savills

UK Commercial Market in Minutes
Property returns are still remarkably attractive

April 2015

Prime yields stay stable, but some divergence starting to show

■ The average prime yield stayed stable in March at 4.59%, the third consecutive month at this level. However, against this background of stability there is beginning to be a split between sectors that are expected to see upward or downward pressure over the next three months.

■ This divergence seems to have more to do with comparative yields, rather than any underlying fundamentals, and as such the pressure could diminish if yields on other sectors move. For example, prime yields for High Street Retail are currently 4.25%, the same as Shopping Centres. However, the long run average is for High Street Retail to be nearly 75bps lower than Shopping Centres. Clearly investors are betting on a reassertion of the norm, as well as speculating that the demise of the high street has been overstated.

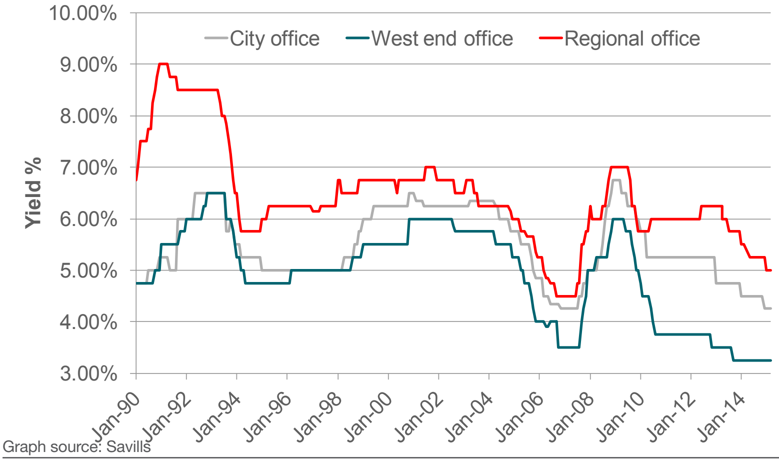
■ This begs the question of what other sectors are looking comparatively cheap at present. In the office market, the gap between prime regional office yields (at 5.00%) and prime City of London yields (at 4.25%) is historically narrow. The yield gap between regional offices and the West End of London has also narrowed during the past year (by 50 basis points).

■ Does this mean that we expect central London office yields to harden imminently? This certainly looks possible, primarily due to the weight of money that is targeted at larger office lots in the UK, something that is easier to find in the City of London than anywhere else.

■ Of course investing based on comparative yields is only sensible if the leasing market fundamentals have not changed significantly from the "norm". However, we do believe that there is still a degree of overpricing of risk in some segments, and this will be where the strongest returns will be achieved over the next 12 months.

GRAPH 1

The spread between prime regional and London office yields is wider than normal



Graph source: Savills

TABLE 1

Prime equivalent yields

	Mar 14	Feb 15	Mar 15
West End Offices	3.25%	3.25%	3.25%
City Offices	4.50%	4.25%	4.25%
Offices M25	5.75%	5.00%	5.00%↓
Provincial Offices	5.50%	5.00%	5.00%
High Street Retail	4.50%	4.25%	4.25%↓
Shopping Centres	5.00%	4.25%	4.25%
Retail Warehouse (open A1)	4.75%	4.25%↑	4.25%↑
Retail Warehouse (restricted)	5.50%	5.25%↑	5.25%↑
Foodstores	4.25%	5.00%	5.00%↑
Industrial Distribution	5.75%	4.75%	4.75%
Industrial Multi-lets	5.50%	5.00%	5.00%
Leisure Parks	6.00%	5.25%	5.25%
Regional Hotels	6.75%	5.75%	5.75%

Table source: Savills

Property to out-perform, particularly in a 'noflation' environment

■ With the average total return on UK commercial property standing at more than 19% for the 12 months to end of 2014, it is clear that property is once again in one of those phases of the market when it is out-performing returns on the majority of other asset classes. Indeed, even the income return alone at around 6% looks very attractive in an environment of low or noflation and generally lower returns on many other sectors (Graph 2).

■ Indeed, if we examine the risk-return for a variety of asset classes over the last three months, all commercial property sectors are showing a lower volatility in comparison to most other asset classes, and the returns on offer from property are amongst the highest on offer from equities, bonds and commodities.

■ This situation will be further enhanced by the major macro-economic news that consumer prices were unchanged in the year to February, the first 12-month period of zero inflation since 1960. February's drop was primarily driven by a decline in the cost of transport and food. However, even disregarding food and fuel prices, the core level of inflation also fell from 1.4% in January to 1.2% in February.

■ Looking ahead, while the impact of the fall in petrol prices is probably now over, the recently announced cuts in gas prices will begin to feed through to the inflation rate in March's numbers.

■ This raises the stakes for the MPC, and the debate over good and bad deflation will undoubtedly run for some months to come. If they choose to follow the Swedes, who recently cut their central bank rate to -0.5%, this will further boost the rationale for investing in property. However, we expect that UK inflation will start to drift upwards from the summer once the impact of recent falls in the price of oil have diminished, and wage growth also starts to rise.

UK politics - from consensus to chaos?

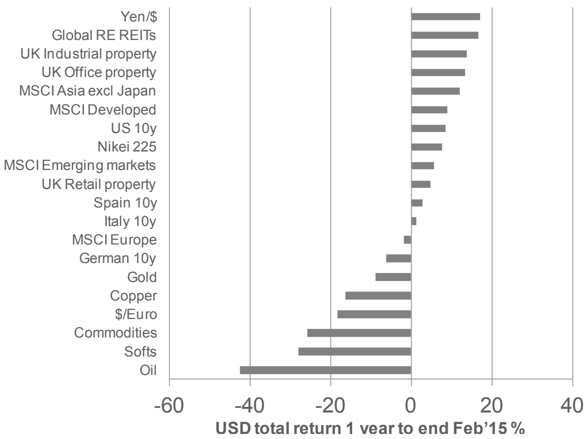
■ While a coalition government was an exciting new story five years ago, there were many that were worried that it would lead to a degree of policy stagnation. However, while this could be used as critique of the coalition, it is also evident that we have been through a period of remarkable political consensus around the need for fiscal consolidation and the need to bring down the structural deficit.

■ However, the gloves are off now and the consensus is disappearing. The battleground for the general election is becoming where and how cuts in public spending will have to fall. However, our analysis is increasingly centring on whether any government will have the seats to deliver any kind of further austerity programme, and what this means for global confidence in the UK.

■ The primary risk for property around May's election is the removal of this political consensus. A lack of clarity on fiscal and political priorities will be a drag on investor confidence, so the sooner the period of post-election negotiation is over the better.

GRAPH 2

Property is out-performing many other asset classes



Graph source: Investment Property Databank; Thomson Reuters, Savills

■ The market instability that took place around the Scottish Referendum and the last general election was relatively short-lived. However, the closer the election result that is achieved in May 2015, the longer the period of negotiation to form a coalition will be, and the longer it will take for that government to come up with a common policy on spending cuts and taxation.

This will not result in a surge in global concerns about the strength of the UK as an investment destination, but a sustained period of 'wait and see' would not be good for the global perception of the UK as a stable destination for safe-haven type investments.

Please contact us for further information

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

Mat Oakley
Research
+44 (0)20 7409 8781
moakley@savills.com