Research Bulletin

EPMR

Economic & Property Market Review

UK
Q1 2009

In this issue

- The worst recession since the 1930s and negative employment growth for 2-3 years means falling rental values.
- Total property returns are forecast at -10% this year as rental falls accelerate, but should turn positive in 2010.

Economic trends

Economic output fell 0.7% in Q3 and 1.6% in Q4 2008 and will fall at a greater rate in Q1 2009. The National Institute of Economics and Social Research estimates that over the three months ending in February output fell by 1.8%, so a fall of at least 1.8% in Q1 seems likely. This would make the decline a total of 4% so far from the Q1 2008 peak. The total decline in the last recession was 2.5%.

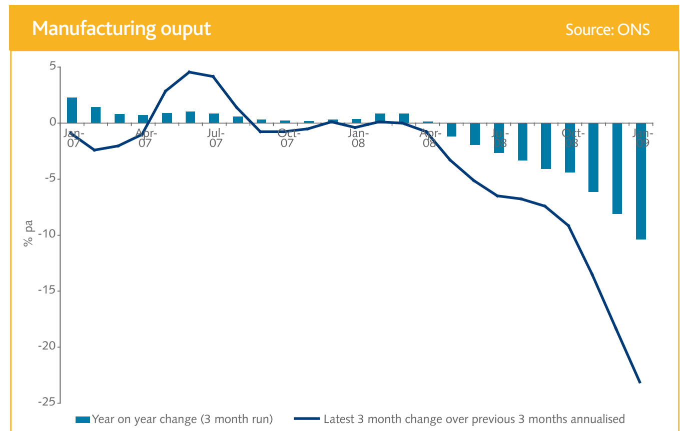
All sectors have been badly hit but the worst is manufacturing. Output in January was 12.8% below its January 2008 level. Over the three month period to the end of January, output fell by 6.4%, an equivalent annual rate of decline of 23%! As the chart shows this decline has been rapid, but an even steeper decline has occurred in many countries such as Germany, France, Italy and Japan.

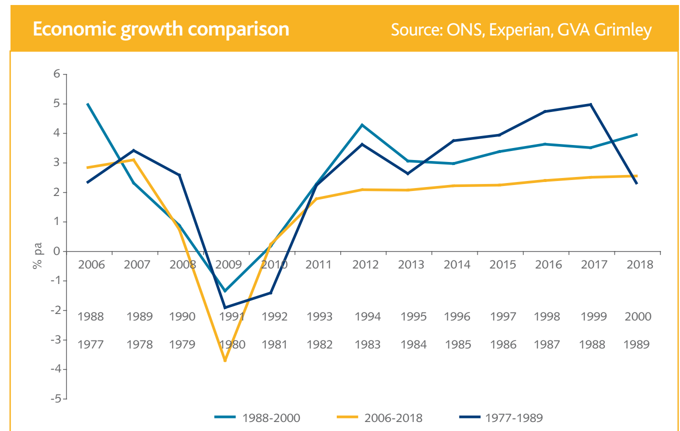
Interest rates at 0.5% are virtually as low as they can go so the Bank of England is now loosening monetary policy further by injecting new money into the system by buying bonds and government securities (Quantitative Easing) and hoping that banks will lend the money they receive. If they do, this could stimulate activity and help end the recession, but it's a fine balance between stimulating the economy and creating inflation. The yield on 10 year gilts has fallen and widened still further the yield gap between property and gilts which is good news for property investment.

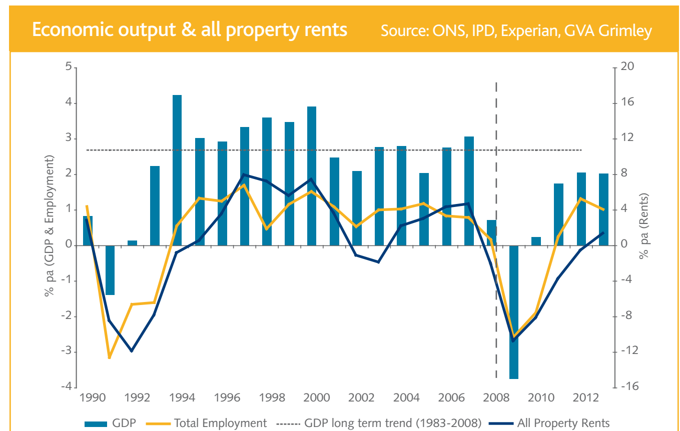
Economic outlook – consensus forecasts for 2009 have weakened further. A year ago the forecast for 2009 was +2%, now it is -3.2%, with some recent forecasts anticipating closer to -4% than -3% in 2009. The total decline in output in this recession is now likely to be 6% or more, much greater than in the early 90's (-2.5%), the early 80's (-4.6%) or the mid 70's (-3.4%).

