

UK Commercial Market in Minutes

UK economy and property 'turning the corner'

September 2013

More yield compression expected

■ Of the 13 sectors tracked by Savills, only four do not have an inward yield trend attached.

■ A lack of investment stock on the market has put strong upward pressure on pricing. As we 'turn the corner', we need to ensure that pricing does not get ahead of itself.

■ The occupational markets need to show further signs of recovery. The core markets are seeing increased activity, but a consistent level of growth is required to further bolster investors' preference for UK property away from prime South East. Prices have recovered to a level where sellers are prepared to sell and return expectations are lower. This will enable a firm recovery.

How far are we 'around the corner'?

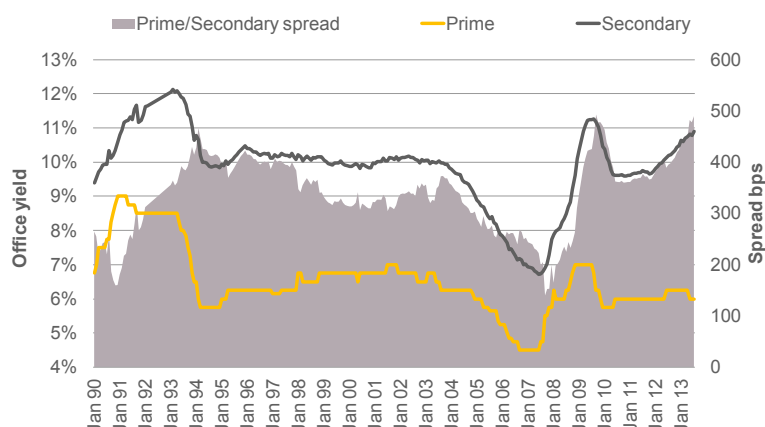
■ The positivity of the investment market has grown quickly and average yields peaked in May and have trended

downwards since. This 'average' measure shows that secondary property yields will move in during the next few months. Only a year ago we were highlighting the prime/secondary yield spread widening.

■ As presented in Graph 1, the office sector is now showing the widest yield spread ever recorded. This, coupled with anecdotal evidence that investors are only searching outside of the South East, strongly suggests that sentiment in the regions is strengthening. This will be supported by the service sector seeing the fastest rate of growth for more than six years, according to the Markit/CIPS survey and the fact that development levels are very low.

■ A measure from Lloyds shows the South East private sector (service and manufacturing) increasing at the fastest rate in the survey's 16-and-a-half-year history. We would expect a lag, but the end-July data from IPD, shows that voids rates are heading lower. Is this a start of rising occupational demand, which underpins the investment value?

GRAPH 1
Widest ever yield gap for UK offices



Graph source: Investment Property Databank

TABLE 1
Prime equivalent yields

	Aug 12	Jul 13	Aug 13
West End Offices	3.75%	3.50%	3.50%
City Offices	5.25%↓	4.75%	4.75%
Offices M25	6.25%	6.00%	6.00%↓
Provincial Offices	6.25%↑	6.00%↓	6.00%↓
High Street Retail	4.75%	4.75%	4.75%
Shopping Centres	5.50%	5.00%↓	5.00%↓
Retail Warehouse (open A1)	5.25%↑	5.25%↓	5.25%↓
Retail Warehouse (restricted)	6.00%↑	6.00%↓	6.00%↓
Foodstores	4.50%	4.25%	4.25%
Industrial Distribution	6.25%↑	6.00%↓	6.00%↓
Industrial Multi-lets	6.00%	6.00%↓	6.00%↓
Leisure Parks	6.50%↑	6.25%↓	6.25%↓
Regional Hotels	7.00%	7.00%↓	7.00%↓

Table source: Savills

→ How do the recent forecasts differ?

