UK Commercial Market in Minutes
Are prime yields near the bottom?

June 2014

Yields edge closer to their previous nadir

■ May saw a continuation of the downward trend in prime yields with a five basis point (bps) hardening in average prime yields. This was in response to three sectors, Provincial Offices, Industrial Distribution and Regional Hotels, reporting a 25 bps hardening in yields.

■ The hardening in Provincial Office yields means they are now 25 bps lower than M25 Offices, marking a return to the long term differential that has existed between the two sectors and highlights the entrenchment of investor confidence in the regional office markets.

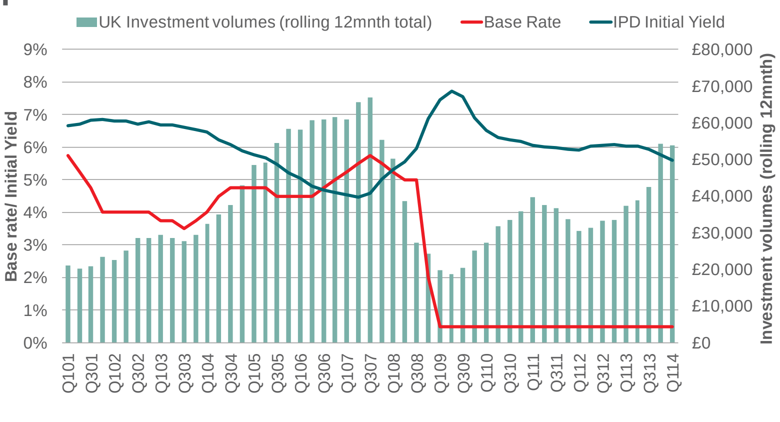
■ The fall in prime Industrial Distribution yields was helped by stock availability constraints and continued investor appetite for the sector. In terms of its peak differential, yields are now only 25 bps off their 2007 low. As prime yields in some sectors move closer to their 2007 low could we be reaching the bottom?

■ With inflows into retail funds continuing and their greater allocation to property, the weight of money targeting property shows no sign of abatement. This will generate further downward pressure on yields. In some markets this will be exacerbated by the lack of good quality product, both from an investment and occupational perspective. However, these value improvements may encourage the release of more stock to the market.

■ Going forward, the prospect of interest rate rises does raise some questions considering that the property yield/swap spread seen over the last five years has helped to attract investment. Having looked at the last cycle an increase in base rates did not correspond with a slowdown in investment activity, although this was partly fuelled by greater debt availability and which is now also improving (Graph 1). However, the impact of interest rate rises on wider consumer confidence, spending and in turn GDP may dampen wider investor confidence.

GRAPH 1

Investment volumes have grown during previous periods of interest rate rises



Graph source: Bank of England; Investment Property Databank; PropertyData

TABLE 1

Prime equivalent yields

	May 13	April 14	May 14
West End Offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.50%	4.50%
Offices M25	6.00%	5.50%	5.50%
Provincial Offices	6.00%	5.50%↓	5.25%
High Street Retail	4.75%	4.50%	4.50%
Shopping Centres	5.00%	4.75%	4.75%
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	6.00%	5.50%	5.25%
Industrial Multi-lets	6.00%↓	5.50%↓	5.50%↓
Leisure Parks	6.25%	6.00%↓	6.00%↓
Regional Hotels	7.00%	6.75%↓	6.50%

Table source: Savills. Arrows indicate expected short term movement

Employment growth to continue

■ Latest data suggested that UK employment hit its highest level in April with 30.5 million people in employment, reinforcing the positive outlook for the UK economy. It was also the greatest quarterly and year-on-year increases in actual numbers since Q1 1999.

■ The headline data is perhaps skewed by the growing trend in part-time employment. However, unemployment continued its downward trajectory, coming in at 6.6% for Q1 down 60 basis points on the previous quarter. This trend should prove positive for occupational demand, particularly in the office sector, as it is closely aligned to employment changes.

■ This is supported by Manpower Group's recent Employment Outlook Survey for Q3 2014. The survey asks employers whether they expect their hiring intake for the coming quarter to increase, decrease or stay the same. Based on the net balance of these responses the outlook for the UK was one of the strongest in Europe. It was also the outperformer of the major European economies exceeding Germany and France, with the latter reporting a negative outlook (Graph 2).

■ Much of this positive sentiment in the UK is being driven by the regions with the South West, East and East Midlands posting the strongest outlooks.

Regional development activity expands further

■ It would appear that the optimistic outlook for employment growth and in turn future occupational demand is already feeding through to commercial development activity.

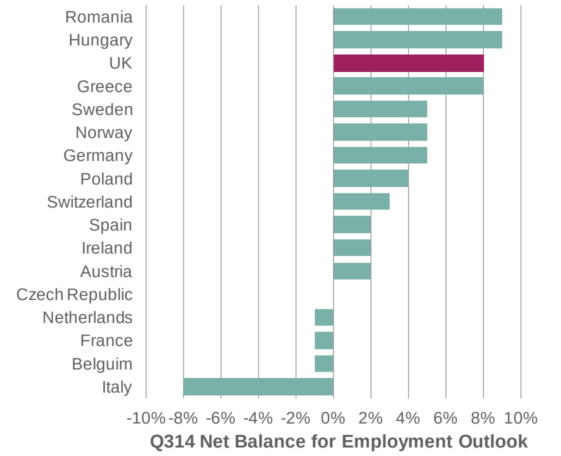
■ Based on our Commercial Development Activity survey, total activity levels saw further expansion in May. Yet it is the regions (rest of UK) that is leading with a higher net percentage of respondents noting an increase in activity levels compared to London and the South East (Graph 3). In May the rolling 12 month average for the regions hit its highest level since the survey began in 2003. On a month-on-month basis it also reported the sharpest expansion across the three regions covered.

■ The industrial sector continues to be the strong performer in the survey with a higher net balance of respondents noting an increase in activity than any other sector. No doubt the strength of occupational demand and investor appetite for the sector has been influential.

■ Expectations for future activity also remained in positive territory in May with a net balance across respondents of 24.8%. While this was down on the previous month, on a rolling 12 month average basis it is still moving in the right direction pointing to further expansion in activity levels.

GRAPH 2

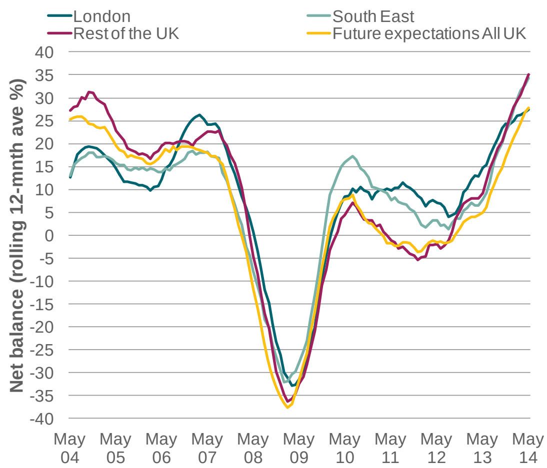
Outlook for UK employment growth one of the strongest in Europe



Graph source: Manpower Employment Survey

GRAPH 3

Commercial Development PMI by sector and future expectations



Graph source: Markit; Savills

Please contact us for further information

Mark Ridley
Chief Executive Officer Savills UK
+44 (0)20 7409 8030
mridley@savills.com

Marie Hickey
Research
+44 (0)20 3320 8288
mlhickey@savills.com