Research report

EPMR

Economic & Property Market Review

Q2 2013

Economic trends

Positive economic growth between Q4 2012 and Q1 2013 was a welcome relief from a feared triple dip recession, even if growth was only a weak 0.3%. This means that over the last two years UK economic output has only increased by 1.1%, or an annual average of just 0.5%. This compares to an annual average of 3% in the decade before the 2008 recession.

However, North Sea oil and gas extraction has declined by 21% over the last two years. If this is excluded slightly healthier economic growth of 1.5% has been achieved. The other main drags on economic growth over the last two years have been manufacturing output (-3.1%) and construction (-10.1%), whereas the service sector has increased by 2.9% in total, with business services and finance showing the strongest growth of 3.5%, but with finance much weaker than business services.

In Q1 2013 sector output growth was similar to the pattern over the last two years. However, when compared to the quarterly sector averages in the 10 years before the recession started (i.e. up to the end of 2007), the current economic weakness is dramatically illustrated, as the first chart shows.

Ironically, just as output growth went positive in Q1, **employment growth went negative** and unemployment increased, reversing the trend of the last 18 months when total employment increased by 600,000. However, surprisingly strong employment growth has a downside, which is very weak pay growth and declining productivity.

Total annual pay growth was only 0.4% over the latest three month period, compared to CPI inflation of 2.8% pa and RPI inflation of 3.3% pa, meaning a large fall in earnings in real terms, as the second chart shows. This indicates a strong squeeze on household purchasing power and is in marked contrast with the previous two post recession upturns when household spending growth played an important role. It is hardly surprising that retail spending growth has recently been weak, compounding the problems for the retail property market from a strong growth in internet sales.

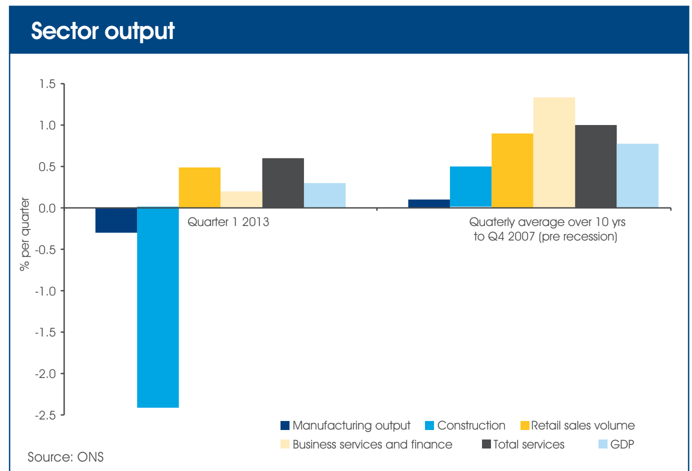
The consequence of weak economic growth has been **no underlying improvement in the budget deficit** and a further increase in the national debt. The IMF is now of the view that severe austerity policies may be counter productive for the UK, especially when similar policies are being pursued in the Euro area, our main export market. As a result, their latest forecast for the UK is for only 0.7% economic growth this year and 1.5% next year, and even weaker growth in the Euro area, where -0.3% and 1.1% respectively is expected. This contrasts with a relatively healthy 1.9% and 3% in the USA.

The government's response to growing concerns about very weak economic growth has been to try to free up bank lending, particularly to small and medium sized firms, but also to homeowners to increase effective housing demand and so boost house building. The lack of bank lending is seen as a main stumbling block to stronger economic output growth.

The Funding for Lending scheme has had only a small effect on bank lending so far, due to the perceived risks of lending to smaller companies and arguably weak demand from smaller businesses for higher borrowing due to lack of confidence. The recent budget provided increased incentives for banks to lend to small and medium sized companies, but the general view is that these policies will only have a limited effect.

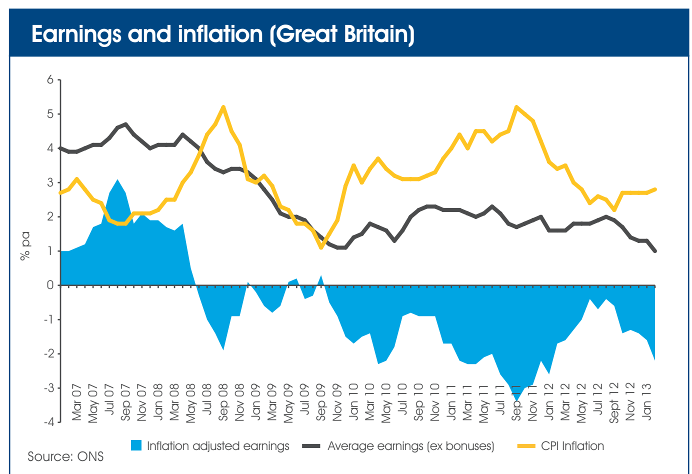
The latest consensus forecasts for economic growth are similar to the IMF's – a slow and weak improvement over the next two years at least. As the third chart indicates, this will mean only a slight improvement in occupier demand for property outside London and slowly increasing levels of UK rental growth.

