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UK Commercial Market in Minutes
Will rising interest rates influence rental growth?

August 2015

Stable but with downward pressure

■ The latest prime yields show a static position over the previous month. The only change has been the removal of the downward trend on shopping centre prime yields.

■ Nine of the sectors have lower yields compared to 12 months ago. Despite this, the average across the 13 sectors, shown in Table 1, has fallen by only one basis point during July and now stands at 4.70%. This is 19 basis points above the May 2007 peak level.

■ There is still room for some further yield reduction, as capital to be deployed in UK property remains high with funds seeing net inflow each month.

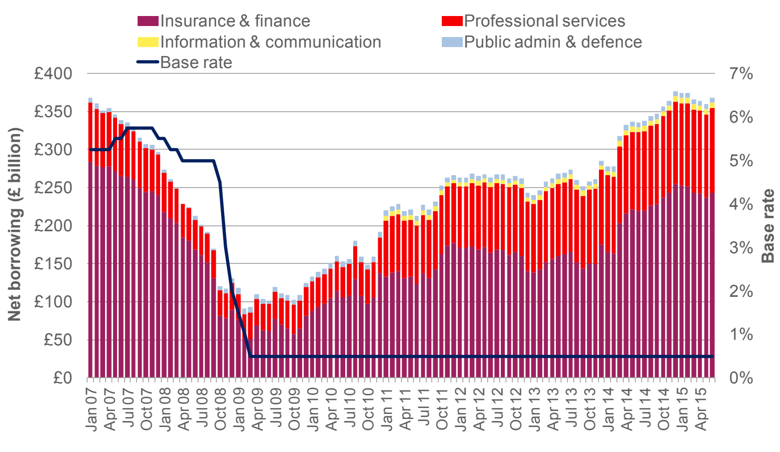
■ Interest rate sensitivity and impact from the expected rises, during the next 12 months, has centred on what it means for investors investing in UK property. However, much less, if anything, has been discussed about the occupier impact. The return of rental growth has been a more popular theme during the last few quarters. However, companies' profit and loss will be impacted by the cost of their finance. Consequently, property costs may come under increasing scrutiny.

■ To illustrate exposure to interest rate movements, Graph 1 shows the high level of net borrowing by UK office-based companies using data from the British Bankers' Association (BBA). The overall level has fallen in the past few months but is similar to 2007. When base rates rise, depending upon the company's exposure to a floating rate of interest, there will be varying financial impacts of servicing the debt.

■ With rising cost of debt, it is anticipated that some companies will be more resistant to above average rental growth. In addition, they are having to absorb higher wage growth pressures driven by the strengthening economy.

GRAPH 1

Borrowing back at 2007 levels



Graph source: British Bankers' Association (borrowing levels for the four major office-based business sectors)

TABLE 1

Prime yields

	July 14	June 15	July 15
West End Offices	3.25%	3.00%	3.00%
City Offices	4.50%	4.00%	4.00%
Offices M25	5.25%↓	5.00%↓	5.00%↓
Provincial Offices	5.25%↓	5.00%↓	5.00%↓
High Street Retail	4.50%↓	4.25%↓	4.25%↓
Shopping Centres	4.50%↓	4.25%↓	4.25%
Retail Warehouse (open A1)	4.25%	4.50%	4.50%
Retail Warehouse (restricted)	5.25%	5.50%	5.50%
Foodstores	4.50%	5.25%	5.15%
Industrial Distribution	5.00%	4.75%↓	4.75%↓
Industrial Multi-lets	5.00%	5.00%↓	5.00%↓
Leisure Parks	5.75%↓	5.25%	5.25%
Regional Hotels	6.50%	5.50%	5.50%

Table source: Savills

Where is the office employment growth?

■ It is worth reviewing the expectations for employment growth within the office sector over the next decade. This will drive floorspace demand from companies, of all sizes, and this will contribute to rental growth trends.

