Research report

EPMR

Economic & Property Market Review

Q4 2012

Economic trends

Economic output growth in Q3 was a strong 1%, reversing the decline in output over the three previous quarters. However, this only leaves output at the same level as 12 months ago and only 0.6% higher than two years ago.

When the extra bank holiday in Q2 is taken into account, along with all the Olympic and Paralympics ticket sales being treated as occurring in Q3 rather than when the money was actually spent, this reduces the effective growth in Q3 to a relatively weak 0.3% as indicated in the first chart. Still at least this is a positive figure which is encouraging.

Other recent reasonably good news is healthy but slowing **employment growth** and some **improvement in real income growth** over recent months, although it is still negative. Any further improvement in real income growth seems some way off as inflation increased significantly in October and may well increase further over the next few months as higher energy costs and food prices feed their way through.

Employment growth has been surprisingly strong over the last year (total employment is now 513,000 higher than a year ago) despite no overall growth in economic output. However, the rate of growth has slowed over the last three months (to the end of September). Although total employment growth was a reasonably healthy 100,000, this growth was less than half what it was over the three months to the end of July and 50% of recent growth was from people working part time (see second chart).

Even though **unemployment** has fallen recently to its lowest level for 14 months (2.5 million) it is still 800,000 higher than before the start of the 2008/2009 recession.

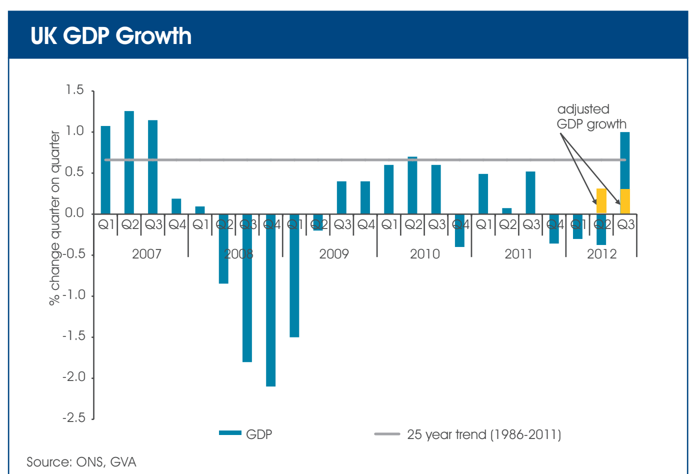
Other reasonably good news has been continued economic growth in the US in Q3 (0.5% or an annual equivalent of 2%) and the recent action by the European Central Bank to buy, without limit, government bonds of at-risk countries in the Eurozone. As a result their cost of borrowing has been reduced noticeably. This is a major step forward for the Eurozone and exceeded market expectations.

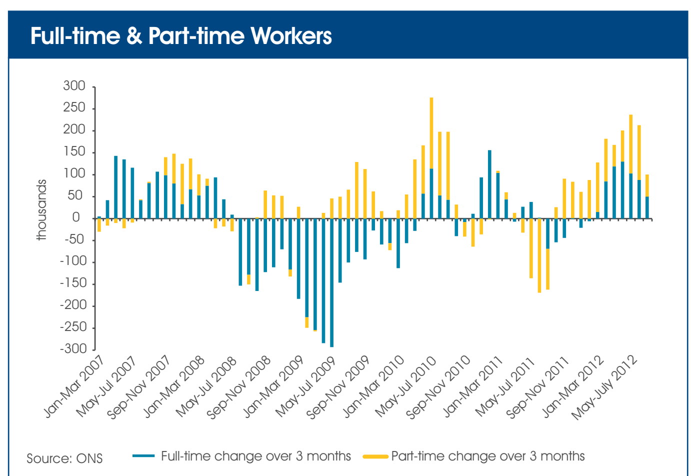
Nevertheless, the latest IMF **outlook for the Euro area** shows negative overall economic growth this year and only marginal growth next year of 0.2%. Even Germany and France are expected to have weaker growth next year than the UK.

