Recovery in UK property market to gain momentum

"This hasn't been a typical recession and it won't be a typical recovery. Nevertheless a recovery is in sight."
Mervyn King, Governor of Bank of England, 15 May 2013

A better than expected rise in GDP, the FTSE 100 index within touching distance of all time highs, historic low yields of 10-year government bonds and rising UK real estate investor confidence are a few of the reasons that we believe the recovery in the UK commercial property market is gaining momentum.

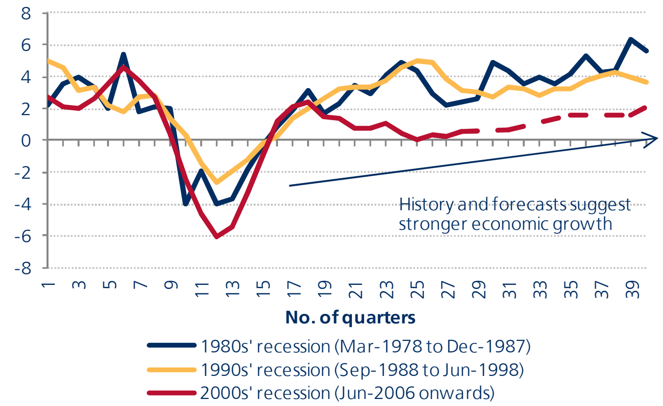
In this note, we list few key themes that, in our view, are driving the market forward:

- Economic growth recovering
- Rents have already found a floor for offices and industrials, with leading indicators suggest improving trends
- Net lending to return and investor confidence is rising
- Weight of money is chasing yields and risky assets
- A real estate upturn is imminent

Economic growth recovering

- According to the Office for National Statistics, the UK economy grew 0.3% q/q in Q1 2013, which was better than the consensus expectation.
- Moreover, recent statements by the Bank of England's Governor, Sir Mervyn King, and the Chancellor of Exchequer, George Osborne, suggest that the economy is seeing **a modest but sustained recovery**.
- If we are to draw conclusions from comparing existing economic cycle with the previous ones, **economic growth is expected to accelerate** over the coming quarters. This view is also consistent with that of consensus forecasts provided by Consensus Economics.

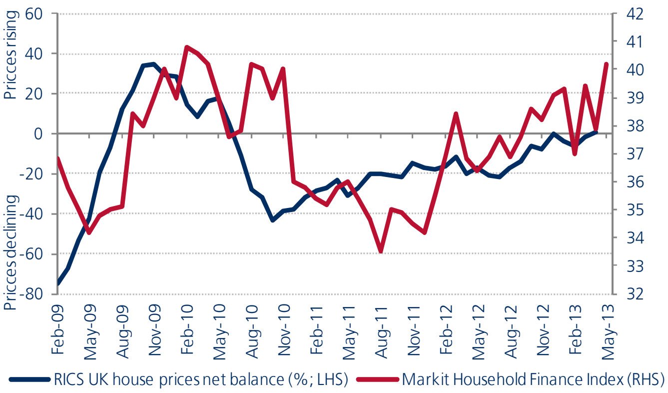
Figure 1: Real UK GDP growth (rolling y/y %)



Source: Bloomberg, Consensus Economics, Cordea Savills

- With general elections due within two years**, economic growth has become a political issue**. The Government has announced a series of schemes to boost lending, the housing market and construction.
- These steps are supporting house prices, with more RICS members suggesting rising than falling house prices in April.
- Households are also supported by higher levels of income from employment. According to Markit, with inflation subdued, **the squeeze on household budgets is easing**. This will help to improve consumer spending over the coming quarters.

