UK Commercial Market in Minutes
This time it's different.....?

May 2015

Yields stable but will market conditions cause inward shift?

■ In our January Market in Minutes we suggested that sentiment shift in the investment market would only be caused if the opinion polls were forecasting a change of government. With the election now passed and the pollsters licking their wounds it comes as no surprise that the Savills average prime yield remains constant for the fourth consecutive month at 4.59%.

■ Given the previous nadir of 4.51% was reached in May 2007 will we see the weight of money targeting UK real estate drive prime yields back towards those levels and create a new benchmark?

■ If this downward shift is to occur then it will be driven by downward pressure in the business space sector as both M25 and provincial offices are showing downward pressure on prime yields and have yet to reach their 2007 peak, of 4.75% and 4.50% respectively.

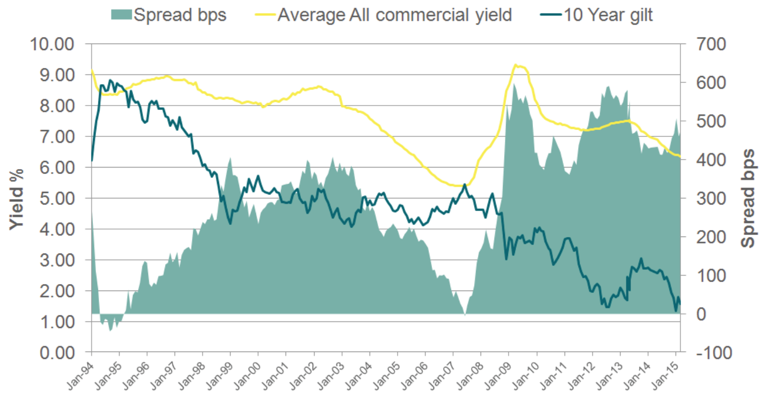
■ With most business space markets being impacted by an imbalance between supply and demand, rental growth will start to make up a higher proportion of total returns. Whilst there are regional differences for 2015 we expect rental growth of 6.2% for offices, 2.8% for retail and 3.6% for industrials.

■ As investor demand continues unabated and yields approach 2007 levels why is sentiment not shifting the market to a more cautious approach?

■ With strong property leasing fundamentals a further key driver in any potential yield compression is the relative pricing of UK commercial real estate compared to other asset classes. With the spread between the IPD average all property yield and the UK 10 year gilt currently near 500bps, compared to -6bps in 2007, it is easy to see how the new normal could be a lower yielding environment.

GRAPH 1

Relative property pricing



Graph source: Savills/IPD/Thomson Reuters

TABLE 1

Prime equivalent yields

	Apr 14	Mar 15	Apr 15
West End Offices	3.25%	3.25%	3.25%
City Offices	4.50%	4.25%	4.25%
Offices M25	5.50%↓	5.00%↓	5.00%↓
Provincial Offices	5.50%	5.00%	5.00%↓
High Street Retail	4.50%	4.25%↓	4.25%↓
Shopping Centres	4.75%	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	5.50%	4.75%	4.75%↓
Industrial Multi-lets	5.50%	5.00%	5.00%↓
Leisure Parks	6.00%↓	5.25%	5.25%
Regional Hotels	6.75%	5.75%	5.50%

Table source: Savills

Did the general election impact the investment market?

■ As previously mentioned, our January Market in Minutes suggested that the performance of the investment market in election years was actually driven by the market fundamentals at the time and that any short term volatility would be due to a potential change in government.

■ Given that right until the first exit poll showed us heading for another coalition government we therefore observed no change in investor sentiment and deal volumes have continued their upward trajectory from 2014.

■ Indeed, the first quarter investment volumes for 2015 reached £17.6bn up 50% on the first quarter of 2014, and are the strongest first quarter in 15 years. This has continued into the second quarter with year to date volumes currently standing at £22.1bn halfway through the second quarter. Now that the election has passed and a majority government is in place any delayed investment decisions will ensure that investment volumes for the for first half of 2015 surpass the first half of 2014.

■ Moreover, the first four months of 2015 have seen £5.4 billion of non-domestic purchases of commercial real-estate investments outside London, nearly half the total volume that was seen in 2014 (which was in itself a record year for non-domestic investment outside London).

■ With all of this good news attention will now shift to how the policies of a majority Conservative government will impact UK commercial property.

■ A referendum on the UK's membership of the EU will now take centre stage and has the potential to create uncertainty in the market for a prolonged period of time, damaging both occupier and investor confidence. Deutsche Bank, for example, has recently established a working group to review its options should the UK choose to exit the EU.

Stock supply a drag on volumes?

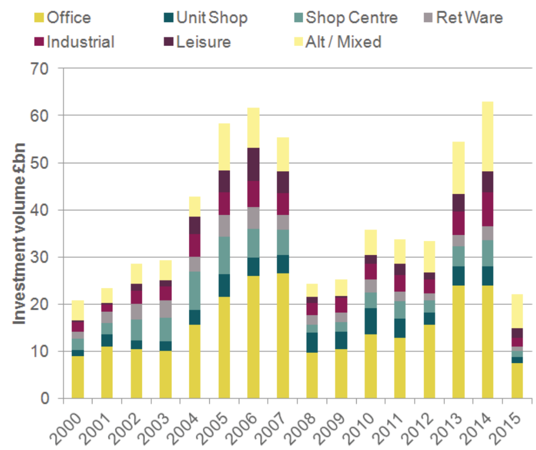
■ With the industrial and logistics market having a record 2014, it perhaps comes as no surprise that 2015 feels a little subdued. However, all sectors aside from industrial and logistics have seen investment volumes rise in 2015.

■ Investors are actively trying to deploy capital in the sector, however with levels of stock in the occupational market reaching record lows along with investors and developers holding stock once build to suit deals have completed we are witnessing strong competition for prime assets.

■ This is also driving some investors to focus on only the most prime assets, which could be brought back to the market with ease in the next stage of the cycle. Hence, we have seen the spread between long and short term income in the logistics sector decrease to just 100bps.

GRAPH 2

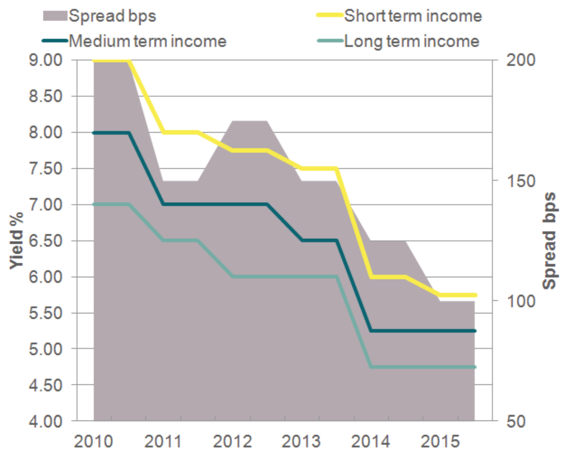
UK Investment volumes



Graph source: Savills, Property Data

GRAPH 3

Logistics yield spread tightening



Graph source: Savills

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