Sector output



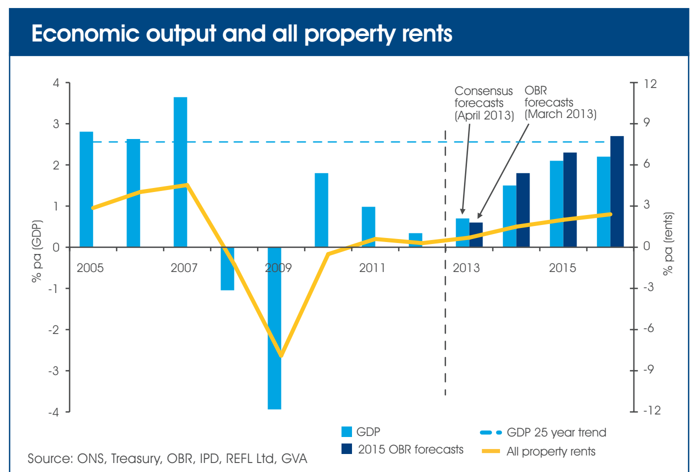
Source: ONS

Earnings and inflation (Great Britain)



Source: ONS

Economic output and all property rents



Source: ONS, Treasury, OBR, IPD, REFL Ltd, GVA

Latest consensus forecasts, April 2013

	2012	2013	2014	25 year trend
Economic growth (GDP)	0.3%	0.7%	1.5%	2.6% pa
Private consumption	0.8%	0.9%	1.3%	
Employment growth	2.4%	0.8%	0.6%	0.7% pa
Bank base rate (Q4)	0.5%	0.5%	0.7%	
CPI – Inflation (Q4)	2.6%	2.8%	2.5%	
RPI – Inflation (Q4)	3.1%	3.3%	3.1%	
House price inflation (Q4)	-1.1%	1.3%	2.4%	

Source: HM Treasury (compilation of forecasts), GVA

Commercial property market

The occupier market

With the UK's economic output still 2.5% below its pre-recession peak and a weak and protracted recovery, it is not surprising that the occupier market remains subdued. Average rental values have barely moved over the last two years. All property rental growth was zero in the 12 months to March 2013 (IPD Quarterly Index).

Rental values have continued to rise in central London, at an annualised rate of more than 5% in Q1 for average office and retail property, well above inflation. Central London office take-up has been above average in recent quarters. During Q1, nearly 2.5 million sq ft was let, although boosted by Google's deal to take 860,000 sq ft at King's Cross Central. We expect this above-inflation rate of rental growth to be maintained this year.

The suburban London office market has also seen rising rents (1.9% over the last year) and there are signs of cautious optimism in the wider South East office market where average rental values have stabilised.

There was a positive start to the year in the regional office markets, with take-up in Q1 at its highest level for more than three years, and the out-of-town markets seeing a notable improvement. Average rental values are still falling but prime headline rents and incentives have been stable across most key centres. Edinburgh saw an increase in the prime headline rent in Q1.

A number of schemes in the UK's key regional city centre office markets have either started or are moving closer to a start date, on a speculative or part-speculative basis. This is encouraging and is a step towards providing the levels of new space that will be needed if grade A supply shortages are to be avoided over the next few years.

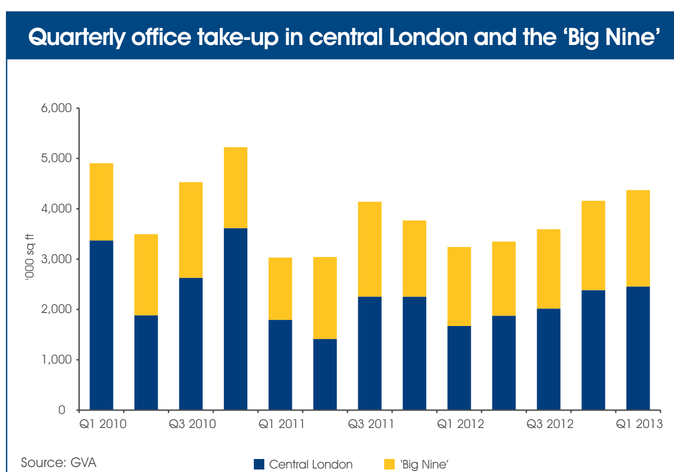
Much of the high street continues to be affected by weak consumer spending and the focus of sales growth towards the internet. Other factors such as the delay in the rating revaluation will certainly not help weaker centres.

