

# UK Commercial Market in Minutes

## Prime/secondary yield gap is starting to close

November 2013

### Prime and secondary yields are now hardening

■ Six out of the 13 sectors that we monitor either saw yields harden this month, or are expected to harden in the next few months.

■ This means that the UK average prime yield is now 5.27%, a full quarter point lower than it was at the beginning of this year.

■ While this hardening is just the continuation of a trend that has been going on for the last two years, the recent trend in average and secondary yields indicates that maybe an inflexion point has been released in the UK property market over the last three months.

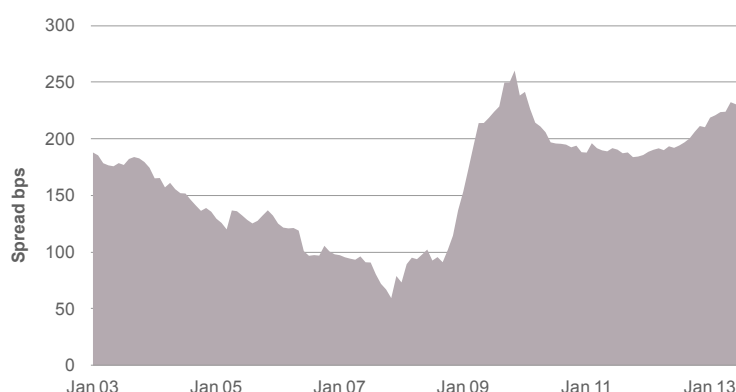
■ The IPD All Property average equivalent yield stood at 7.43% at the end of September, having peaked at 7.53% in May 2013. This means that the spread between prime and average has narrowed from 232 basis

points to 224bps over the last four months.

■ Secondary yields, at least on the valuation-based indices, have shown less inward shift over the last three months - only moving in from 10.09% to 10.07%. However, market evidence indicates that the movement has been more substantial, and thus we would suggest that the point has now been reached when the spread between prime and secondary yields is starting to close.

■ 2014 will see an acceleration of this trend with the investment markets moving ahead of the leasing markets. The faster than expected economic recovery will stimulate a recovery in the leasing markets, and this will in turn lead to a decline in investor risk-aversion and an acceptance of the merits of good quality Grade B property across the UK. We also expect to see a rise in interest in development funding, with lower hurdles for pre-letting as confidence in the leasing markets rises.

GRAPH 1  
Prime/average yield spread has started to narrow



Graph source: Savills Research

TABLE 1  
Prime equivalent yields

	Oct 12	Sep 13	Oct 13
West End Offices	3.75%	3.50%	3.50%
City Offices	5.25%	4.75%	4.75%
Offices M25	6.25%	5.75%↓	5.75%↓
Provincial Offices	6.25%	5.75%	5.75%
High Street Retail	4.75%	4.75%	4.75%
Shopping Centres	5.25%	5.00%↓	5.00%↓
Retail Warehouse (open A1)	5.25%	5.25%↓	5.00%
Retail Warehouse (restricted)	6.00%	6.00%↓	5.75%
Foodstores	4.50%	4.25%	4.25%
Industrial Distribution	6.25%	6.00%↓	6.00%↓
Industrial Multi-lets	6.00%	5.75%	5.75%
Leisure Parks	6.25%	6.00%	6.00%↓
Regional Hotels	7.00%	6.75%	6.75%

Table source: Savills

## → Rental growth is starting to go positive

■ One of the most common questions that investors have been asking this year has been "when will there be some rental growth outside London?". The short answer to this question is "now", with more than half of the subsectors on the IPD monthly index showing flat or positive rental growth on a three month annualised basis (Graph 2).

■ The office and industrial sectors are leading this recovery, with rising rents across the majority of regions.

■ The retail property subsectors generally remain fairly depressed. Cyclical and structural change continue to keep vacancy rates high, and retailer demand selective. However, we expect this to change in 2014, as rents on some secondary centres and pitches stop re-rating and begin to rise

## Is the UK economic recovery broad-based, or just about shoppers and homeowners?

■ The dominant economic stories this month have been about the sharp rise in consumer confidence, and steady upgrading of UK economic forecasts for 2014 and beyond.

■ The biggest contribution to economic growth in Q2 2013 was consumer spending, which accounted for the majority of that quarter's growth, despite real income growth falling. We have written many

times in this note that a recovery in consumer confidence is vital for the UK economy, and it now seems that rising job security is feeding through to less precautionary saving in many UK households.

■ The housing market has also played its part, with residential investment rising in Q2, along with transactional activity and prices.

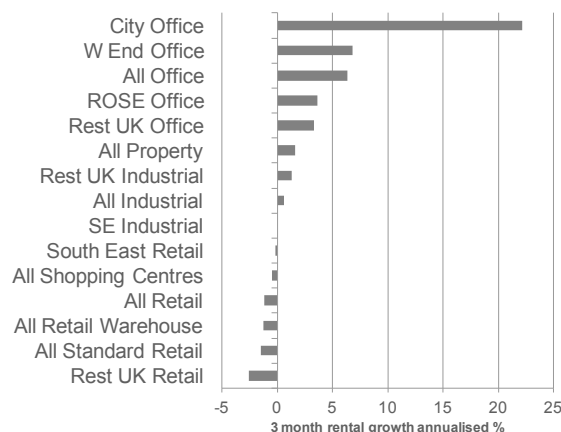
■ The story in the rest of the economy is more moribund, with business investment remaining low, and companies still choosing to sit on their historically very large levels of cash. However, the usually reliable forward looking PMIs (Graph 3) are indicating that a strong pick-up in investment is coming, and that a rise in export activity is also expected as the US and Japanese economies look likely to recover faster than many people expected

■ This all points to a more balanced economic recovery in 2014, with the consumer still playing a strong part, but this also being supported by a pick-up in corporate investment and export activity.

■ The latest consensus view for UK GDP growth in 2014 is for a near-trend rise of 2.2%. This is almost a full 100bps more optimistic than the consensus view a year ago. Thereafter, the UK is forecast to grow at a steady (but below trend) 2% per annum. ■

GRAPH 2

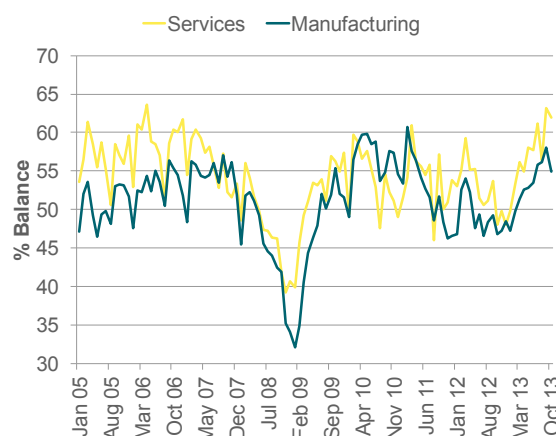
## The majority of subsectors are no longer seeing rental falls



Graph source: IPD, Savills

GRAPH 3

## Surveys are showing a strong manufacturing and services recovery



Graph source: CIPS/Markit

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