Market in Minutes

July 2010

A renewed search for security will widen the yield spread between prime and secondary

Search for security and rental growth polarises the market in June

- The average prime yield rose from 5.73% in May to 5.80% in June. While most sectors were broadly stable, there is still downard pressure on prime London office and retail yields as domestic and international investors chase their preferred mix of security and rental growth prospects.
- In the secondary market there is now firm outward pressure on yields, particularly where the rental growth prospects are perceived as minimal. While the gap between prime and average yields is now in line with the long term average (222bps), we believe that given the instability in the economy a more sensible spread would be similar to that seen in the mid 1990's i.e. around 300bps.
- This realistic pricing of risk (as well as increasing desire for security) will be made up of a further hardening in prime yields in some sectors, and a general softening in secondary and tertiary yields in other markets over the next six to nine months. We do not expect the spread to begin to narrow back to the 200-250bps range until a real economic recovery is underway in late 2011/early 2012.

Prime equivalent yields

	Jun-09	May-10	Jun-10
West End Offices	5.75%	4.50%-	4.25%
City Offices	6.50%	5.25%	5.25%
Offices M25	7.50%	6.25%	6.25%+
Provincial Offices	7.00%	5.75%+	6.00%
High Street Retail	6.00%	4.75%+	4.75%+
Shopping Centres	7.25%	6.00%	6.00%
Retail Warehouse (open A1)	6.50%	5.00%+	5.25%
Retail Warehouse Park (restricted)	8.50%	6.00%+	6.25%
Foodstores	-	4.50%	4.50%
Industrial Distribution	7.50%	6.25%	6.50%
Industrial Multi-lets	8.00%	6.25%	6.25%+
Leisure Parks	8.75%	7.00%	7.00%
Regional Hotels	7.25%	6.75%	7.00%

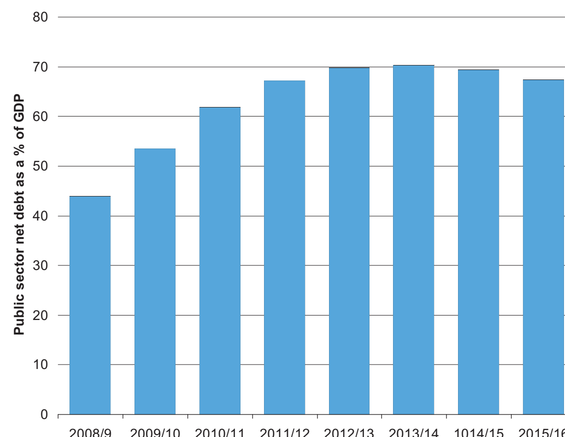
Source: Savills

Note: In some sectors initial yield pricing is becoming more relevant than equivalent yields. This particularly applies to retail warehousing and hotels where the figures indicated above are net initial yields. The +/- against the figures in the table above reflects the expected direction of movement in yields over the next 3 months.

Property's role in government deficit reduction

- Much of the focus on property in the emergency Budget and associated papers was on efficiency savings. However, we believe that given the swing back to risk aversion in many global property investor's plans, the opportunity for the UK government to consider sale and leasebacks should not be overlooked.
- The German government has led the way with around €350 million of asset sales last year. In the UK concrete plans are yet to emerge, but we believe that particularly in London there would be strong investor demand for office investments with long leases to the government in place. While this might fly in the face of the Smith and Lyons reports, it would deliver cash today which can be used to pay down the deficit.

Creative ideas for reducing the deficit welcomed!



Source: OBR

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Market in Minutes

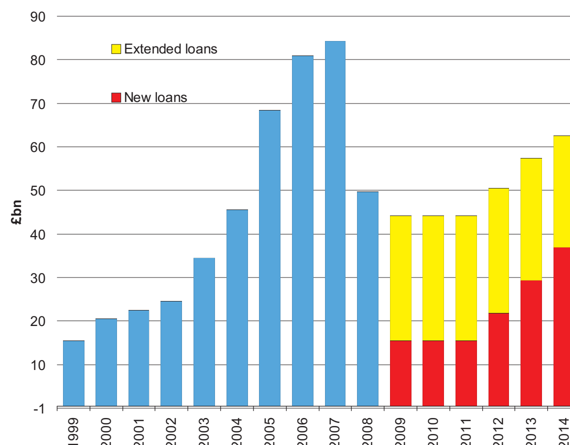
New lending to remain muted until 2013

- We have long been of the view that while equity rich investors are widespread enough to support the UK investment market at its current levels, the real recovery will not come until property lenders begin to loosen their purse strings.

- The key conclusions of our recent series of "Financing Property" presentations were that releases of distressed assets to the market will remain muted, but new lending activity will be restrained for the next 18 months due to the demands of refinancing, Basel II, and other factors.

- Once refinancing begins to become less of an issue, we believe that new lending levels will rise and this will stimulate a more solid recovery in investment volumes.

Debt will remain scarce in 2010-2012



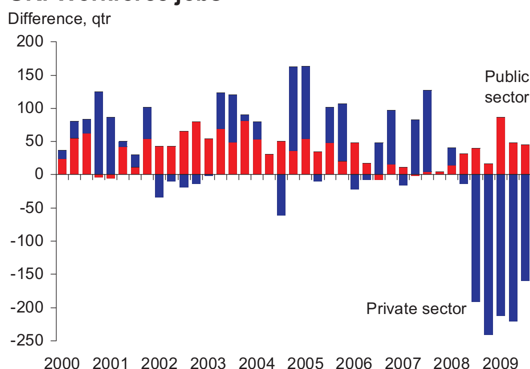
Source: De Montfort University (history), Savills (forecast)

Public sector austerity is a problem for us all

- Following last month's emergency Budget there has been much focus on how public sector austerity will hit some regions more than others. This is undoubtedly true, with 12 out the top 20 most public sector reliant cities in the UK being north of Birmingham. However, we would caution against too much smugness in the south!

- The chart to the right presents a worrying story, with the only part of the economy that is currently creating jobs being the public sector. This will undoubtedly come to an end soon, but without private sector job creation the demand for commercial property in all parts of the UK is going to remain severely muted. While there are pockets of private sector job creation (e.g the City of London), the recovery in GDP growth at the moment is being driven by productivity gains. Rental growth will not emerge until job creation in the private sector picks up, and at a national level this is unlikely to be seen until Q2 2011.

The private sector is still shedding jobs



Source: ONS, Oxford Economics

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