Savills World Research
UK Commercial

UK Commercial Market in Minutes
Retail yields hardening

July 2014

Yield hardening continues, led by retail

■ June saw the average prime yield harden from 4.98% to 4.84%. This is the largest monthly downward shift in yields since early 2010, and it was predominantly driven by the retail sector.

■ Four out of six retail subsectors saw a quarter point hardening in yields this month, though Foodstores saw a quarter point rise in yield due to concerns about long-term interest in the sector from the annuity funds.

■ Amongst the office and industrial sectors, only M25 Offices and Industrial Multi-lets saw a hardening in their prime yield this month.

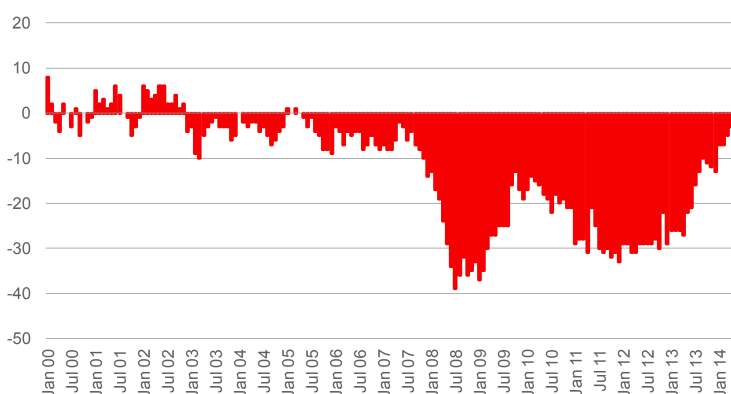
■ The rise in investor interest in retail property is being driven by several factors. Firstly, there is a rising acceptance that the retail economy is improving. While real average earnings growth is still flat, consumer confidence is now at its highest level since 2005, and retail sales growth is recovering. The second reason is the increasing acceptance that the structural change in retailing that has been driven by the rise in internet sales is not a terminal issue for traditional retailers. The proportion of retail sales that is being spent on the internet is still rising, but so is the volume that is being spent in-store. The days of the argument being clicks versus bricks have now passed as retailers and landlords have got used to an omni-channel world.

■ We expect to see continuing investor demand for retail assets, particularly dominant shopping centres and bulky goods retail warehouse parks.

■ Generally the first half of 2014 has seen better than expected capital value growth across all sectors. This is particularly true outside London. As a result of this we have revised our forecasts for this year upwards, with prime capital growth on all sectors expected to average 10% this year, before slowing to 4.4%pa over the next five years.

GRAPH 1

Consumer confidence has recovered to a level not seen since 2005



Graph source: GFK

TABLE 1

Prime equivalent yields

	Jun 13	May 14	Jun 14
West End Offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.50%	4.50%
Offices M25	6.00%	5.50%	5.25%
Provincial Offices	6.00%	5.25%	5.25%↓
High Street Retail	4.75%	4.50%	4.50%
Shopping Centres	5.00%	4.75%	4.50%↓
Retail Warehouse (open A1)	5.25%↓	4.75%↓	4.50%
Retail Warehouse (restricted)	6.00%↓	5.50%↓	5.25%
Foodstores	4.50%	4.25%↑	4.50%
Industrial Distribution	6.00%	5.25%	5.25%↓
Industrial Multi-lets	6.00%↓	5.50%↓	5.25%↓
Leisure Parks	6.25%	6.00%↓	5.75%
Regional Hotels	7.00%	6.50%	6.50%

Table source: Savills. Arrows indicate expected short term movement

Rental growth now positive for all three main sectors

■ The latest IPD monthly index (May 2014) shows that average rental growth on a three month annualised basis is now positive for office, retail and industrial. The big change in recent months has been the flattening out of retail rents. with retail warehousing in particular now showing three month annualised growth of 1.05%.

■ On the same measure All Office rental growth is running at 5.27%pa (with City and West End offices delivering growth of over 10%), and All Industrial rents rising at 1.97%pa.

■ We expect this trend to continue for the remainder of 2014, making this the first year since the downturn that all three main sectors have shown positive rental growth.

■ Generally the drivers of rental growth over the next five years are expected to be broadly similar across all three sectors. In particular, the development pipeline outside London is forecast to be very restrained, and this will lead to a steady fall in Grade A vacancies across all sectors.

■ The demand-side is also expected to show a solid recovery. Both the Manufacturing and Services PMIs are showing robust month-on-month rises in activity, and this will feed through into business expansion in the remainder of the year and beyond.

■ Rental growth prospects are generally improving, and our mid-year update now has average annual rental growth over the next five years for industrials of 1-2%pa, for offices of 1.5-5%pa, and retail at 0.5%pa to 3%pa. We will be going into these in more detail in our mid-year cross sector update later this month.

Is an early interest rate rise likely?

■ Mark Carney's recent comment that an interest rate rise could happen "sooner than markets currently expect" has led to a flurry of speculation and comment that the MPC has swung towards a more hawkish view on the future. However, the rationale for this view is hard to find.

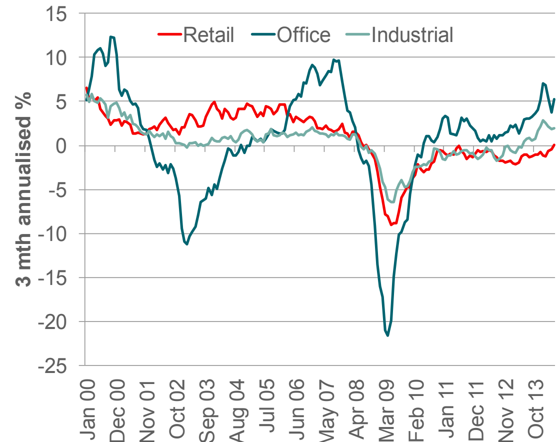
■ While much of the comment about this perceived change of stance has focused on house price growth, we mustn't lose sight of the fact that the sole focus of the MPC is to maintain inflation at its target level. Given that the May CPI release showed that core inflation is running at 1.5%pa, there appears to be very little rationale for an imminent rise in the base rate. Indeed, service sector inflation fell to 2.3% in May, a record low.

■ Wage growth also remains anti-inflationary, with April's data showing that average weekly earnings fell by 1.7% year on year.

■ We suspect that Mr Carney's speech was designed to get people used to the idea that rates will go up, not to herald an earlier than forecast rise.

GRAPH 2

Average rental growth is now positive for all three sectors



Graph source: IPD

■ In the commercial property markets it is clear that lenders are lowering margins to compensate for the rise in the five-year swap. Thus we do not see a rate rise, when it happens, as a particular risk to the property market recovery. We remain of the view that a gentle rise in rates from Spring 2015 is the most likely path, and this will have little impact on property yields.

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