■ Increased occupier demand will be driven by the need to acquire/expand their office space as the UK economy continues to grow. A recent survey of UK small to medium-sized enterprises (SME) showed that the economy was only cited by 59% of companies as the biggest barrier to growth. This level has fallen from 78% when surveyed in 2012.

■ Therefore, other issues including attracting and retaining staff has become a much more important issue to SMEs over the past couple of years. Map 1 shows the South East and London will see the higher employment growth, but there will also be more significant growth throughout the Midlands and the North West regions. This will increase the competition for the scarce supply of office space.

■ So employment levels will rise and rental growth will remain above the historic average, but tempered by debt cost impacts.

■ To the end of June, office rental growth was 7.7% over the year. In June 2014, it was 5.5%. Annual growth forecasts from the Investment Property Forum suggests 3.5%pa during the next few years. This is higher than the 1.8% average for the last decade. The next section shows how this rental growth story is yet to be reflected in the capital growth recovery.

Opportunities outside of the South East?

■ Dispersed employment growth through the UK is evident from Map 1. However, this is yet to feed through into rising take-up in some locations.

■ A year ago we highlighted a need to look beyond the South East. So what has happened in the past 12 months? Overseas investors were more nervous about investing outside the South East last year, but have become significant buyers. The share of non-domestic buyers outside of London averaged 13% of the total during the past 10 years; the first half of 2015 saw that share increase to 25%.

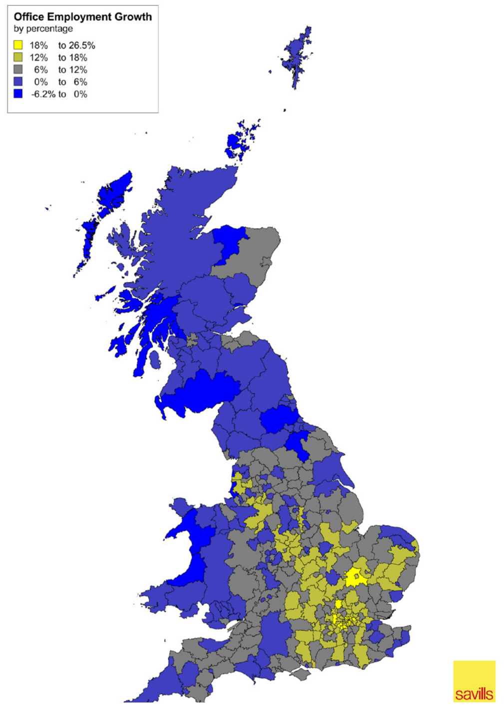
■ Graph 2 presents the capital value growth index re-based to July 2009. Leading up to the peak in late-2007, the markets followed broadly similar trends. However, UK offices, for example, have seen 60% growth since mid-2009, but have only just reached parity outside of the South East. Central London will have driven the office recovery.

■ Standard shops remain below the 2009 trough and it is only industrials that seem to be currently showing a similar trend for both geographies.

■ Coupled with wider employment growth, throughout the UK, there is still unjustified divergence and, therefore, opportunity for investors in the whole of the UK office market. ■

MAP 1

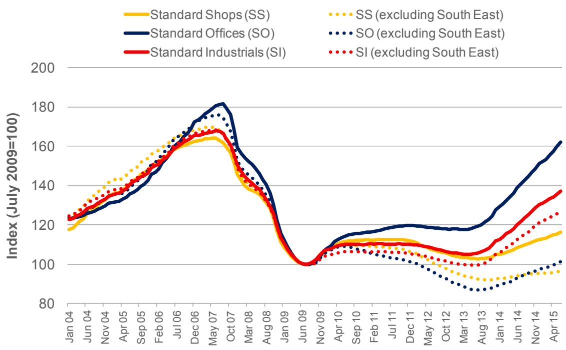
10-yr total office employment growth



Graph source: Savills, Oxford Economics (employment growth in next 10 years)

GRAPH 2

Capital growth recovery is uneven



Graph source: MSCI

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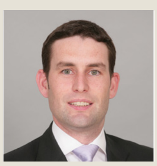

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