

UK Commercial Market in Minutes

Prime yields continue to slip downwards, but 2016 will see a change of tone

December 2015

Capital value growth continues, but the rate of growth is slowing

■ November saw a very marginal hardening in our all sector prime yield to 4.63%, its lowest level since June 2007. However, the mood music in the investment market has definitely changed over the last six months, and we are seeing more selective bidding than we did in the first half of 2015.

■ Is this increased selectivity a sign that investors are worried about some kind of macro or market shock in 2016? We think not. However, there is now a broad consensus that the total return on commercial property will slip into single digits next year, and that the drivers of this return will be more income than capital value growth based.

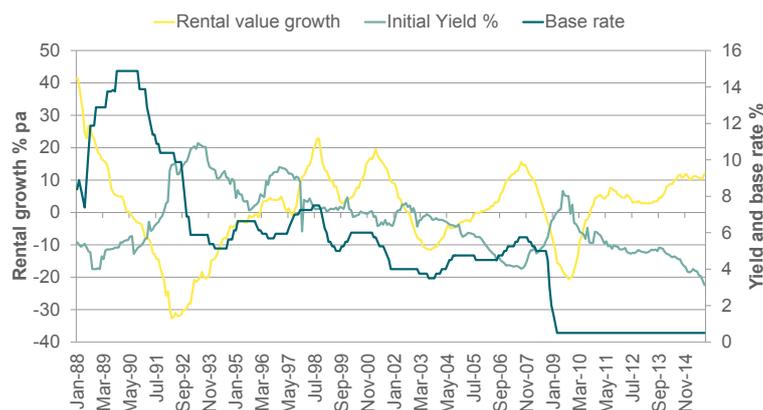
■ The short term path of the prime property yield will depend very heavily on whether the traditional final quarter rush of sales all happen at the prices that the vendors were hoping for.

This will probably be the case in the prime segments of each market, but there has definitely been a cooling of investor demand for secondary and tertiary assets over the last few months, and some of those segments may well see a rise in yields in the first quarter of 2016.

■ The key differentiator between prime and secondary assets in many investor's minds at the moment seems to be whether the asset offers either a secure income stream, or the possibility for rental growth. These are particularly important questions to be asking as capital value growth is no longer a given, and also because historic analysis shows us that there is no correlation between rising base rates and property yields unless the rents are falling.

■ This means that the best prospects for both returns and income protection over the next five years will be those markets with a demonstrable rental growth story.

GRAPH 1
There is virtually no correlation between property yields and base rates, unless rents are falling



Graph source: IPD, Thomson Reuters, Savills. Property data is for City of London offices

TABLE 1
Prime yields

	Nov 14	Sep 15	Nov 15
West End Offices	3.25%	3.00%	3.00%
City Offices	4.50%	4.00%	4.00%
Offices M25	5.00%	5.00%	5.00%
Provincial Offices	5.25%	4.75%	4.75%
High Street Retail	4.50%	4.25%	4.00%
Shopping Centres	4.50%	4.25%	4.25%
Retail Warehouse (open A1)	4.25%	4.50%	4.50%
Retail Warehouse (restricted)	5.25%	5.50%	5.75%
Foodstores	4.75%	5.15%	5.00%
Industrial Distribution	5.00%	4.50%	4.50%
Industrial Multi-lets	5.00%	4.75%	4.75%
Leisure Parks	5.50%	5.25%	5.25%↓
Regional Hotels	6.00%	5.50%	5.50%

Table source: Savills

→ **Rental growth prospects in 2016**

■ Generally we expect to see a similar pattern of rental growth in 2016 as we saw in 2015. London offices and retail will continue to deliver the strongest rental growth, both in terms of average and prime. However, the best regional office markets will see further rental increases on new build space, as well as the beginnings of upward rental growth on refurbished office space.

■ The central London markets are undoubtedly a few years ahead of the regional markets in the recovery cycle, and this means that we expect to see the rate of rental growth slowing in the City and West End over the next two to three years. Investors who are looking for better rates of rental growth in London would do well to look to future core locations, both for office and retail opportunities.

■ The industrial and logistics markets, which outperformed their trend rate of rental growth in 2015, will continue to do so. However, we do not expect to see such strong rates of growth in the distribution warehouse market over the next five years as has been seen over the last year. Urban industrial estates will continue to outperform, with demand far exceeding supply for brownfield land within the M25. This story will be exacerbated by the planned allowance of conversion of light industrial space to residential under the Permitted Development Rights regime.

■ Retail will continue to be the laggard of the three sectors in rental growth terms, other than in central London.

However, 2016 will see more towns and pitches starting to show some rental growth from their rebased rents, though we still expect a wide spread of rental performance between locations.

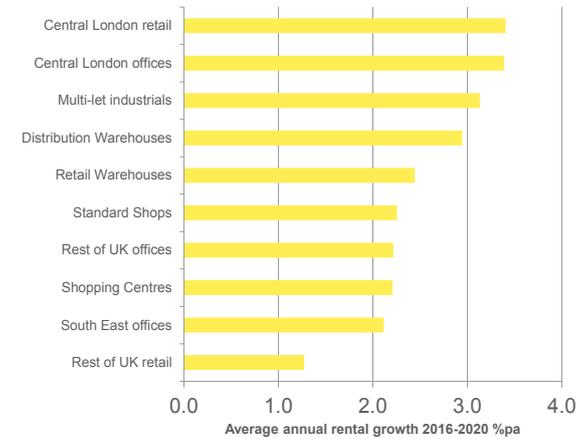
■ The best managed shopping centres will continue to be the location of choice for experience focused shoppers and retailers. However, we remain of the view that retail warehouses are the most internet-friendly segment of the retail market, with their combination of easy parking, large units and low rents. Indeed, tenant demand for that sector is currently at exceptionally strong levels, and we expect this imbalance between falling vacancy rates and strong demand to drive better rental growth than will be seen in other retail segments.

Economic background for 2016 looks stable

■ We expect that UK GDP growth will be broadly the same in 2016 as in 2015, at around 3%. Much of this growth will be driven by the consumer economy, with the combination of positive real earnings growth and falling unemployment supporting consumer spending.

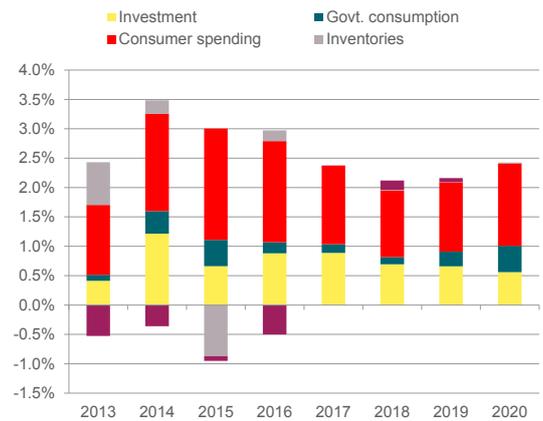
■ However, the bounce in consumer spending will slow from 2017 as public spending cuts drag on some regions. This will leave the corporate sector having to do most of the heavy lifting in the UK economy. At present there is a robust level of confidence in both services and manufacturing, but this could easily be derailed by external or internal factors such as China or Brexit speculation ☒

GRAPH 2
Income will be the most important component of returns in 2016-2010



Graph source: Savills

GRAPH 3
Components of GDP growth



Graph source: Savills analysis of Oxford Economics data

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