

UK Commercial Market in Minutes

Investors to become more comfortable with secondary

March 2015

Weight of money targeting property back to pre-crisis levels

■ Prime yields would appear to have reached a point of stasis with all of the 13 sectors that Savills monitor reporting no yield movement. For five of the sectors it was the fifth consecutive month of zero movement.

■ In fact some markets have seen the downward pressure reverse due to wider market conditions and/or investor sentiment that yields are perhaps too steamy in light of the property fundamentals. Foodstores are a prime example with a 25 basis points (bps) softening in January. Retail Warehouses, both open A1 and restricted, are now starting to experience upward pressure although outward shifts have not yet materialised.

■ This leveling out in prime yields has taken place despite the fact the weight of money targeting property is at its highest level in eight years. Net inflows into institutional and retail property

funds totalled £4.5bn in 2014 with similar levels expected this year.

■ The general consensus is that further hardening in the prime segments will be relatively limited going forward particularly for those sectors where yields are at, or close to their 2007/8 nadir. However, for those 'trophy' assets that appeal to overseas investors further yield compression is expected.

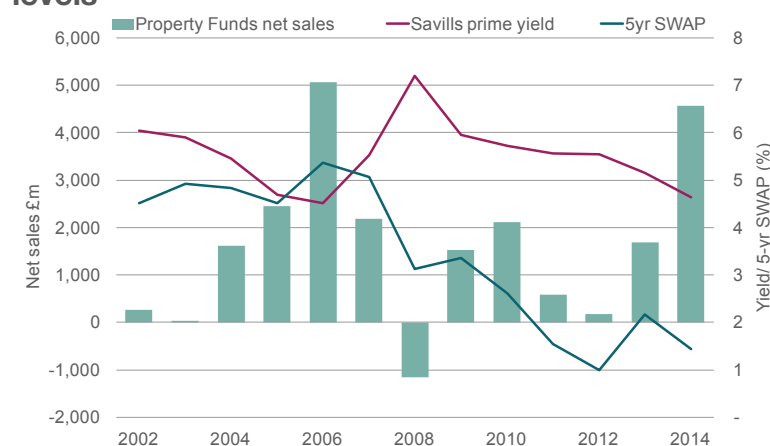
■ So if there is restrained opportunity for further yield hardening in the prime segments where can investors find value uplift? The hunt for value, stronger prospects for value growth and the need to allocate funds means that investors are likely to become less risk averse. As a result, we expect to see a growing interest in good quality secondary assets in strong regional cities and 'alternative' sectors. Prime assets when they become available will of course remain highly attractive, but for others it will be the attractiveness of the pricing that will be the real turn on.

TABLE 1 Prime equivalent yields

	Feb 14	Jan-15	Feb-15
West End Offices	3.25%	3.25%	3.25%
City Offices	4.75%	4.25%	4.25%
Offices M25	5.75%	5.00%	5.00%
Provincial Offices	5.75%	5.00%	5.00%
High Street Retail	4.50%	4.25%	4.25%
Shopping Centres	5.00%	4.25%	4.25%
Retail Warehouse (open A1)	4.75%	4.25%↑	4.25%↑
Retail Warehouse (restricted)	5.50%	5.25%↑	5.25%↑
Foodstores	4.25%	5.00%	5.00%
Industrial Distribution	5.75%	4.75%	4.75%
Industrial Multi-lets	5.75%	5.00%	5.00%
Leisure Parks	6.00%	5.25%	5.25%
Regional Hotels	6.75%	5.75%	5.75%

Table source: Savills

GRAPH 1 Weight of money targeting property close to 2006 levels



Graph source: Savills; Bank of England; The Investment Association

→ Low inflation enhancing real rental growth....

■ UK inflation has been slowly falling below the Bank of England target of 2% since January 2014, helped by declining food prices and relatively weak demand. More recently, the shock of falling oil prices has raised concerns that deflation may take hold.

