MARKET IN MINUTES

Savills Research

Market in Minutes

A temporary pause?

Nearly all sectors saw an upward shift in prime yields of 25bps in July, with the exception of Foodstores and West End and London City offices. This moves the average prime yield out to 6.0%; 20 bps higher than the month previous, 25 bps higher than the long-term average and more than 100 bps higher than 12 months ago.

This sustained outward drift in pricing is clearly linked to the sentiment surrounding the strength of the UK's recent economic headwinds. The outlook at the beginning of the year was particularly austere. Nevertheless, as we move into H2, you could argue that some of these negative concerns have significantly dissipated. A UK recession is no longer the consensus view; good news for both corporate and rental growth. By comparison, average prime yields are still significantly below the 7.25% average reached at the peak of the GFC (Jan 2009).

Furthermore, winter 2022/3 was warmer than expected, and wage growth has accelerated. As a result, despite the absence of any anticipated yield compression in the short term, only three sectors are expected to see further upward movement in the coming months. This suggests that for the investor, at least, pricing may be as good as it will get for the time being.

However, despite improving fortunes, transactional hesitation remains, which may of course be fuelled by a period of sustained interest rate rises. The Bank of England (BoE) has just announced a further 25 bps increase in interest rates for August, reaching 5.25% for the first time since 2008, in order to try to curb inflation. This is particularly important for the outlook of the consumer economy. The negative impact of 14 consecutive interest rate rises appears to have been relatively minimal so far, however, we do not believe that this consumer resilience can last in the face of further rises in the cost of money.

Academic research suggests that, on average, there is an 18-month lag between an interest rate rise and its impact being felt in the wider economy, which means that consumers should be feeling the early impacts now. Furthermore, while the latest wage growth data surprised on the upside, the rise in the unemployment rate from 3.8% to 4.0% surprised on the downside. All of this may lead to weaker occupational market fundamentals in some sectors, especially for those intrinsically linked to consumer spending.

In reality, the mixed messages around the UK's economic outlook may suggest we are not at the nadir in terms of pricing, and that we may see some further rises before we see any falls. In the short term, we may see a short pause in yield softening provided the BoE also pause for a moment on further interest hikes following August's announcement. Clarity is needed on whether the changes it started implementing last year are really impacting the wider economy and starting to bring inflation down.

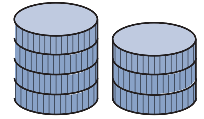
In many sectors, these prime yields only reflect a small 'sample' of transactions that can be taken on by ungeared investors and are therefore not representative of the wider market where debt is still required. The chart below highlights a 54.6% reduction in H1 volumes versus the same period last year. Deal volumes have, in fact, been slowing since Q2 2022, albeit we are still way off GFC deal count lows. Much of the slowdown can be attributed to mismatched seller-buyer expectations, with fewer vendors willing to sell at current pricing unless they have to.

Savills prime yields

	July 2022	June 2023	July 2023
West End Offices	3.25%	4.00%	4.00%
City Offices	4.00%	5.00%	5.00%
South East Offices	5.25%↑	6.75%↑	7.00%
Provincial Offices	4.75%	6.00%↑	6.25%
High Street Retail	6.00%	6.50%↑	6.75%↑
Shopping Centres	7.50%↑	8.00%↑	8.25%
Retail Warehouse (open A1)	5.00%↑	5.50%↑	5.75%
Retail Warehouse (restricted)	5.00%↑	6.00%↑	6.25%
Foodstores (OMR)	4.50%↑	5.00%	5.00%
Ind/ Distribution (OMR)	3.75%↑	5.00%↑	5.25%
Industrial Multi-lets	3.75%↑	4.75%↑	5.00%
Leisure Parks	6.75%	7.25%↑	7.50%↑
London Leased (core) Hotels	3.50%↑	4.25%↑	4.50%↑

