UK Commercial Market in Minutes
Will lack of liquidity drive further yield hardening?

May 2014

Yield hardening continues as risk-aversion diminishes

■ April saw a further hardening in our national prime yield indices to an average of 5.02%. This is the lowest level that it has reached since October 2007.

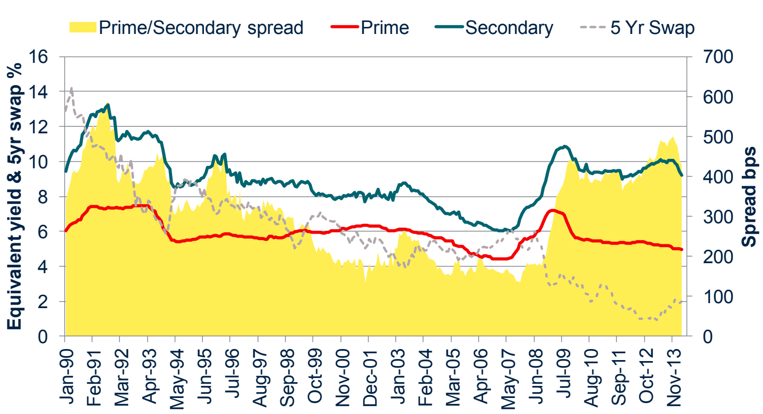
■ Key sectors that hardened this month include provincial offices, where the current prime yield of 5.50% is nearly 100bps keener that it was 12 months ago. Indeed, the spread between prime London office yields and prime regional office yields is now 250bps, 50bps narrower than it was at the end of 2013 - a reflection of increased confidence in the regional leasing recovery, and the desire to benefit from some mis-pricing.

■ Risk-aversion continues to diminish, and this is also affecting the spread between prime and secondary yields. This now stands at 425bps, 75bps tighter than its peak last year. However, as Graph 1 shows, the prime/secondary spread still has some way to go before it reaches its long-run average level of 312bps. We expect to see continued tightening of this spread over the remainder of 2014, though in some markets the prime yield is expected to step downwards at much the same pace as the secondary for the rest of this year.

■ Another point to note from this month's yield table is the reappearance of an upward arrow. It has been over a year since we last noted that there was upward pressure on one of our yield series, and this month we are suggesting that there is upward pressure on foodstore yields. This may well be the first sign that the announcement in the Budget about annuity funds is having an impact on the property market, with large foodstores with their typically very long, and often inflation-linked, leases traditionally being a popular investment for the annuity funds.

GRAPH 1

Prime/secondary yield spread is starting to tighten



Graph source: Savills, Thomson Reuters

TABLE 1

Prime equivalent yields

	Apr 13	Mar 14	Apr 14
West End Offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.50%	4.50%
Offices M25	6.25%	5.75%↓	5.50%
Provincial Offices	6.25%	5.50%	5.50%
High Street Retail	4.75%	4.50%	4.50%
Shopping Centres	5.00%	5.00%↓	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%	5.75%↓	5.50%
Industrial Multi-lets	6.00%	5.50%	5.50%↓
Leisure Parks	6.25%	6.00%↓	6.00%↓
Regional Hotels	7.00%	6.75%↓	6.75%↓

Table source: Savills. Arrows indicate expected short term movement

Regional investment and market liquidity

■ We have been waving the flag for the attractions of investing in the UK regions for over a year now, and the tide is definitely starting to flow in that direction. Graph 2 looks at the proportion of the investment in UK offices that has been outside London, and this shows a sharp rebound in regional deals in Q1 2014.

■ The rationale for this pick-up is well-rehearsed and utterly logical, but how easy will it be for investors to deploy the capital that they have targeted at the UK regions?

■ For bigger ticket investors the shopping centre market is proving popular, with a 36% increase in turnover in Q1 to £1.9bn. This strength will continue, with £500m under offer, £1.1bn of assets currently being marketed, and another billion pounds of shopping centre investments likely to be brought to the market over the remainder of this year.

■ In other sectors, most notably the office market, liquidity could prove a problem. The average lot size purchased by a UK institution over the last 14 years has been £19.5m, and for non-domestic investors this rises to £40.8m. While deals of this size are readily available in London, the liquidity in the major regional cities is more challenging.

■ For example, over the last 14 years Bristol and Leeds have averaged between two and three deals per annum of £20m and above, while Manchester, Glasgow, Edinburgh and Birmingham have averaged four to five.

■ The story become even more challenging when it comes to satisfying the typical non-domestic investor requirement of £40m and above. Here, even the largest and most active regional investment markets (Birmingham and Manchester), only average two to three such deals a year.

■ What does this mean for the outlook for the regional investment markets? The first conclusion must be that the remainder of 2014 will see a significant number of unsatisfied investment requirements. As we get closer to the end of the year (and the expected pre-election hiatus in early 2015), pressure on pricing will intensify, and prime regional yields will harden more quickly than those in London.

■ Some investors will probably still end up disappointed, and may well re-target their strategies back towards the more expensive, but also more liquid, London market.

■ Clearly the environment is good for those who own good quality regional investments of any type. Should owners worry that their assets might be too small to interest the national and global funds? Perhaps not, the next big opportunity might well be to package up groups of smaller assets into high quality regional portfolios that will be big enough to interest the current generation of large investment requirements.

■ The other major opportunity for the next five years will be in creating new product. Development activity across all sectors is more than 50% below its long-term average level, and tenant requirements remain heavily skewed towards prime. In the short term, whilst lender's attitudes towards part pre-let or speculative developments remain cautious, there will be a real opportunity for investors to forward fund high quality developments in the regions.

■ We do expect lender's attitudes towards development funding to relax in the medium term, but they are unlikely to return to boom levels. Developers with strong track records in their local markets will find it easier to access this funding, and the pick-up in development activity will also provide some institutions with the stock that they are looking for.

GRAPH 2

Nearly 30% of the office investment purchases this year have been outside London

Graph source: Savills

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