The Local Data Company reports that the vacancy rate for UK shops is 14.1% (March). This is undoubtedly a worryingly high figure and contrasts with sub-4% vacancy rates before the financial crisis. But the rate has at least held broadly stable over the last year despite the combined effects of corporate retailer failures and managed programmes to reduce store numbers through lease renewals and break options.

Although average industrial rental values have fallen by 0.6% over the last year (IPD Quarterly Index) the rate of decline is moderating and indeed rental values were virtually flat during Q1. Again, it is in London where the market is strongest. Rental value growth has been in positive territory for most of the last two years, and we expect further modest sub-inflation growth this year.

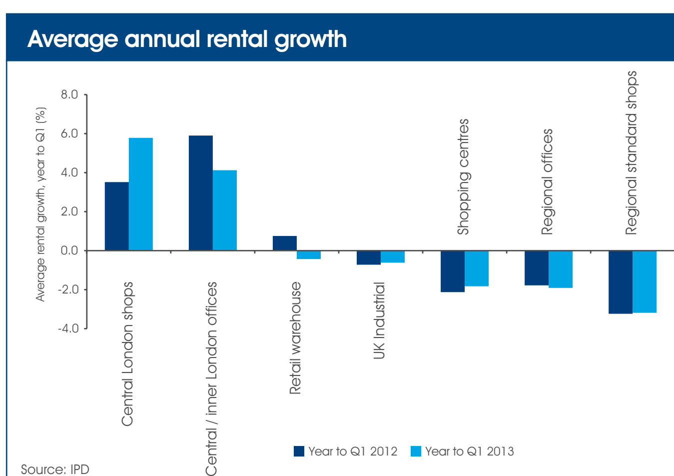
Overall, we are seeing a gradual improvement in occupier sentiment across many of the UK's occupier markets. Barring any further major economic shocks, we expect average UK commercial property rental values to rise by 0.7% this year, a modest acceleration on the 0.3% achieved in 2012. We then expect the rate of growth to broadly double in 2014, at around 1.5% pa.

Quarterly office take-up in central London and the 'Big Nine'



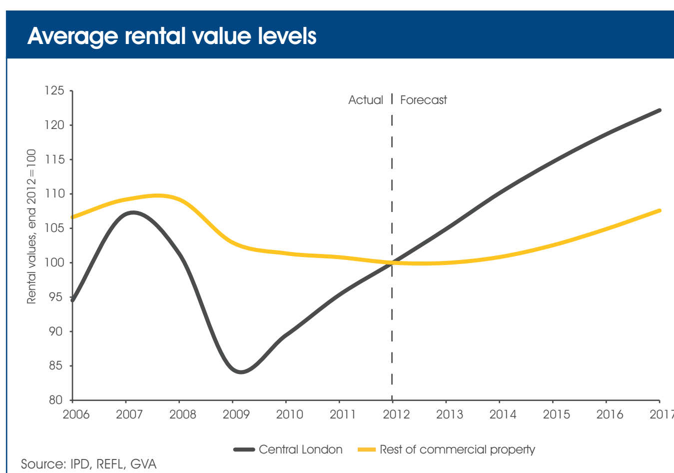
Source: GVA

Average annual rental growth



Source: IPD

Average rental value levels



Source: IPD, REFL, GVA

All property rental growth forecasts

	2013	2014	2015	2016	2017
Consensus (February)					
Maximum	1.3%	2.9%	4.5%	-	-
Minimum	-1.8%	-1.4%	0.4%	-	-
Average	0.2%	1.3%	2.1%	-	-
GVA (April)	**0.7%**	**1.5%**	**2.0%**	**2.4%**	**2.6%**

Investment market commentary

Recent investment performance

The value of investment transactions increased to more than £36 billion in the year to Q1 2013 (Property Data), an improvement on the £30.5 billion recorded over the year to Q1 2012, but still some way off the recent peak of almost £40 billion in the year to Q1 2011 (see chart 1).

Overseas investors have increased their share of overall purchases significantly over the last 18 months, as chart 1 illustrates, and now account for almost half of the total market.

The yield gap between prime and secondary property widened significantly following the financial crisis. This gap has increased further over the last year as secondary yields have moved outwards, whilst yields at the prime end of the market have been broadly stable (see second chart).

The latest IPD figures show that the total return has risen for the third successive quarter, reaching 1.1% during Q1 2013, taking the annual figure to 3%. This mirrors an improvement in capital value performance, with values falling by 0.4% in Q1 compared with a peak of -1.1% in Q2 2012.

Investment market outlook

Investor demand has improved over the last year, driven by UK equity investors and the continued influx of overseas money. Bank sentiment also appears to have improved and the availability of debt from UK banks, insurers and overseas lenders has risen.

The 2013 IPF Lending Intentions Survey suggests that over £36 billion could be available (based on the 36 lenders surveyed), which would represent a significant increase on 2012, and the latest Bank of England Credit Conditions Survey suggests an improved sentiment towards the commercial property sector.

