Market in Minutes

January 2012

Are property yields correctly reflecting the state of the market?

Prime yields have been broadly stable for 12 months. Will this be repeated in 2012?

- Our prime yield table doesnt tell a new story this month, other than a quarter point hardening in prime M25 office yields. Indeed, eight out of the 13 sectors that we track every month have seen no yield movement for 12 months. This degree of stability looks odd when set against a background of massive volatility in rental growth expectations, the economic outlook, and tenant and investor lack of confidence outside London and the SE.

- Against this background of volatility are prime yields sustainable at their current level, and has the definition of prime become so esoteric as to be almost irrelevant? The story of the investment market in 2012 is going to contain many of the same words as 2011. "safe haven", "prime", and "secure income" are all going to be top of many investor's lists of requirements. Vendors of this type of product are going to be limited, possibly more limited than last year, though outflows from some retail funds could stimulate some sales.

- This supply/demand imbalance will continue to support prime yields at their current level, and may even deliver some further hardening. However, this year we do expect to see more buyers exploring the higher yielding secondary segment.

Prime equivalent yields

	Jan-11	Dec-11	Jan-12
West End Offices	3.75%	3.75%	3.75%
City Offices	5.25%	5.25%	5.25%
Offices M25	6.50%	6.50%-	6.25%
Provincial Offices	6.00%	6.00%	6.00%
High Street Retail	5.00%	4.75%	4.75%
Shopping Centres	5.50%	5.50%	5.50%
Retail Warehouse (open A1)	5.25%	5.25%	5.25%
Retail Warehouse (restricted)	5.75%	5.75%	5.75%
Foodstores	4.50%	4.50%	4.50%
Industrial Distribution	6.50%	6.25%	6.25%
Industrial Multi-lets	6.25%	6.00%	6.00%
Leisure Parks	6.25%	6.25%	6.25%
Regional Hotels	7.00%	6.75%	6.75%

Source: Savills

Note: The +/- against the figures in the table above reflects the expected direction of movement in yields over the next 3 months.

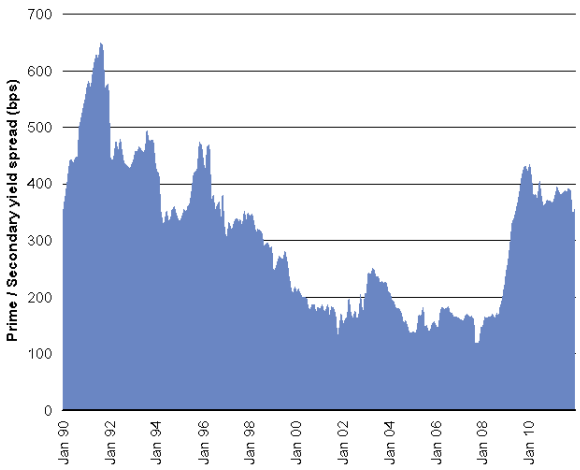
If prime is stable, what it happening to the rest of the market?

- If prime yields are difficult to measure at present, then secondary and tertiary yields are even harder. The almost complete lack of transactional evidence means that there is greater interpretation in valuers judgement and this can lead to a degree of mispricing.

- If we were to use the IPD All Property yield as a proxy for non prime then it is clear that the yield spread has widened from its boom level of around 50bps, to a more realistic 165bps. However, this is a much narrower spread than the 300+ bps that we saw coming out of the early 1990's downturn.

- A more realistic analysis might be between prime and secondary yields (shown in the chart), and while data is scarce at the moment we estimate that the spread here is now 350bps, which is almost exactly in line with the mid-1990's.

The prime/secondary yield spread looks sensible



Source: Savills

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Consumer recovery ahead?

- We have long been a believer that as soon as inflation's dragging effect on incomes began to fall in January this year, then there would be the beginnings of a recovery in consumer confidence and ultimately consumer spending. Given that weak consumption was the major driver of the UK's economic underperformance in 2011, an improvement in consumer confidence is pretty vital for 2012.

- CPI annual inflation fell from 4.8% to 4.2% in December 2011, and is expected to fall to around 2.5% by the end of this year. This hasn't happened yet, but as the latest consumer confidence figures from GfK NOP show, maybe the UK consumer is already anticipating a return to real income growth? Indeed, the overall index of consumer confidence rose to its highest level for over six months in January 2012.

- Announcements by the major utility companies of impending price cuts will certainly have helped, however deep discounting by retailers in the January sales must also be a factor that has contributed to this "feel less bad" factor, and the effects of these will soon diminish.

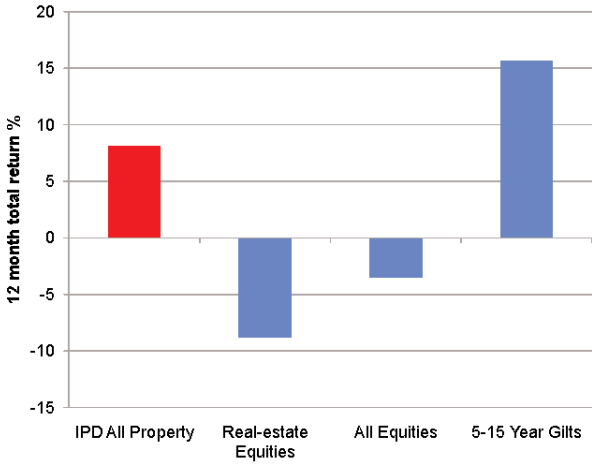
- We do expect consumer gloom to improve over 2012 and 2013, but there is still some way to go before we return to normal levels of consumer confidence and spend. Furthermore, while the government's deficit reduction programme is on track, the full effects of spending and headcount cuts are yet to be felt across the UK.

Investment trends in 2012 - Is property once again the "least worst asset?"

- The outlook for real-estate rental growth and returns in the UK is by no means exciting. Yes, 2012 will see rising rents ceasing to be just a London story, but our forecasts for average rental growth and total returns over the next five years paint a picture of a slower recovery than that of the mid-1990's. So how come direct property investment remains so popular?

- Around £34bn was invested in UK commercial property last year, well above the downturn levels of £20bn and broadly in line with the medium term average. Not all of this was in the perceived "safe haven" of London. However, even though the returns aren't great on UK commercial, they are a lot better than those achievable on equities or cash. With the IPD All Property total return for the year to December 2011 at 8.1%, maybe unexciting is the investment choice for 2012?

Comparative 12 month total returns



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