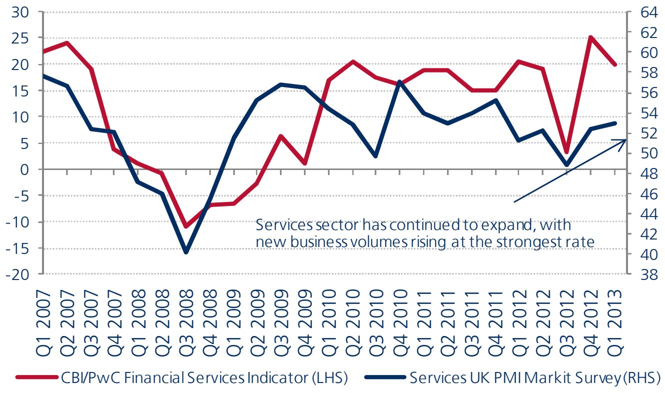
Figure 2: Households' position is improving



Source: Bloomberg, RICS, Markit

- Looking at granular detail, economic growth in the UK is being driven by the service sector. The sector, which accounts for three-quarters of the UK's GDP, is seeing further improvements, with April recording the **fastest increase in activity**. Since the start of the year, growth has steadily strengthened, boosted in part by increased volumes of new business.
- Sales volumes continue to accelerate, which is putting some pressure on capacity. Moreover, in April over 46% of service providers were forecasting a rise in business activity from present levels in 12 months time.
- The CBI/PwC financial services survey also shows a further improvement in sentiment, matched by a recovery in business and top-line revenues.
- In our view, this **is positive for office take-up** and rental growth

Figure 3: Services sector is powering ahead

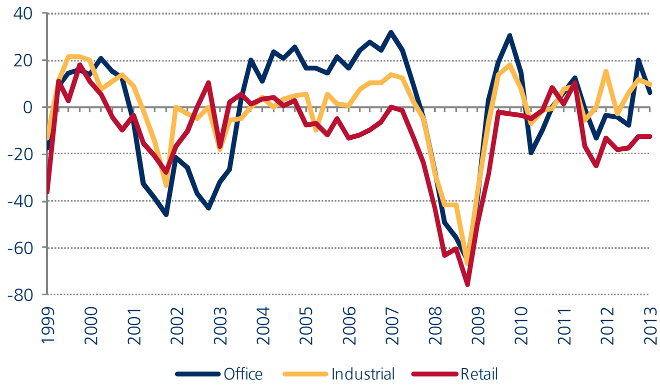


Source: Confederation of British Industry, PricewaterhouseCoopers

Rents are approaching floor

- The occupier requirement balance from the RICS commercial property survey continues to improve and surveyors think that **rents have already found a floor for offices and industrials**.
- As a percentage of balance, a greater number of surveyors are expecting demand for offices and industrials to improve. Demand for retail property is less bearish compared to 2012. However, internet and vacancies will continue to act as a headwind for the sector.

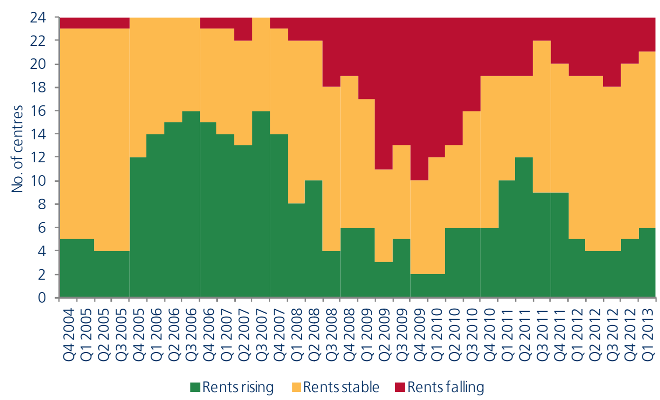
Figure 4: Surveyors reporting improving occupier demand (% of balance)



Source: RICS, Cushman & Wakefield

- Furthermore, Cordea Savills' prime rent monitor* based on Cushman & Wakefield's data suggests that year-on-year **rent changes are stabilising**, with more centres experiencing rental increases than falls in Q1 2013.

Figure 5: Prime rent stabilising in key regions for all sectors (y/y change)

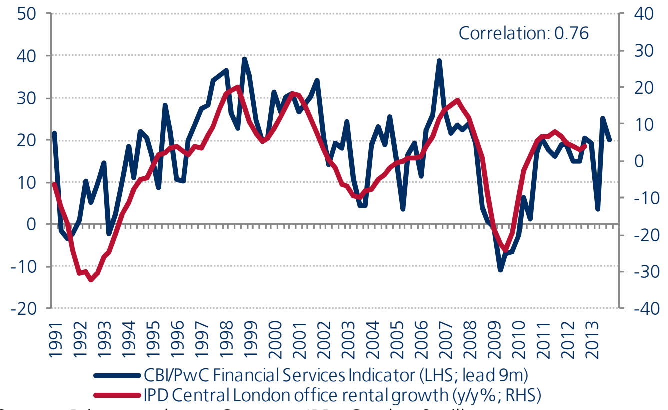


Source: RICS, Cushman & Wakefield, Cordea Savills

* The monitor observes yearly changes in prime rents for all three sectors in eight key cities in the UK.