The huge stimulus from very low interest rates, quantitative easing, sterling's depreciation, the fall in energy prices and the government's increased spending should help to end the recession in the latter half of 2010. But the upturn will be constrained by significant tax increases and severe public spending restraint to cut government debt, together with conservative lending by banks reinforced by increased regulation. Post 2010, 2% pa economic growth will be the norm rather than the 2.9% pa enjoyed over the last 15 years. By the middle of the next decade long term trend growth of 2.5% pa should be more likely.

Employment growth and hence occupier demand for property will suffer from the severe recession and the weakish upturn that will follow. Unemployment increased in February by double the amount reported in each of the previous three months and is expected to increase by 50% over the next two years. The latest consensus view is that employment growth will be negative this year (-2.6%) and in 2010 (-1.6%), with a further probable fall in 2011. However, this would be better than in the early 80's recession, the worst post war recession until now, when employment growth was negative for four years.







Latest Consensus Forecasts, March 2009 — Source: HM Treasury, GVA Grimley

	2008	2009	2010	Long-term average
Economic growth (GDP)	0.7%	-3.2%	0.3%	2.7% pa ('83-'08)
Private Consumption	1.7%	-2.2%	-0.3%	
Employment growth	0.4%	-2.6%	-1.6%	0.4 - 0.6% pa
Bank base rate (Q4)	2.6%	0.5%	1.1%	
CPI – Inflation (Q4)	3.8%	0.3%	1.7%	
RPI – Inflation (Q4)	2.7%	-2.1%	2.6%	

Commercial property market

Occupier market

All Property rental growth – The deteriorating economic conditions are now being clearly reflected in rental performance. At the All Property level, rental values on the IPD Monthly Index have been falling since the middle of last year, and at an accelerating rate. February 2009 saw rents fall by 0.9%, compared with 0.8% in January and 0.7% in December 2008.

Central London offices – it is in the central London office market that rental falls are being felt most keenly, with occupier demand very weak and speculative schemes continuing to complete. There has been a sharp fall in headline rents during Q1 in both the City and West End markets. In Mayfair, the prime headline rent fell from £95 psf to £70 psf a drop of 26% and in the City central core, the fall was from £52.50 psf to £45 psf, a decrease of 14%. Both markets also saw a rise in incentive levels.

Retail – The retail sector is being hit hard as consumers reign in their spending. The ever-growing list of retailers going into administration is adding to void rates, with Woolworths alone adding around 14 million sq ft of vacant space to the UK's high streets. IPD reports a fall in UK retail rents of 1.6% in the three months from December to February.

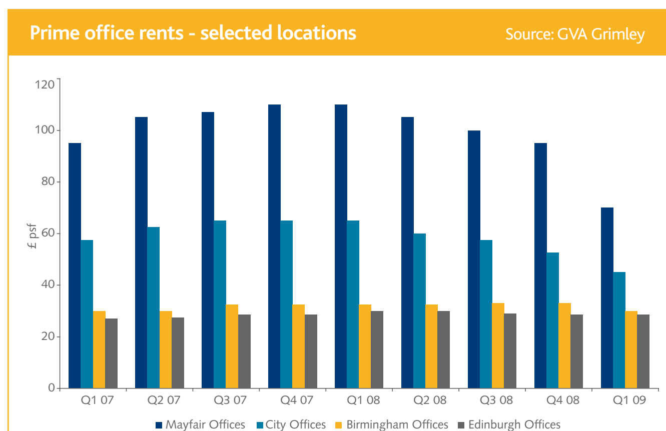
Industrial – Prime industrial rents held broadly steady during Q1, with weakening occupier demand being reflected in increasing incentives. On the IPD average measure, rents are now clearly falling – the drop was 1.1% in the three months to February.

