**	**1.6%**	**2.3%**	**2.7%**	**2.8%**

Recent investment performance

Market activity continues to be constrained by a shortage of good quality assets and of debt finance. The total value of UK investment transactions in 2011 was £32.2 billion, according to Property Data, 6% below the £34.2 billion recorded in 2010. Overseas buyers maintained a very strong interest in the UK, purchasing property worth £11.7 billion in 2011, marginally higher than in 2010, and accounting for 36% of last year's total.

In net terms (taking into account property sold), overseas investors increased their exposure to UK property by £4.6 billion in 2011. This continues a long-term trend. Indeed, overseas buyers have increased their net holdings in UK commercial property by more than £50 billion over the last decade.

The IPD Monthly Index reports a modest increase in capital values of 1.2% during 2011, although measured against RPI this represents a fall of 3.6% in real terms. Average capital values have recovered by nearly 18% since bottoming out in July 2009. But values would need to rise by a further 50% to reach their all-time peak achieved in 2007, even in nominal terms.

However, such averages are very misleading in today's market. Indeed, values for prime and those for poor quality secondary property have been moving in opposite directions.

Commercial property as a whole still looks fairly priced relative to the long-term. Gilt yields fell sharply during 2011, as the second chart shows, and 15-year gilt yields are at an historically low 2.6% compared with an all-property equivalent yield of 7.2% for all commercial property (IPD Monthly Index, December 2011). This is a significant yield gap and commercial property looks highly attractive relative to the risk-free rate.

Investment market outlook

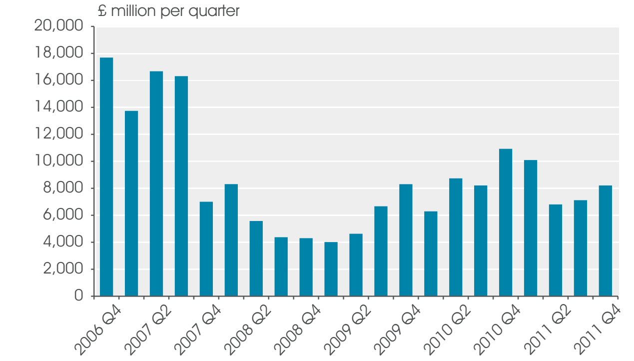
The UK will remain an attractive market for overseas investors, especially considering the competitive value of sterling, and healthy demand for quality assets should continue. We expect demand for prime assets to remain strong in 2012 and prime yields should remain at broadly current levels. However, we may well see some further upward movement of secondary yields.

Our forecasts for all property total returns are set out in the table, together with those from the IPF consensus forecasts. The latter reflects the large amount of uncertainty, with forecasts for returns in 2012 ranging from more then 8% to below -2%.

Our forecast of a 6% total return this year assumes broadly zero capital growth as a modest rise in rental values is offset by some upward yield movement. So performance will be almost entirely derived from the income element. But if there is a major escalation of the European financial crisis, the outturn could be very different.

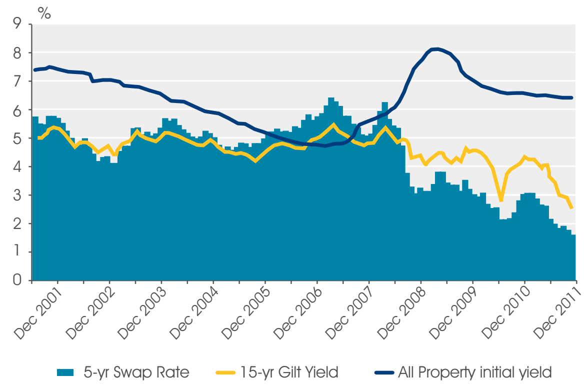
The polarisation between the prime and secondary/tertiary markets will remain. Given the renewed economic uncertainty investors will be concerned about the impact on secondary property, where shorter leases and weaker covenant strengths increase the risk of voids and oversupply will make re-letting difficult in many markets. So investor demand for secondary will remain subdued although, at least on the supply side, we do not expect a flood of properties to come onto the market.

Value of property transactions



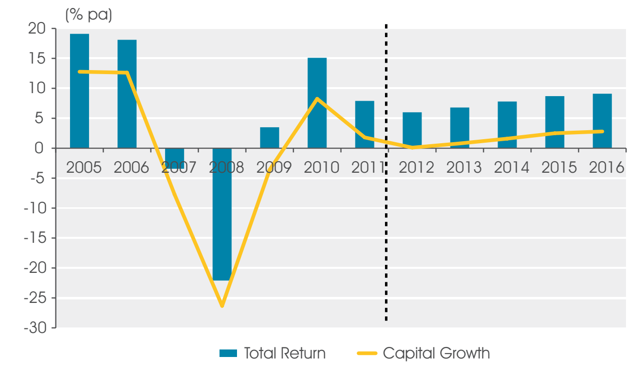
Source: Property Data, GVA

Yields and swap rates



Source: IPD, FT, GVA

Forecasts for capital growth and returns



Source: IPD, REF Ltd, GVA

All property total returns forecasts

	2012	2013	2014	2015	2016
Consensus (November)					
Maximum	8.4%	13.7%	-	-	-
Minimum	-2.4%	4.8%	-	-	-
Average	4.5%	7.7%	-	-	-
GVA (December)	**6.0%**	**6.8%**	**7.8%**	**8.7%**	**9.1%**

Published by GVA - 10 Stratton Street, London W1J 8JR

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