■ Mark Carney stated that inflation could temporarily turn negative in the spring because of falling oil prices. Yet, added that it would pick up again through the course of 2015 as the initial declines drop out of the annual comparison, subject to energy and food prices stabilising.

■ While persistent deflation is a potential risk to the UK economy, a period of low inflation does offer property investment benefits.

■ Improved real rental growth is the more obvious benefit. All UK Property did not report consistent annual rental growth until September 2013. In real terms growth did not materialise until July 2014 as inflation remained above its 2% target.

■ The slowing rate of inflation, coupled with improving occupational markets over the second half of 2014, meant that the 2.5% annual growth in real rents reported in December was its highest level since July 2001. This is forecast to increase to 3.5% in 2015 in light of rental growth and inflation forecasts. Looking beyond the South East, the strongest rental growth markets are forecast to be Cambridge and Cardiff offices with real growth of 5.7% and 4.6% respectively.

...and retail sales

■ The combined effect of low inflation, an improving economy and wage growth should mean that people will see more money in their pocket in 2015, boosting retail sales.

■ Slowing inflation over the latter part of 2014 corresponded with an improvement in retail sales, with the most noticeable growth in comparison spending. Household goods reported a significant 7.0% increase year-on-year in December, on a rolling 12-month basis, its highest level since December 2004 (see Graph 3).

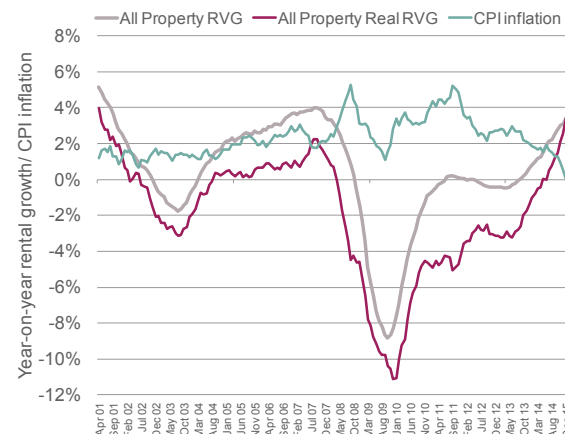
■ This upward trend in sales should continue into 2015 as indicated by historical trends. For example, between May 2000 and May 2001 the low inflation environment corresponded with an average annual growth in clothes and household retail sales of 6.8% and 6.5% respectively.

■ The real question is whether this improvement in sales can be captured by the high street. Out of town retail parks were the only centres to report footfall growth during the latter part of 2014 helped by the convenience they offer in terms of click-and-collect and the improving demand for household goods, which tend to concentrate in out-of-town locations.

■ Going forward, it is likely to be the 'destination' high streets and shopping centres, which offer consumers something different, that will be the primary beneficiaries of the improving sales environment. ■

GRAPH 2

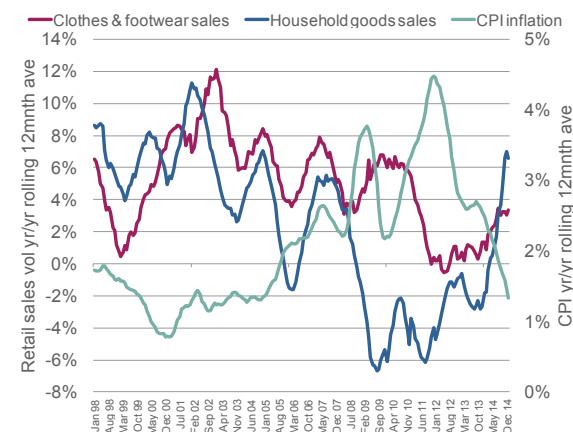
Low inflation environment boosting real rental growth.....



Graph source: Investment Property Databank; ONS

GRAPH 3

...and should prove beneficial in terms of retail sales



Graph source: ONS

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