UK Commercial Market in Minutes
Time to focus on rental growth?

November 2014

Prime yield stable this month

■ The prime yields in every single sector remained stable this month, the first time that this has happened since January 2014. While we believe that there is still downward pressure on high street retail and provincial office yields, it is clear that the market may well be signalling that the yield cycle may be close to its bottom.

■ On a pure cyclical analysis this may well be a rational thought process. As Graph 1 shows, the majority of prime yields are well below their long-term average, with two sectors now at record lows.

■ However, when considering the future path of prime yields we must look beyond the historic trend. With the IPD All Property index showing an annual total return of 19.67% to the end of September, it is very likely that institutional weightings towards property will at least be maintained in 2015, and may even be increased.

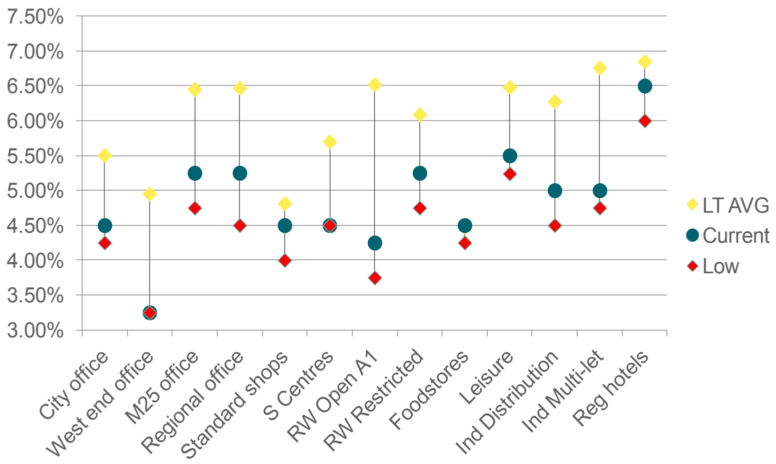
■ While we are forecasting that the All Property total return will be lower in 2015, at around 12%, this still represents a very healthy performance for property compared to cash, sovereign bonds, and corporate bonds. Indeed, the recent volatility in the equity market will probably mean that once again commercial property is seen by many fund managers and investors as the least worst asset class.

■ We expect to see more focus on rental growth and income return prospects in 2015, though there will still be some opportunities in secondary locations and assets to ride the closing of the yield gap to a more normal level with prime.

■ Rental growth is undoubtedly becoming easier to find, with our latest forecasts showing that the majority of towns and cities will deliver positive rental growth over the next five years. In particular the growth story is now spreading to key towns outside London and the South East.

GRAPH 1

Prime yields are close to historic lows in most sectors



Source: Savills Research

TABLE 1

Prime equivalent yields

	Oct 13	Sep 14	Oct 14
West End Offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.50%↓	4.50%↓
Offices M25	5.75%↓	5.00%	5.00%
Provincial Offices	5.75%	5.25%↓	5.25%↓
High Street Retail	4.75%	4.50%↓	4.50%↓
Shopping Centres	5.00%↓	4.50%	4.50%
Retail Warehouse (open A1)	5.25%↓	4.25%	4.25%
Retail Warehouse (restricted)	6.00%↓	5.25%	5.25%
Foodstores	4.25%	4.75%↑	4.75%↑
Industrial Distribution	6.00%↓	5.00%	5.00%
Industrial Multi-lets	5.75%	5.00%	5.00%
Leisure Parks	6.25%	5.50%	5.50%
Regional Hotels	6.75%	6.00%	6.00%

Source: Savills Research

Time to buy retail?

■ Last month's Market in Minutes focussed on the opportunities in the central London retail market, but we believe that other parts of the retail sector are worth examining more closely.

■ The first reason for looking at retail property is slightly contra-cyclical. Many investors are still cautious about the prospects for retailing in the UK due to the impact of internet retailing and the consumer recession. However, we think that there has been too much pessimism about the structural change that is e-tail, and not enough weight put on the inevitable cyclical recovery that will follow the steady improvement in consumer confidence that has been seen over the last nine months.

■ Retailer demand is now spreading from the prime towns and pitches down to the secondary markets where rents have rebased enough to make new store openings viable. While there are still a significant number of lease events due to take place next year, we expect that 2015 will be the nadir of this aspect of the retail cycle.

■ The second reason to look at retail property is that it is one of the few sectors that offer larger lot sizes outside London. Anecdotal comments from many domestic and international institutional investors are pointing towards a desire to invest in the UK regions, but this is being foiled by a severe shortage of office investments of £50 million and above coming to the market. The average lot size of shopping centre transactions this year has been £94.7 million, with more than 80 centres sold in the first nine months of the year.

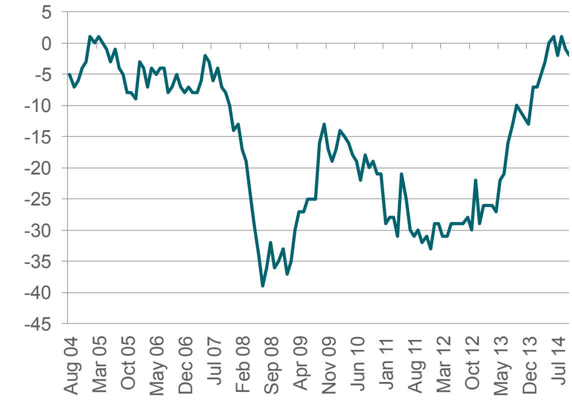
■ The final reason for re-examining the joys of retail property is the risk profile. While many investors still perceive retail as being relatively high risk due to the aforementioned cyclical and structural changes that are taking place, the sector offers similar or better income security to both office and industrial investments.

■ For example, supermarkets, standard shops, shopping centres and retail warehouses all offer a comparable or better WAULT than the other commercial sectors, and a lower void as a percentage of the overall ERV. Furthermore, while the travails of Tesco have dominated the headlines in recent weeks, the covenant strength of many retailers is strong, particularly since in segments like bulky goods and electricals many retailers now have significant market share due to the failure of their competitors during the downturn.

■ While it would be nice to say that we have spotted these trends before the rest of the market, it is clear from the recent levels of investment into retail warehousing and shopping centres that the attractions of retail are rising in investor's minds. Indeed, as Graph 3 shows, the investment turnover in these two segments in the first three quarters of 2014 has exceeded the full year 2013 total, and is likely to reach pre-boom levels by the end of this year. We expect that this strong level of interest in the sector will continue into 2015.

GRAPH 2

Consumer confidence has recovered



Source: GfK

GRAPH 3

Shopping centre and retail warehouse investment turnover is likely to hit pre-boom levels this year

Source: Savills Research

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