

# UK COMMERCIAL PROPERTY MONTHLY

Oct. 2009



*A round-up of the latest economic and commercial property market data*

Editors: Roger Bootle and Ed Stansfield

## Capital values up in August; returns set to continue to improve

- Although the **economy** may now have started to grow again, conditions will continue to *feel* recessionary for many households, as unemployment rises further. In turn, average earnings growth will remain under downward pressure, as will inflation. Accordingly, we see little scope for monetary policy to be tightened for at least another year. (See page 2.)
- The latest **market intelligence** shows that the combination of weak demand and rising supply continues to put upward pressure on vacancy rates. Even in light of the downbeat outlook for rental values, however, no forecaster in the latest IPF Consensus expected total returns to be negative again in 2010. Derivatives pricing currently implies a total return in 2010 of around 10%. (See page 3.)
- The **IPD Monthly Index** showed that all-property rental values fell again in August, though the decline of 0.5%/m/m was the smallest since October last year. Offices continue to underperform, though the pace of decline in rental values in this sector, especially in the key Central London markets, has eased quite sharply over the past few months. (See page 4.)
- That smaller fall in rental values, when combined with a positive yield impact, was enough to bring to an end the 25-month unbroken run of capital value falls. Capital values rose by 0.2%/m/m in August, pushing up total returns from 0.6%/m/m in July to 0.9%/m/m. As we noted last month, the downturn in the commercial property market (as a whole) is now almost certainly over. (See page 5.)
- Propertydata.com figures show that **investment market** activity rose further in August, and recent patterns – with the final month of the quarter being strong – suggest that it may increase again in September. That would certainly be consistent with reports of steadily improving sentiment and more new fund-raising. (See page 6.)

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### Capital Economics

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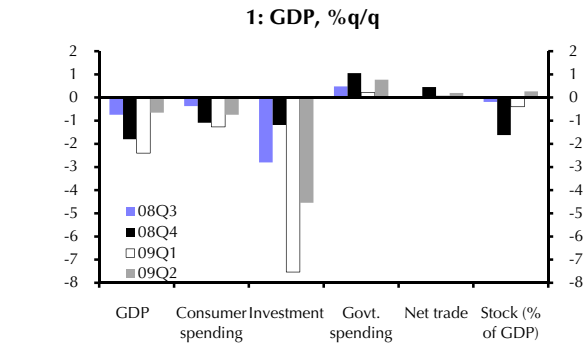
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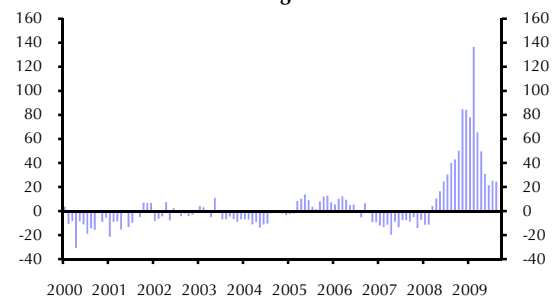
## Economic drivers

### *Hard to see where strong economic growth will come from*

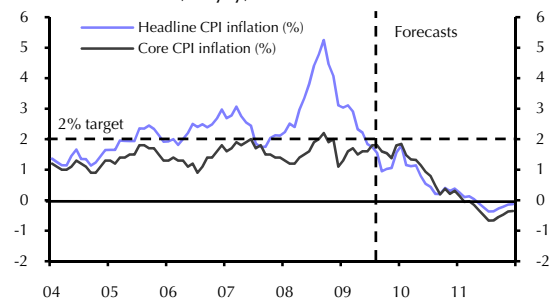
- The expenditure breakdown of GDP in Q2 didn't inspire confidence in the foundations of any medium-term economic recovery. For a start, as Chart 1 shows, consumer spending declined again in Q2, and, with households remaining highly indebted, we expect these falls to continue. In addition, investment remains very weak and the need to shore-up the public finances means that the boost to growth from government spending is sure to fade.
- So while the economy *may* have pulled out of recession in the third quarter, we do not think that it will instantly return to trend rates of growth. This means that unemployment – which, as Chart 2 shows, rose by a further 24,000 on the claimant count measure in August – is likely to continue to increase until at least late 2010.
- Rising unemployment will mean that average earnings growth will remain under downward pressure, and may even turn negative over the next year or so. In turn, this would intensify the downward pressure on inflation that is already being generated by the growing amount of spare capacity in the economy. Accordingly, we think deflation remains more likely than rampant inflation over the medium-term. (See Chart 3.)
- Consistent with all of this, we expect the repo rate to stay at 0.5% for a prolonged period. (See Chart 4.) As it becomes clear that the economic recovery is set to remain slow, not least because of continued tightness in bank lending, we also anticipate bond yields easing down, by perhaps 100bps, over the next 12-18 months.



