

UK Commercial Market in Minutes

Short-term headwinds puts yields on level trajectory

February 2016

Yields levelling

■ January prime yields remained static with the UK average at 4.6%, a level last recorded in July 2007. Leisure prime yields moved in by 25 basis points, but downward shifts in this sector have lagged the others due to lack of liquidity.

■ Most asset classes face an increasing degree of uncertainty, which has dominated the first few weeks of 2016. Core government bonds have been boosted by a flight from riskier assets, which may impact on commercial property pricing.

■ For example, despite falling consistently throughout 2015, oil prices continue to dominate headlines, steer investor sentiment and impact on global sentiment. Equity markets have responded accordingly. However, investor appetite for UK property will remain, including further interest from global investors.

■ As shown in Graph 1, the MSCI

data for December 2015 now gives us a complete picture for last year. UK capital value growth in 2015 will be around 8%. The peak, in October 2014, was 14% year-on-year. The impact on total returns has seen them settle around 14% last year. This will 'cool' to 8-9% this year and 7-8% in the next five years.

■ 'All Property' rental value growth, on an annual basis, grew 4.2% during 2015. A level of annual growth that has not been seen since July 2001, which highlights the ability and willingness for occupiers to accept higher rental growth.

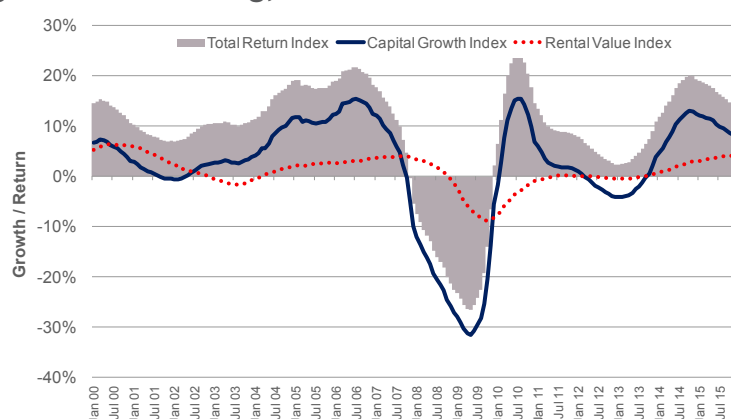
■ However, rental payments remain a significant cost within large corporates and, despite having higher levels of cash on the balance sheet, companies will remain cautious in how they spend this, especially in the face of rising employment costs, with rising wage growth expectations and slowing global growth.

TABLE 1
Prime yields

	Jan 15	Dec 15	Jan 16
West End Offices	3.25%	3.00%	3.00%
City Offices	4.25%	4.00%	4.00%
Offices M25	5.00%	5.00%	5.00%
Provincial Offices	5.00%	4.75%	4.75%
High Street Retail	4.25%	4.00%	4.00%
Shopping Centres	4.25%	4.25%	4.25%
Retail Warehouse (open A1)	4.25%↑	4.50%	4.50%
Retail Warehouse (restricted)	5.25%↑	5.75%	5.75%
Foodstores	5.00%	5.00%	5.00%
Industrial Distribution	4.75%	4.50%	4.50%
Industrial Multi-lets	5.00%	4.75%	4.75%
Leisure Parks	5.25%	5.25%↓	5.00%
Regional Hotels	5.75%	5.50%	5.50%

Table source: Savills

GRAPH 1
UK capital values continue to rise, year-on-year, but growth is receding; rents continue to rise



Graph source: MSCI

→ Deal or no deal?

■ This time last year the UK market was commenting on the impact of the General Election and the likely impact on the UK property investment and occupational markets. The key question was regarding the slowdown due to rising uncertainty. Economists at Bank of America Merrill Lynch propose the UK referendum as the biggest risk to the UK economy in 2016. Therefore, the risk to property activity may also be significant.