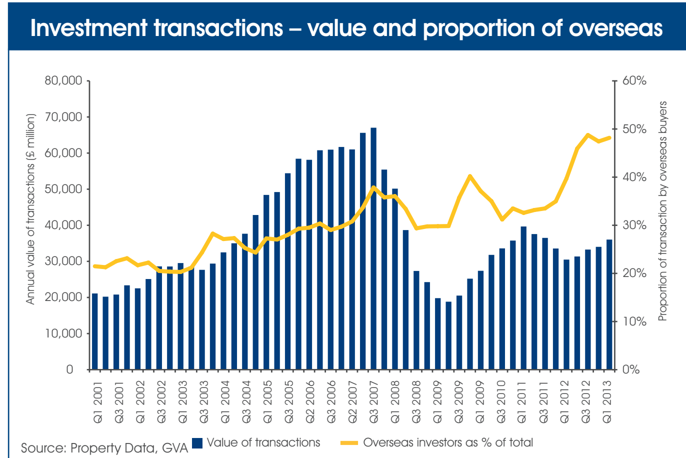
However this has not translated into a more marked increase in transactions, largely because of a lack of product. Supply remains restricted due to the low level of development plus a slow outflow from the banks as 'distressed' property is increasingly going into loan portfolios.

The shortage of opportunities means investors are increasingly looking higher up the risk curve and we are seeing an improved sentiment towards good quality secondary property. Increasingly, overseas investors are starting to look outside London for opportunities.

We expect that this will begin to be reflected in yields, with some downward movement in good quality secondary yields. But the market is likely to remain segmented and yields for properties at the tertiary end of the spectrum could well see further outward movement. Income security will remain of key importance and the unexpired term will continue to be a key determinant of performance.

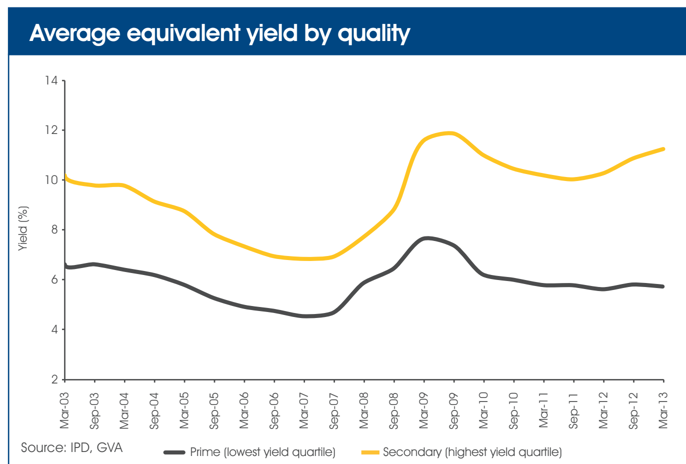
Our forecasts for the all property IPD index are for a total return of 6.2% this year. This suggests a modest pick-up in the Q1 rate of 1.1%, driven by a further improvement in rental growth performance and yields reacting to more positive investor sentiment. These trends should accelerate in 2014 and we expect the total return to rise to around 8% pa.

Investment transactions – value and proportion of overseas



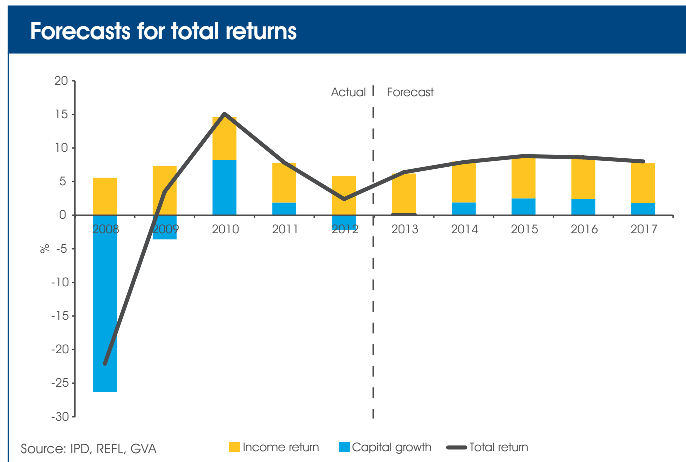
Source: Property Data, GVA

Average equivalent yield by quality



Source: IPD, GVA

Forecasts for total returns



Source: IPD, REFL, GVA

All property total returns forecasts

	2013	2014	2015	2016	2017
Consensus (February)					
Maximum	7.6%	9.9%	11.9%	-	-
Minimum	2.0%	5.2%	5.9%	-	-
Average	5.2%	7.4%	8.4%	-	-
GVA (April)	**6.2%**	**8.1%**	**8.7%**	**8.6%**	**7.9%**

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