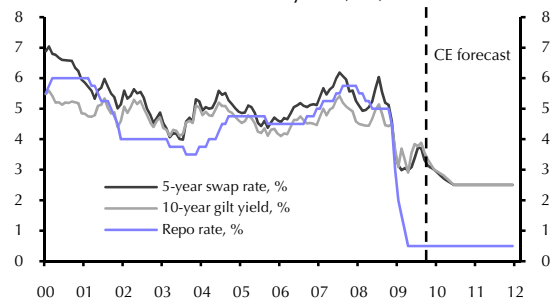
**2: Claimant count unemployment, monthly change, '000s, 2000 – August 2009**



**3: Inflation, %y/y, 2004 – December 2011**



**4: Interest rates and bond yields, %, 2000 – 2011**



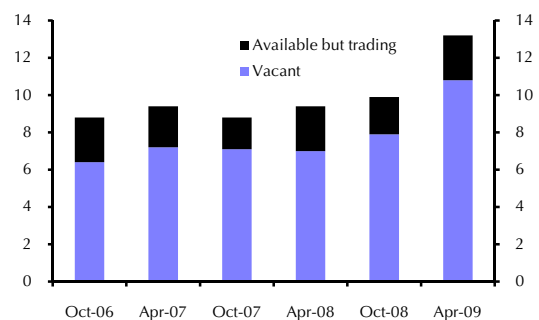
Source – Thomson Datastream

## Market Intelligence

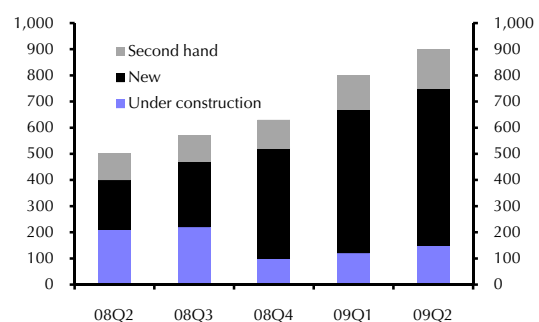
### Occupier outlook still downbeat, but 2010 returns prospects brighter

- The latest National Retail Barometer from Colliers CRE showed that the retail vacancy rate is now sharply higher than it was in the final quarter of 2008. (See Chart 1.) The most recent rise was driven primarily by an increase in the amount of “hard” vacant space, rather than space that is available to let but is still occupied by a trading tenant. With occupier demand still weak, higher vacancies imply further falls in retail rental values.
- Availability also continues to rise in the office sector, as demand remains weak and supply increases. King Sturge data, for example, show that there is now about 900,000 square metres of available floorspace in the City office market (including space under construction), with newly-built stock comprising the bulk of the total. (See Chart 2.) Again, that will surely put further downward pressure on rental values.
- Despite the weak outlook for the occupier market, however, forecasts for total returns have recently been revised up, due to stronger investment market prospects. Indeed, even the most bearish forecaster in the latest IPF Consensus survey (not us!) no longer expects a negative total return next year. (See Chart 3.)
- There are reasons to be cautious of the returns that are implied by property derivatives pricing. For example, a majority of trades being done for speculative profit-making purposes may exaggerate implied returns on the upside. That said, the derivatives market now points to total returns of 10% next year. (See Chart 4.) As recently as June, the market was pricing in total returns of 4%.

