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UK Commercial Market in Minutes
Attraction of income intensifies

December 2017

Income prospects supporting yield compression

■ Yield compression returned in October and November highlighting continued investor appetite for prime real estate. The November/December average prime all sector yield came in by 4bps (basis points) following a 10bps compression in October.

■ While investor appetite remains strong, it is being further concentrated on 'prime' and in particular on long income producing assets as well as those with strong rental growth prospects.

■ For example, foodstores and regional hotels, sectors associated with relatively long index linked leases, reported downward shifts in prime yields of 25bps in October and November, respectively. Likewise, retail warehouses and industrial, both of which enjoy some of the strongest rental growth prospects, saw yields compress by 25bps in October.

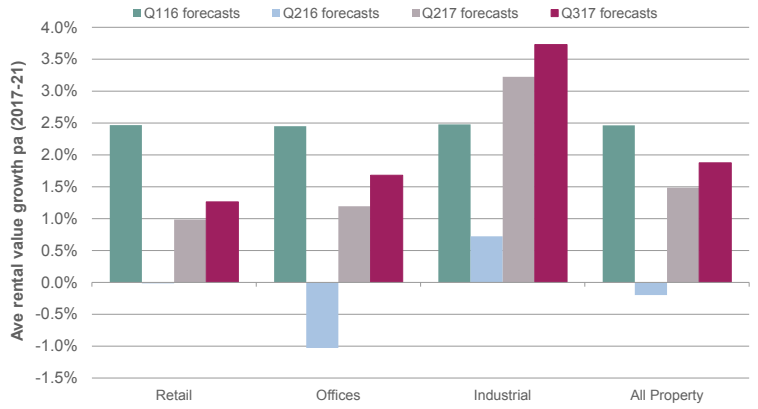
■ The improved outlook for rental growth is also supporting the continued investor confidence in UK real estate.

■ In the immediate aftermath of the EU Referendum the outlook for rental growth was significantly downgraded. However, while Brexit is generating a drag on economic growth, it remains positive with occupational demand in a number of sectors also remaining robust. This has supported upward revisions to rental growth forecasts (see Graph 1).

■ The current five year outlook is that All Property will report average rental growth per annum of 1.9%, 59bps below its pre-Brexit level. Forecasts for industrial property have improved beyond their pre-Brexit level with 3.7% per annum forecast through to 2021 supported by increased demand on the back of the growth in online retailing. While the outlook remains positive the real test will be dependent on the outcome of the Brexit negotiations.

GRAPH 1

Forecasts for the rental growth have been revised upwards (forecasts to 2021)



Graph source: Savills Research; RealFor

TABLE 1

Prime yields

	Nov 16	Oct 17	Nov/Dec 17
West End Offices	3.25%	3.25%	3.25%
City Offices	4.25%	4.00%	4.00%
Offices M25	5.25%	5.00%↓	5.00%↓
Provincial Offices	5.25%	5.00%↓	4.75%
High Street Retail	4.25%↓	4.00%	4.00%
Shopping Centres	4.50%	4.75%	4.75%
Retail Warehouse (open A1)	5.25%	5.00%	5.00%
Retail Warehouse (restricted)	6.00%	5.25%	5.25%↓
Foodstores (OMR)	5.25%	4.50%	4.50%
Industrial Distribution	5.00%	4.50%↓	4.50%
Industrial Multi-lets	4.75%	4.25%	4.25%
Leisure Parks	5.25%↓	5.00%	5.00%
Regional Hotels	5.50%	4.75%	4.50%

Table source: Savills

Search for income refocuses attention on the 'alternatives'

■ Investors refocus on income is apparent in the rising acquisition of 'alternative' asset classes.

■ The alternatives, largely constituting hotels and student housing, account for 32% of total UK volumes to date in 2017. This exceeds its pre-GFC share of 26%. Hotels alone have seen £4.4bn of transactions at the end of November suggesting the 'alternatives' are not that alternative any longer.

■ The long index-linked leases found in the hotel investment sector is boosting its appeal. The fact that the sector has been relatively immune to Brexit headwinds has also aided its attraction to income focused, risk averse investors. For example, London and Edinburgh have seen operational performance improve in 2017 aided by Brexit as weaker Sterling has enhanced the attractiveness of the UK as a tourist destination.

■ With prime indicative yields on leased hotels on a strong covenant (such as Premier Inn) now at 3.75%, investors are starting to turn their attention to higher yielding leased hotels and hospitality subsectors such as hostels and serviced apartments. For example, indicative prime yields on a fixed lease hotel with an 'unproven covenant' are in the region of 5.5%, 175bps higher than those on a strong covenant (Graph 3).

Too early to speculate on the impacts of the proposed CGT changes

■ While not receiving much attention in the immediate aftermath of the recent Budget, the changes proposed to Capital Gains Tax (CGT) for offshore vehicles is being assessed more closely.

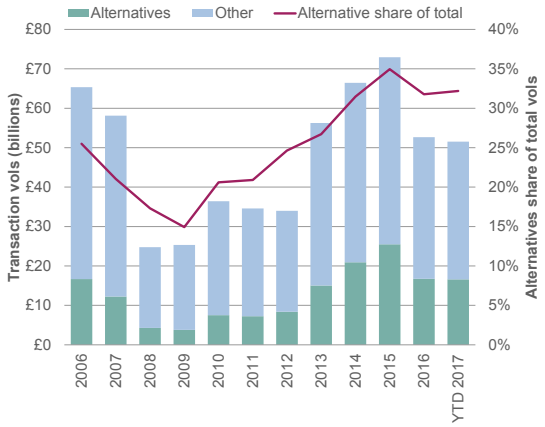
■ In very quick summary, from April 2019 offshore investors (those who own/sell commercial property via an offshore vehicle whether held directly or indirectly) will be required to pay CGT on the profits from UK commercial real estate transactions. This is envisaged to be in line with that incurred by onshore investors. Previously, offshore investors were exempt from CGT.

■ Considering the volume of overseas investment into UK property over recent years these changes could pose a challenge to the overall attractiveness of UK property to this buyer group. However, assuming offshore entities are charged at the same level as onshore entities, the UK rate would still be one of the lowest across the major international real-estate markets.

■ It is too early to speculate what impact these changes, if implemented, could have on overseas investor activity. Post the announcement, we continue to see interest and activity from overseas buyers demonstrating the UK's continued appeal as the fundamentals that make it an attractive destination market remain. However, taxation of the UK property sector remains a critical factor in investor sentiment.

GRAPH 2

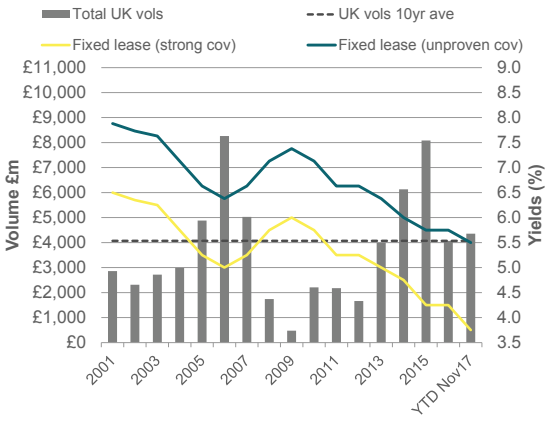
'Alternatives' no longer that alternative



Graph source: Savills Research; Property Data

GRAPH 3

Hotel transaction volumes vs leased hotel yields



Graph source: Savills Research

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