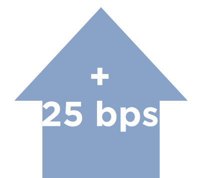
Source Savills

Key Stats



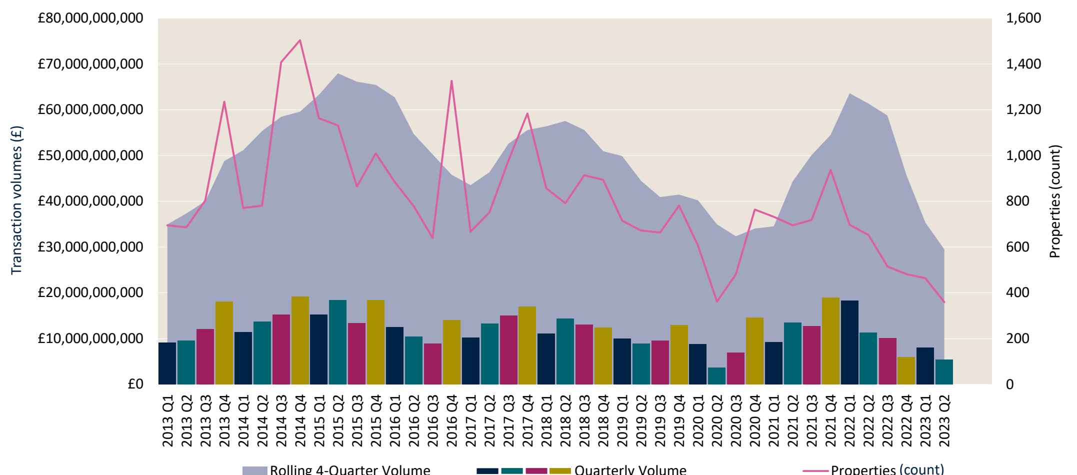
c.£13.4bn
Commercial investment volumes in the first half of 2023 - the worst H1 since the pandemic

The UK average prime yield edged slightly higher in July



10 sectors saw an upward shift in prime yields of 25 bps

Commercial property investment market transaction volumes*



*includes offices, industrial, retail, hotel and hospitality

Source Savills,

Despite falling back to pre-Covid averages, requirement levels suggest that take-up will rise in H2 in the UK logistics market

With an uncertain economic backdrop and capital markets in a state of flux, the UK logistic market has seen a reduction in the space operators have taken in H1 this year.

Higher costs of capital means developers find it harder to fund speculative developments, which will constrain the development pipeline. Furthermore, the pricing aspirations of investors remain mismatched, and occupiers will consider their options on financing when it comes to capital expenditure.

At a national level, take-up for the half year has reached 12.49m sq ft across 56 separate transactions, which is the lowest H1 take-up since 2013, albeit just 1% shy of the pre-Covid H1 average. The predominant driver behind the slowdown has been the level of build-to-suit take-up falling back to 5.2m sq ft, accounting for 41% of demand this year (last year totalled 23.9m sq ft equating to 50% of demand).

At a deal count perspective, the level of individual transactions is in line with long-term averages, but with just six deals this year over 400,000 sq ft, this has had a dampening effect on the average deal size which has fallen from 272,000 sq ft over the last three years to 222,000 sq ft in 2023.