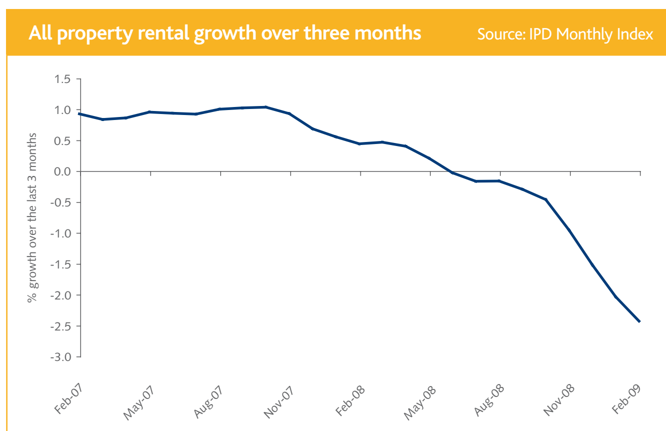
2009 outlook – With continued downward revisions to economic forecasts, the outlook for rental growth has deteriorated further. We now expect All Property rents to fall by 11% in 2009, compared with -1.2% in 2008. However, we expect a very wide variation between central London offices, where we now forecast a fall of 25%, and most of the rest of the market, where the expected fall is typically around 6-8%. The effect of rental falls this year will be moderated to some extent by very low inflation or deflation (depending on which measure is used), with consensus forecasts of RPI at -2.1% and CPI at just 0.3%.

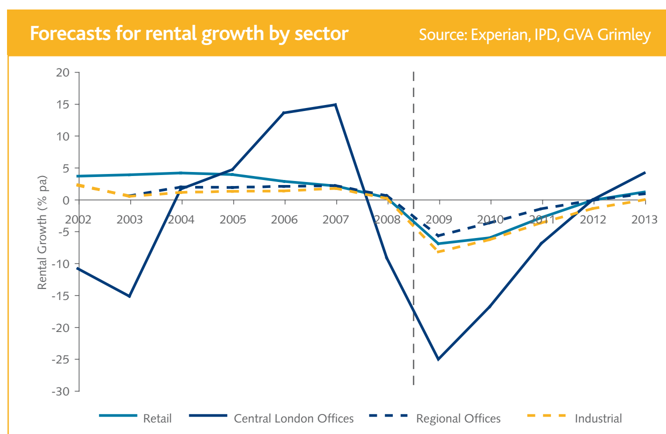
Outlook from 2010 – With any return towards economic growth not now likely to occur until late 2010, the outlook is for rents to continue to fall for the next four years to 2012, although 2009 will see the steepest declines. Even once economic growth resumes, there will be a lag with property market performance - economic growth needs to translate into employment growth and consumer spending, and then into demand for property and excess supply then needs to be absorbed.

At the All Property level, average property rents are forecast to be more than 20% lower at the end of 2011 than at the end of 2008. Even post-2011, the upturn looks set to be a slow and moderate one, as the bottom chart shows.

Whilst our rental growth forecasts may appear unduly pessimistic, it is worth noting that average rents fell for more than three years during the early 1990s recession. The total fall in rental values now looks set to be similar to that in the early 1990s. Indeed, the current recession is likely to be more severe than that in the early 1990s, although on the positive side, the development cycle has been much less pronounced this time around.







All property rental value growth forecasts

	2009	2010	2011	2012	2013
Consensus Forecasts					
Maximum	-4.7%	-3.2%	1.7%	-	-
Minimum	-16.0%	-13.9%	-6.4%	-	-
Average	-10.3%	-7.9%	-2.0%	-	-
GVA Grimley	-10.8%	-8.2%	-3.8%	-0.6%	1.3%

Investment market

Investment transactions – The underlying level of quarterly property transactions has been remarkably stable since the middle of last year, as the first chart illustrates (although there is volatility from month to month). £844 million was transacted during February, according to Property Data, with £4.3 billion transacted over the period December-February.

During Q1 to date, overseas investors have been the key purchasers of commercial property, buying property worth more than £1.2 billion, with interest boosted by the favourable exchange rate. Private investor interest has returned quite strongly, helped by the very low base rate. Institutional interest is also increasing, targeted at the prime end of the market. There remain relatively few forced sellers, despite an increase in receiverships.

Yield movement – The IPD equivalent yield continued to rise during February, moving up to 8.9% compared with 8.7% in January. The total increase since the peak of the investment market in mid-2007 is now 350 basis points.

Capital values have fallen by 11.5% in the three months to February, by 29% over the last 12 months, and by nearly 40% since the peak of the market in mid-2007. Indeed, values are now back to their level as at April 1999. Rising yields remain the most significant factor behind the fall in values, although the effect has begun to moderate somewhat over the last two months. In contrast, the accelerating fall in rents is having an increasing negative effect on values. Although market pricing now appears to be stabilising, the IPD Monthly Index continues to lag behind market valuations.

Total returns – The annual total return as at the end of February was -24.3% (IPD), down from -23.2% in January. Whilst the year-on-year return is still falling, performance measured over three months has started to improve, as the chart shows. The total return was -9.8% in the three months to February, compared with a low of -13.5% in December 2008. Given the very poor performance seen in recent months, the year-on-year figure is likely to deteriorate further before the corner is turned.