- This positive backdrop will **support office take-up and is expected to curb recent decline in average office rents** outside London and the South East. We believe there is an **upside risk to our average rental growth forecast**, of 3.4% pa over 2013-17, if there is a quicker than expected decline in vacancy rates or stronger occupier demand.

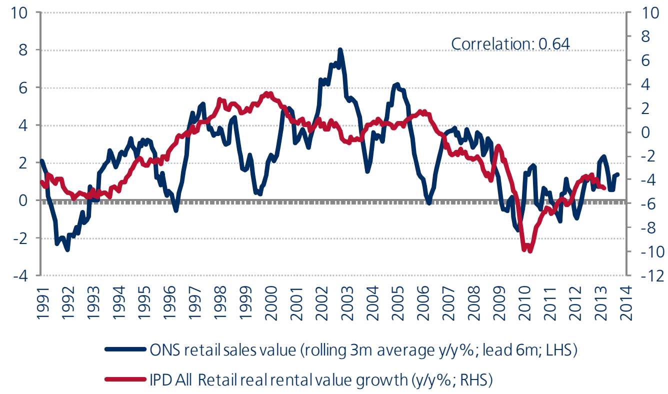
Figure 6: Service sector to support office rents



Source: PricewaterhouseCoopers, IPD, Cordea Savills

- Retail vacancy rates are high compared to pre-recession levels. However, availability remains constrained in prime pitches and **RICS members are reporting less adverse conditions**. In our view, polarisation will continue in this sector, with catchment and asset selection remaining key. We currently expect average retail rents to increase by 1.2% pa over 2013-17, with further growth led by Central London shop rents offset by declines in the rest of UK in the short-term.

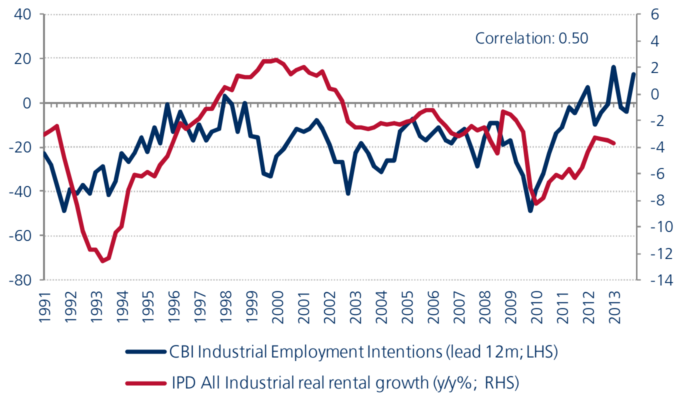
Figure 7: Gradual improvement in retail sales



Source: Bloomberg, IPD, Cordea Savills

- Further evidence that the UK's stuttering **industrial sector is regaining its footing** has emerged, with a survey finding that global industrial companies are increasingly favouring the UK as a place to source automotive and high-tech components, and to seek future profits. A poll conducted by the Economist Intelligence Unit ranked the UK above better-known manufacturing powerhouses of Germany and Japan, as well as above emerging economies such as India and Brazil, as a destination for future profit growth. The survey of 335 senior manufacturing executives around the world placed the UK third, behind the US and China, as the country where global companies expect to derive the majority of their profit growth over the coming years.
- Moreover, a survey by the Confederation of British Industry suggests **that employment intentions for the sector are near their highest recorded levels**. With the economy gaining further momentum, we believe there is an upside risk to our rental growth forecast of 1% pa over 2013-17.