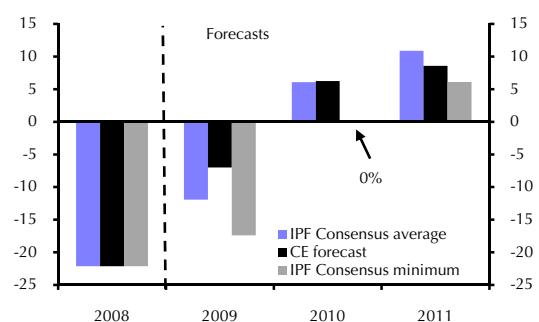
**1: Retail availability, % of total floorspace, 2006 – 2009**



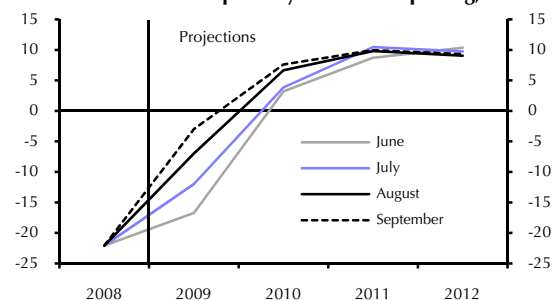
**2: City office availability, '000 square metres**



**3: Total returns, %, 2008 – 2011**



**4: Total returns implied by derivatives pricing, %**



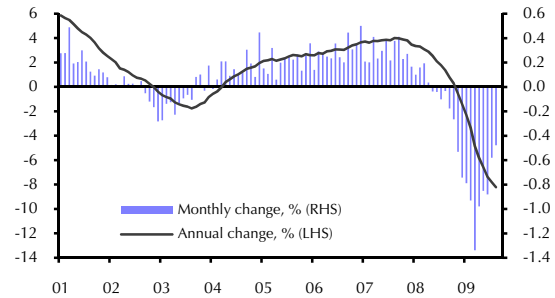
Sources – Colliers CRE, King Sturge, IPF, Morgan Stanley

## Property market indices – rental values

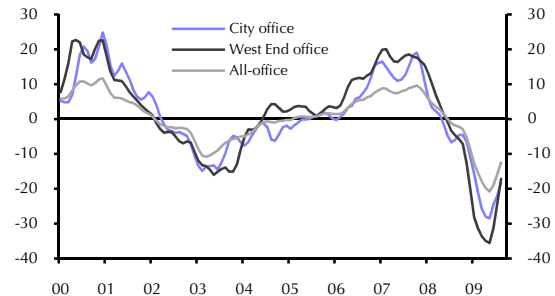
### Double-digit rental value fall remains likely in 2009

- IPD all-property rental values fell by 0.5%/m/m in August, the sixteenth consecutive decline but also the smallest since October last year. (See Chart 1.) That was not enough, however, to prevent the annual rate of decline from slipping to more than 8%, the worst result since November 1993. Despite some better recent economic news, the normal lags mean that average rental values have further to fall.
- All-office rental values declined by 0.7%/m/m and 14.1%/y/y in August, clearly, worse than the all-property average. However, as Chart 2 shows, the pace of decline in IPD West End and City rental values has slowed significantly in recent months. Moreover, anecdotal evidence suggests that, at the very least, *prime* rents in Central London office markets are now close to (or even at) a floor.
- The rate of decline in industrial rental values remains much slower than offices, at 4%/y/y in August. (See Chart 3.) There is also very little regional discrepancy, which has been a feature of recent years. Indeed, since August 2001, the difference between annual rental value growth in the South East and Rest of UK has never been greater than 1.2 percentage points.
- All-retail rental values fell by a further 0.4%/m/m in August, taking the annual rate of decline to more than 6%, a fresh record low on the IPD Monthly index. As with industrials, the retail breakdown reveals minimal sub-sectoral differences in performance. In August, standard shop rental value growth (-5.6%/y/y) was only one percentage point different from shopping centres (-6.6%/y/y). (See Chart 4.)

