savills

UK Commercial Market in Minutes

Yields reach lowest level since Brexit vote

September 2017

Largest yield shift this year

■ Following four consecutive months of no movement in the Savills prime yield series July and August have seen a hardening of 10bps and the average yield reach 4.65%, the lowest level since May 2016.

■ Following the unexpected UK general election, markets are now seeing an uptick in activity. This, combined with relatively low levels of investment stock, has seen pricing for a number of sectors move in following months of downward pressure.

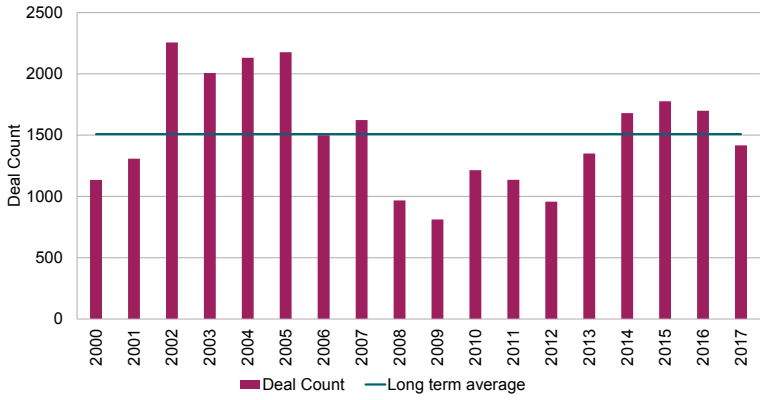
■ July saw yields shift inwards for UK logistics, the sector remains in vogue for investors driven by the well documented structural change in the retail sector which is driving occupier demand. Coupled with the fact that speculative development levels are low and headline rents are maintaining their upward trajectory, investors have been keen to deploy capital into the sector. Indeed at the half year point in 2017 investment volumes in the sector have reached £2.3bn, almost £1bn higher than the same period in 2016 and 150% higher than the long term average.

■ Prime yields for foodstores sharpened in August reaching their lowest level since the end of 2014. With a more robust occupational story assisted by retailer merger and acquisition and the fact foodstores offer long term indexed linked income and potential asset management opportunities led by residential or mixed use development means the sector has become increasingly attractive, particularly to currency sensitive overseas investors and income driven local authorities.

■ Whilst year to date investment volumes are on par with 2016, it should be noted that examining the market by the actual volume of transactions paints a different picture. As demonstrated in graph one, for the eight months of the year so far we have seen 1417 separate transactions, down 6% on the long term average, implying that larger value transactions are maintaining volumes.

GRAPH 1

Investment volumes by deal count fall for the first eight months of the year



Graph source: Propertydata

TABLE 1

Prime yields

	Aug 16	Jul 17	Aug 17
West End Offices	3.50%	3.25%	3.25%
City Offices	4.25%	4.00%	4.00%
Offices M25	5.50%	5.25%↓	5.25%↓
Provincial Offices	5.50%	5.00%	5.00%
High Street Retail	4.25%	4.00%	4.00%
Shopping Centres	4.50%	4.50%	4.50%
Retail Warehouse (open A1)	5.25%	5.25%	5.25%
Retail Warehouse (restricted)	6.00%	5.75%↓	5.50%
Foodstores	5.25%	5.00%↓	4.75%
Industrial Distribution	5.00%	4.75%	4.75%
Industrial Multi-lets	5.00%	4.50%↓	4.50%↓
Leisure Parks	5.25%	5.00%↓	5.00%↓
Regional Hotels	5.50%	4.75%	4.75%↓

Table source: Savills

Is occupier behaviour about to change?

■ From 1st January 2019 new and wide ranging accounting changes, IFRS 16, come into force which have the potential to impact occupier behaviour due to the ways in which leases will have to be accounted for. For leased property today, in most cases, the accounting is entirely current period as an expense through the P&L and does not touch the balance sheet. However, post 2019, all leases of one year or more will be on the balance sheet, both as an asset (right to use property) and as a liability (obligation to pay for that use); the present value of the rents will be depreciated over the term in a straight line and interest will be applied to the undepreciated liability.