Figure 8: Industrial employment intentions are near their highest levels



Source: Confederation of British Industry, IPD, Cordea Savills

Return of net lending and rising investor confidence

- There are clear indications from various surveys that we are seeing **first signs of easing lending conditions**. According to the latest Bank of England Credit Conditions survey, both credit availability and credit demand improved in Q1 and are expected to improve further in Q2.

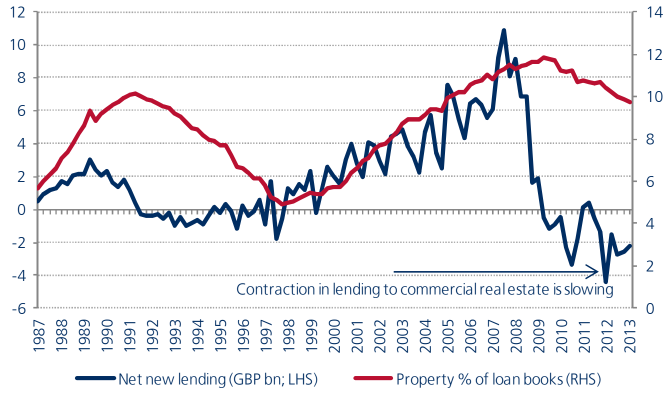
- While improvements in such survey-based indicators have yet to be reflected in the hard data on net property lending, it is evident that pressure on lending is abating. Although traditional lenders, such as banks and building societies are still reducing their exposure to commercial property, lending flows have started to increase from new entrants, such as debt funds, pension funds and life insurance companies. We expect this trend to continue and, as lending from banks stabilises, **we expect total net lending to turn positive by the latter half of this year**.

- The improving economic backdrop and availability of credit are **supporting real estate investor confidence**, which rose further in Q1 according to Jones Lang LaSalle. The confidence index is up 36% y/y and has been on an upward trend since Q2 2012.

- Improving sentiment has been reflected in the investment market, with Q1 investment volumes higher than expected, at GBP 9.3 billion, representing a 28% increase y/y. There is a notable decline in investor expecting investment return to be 'a lot lower', with the majority of respondents according to the Jones Lang LaSalle survey now expecting improving returns. In our view, this is likely **to support investment volumes going forward**, with increasing numbers of investors targeting core-plus and value-add opportunities.

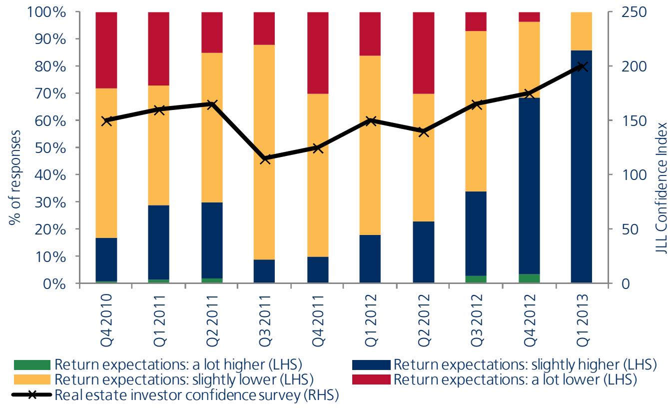
- Whilst activity from the UK institutions, increasing their property allocations, is expected to remain strong, the economic growth differential between the Eurozone and the UK will **also continue to attract capital from overseas buyers**. However, most of the overseas investors are fixated on London; in Q1, most deals were in Central London, and involved overseas buyers from the Far East and Middle East.

Figure 9: Net lending is expected to improve



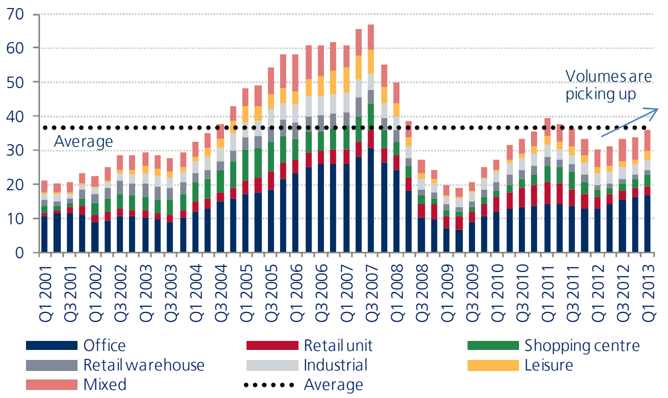
Source: Bank of England, Capital Economics