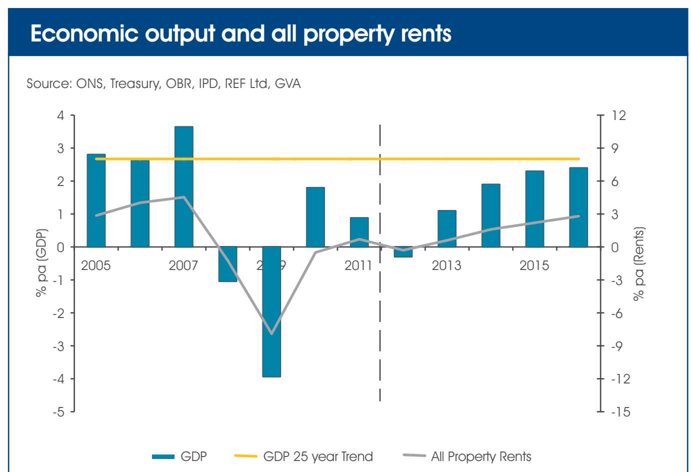
Despite some better news over the last month, **the UK economic outlook** remains weak. The full effects of public spending cuts have yet to be felt and the public sector deficit is no longer falling. Public sector net borrowing so far this financial year is running at a higher underlying level than it was in 2011, due to weaker receipts and higher public sector spending than expected.

This probably means that the cuts will go on for longer, until well after the next election. This prognosis, plus weak Eurozone growth, suggests that a strong UK economic rebound from the recent recession is most unlikely. This view is reinforced by recent survey data from CIPS/Markit, which suggests weak economic growth in Q4. The impasse in the US over fiscal policy resulting from the US election, with a Republican House of Representatives and a Democrat president (albeit with increased authority), is also a concern.

Debt reduction for businesses, households, banks and the government could depress economic growth for a number of years and this will **affect the outlook for the property market.** Bank finance will continue to be in short supply, although interest rates will remain low, occupier demand will remain weak but slowly improve and there will be only a slow increase in development activity outside London. This is summarised in the third chart and the table below.







Latest consensus forecasts, October 2012

	2011	2012	2013	25 year trend
Economic growth (GDP)	0.7%	-0.3%	1.1%	2.7% pa
Private consumption	-0.7%	0.3%	1.0%	
Employment growth	0.2%	1.1%	0.3%	0.7% pa
Bank base rate (Q4)	0.5%	0.5%	0.5%	
CPI – Inflation (Q4)	4.6%	2.3%	2.1%	
RPI – Inflation (Q4)	5.1%	2.7%	2.5%	
House price inflation (Q4)	-0.6%	-1.0%	0.4%	

Source: HM Treasury (compilation of forecasts), GVA

Commercial property market

Recent occupier market trends

The latest RICS UK Commercial Market Survey reflects the weak economic backdrop, with surveyors reporting an overall fall in occupier demand in Q3 (a net balance of -9%, compared with -7% in Q2). It also suggests that supply has continued to increase throughout the first three quarters of this year, although at a noticeably slower rate than in 2011.

Development activity for the UK as a whole remains historically low. The value of new construction orders (a proxy for development activity) is shown in the first chart. This suggests that overall across the UK there has been little change in activity over the last two years.

In contrast to the national picture, activity in central London is relatively strong and rising. 10.3 million sq ft of office space is under construction as at Q3, compared with 6.3 million sq ft a year ago.

At the all property level, average rental values have been flat over the last year with the IPD Quarterly Index registering zero growth in each of the last four quarters. However, this masks a market that has become increasingly polarised, in terms of London versus the rest of the UK (see second chart) and in terms of quality.

Central London continues to drive the UK property market. GVA's own index shows that across the central London office market, prime headline rents have increased by 1.4% during Q3 and by 9.4% over the last 12 months. Average central London office rental values as measured by the IPD Quarterly Index have increased by 3.6% in the year to Q3. However, this a considerable slowdown compared with the peak rate of growth in Q3 of last year of 7.8% pa.

Retailing in central London also continues to see relatively strong rental growth. In the year to Q3, average rental values increased by 3.6% (the same rate as for central London offices).

Outside London average rental values continue to fall modestly across most of the mainstream markets, although supermarkets have bucked the trend, with rental values rising by 1.9% for the UK as a whole over the 12 months to Q3.

Performance is highly dependent upon the quality of the asset. For example, figures from IPD show that the lowest yielding 25% of standard (high street) retail properties within the index - a proxy for prime - saw rental values rise by 1% in the year to Q3. But secondary high street retail property (the highest yielding 25% of properties) saw a significant fall in rental values of 4.7%. A differential in performance by quality can be seen across all of the main sectors.