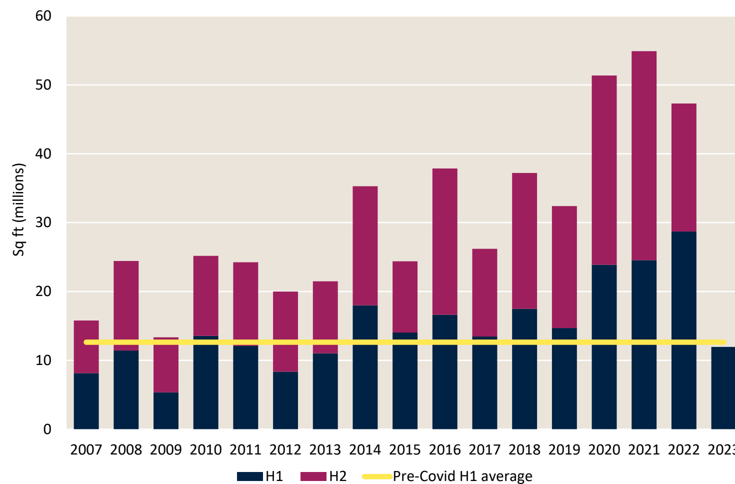
Nevertheless, demand for speculatively constructed units remains strong, accounting for 22% of the market, broadly in line with 2022. Meanwhile, on a proportional basis, a rise in demand for second-hand units has improved, accounting for 37% of the market, up from just 21% in 2022. Whilst this remains lower than long-term averages, as the second-hand market typically accounts for 46% of transactions, it does suggest that occupiers are taking advantage of more flexible terms available through the space being marketed for sublease.

With the lowest H1 take-up since 2013, it is tempting to suggest that the recent boom in market activity has run its course. However, the promising news is that Savills requirements index has historically evidenced a strong correlation of requirements to take-up which, if maintained, would see a rise in the level of new leases signed in H2.

The diversity of the occupier mix continues to point to a well-balanced market less dominated by one particular segment, as we have witnessed with online retailers over the last five years. Indeed, online retailers accounted for just 6% of space taken so far in 2023, and manufacturing-related demand has continued its resurgence, accounting for 28% of all take-up, up from just 13% in 2021.

With the online retail penetration rate in the UK set to rise to 35% by 2027 (Statista) and demand from manufacturing-related occupiers continuing to rise as companies look to re-risk their supply chains, the long-term future of the sector remains positive.

Take-up - H1 drops to pre-Covid averages

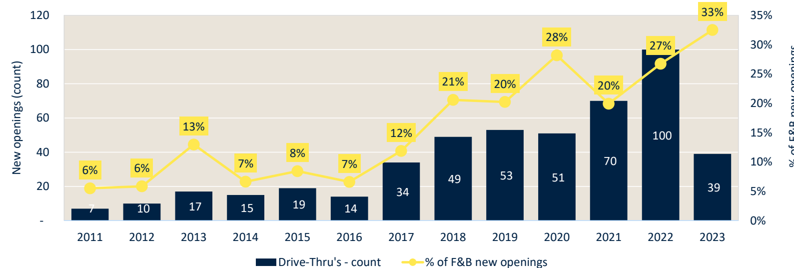


Source Savills Research

Drive-Thru net effective rental growth outperforms the rest of the retail warehouse market as appetite for new space remains high

Contrary to popular belief, it is not just the discounters that have been driving record take-up in the retail warehouse market in recent years. F&B operators have consistently featured in the top 20 most acquisitive operators which in H1 this year included Greggs (20 units), Starbucks (19), Costa (12), Burger King (7), McDonald's (7), KFC (6), Taco Bell (6) and Tim Hortons (6).

Out-of-town Drive-Thru new openings



Source Savills Research

Having become so popular with the UK consumer during the pandemic, Drive-Thrus are the format of choice for these operators. Last year we saw 100 new Drive-Thru openings in the market, just under double the number opened in 2019 pre-Covid. The truth is the most acquisitive F&B operators would like to do more were it not for scheme configuration and planning constraints.

With vacancy now as low as 4.4% across the sector, there is very little opportunity to satisfy further demand, which is why many of the new Drive-Thru openings are newly constructed roadside developments rather than the reparation of voids.

As a result, rents have increased dramatically, as firstly, the competition for space has become so fierce and secondly, in order to make a development viable to the landlord, due to the recent and significant increase in construction costs. Drive-Thru & Drive-To net effective rents now stand at £47.19 psf on average, an increase of 27.9% versus pre-pandemic. By comparison, the rest of the market has plateaued at c.£18.09 psf, with a marginal decrease of -1.1% in the same time period.

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