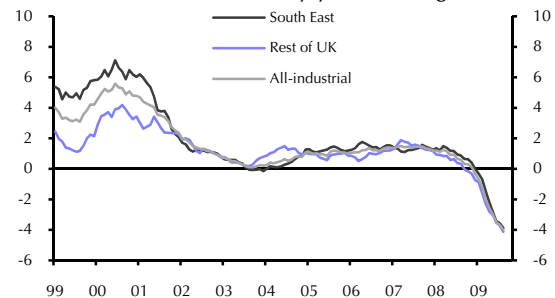
1: All-property rental values, 2001 – August 2009



2: Office rental values, %3m/3m annualised, 2000-Aug. 2009



3: Industrial rental values, %y/y, 1999 – August 2009



4: Retail rental values, %y/y, 1999 – August 2009



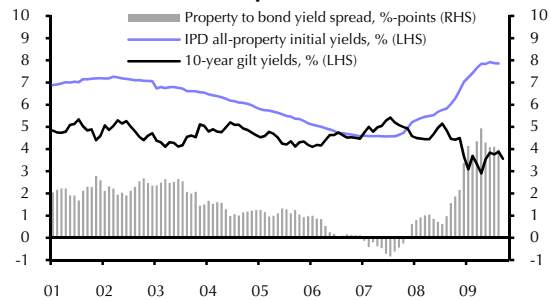
Source – IPD

## Property market indices – yields and capital values

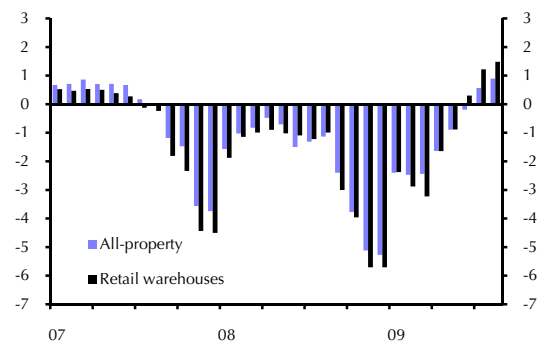
*Little chance that capital values will fall further*

- All-property initial yields dropped marginally in August, from 7.87% to 7.86%, leaving the property/bond yield spread at around 400bps. (See Chart 1.) Our central view is that, as the strength of the economic recovery proves disappointing, lower bond yields over the next 12 months will help property yields to fall. But, if the economy grows faster than we anticipate, property yields would also tend to fall, thanks to better risk appetites.
- When combined with a smaller fall in rental values in August, the marginal decline in initial yields was still enough to break the 25-month run of capital value falls. Capital values rose by 0.2% in August, pushing all-property total returns up to 0.9% for the month. (See Chart 2.) As was the case in June and July, retail warehouses again outperformed the average.
- Looking ahead, we think it is unlikely that capital values will fall much, if at all, further. The rally in real estate equities has continued in recent weeks, and – while it partly reflects general confidence in the wider stockmarket – this suggests that the markets may also consider that the worst for commercial property has now passed. (See Chart 3.)
- For now, property total returns remain substantially negative on a year-on-year basis. (See Chart 4.) But this measure will rapidly improve as yields ease down over the coming months. Elsewhere, bond returns remain solid, while (despite the recent rally) *annual* real estate equity returns are still poor.

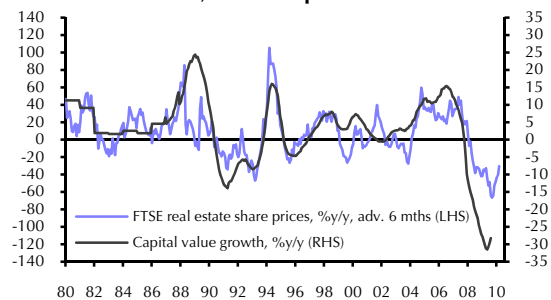
**1: All-property initial yields and 10-year gilt yields, %, 2001 – September 2009**



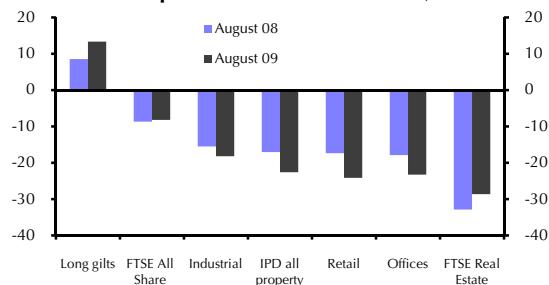
**2: Total returns, %m/m, 2007 – August 2009**