■ The latest forecasts from Investment Property Forum (IPF), based upon a consensus of forecasters, is showing a much more positive outlook compared to earlier this year. Over the next five years, total returns from UK property are expected to be 7.6% per annum. This compares favourably to Investment Property Databank's base scenario of 6.9% in the next five years.

■ Interestingly, from the IPF, the fund managers expect a 7.3% annual return through the next five years, which is 70 basis points lower than the 'property advisors & research consultancies' (see Graph 2).

■ It has been suggested that base rates will remain at 0.5% until 2017. However, GDP is growing faster than anticipated and inflation is showing slight falls. Will we see rates rise higher sooner?

How soon for base rate rises?

■ The Chancellor of the Exchequer acknowledges the continued risk, but said the recovery is underway and the UK economy is "turning the corner".

■ This issue remains the biggest on the UK economic horizon. The impact of a rise on funding/borrowing costs and UK company's ability to absorb higher finance costs, remain key for the future direction of the occupational markets.

■ The Governor of the Bank of England outlined explicit guidance

on interest rates in the UK. Economic slack needs to reduce before the highly stimulative stance on monetary policy is reduced. Broadly, this slack has been associated with unemployment rates and the threshold of 7% set, above which, further asset purchases will remain in place and rates on hold.

■ The Bank of England suggests that the base rate and asset purchases linked to unemployment will cease if three 'knockouts' were breached, two of which are aligned to inflation moving higher and becoming unstable or if financial stability is threatened.

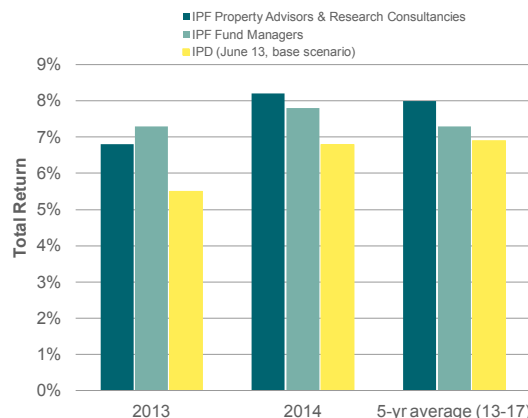
■ The question is how close are we to a 7% unemployment rate in the UK? Assuming that the economically active GB population remains constant, today, a net additional 224,000 jobs would push the rate to 7% (from 7.7% currently).

■ Graph 3 illustrates the annual change in employment over a 12-month period. Only during the mid and late-1990s was there an annual change that is above the 224,000 jobs required. The Governor expects it'll be three years before the 7% threshold is reached. However, as recent as Oct 2012 there was an annual increase of 182,000. Of course, there have been monthly falls since, but the UK could be there earlier if current economic conditions continue to improve and employers' increasing confidence leads to hiring.

■ This shows why the financial markets initially reacted negatively to this 'forward guidance' as rates were perceived to be rising sooner than expected six months ago. ■

GRAPH 2

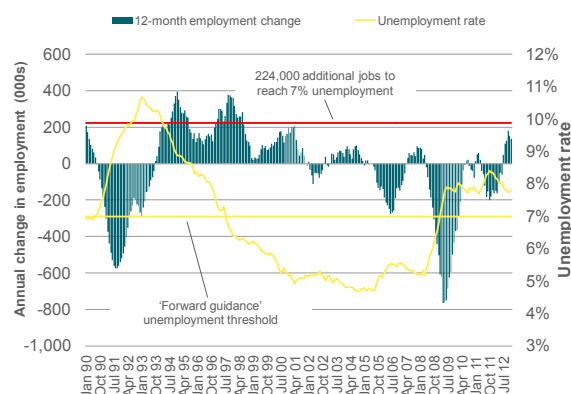
Capital value growth forecasts back in positive territory driving returns higher



Graph source: Investment Property Forum / Investment Property Databank

GRAPH 3

How close are we to reaching the Bank of England's 7% threshold?



Graph source: Office for National Statistics

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