UK Commercial Market in Minutes
Yield hardening to continue October 2014

Yield compression to continue

■ Two sectors, Regional Hotels and M25 Offices, saw prime yields come in last month. The interest from the UK Funds for M25 offices is exerting the greatest downward pressure on yields. In contrast, Foodstores saw another yield shift out as demand weakens in the face of tenant demand concerns.

■ Investors continue to ask, "Where are yields heading?". Average prime yields reported a two basis point (bps) movement down in September and are now within 22bps of early 2007 levels. Three sectors are at, or below where they were in mid 2007 (WE offices, shopping centres, and distribution).

■ However, the advance of yields towards market peak levels is unlikely to subdue demand. Buyers last year had the same concerns but investment volumes reached its highest level since 2007. The brakes on yield hardening will only materialise if there was a significant slowdown in the economy.

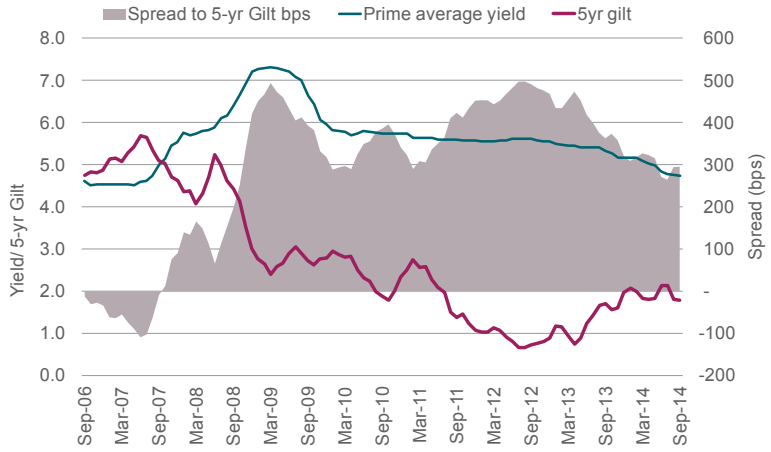
■ Eight of our sectors still have prime yields at least 25 basis points above 2007 levels. Even with a further movement downwards, the yield spread to Gilts means that property investment will continue to be attractive.

■ The later and slower than expected rise in interest rates next year will see Gilt yields increase. Even if Gilts were to rise in line with Base Rate forecasts, a relatively healthy spread to Property in excess of 150bps would still remain. It currently stands at 295bps. As a result we expect yield compression will continue, albeit at a slower rate.

■ Those sectors where yields are still some way off 2007 levels, and offer the greatest opportunity for rental growth, are likely to see the more pronounced downward shifts. Regional offices, particularly in the stronger markets of Manchester and Leeds, stand out on this basis as occupational demand picks up in the face of Grade A availability constraints.

GRAPH 1

Spread between Prime yields and Gilts remains well above 2007 levels



Source: Savills Research, Bank of England

TABLE 1

Prime equivalent yields

	Sep 13	Aug 14	Sep 14
West End Offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.50%	4.50%↓
Offices M25	5.75%↓	5.25%↓	5.00%
Provincial Offices	5.75%	5.25%↓	5.25%↓
High Street Retail	4.75%	4.50%↓	4.50%↓
Shopping Centres	5.00%↓	4.50%	4.50%
Retail Warehouse (open A1)	5.25%↓	4.25%	4.25%
Retail Warehouse (restricted)	6.00%↓	5.25%	5.25%
Foodstores	4.25%	4.50%	4.75%↑
Industrial Distribution	6.00%↓	5.00%	5.00%
Industrial Multi-lets	5.75%	5.00%	5.00%
Leisure Parks	6.25%	6.00%↓	5.50%
Regional Hotels	6.75%	6.50%	6.00%

Source: Savills Research

Is the economy slowing?

■ While the UK is on track to outperform other developed nations this year, lead indicators suggest economic growth is slowing. The National Institute of Economic and Social Research (NIESR) estimate that output for Q3 will come in at 0.7%, 0.2 percentage points down on Q2.