Figure 10: Both investor confidence and return expectations are improving



Source: Jones Lang LaSalle, Property Data, Cordea Savills

Figure 11: Investment volumes are on an upward trend (GBP billions; rolling 4 quarters)

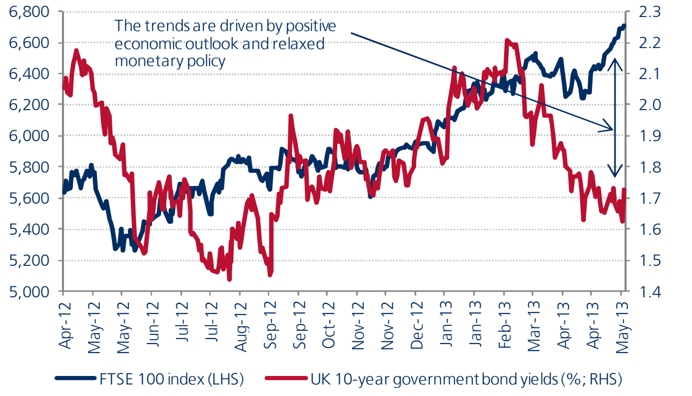


Source: Jones Lang LaSalle, Property Data, Cordea Savills

Weight of money chasing yields and risk

- We expect multi-asset allocators to **diversify out of their investments in both equities and sovereign bond**. Both of these markets are trading at or close to their peaks and, to a certain extent, look over-stretched.
- The recent trends also suggest the outlook for corporate profits has improved significantly, with monetary policy expected to remain relaxed for longer. Historically, this has been a sign for a higher risk taking.

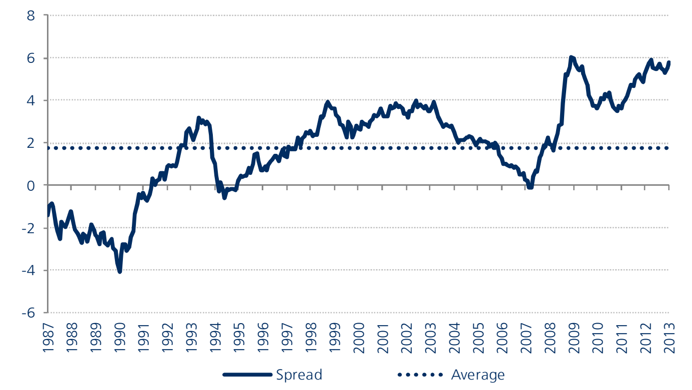
Figure 12: FTSE 100 close to new highs and 10-year bond yields near record lows



Source: Bloomberg

- In comparison with 10-year government bond yields, IPD All Property equivalent yields offer significant spread. The **spread is very close to the levels seen during the peak of the financial crisis.**

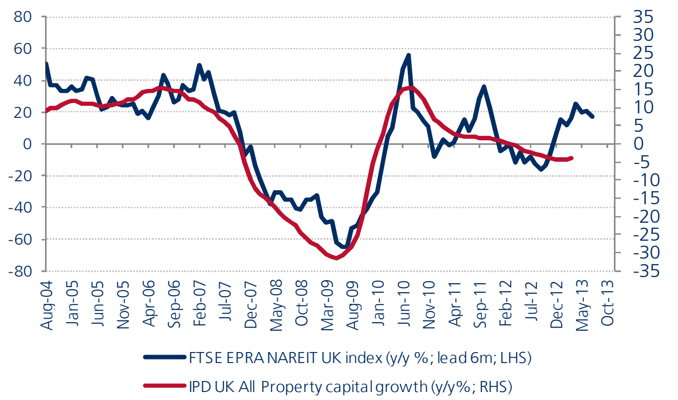
Figure 13: Spread between IPD All Property equivalent yields and 10-year government bond yields (%)



Source: IPD, Bloomberg, Cordea Savills

- Property equity prices remain buoyant and suggest that **an upturn in property values is imminent**. The buoyancy in property securities is supported by the better than expected results from the larger real estate investment trusts, especially those that have a higher that industry average exposure to London. Shares in both Land Securities and British Land are now trading at around a 10% premium to their last reported net asset values.