■ For sale and leaseback transactions profits on sale will be captured on the balance sheet and depreciated over the lease term through the P&L. The lease will no longer be accounted for as an expense, and so EBITDA (earnings before interest, tax, depreciation and amortisation) will increase. The increase in amortisation and interest will change the P&L profile of the lease as graph 2 shows. Whilst the drivers for sale and lease backs may change they will remain a valid business tool.

■ How will the impacts of IFRS 16 be felt by property investors and occupiers? Firstly, there may be much more focus on lease lengths where acquisition and fit out costs are high relative to lease costs, it is likely to provide a better lease profile to have a longer lease (albeit lease break options may still be sought to maintain operational flexibility. Where the fit out is a relatively small component, or for a lease renewal where leasehold improvements are fully amortised, the accounting effects would be lower with a shorter lease. Secondly, for businesses who prefer longer leases there may be a favourable business case for owning property and taking out a mortgage versus leasing. This is because the lease will appear as both an asset and a debt-like liability, incurring an annual interest charge. Therefore the current, and expanding popularity, of the serviced office sector may continue to grow as occupiers demand greater flexibility but the long lease commitment to the operator remains.

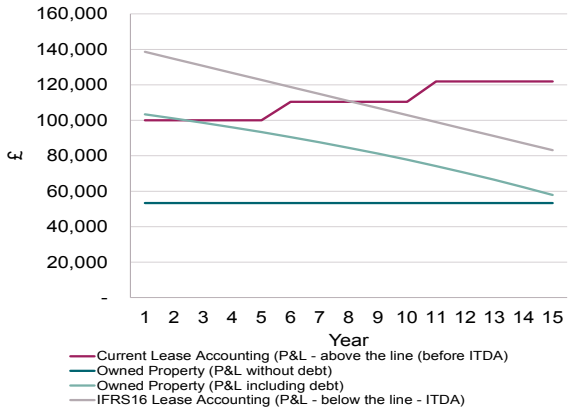
No clarity on clarity

■ Brexit negotiations between the UK and EU start again in earnest following the summer break. The UK has published a number of position papers on key topics including the Northern Ireland border and how regulations will function after Brexit. However, for the moment, the EU is maintaining an entrenched view that no trade negotiations can begin until the potential "divorce" bill is settled and the rights of existing EU nationals are decided. It is expected that further clarity may arrive once the results of the German Federal Elections are know on the 24th September.

■ Global central bankers recently met at their annual summit in Jackson Hole, Wyoming. Against commentators predictions little clarity emerged regarding EU policy on quantitative easing and the global normalisation of monetary policy, both of which will fundamentally impact future asset pricing. Politically, with GDP forecasts remaining positive, as highlighted in graph three, it seems such policy decisions can wait.

GRAPH 2

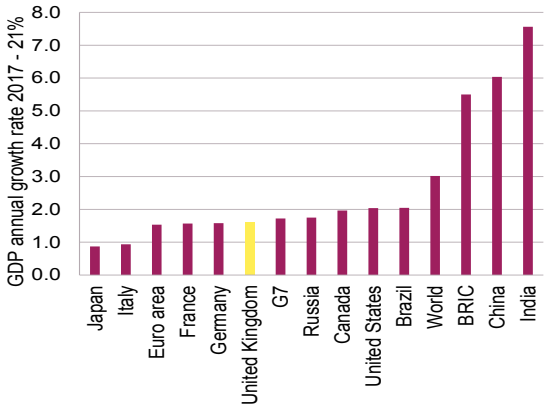
Sample of impact on P&L of lease accounting versus owned property



Graph source: Savills Worldwide Occupier Services

GRAPH 3

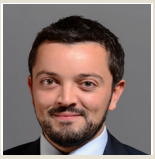
UK economy in line with Europe and USA



Graph source: Focus Economics

Please contact us for further information

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



Kevin Mofid
Research
+44 (0)20 3618 3612
kmofid@savills.com