■ UK manufacturing output decelerated month-on-month in August. Markit's/CIPS Purchasing Managers Index for the services sector, a lead indicator of growth, also pointed to a softening in expansion.

■ Some of this slowdown may reflect the usual summer lull and the impact of the Scottish Referendum. However, the weak Eurozone, the UK's largest export market, is no doubt exerting a drag.

■ Yet, newsflow remains mixed. The Financial Services sector expanded at its fastest rate since 2007 in Q3 according to CBI and PwC's quarterly survey, forecasting job growth of 28,000 by the year end. Good news for the office occupational markets.

■ Newsflow surrounding the UK economy, plus wider geopolitical stories, will no doubt exert influence over business and consumer confidence. It will be this confidence that will have the most significant bearing on economic growth, as seen historically.

West End Retail - demand continues

■ The West End retail market has seen intense occupational and investor demand over the last three years. Since 2012 alone, 67 new international entrants have opened their first UK store in London.

■ Prime Zone A rents in the core West End have increased by an average of 10.1% per annum over the last three years, exceeding the 9.4% seen for average prime West End offices.

■ Occupational demand is intensifying due to a number of factors. London's rising prominence as a major tourist destination; expected growth in Chinese and Gulf State visitors due to visa application streamlining; and 'cheaper' prime rents relative to other Global cities such as Hong,Kong, New York and Paris.

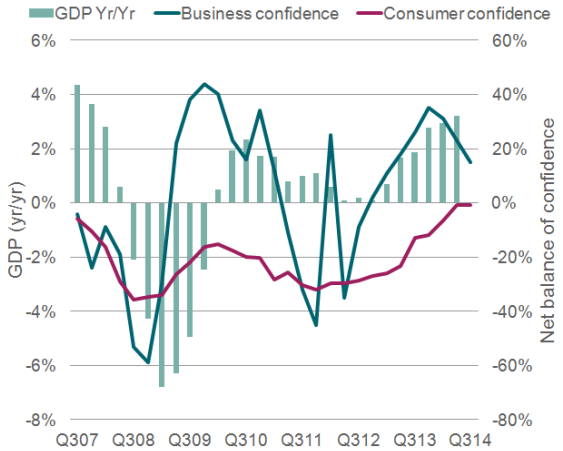
■ For example, the Middle-East based 'The Toy Store' have just agreed to open their first UK store on Oxford Street at a record Zone A rent of over £900 per sq ft. Savills advised the landlord.

■ Availability constraints on the traditional streets of Bond, Oxford and Regent has meant retailers have looked to new pitches in order to satisfy demand, particularly in the 'Luxury Quarter' close to Bond Street.

■ Mount Street is already a relatively well established alternative to Bond Street. However, Dover and Albemarle streets (Bond Street fringe) are emerging as destinations for luxury brands. Considering their comparatively low rents these streets are likely to see the most significant uplift in rents going forward.

GRAPH 2

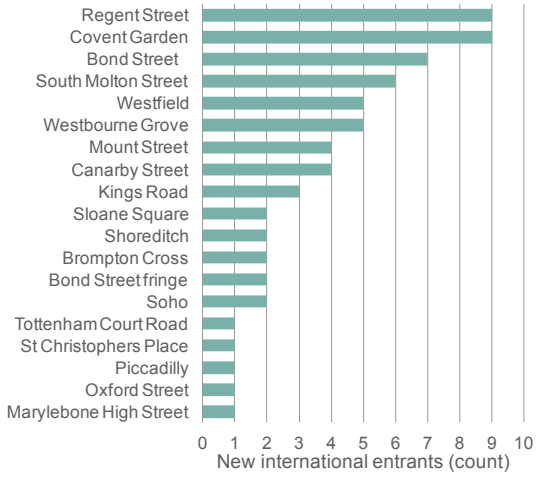
Close correlation between confidence and economic growth



Source: ONS, Deloitte CFO Survey, GfK

GRAPH 3

New international entrants



Source: Savills Research

Please contact us for further information

Mark Ridley
Chief Executive Officer UK & Europe
+44 (0)20 7409 8030
mridley@savills.com

Marie Hickey
Research
+44 (0)20 3320 8288
mlhickey@savills.com