Figure 14: Property securities suggesting an imminent upturn in property values

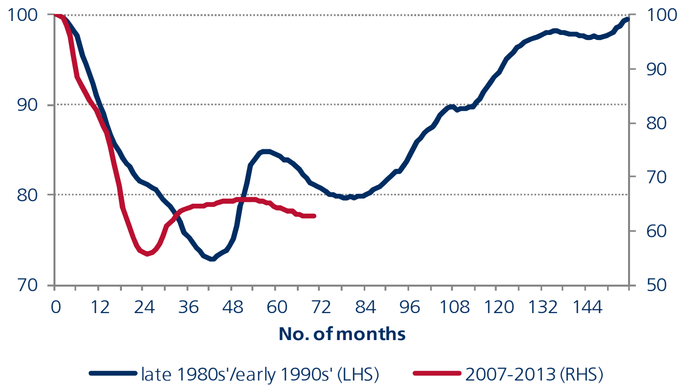


Source: IPD, Bloomberg, Cordea Savills

The upturn is imminent

- After declining for 17 months, the IPD Monthly All Property capital growth index recorded a relatively unchanged month in April. While a comparison with the cycle of the late 1980s'/early 1990s' suggests that we are very close to a turning point, **most of the leading indicators and the economic backdrop suggests that the recovery should gain momentum**.

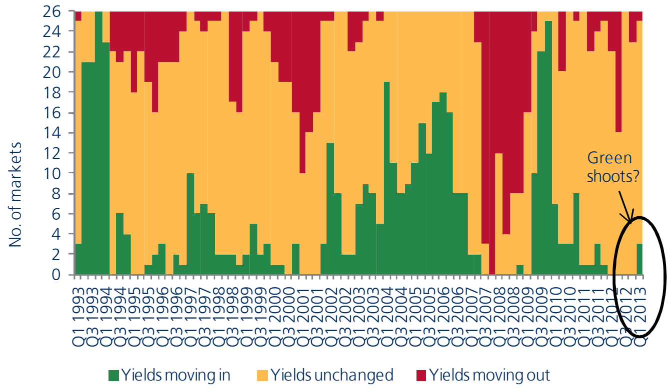
Figure 15: Comparison of IPD All Property capital growth cycles



Source: IPD, Cordea Savills

- Cordea Savills' prime yields monitor* based on Cushman & Wakefield's data suggests that quarter-on-quarter **yield changes are stabilising**, with more markets seeing yields moving in compared to moving out in Q1.

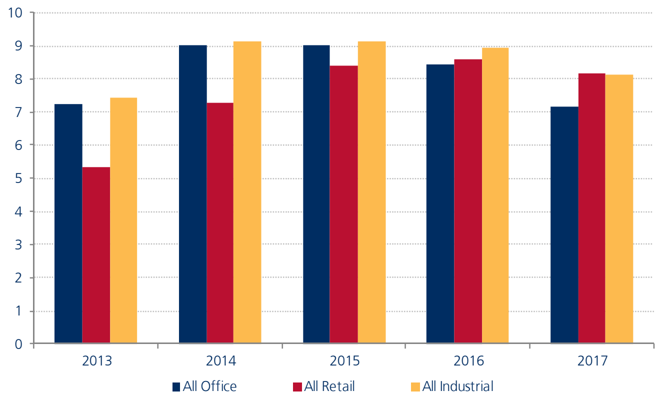
Figure 16: Yields moving in (q/q)



Source: Cushman & Wakefield, Cordea Savills

- Despite our current forecast for positive capital growth in 2013 (All property 0.2%, Office 1.5%, Industrial 0.5% and Retail -0.5%), we believe given the backdrop and sentiment, there is an **upside risk to our numbers**. The performance is expected to be led by the office sector, notably Central London offices. We expect opportunities to emerge in strong service sector centres outside London, with core yields moving in first. Industrials also remains a favourite given the supporting economic and property trends.

Figure 17: Total return forecasts (%)



Source: IPD, RealFor, Cordea Savills

* The monitor observes quarterly change in prime yields for all three sectors in eight key cities in the UK

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