**3: FTSE Real Estate equities and IPD all-property capital values, 1980 – September 2009**



**4: Comparative annual total returns, %**



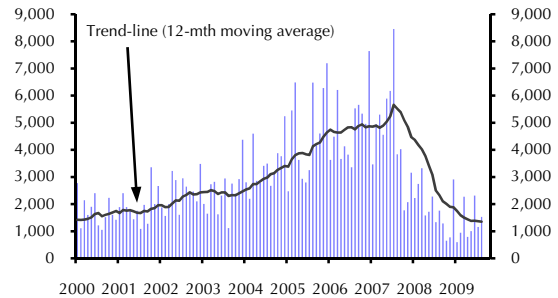
Sources – IPD, Thomson Datastream

## Investment market

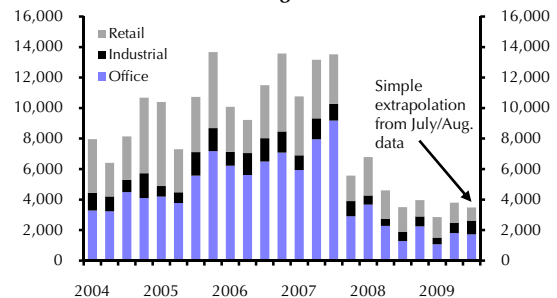
### Activity up in August; recent pattern points to good September too

- Propertydata.com's preliminary figures showed that there were £1.5bn of investment market deals in August, up from £1.1bn in July. (See Chart 1.) Recent patterns in the monthly data point to another rise in September. The past three quarter-end months (i.e. December, March and June) have been strong. Such an outcome would be consistent with our view that a gentle recovery in deal volumes will be seen over the short- to medium-term.
- Transactions activity in the office and retail sectors in August was below the average of the previous six months. Industrial deal volumes, however, were strong. (See Chart 2.) Indeed, the monthly total of £550m was the highest in this sector since September 2006. Two big portfolio deals (Industrious, worth £230m, and Equiton, worth £200m) boosted the industrial sector in August.
- Net investment inflows to the UK market from overseas buyers faded slightly in August, due to increased selling rather than lower buying. Irish and US investors were key contributors to higher selling activity. (See Chart 3.) Demand from German and Middle Eastern investors, however, remained solid.
- Net purchases of property by private individuals were lower in August than in July, although they remained positive for the 12<sup>th</sup> consecutive month. Perhaps more noteworthy, however, was that August was the first month of net buying by UK institutions since December last year. As Chart 4 shows, institutions are on track for only a small net disposal in Q3, but we would not be surprised to see a net purchase in Q4 as a whole.

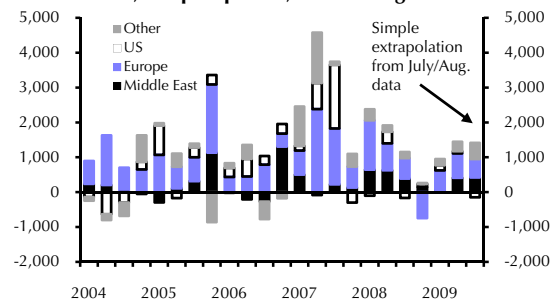
1: Value of transactions, £m per month, 2000 – August 2009



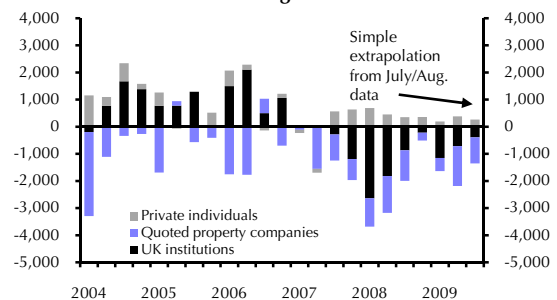
2: Total investment flows by sector, £m per quarter, 2004 – August 2009



3: Net investment by type of foreign buyer, all property sectors, £m per quarter, 2004 – August 2009