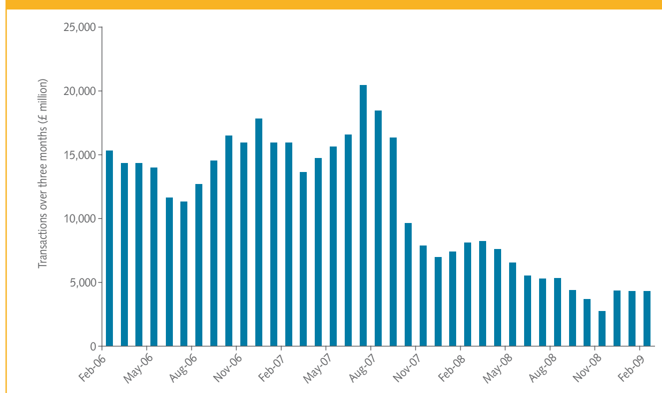
Property market fundamentals – The increase in commercial property yields continues to contrast with falling gilt yields and borrowing costs. The February All Property equivalent yield of 8.9% now provides a very significant gap over 15-year gilt yields at 3.9% and 5-year Swap rates at 3%. Whilst borrowing costs may be low in theory, the availability of debt finance remains constrained for secondary property, but can be secured at the prime end of the market. Current yield levels are well above their historical average levels, suggesting that property is now attractively priced in the long-term context. Of course, in the short term, rising default and void rates and falling market rental valuations are clearly a major concern.

Forecasts – The upward yield movement that has driven the major falls in capital values over the last 18 months should now be almost over. We expect a total return of -10% for 2009, which would represent a significant improvement on current performance, followed by +5% in 2010. This is similar to the consensus view (-11% followed by +4%).

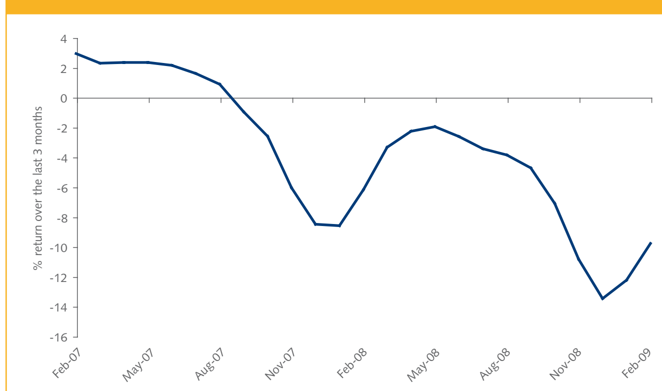
However, the risk to this outlook remains very firmly on the downside and the pricing of property derivatives suggests a much weaker performance. With so much uncertainty surrounding the economic outlook and when a return to more normal credit conditions may occur, as well as the unpredictable nature of investor sentiment, the timing of the recovery in the investment market is inevitably hard to predict.

From 2011 we expect performance to revert to more normal levels as the economy recovers, investors anticipate rental growth, void levels reduce and the supply of credit increases. We therefore forecast total returns of 9-10% pa from 2011-2013.

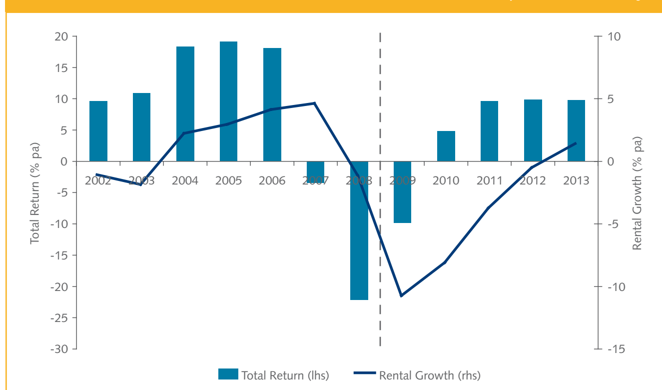
Value of investment transactions over three months Source: Property Data



Total return over three months Source: IPD Monthly Index



Forecasts for rents and returns Source: IPD, Experian, GVA Grimley



All property total returns forecasts

	2009	2010	2011	2012	2013
Consensus Forecasts					
Maximum	-4.4%	9.5%	20.9%	-	-
Minimum	-18.5%	-4.0%	3.0%	-	-
Average	-11.3%	4.2%	11.8%	-	-
GVA Grimley	-9.8%	4.8%	9.6%	9.9%	9.8%

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