■ The early-2015 UK polls showed very mixed messages about the General Election expectations, which turned out to be inaccurate. Graph 2 presents a current poll of the UK views regarding the Brexit issue. Of course, these may not be a true reflection of reality as well. However, as shown, prior to 2015, there were various surveys, which swung between 'stay' or 'go'. However, since the beginning of January 2015, when the referendum became more of a reality, the 'undecided' voters began to appear.

■ Clearly, during the past six months, there has been a convergence between the two camps and around 18% remain undecided. A recent alternative poll from YouGov shows a 14 point majority, to leave, if David Cameron fails to renegotiate the terms of the UK's EU membership. Cameron will seek more concessions and then the endorsement of other EU members at a mid-February summit before scheduling a referendum that may be held in Britain as early as June. This would be the best outcome for the UK property market due to a shorter lead-in period.

■ For UK property investment, there is a higher degree of uncertainty, at present, which will, no doubt, drag on the investment volumes during the first half of this year. However, for January, investment volumes were only 10% lower compared to January 2015.

■ On the occupational side, in our view, the impact of a full exit from the EU membership will be more limited. Any effect will take years to feed through and unlikely to lead to a mass corporate walkout from the UK. The attraction of the UK will remain due to location/time zone, talent, access to capital and the strength of the legal system. Indeed, HSBC has recently announced to retain the global HQ in the UK. One survey of the UK's corporate leaders showed a desire for the UK to be part of the EU trading bloc but without the political links.

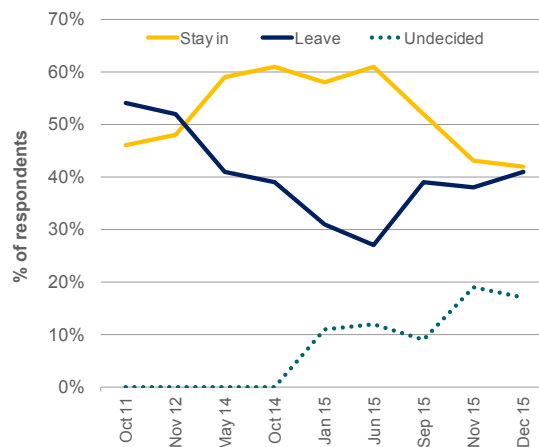
Lower, but stable, UK return expectations

■ As we begin the year, it is worth reviewing the latest forecasts for UK total returns going forward. The low point, in the next part of the current cycle, is expected to be 2017. Many forecasters are putting a zero growth in that year, but note that this is still not a fall. The forecast for the next five years show 7-8% annual average returns per annum.

■ The main driver of total returns will be in the income return element. The driver of this, rental growth, will show strength across various sectors and regions in the next five years. The top 10 locations, in terms of annual growth per annum, are shown in Graph 3. ■

GRAPH 2

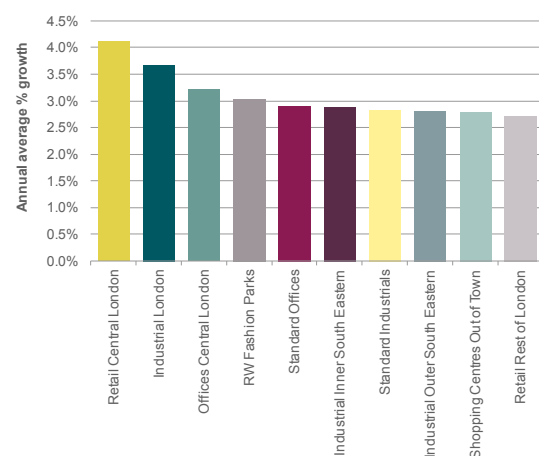
There is clear convergence of the 'two sides' in the past six months



Graph source: Ipsos Mori, ICM

GRAPH 3

A broad mix within the top ten rental growth sectors during next five years



Graph source: RealFor, Savills

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