UK Commercial Market in Minutes
Confidence in the regions becomes entrenched

February 2014

Downward yield shifts holding but not for long

■ January saw prime yields continue to hold at November levels but seven sectors reported downward pressures.

■ Apart from the usual appetite for London, good quality M25 offices, regional offices, industrial distribution and retail warehouses have moved up the hit list for investors.

■ In the case of regional offices, improvements in their occupational markets, lack of new supply and better value play, as opposed to Central London, has intensified demand particularly from institutional investors.

■ This intensity of demand has resulted in some transactions achieving above their asking price as seen with SWIP's £34.5m purchase of Sunlight House in Manchester, originally marketed at £28.5m. We have also seen assets that could not be sold 18 months ago acquired off market below their previous marketing yield. Gazumping has also made a comeback.

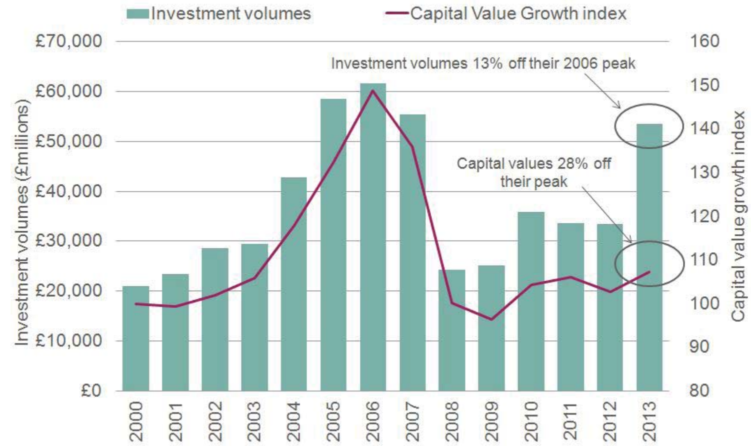
■ This mounting demand saw transaction volumes reach a six year high of £53.6bn in 2013. This was 60% up on 2012 and only 13% off 2006 peak levels. UK institutions accounted for 25% of volumes, an increase on their 2012 share of 20%.

■ However, despite this marked tick up in activity All Property capital values remain 28% off their peak. On a very simplistic basis there has been a strong historical correlation between investment activity and capital value movements. This appears to have disconnected in 2013.

■ Rising capital flows into the institutional funds combined with greater investor willingness to move up the risk curve should result in more pronounced capital growth in the regions this year. The disconnect between investment activity and capital value movements should therefore recede.

GRAPH 1

Capital value recovery trailing investment activity



Graph source: PropertyData; Investment Property Databank

TABLE 1

Prime equivalent yields

	Jan 13	Dec 13	Jan 14
West End Offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.75%	4.75%↓
Offices M25	6.25%	5.75%↓	5.75%↓
Provincial Offices	6.25%	5.75%	5.75%
High Street Retail	4.75%	4.50%	4.50%
Shopping Centres	5.25%	5.00%↓	5.00%↓
Retail Warehouse (open A1)	5.25%	4.75%	4.75%
Retail Warehouse (restricted)	6.00%	5.50%↓	5.50%↓
Foodstores	4.50%	4.25%	4.25%
Industrial Distribution	6.25%	5.75%↓	5.75%↓
Industrial Multi-lets	6.00%	5.75%	5.75%
Leisure Parks	6.25%	6.00%↓	6.00%↓
Regional Hotels	7.00%	6.75%	6.75%↓

Table source: Savills

Capital value and rental growth outlook

■ The robust investor appetite being seen for offices, both in London and increasingly regionally, is being supported by a strong outlook for capital and rental value growth.

■ Prime offices top our forecasts for commercial property through to 2018. Year end capital and rental growth is forecast to hit 10.1% and 4.5% respectively. Capital and rental value growth through to 2018 is expected to average 5.5% and 4.4% per annum respectively.

■ For the top regional office markets falling vacancies and recovering tenant demand, coupled with little or no speculative development activity, will fuel a rental recovery. The yield spread compared to London offices should entice further investment driving capital value growth.

■ Prime retail is also expected to deliver some strong growth with London's core retail pitches likely to offer the best prospects for double digit rental growth. Over the next 12 to 18 months, prime Zone A rents across the key London pitches are expected to increase by an average of 15.3%, with the luxury enclaves leading.

■ On a cross sector basis, however, agricultural offers the best prospects. Savills forecasts for All Farmland point to average annual growth in capital values and rents of 6.0% and 7.0% respectively through to 2018 with a 200 basis point uplift for top quality farmland.

Risk of imminent rate rises diminishes

■ The faster than expected growth in the UK economy last year has already become apparent in consumer, business and development sentiment surveys.

■ But what about interest rates? Future increases had been flagged as an imminent risk to confidence as unemployment crept closer to the 7% threshold set by the Monetary Policy Committee (MPC).

■ However, this potential 'risk' looks set to be delayed following the Bank of England's (BoE) scrapping of the guidance that linked rates to unemployment. The BoE also revised its 2014 forecasts for the UK economy upwards from 2.8% to 3.4%.

■ Inflation (as measured by CPI) came in from 2.0% to 1.9% in January, its lowest level since November 2009, which has further mitigated the need to increase rates. As a result, the general consensus is that rates are unlikely to rise before next year's election.

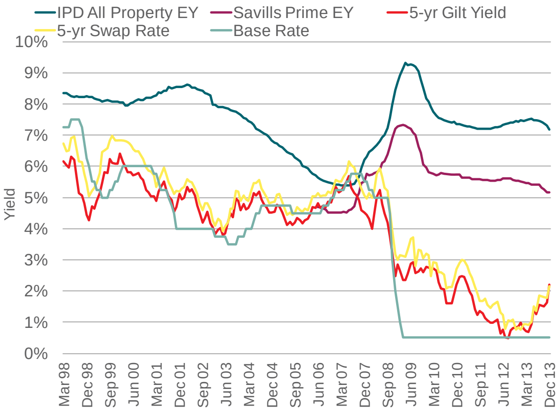
■ With interest rates forecast to reach 2% over the next three years, relatively low historically, the resultant yield spread between property, Gilts and five year Swaps is likely to ensure that property remains an attractive asset. As a result this will intensify the downward pressure on both prime and secondary yields.

TABLE 2
Savills forecasts

Subsector	2014 Gross yield	2014 Capital growth	2014 Rental growth	Average 2014-18 Capital growth	Average 2014-18 Rental growth
Retail: Prime	4.7%	7.8%	2.3%	4.1%	3.0%
Retail: Secondary	6.9%	6.6%	-0.6%	2.7%	0.6%
Office: Prime	4.9%	10.1%	4.5%	5.5%	4.4%
Office: Secondary	8.3%	6.4%	0.0%	3.4%	1.5%
Industrial: Prime	5.8%	7.2%	2.5%	2.5%	1.6%
Industrial: Secondary	9.3%	7.8%	2.0%	3.0%	1.3%

Table source: Savills

GRAPH 2
Low interest rates to maintain attractive yield spread



Graph source: Savills; Investment Property Databank; BoE

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