

UK Commercial Market in Minutes

Lower, but solid, returns next year

December 2014

Will yields fall further?

■ During the seven month period before October, the 'average' prime UK yield fell in each month. Despite static yields across all sectors in October, they fell again in November. This has been driven by City Offices, Industrial Distribution and Leisure Parks.

■ However, one of the most significant changes, since last month, is the appearance of more upwards yield trend arrows within the retail sector.

■ The prime average is 4.66%, the lowest since June 2007. Can they move lower? Some sectors remain firmly on the buy list for UK institutions as cash continues to flow in.

■ This demand from the funds is illustrated by looking at Unit Trusts/OEICs data. According to the Investment Management Association, they have seen property funds, under management, expand from £17.6bn in November 2013 to £23.0bn in October 2014, a 31% increase.

■ The gap between the IPD 'average' and Savills prime equivalent yield, compared to the 5-yr Swap rate, is 300 and 470 basis points, respectively. This is in-line with the medium-term average. Encouragingly, as shown in Graph 1, the main sectors have seen annual rental growth back in positive territory. This is driven by London performance, but the 'Rest of UK' retail is also expected to move to positive growth within the next few months.

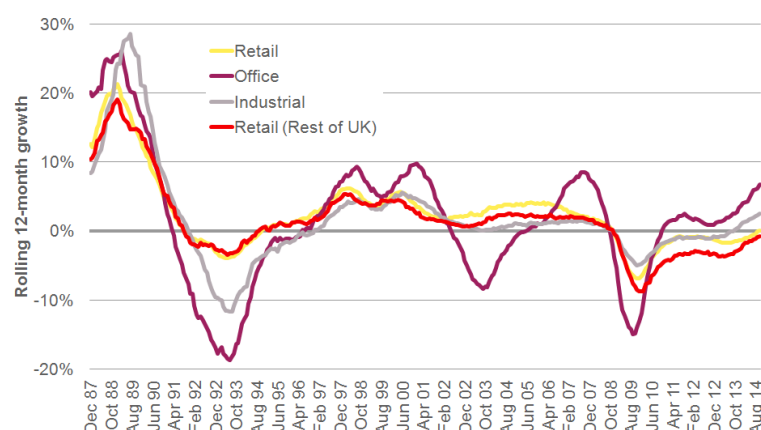
■ Overall, total UK investment will break through the £50bn barrier again this year (£54.5bn in 2013). UK institutions and overseas investors are the largest net buyers in 2014, which has been driven by enhanced confidence in the regions and more liquidity in London. In fact, the property company sector has seen net disinvestment of £5.9bn, as at end-November, due to the expectation of slower returns next year and taking the opportunity to recycle the capital gain into new opportunities, potentially within secondary assets.

TABLE 1 Prime equivalent yields

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

Table source: Savills

GRAPH 1 Average rental growth heading back into positive territory across the UK



Graph source: Savills / Investment Property Databank

→ Sticky pricing

■ Since the end of last year, oil prices have been falling steadily. With the price now 41% below the 2013 year end. The question is how will this impact the British consumer and corporates?

■ UK businesses, from a recent Lloyds Bank survey, found that cost pressures are lower due to flat output prices as transport and commodity costs have fallen. The overall reduction in households' fuel bills is estimated to be £14bn (or 0.8 per cent of GDP). This will have a positive impact on consumers' spending powers and economic growth. It's a step too far to suggest that occupier demand will increase, but any cost savings bodes well for corporate willingness to take floorspace and absorb the anticipated rental increases.

■ For consumers, we are yet to see the impact of oil price falls to feed through directly to the cost of petrol at the pump. Compared to the 41% fall in oil prices, over the same period, petrol prices are only 8% lower - an economist would suggest 'stickiness'. Oil companies are looking to cut their non-operational cost base and prices on the forecourt will not be a priority unless price competition increases. Therefore, more favourable petrol prices, back to the £1 per litre level, will continue to elude drivers in the short-term, a level not seen since 2009.

■ Overall, cost pressures are receding in the UK. Inflation has fallen from the Bank of England's target of 2%, at the end of last year, to 1.3% in October 2014. GDP is now poised to exceed

the consensus next year and base rate rises now pushed back to end-2015.

Are we at the top of the current cycle?

■ As we approach the end of the year, it is timely to review some short-term forecasts. The Investment Property Forum Consensus Forecasts were recently released and the total returns predictions are shown in Graph 3.

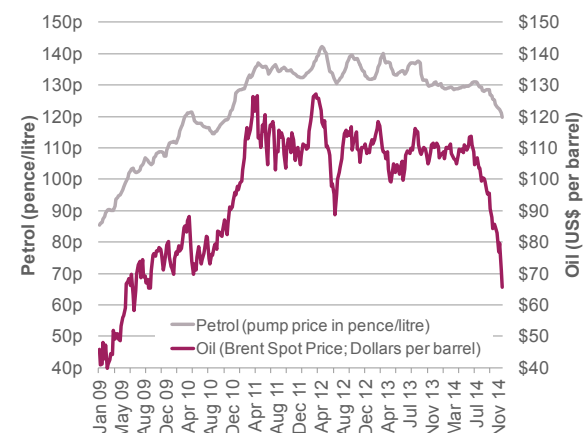
■ The expectation for 2015 is lower returns, compared to this year, driven by slower capital value growth. Despite this, all UK sectors are anticipated to be at double-digits. As seen this year, the office and industrial sectors are anticipated to out-perform retail.

■ Higher corporate demand, resulting in increased take-up levels across all sectors and lack of development regionally, will justify the buoyant investment markets seen in the past couple of years. However, there are headwinds. The known 'unknowns' include the impact of the General Election in May and how this will impact on corporate spending in Q1, particularly the appetite to take space and drive rental growth.

■ Of course, the UK relies heavily on the eurozone as a trading partner and this balances out the more positive domestic outlook. The deflationary forces at work there, compounded by falling energy prices, has put increasing pressure on the European Central Bank to begin Quantitative Easing described as a "last throw of the dice". Falling demand for UK exports/services would be detrimental to the UK economy and, ultimately, commercial property. ■

GRAPH 2

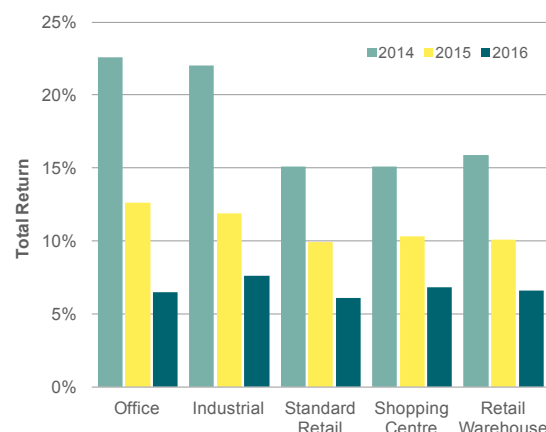
Will petrol prices start to fall?



Graph source: Office for National Statistics / US Energy Information Administration

GRAPH 3

Lower returns during next two years



Graph source: Investment Property Forum

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