4: Net investment by type of buyer, £m per quarter, 2004 – August 2009



Source – www.propertydata.com

## Economic indicators & the month ahead

ECONOMIC INDICATORS					
	2008Q3	2008Q4	2009Q1	2009Q2	2009Q3
GDP, %y/y	0.5	-1.8	-4.9	-5.5	-
GDP, %q/q	-0.7	-1.8	-2.4	-0.7	-
Financial and business services output, %y/y	1.1	0.3	-3.4	-4.6	-
FBS employment, %y/y	-1.9	-3.3	-2.9	-3.9	-
M&A deals involving UK co's, value and no.	£11.6bn/230	£30.2bn/197	£24.2bn/130	£3.5bn/80	-
Distributive trades output, %y/y	-2.3	-5.4	-7.4	-6.6	-
Household spending, %y/y	0.7	-0.8	-3.1	-3.4	-
CBI Industrial Trends output balance	-40	-60	-64	-40	-16
Manufacturing output, %y/y	-2.8	-8.3	-13.7	-12.4	-
Net new lending to commercial property	£6.9bn	£1.6bn	£1.4bn	-£0.5bn	-
Total outstanding property debt	£240.1bn	£242.0bn	£243.5bn	£246.9bn	-
Lending to property as a % of all lending	11.5	11.6	11.6	11.8	-
5-yr swap rate, %, average over the quarter	5.45	4.06	3.02	3.34	3.50 to date

	May 2009	Jun. 2009	Jul. 2009	Aug. 2009	Sep. 2009
Industrial production, %y/y	-12.1	-10.7	-9.3	-	-
CIPS manufacturing sector PMI	45.6	46.8	50.2	49.7	-
Employment, %y/y	-1.8	-1.9	-2.0	-	-
Claimant count unemployment, %	4.7	4.8	4.9	5.0	-
Nationwide house prices, %y/y	-11.3	-9.3	-6.2	-2.7	-
Retail sales volumes, %y/y	-2.1	3.0	2.9	2.1	-
CIPS service sector PMI	51.7	51.6	53.2	54.1	-
CIPS construction sector PMI	45.9	44.5	47.0	47.7	-
CPI inflation, %y/y	2.2	1.8	1.8	1.6	-
Bank of England repo rate, %	0.50	0.50	0.50	0.50	0.50
5-yr swap rate, %, average over the month	3.22	3.63	3.59	3.54	3.31 to date

Sources – Thomson Datastream, National Statistics

### THE MONTH AHEAD

	Latest number	Period covered	Next release date	Period covered
Nationwide house prices, %y/y	-2.7	August	29 <sup>th</sup> September	September
CIPS construction sector PMI	47.7	August	2 <sup>nd</sup> October	September
CIPS service sector PMI	54.1	August	5 <sup>th</sup> October	September
Industrial production, %y/y	-9.3	July	6 <sup>th</sup> October	August
Bank of England repo rate, %	0.50	September	8 <sup>th</sup> October	October
CPI inflation, %y/y	1.6	August	13 <sup>th</sup> October	September
Employment, %y/y	-2.0	July	14 <sup>th</sup> October	August
Claimant count unemployment, %	5.0	August	14 <sup>th</sup> October	September
MPC minutes (rise-hold-cut)	0-9-0	September	21 <sup>st</sup> October	October
Retail sales volumes, %y/y	2.1	August	22 <sup>nd</sup> October	September
Institutional investment in property	-	2009Q1	25 <sup>th</sup> September	2009Q2
Bank lending to property	-	July	29 <sup>th</sup> September	August
BoE Credit conditions survey	-	2009Q2	1 <sup>st</sup> October	2009Q3
IPD Monthly index	-	August	14 <sup>th</sup> October	September
Pre-Budget Report	-	-	Mid-Oct. (indicative)	-
RICS Commercial market survey	-	2009Q2	Mid-Oct. (indicative)	2009Q3
IPD Quarterly index	-	2009Q2	31 <sup>st</sup> October	2009Q3
CBI/GVA Grimley property trends survey	-	2009H1	Late Oct. (indicative)	2009H2

Sources – Thomson Datastream, National Statistics, IPD