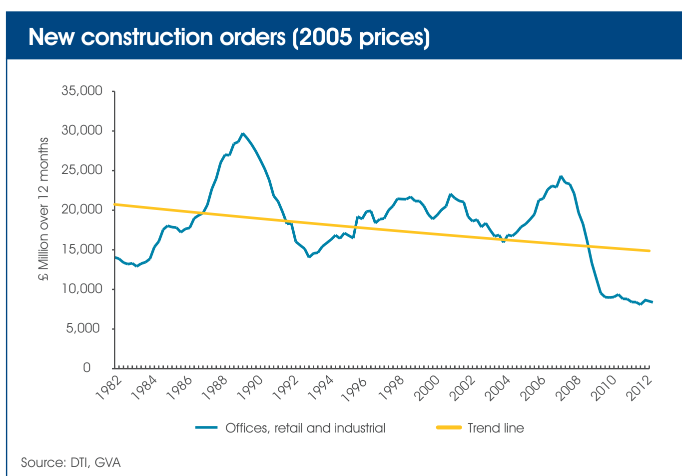
Outlook for occupier market performance

With the muted outlook for UK economic growth and the global uncertainties outlined on the previous page, it is difficult to foresee any marked increase in occupier demand in 2013.

Outside central London we expect average rental values to be broadly flat next year. Looking further ahead, the upturn will be slow and our forecasts suggest that rental values will rise by around 10% over the next five years. This is a rate well below expected inflation, which is good news for occupiers.

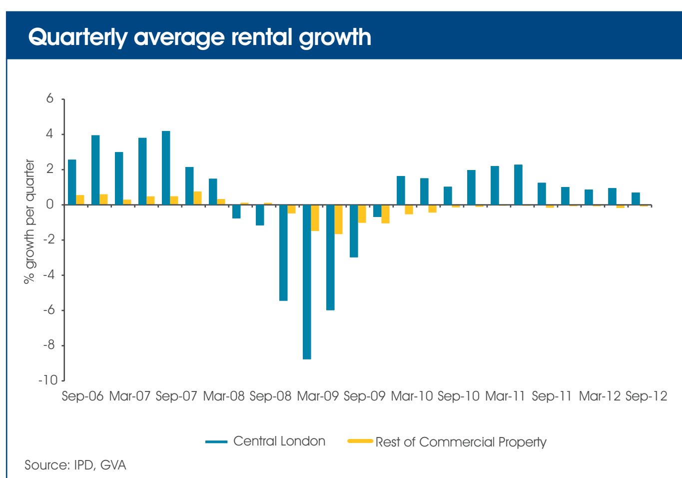
However, central London offices and retail will see respectable rental growth next year of circa 3%, similar to 2012. This is slightly above the expected rate of inflation and so represents an increase in real as well as nominal terms. The rate of growth should start to accelerate again from 2014 and we forecast that by the end of 2017 average rental values will have increased by around 25% compared with current levels (see third chart and table).

New construction orders (2005 prices)



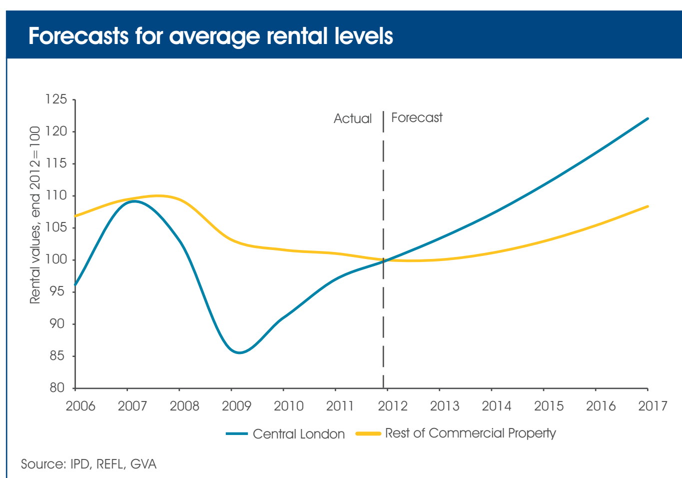
Source: DTI, GVA

Quarterly average rental growth



Source: IPD, GVA

Forecasts for average rental levels



Source: IPD, REFL, GVA

All property rental growth forecasts

	2012	2013	2014	2015	2016
Consensus (August)					
Maximum	0.3%	2.1%	3.7%	-	-
Minimum	-3.0%	-3.0%	-1.2%	-	-
Average	-0.8%	0.0%	1.2%	-	-
GVA (October)	**-0.3%**	**0.6%**	**1.6%**	**2.2%**	**2.8%**

Investment market commentary

Recent investment performance

Q3 saw transactions of more than £9 billion across the UK, the highest quarterly total since Q1 2011 (Property Data). Transactions for the first three quarters of the year totalled more than £24.3 billion, close to the £24.9 billion recorded over the same period last year.

Strong overseas interest, particularly in the London market, continues to buoy overall UK investor demand. Overseas buyers accounted for 48% of the total value of purchases during the first nine months of 2012, compared with just 29% for the same period last year. Indeed, overseas purchasers have increased their exposure to UK commercial property by an impressive £6 billion since the start of the year. Investment transaction values are illustrated in the first chart.

The IPD Quarterly Index shows that all property capital values fell by 0.8% in Q3, the fourth consecutive quarterly decline. Values are now 2.5% lower than a year ago but remain around a third below the all-time peak seen in 2007.

With static rental values, the fall in capital values at the all property level is being driven by an upward movement in yields which have been rising very gradually for almost a year.

In central London, capital values have risen almost continuously throughout the last three years, bucking the national trend. This is down to a combination of positive rental growth and a modest downward movement in yields (the second chart illustrates the differing yield trend between central London and the rest of the UK). Central London values rose by 0.7% in Q3 but have risen by an impressive 40% over the last three years. However, the rate of growth has been on a slowing trend in recent quarters.

The UK market has seen a high degree of differentiation by asset quality. IPD UK-wide data suggests that over the 12 months to Q3, property at the prime end of the spectrum saw a fall in values of less than 0.5% whilst secondary property fell by more than 7%.

Investment market outlook

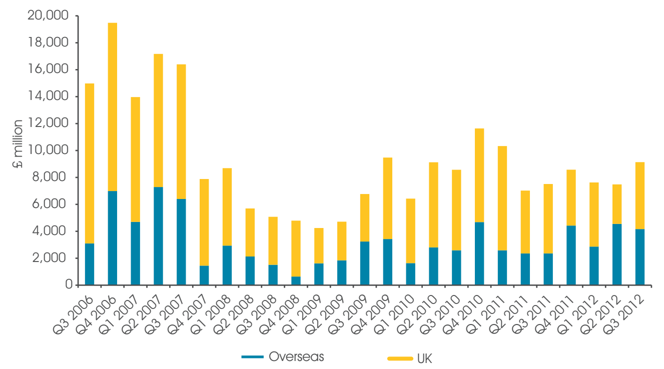
At the UK-wide level the rate of capital value decline looks to have peaked in the summer. With the slightly improved performance over the last couple of months we expect the fall in capital values to be a little over 3% for 2012 as a whole, giving a positive total return of 2.5%.

We expect little change to either rental or capital values in 2013, at least at the all property level. Adding in the income element we forecast a total return of 6.4%.

Beyond this, returns should rise further to 8-9% pa as rental growth begins to feed through across a broader section of the market and the current modest upward yield movement reverses. The central London market will continue to outperform.

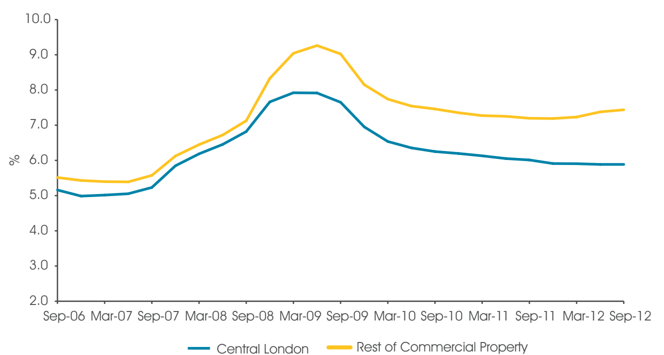
Investor demand for prime assets with long leases, good covenants and in good locations will continue to be strong. However, much of the supply coming onto the market will be poorer quality secondary or tertiary property as banks work their way through their distressed asset portfolios. We therefore expect asset quality to continue to be a significant differentiator in performance.

Value of investment transactions



Source: Property Data

Average equivalent yields



Source: IPD, GVA

Forecasts for total returns

Source: IPD, REFL, GVA

All property total returns forecasts

	2012	2013	2014	2015	2016
Consensus (August)					
Maximum	6.2%	8.7%	14.5%	-	-
Minimum	-2.0%	1.2%	4.2%	-	-
Average	1.1%	5.0%	7.7%	-	-
GVA (October)	**2.5%**	**6.4%**	**7.9%**	**8.8%**	**8.6%**

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