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UK Commercial Market in Minutes

Macro headwinds could test Brexit resilience

March 2018

Yields edge towards 2007 peak

■ Following three consecutive months of no movement in the Savills prime yield series, February saw a hardening of 2bps and the average yield reach 4.50%, this now stands just 19bps from the previous peak of 4.31% in 2007.

■ This was driven by an inward movement of prime yields for the Logistics sector which now stand at 4.25%, the lowest level ever experienced. The Multi-let sector also has downward pressure and we examine the future prospects for industrials overleaf. Due to continued strong interest from investors in the M25 office sector we expect the average prime yield to see continued downward pressure into 2018.

■ Whilst the dominance of overseas investors is well documented, it has been pleasing to note that UK institutions have increased their purchases, accounting for £10.5bn of transactions in 2017, up from £8.2bn in 2016 and higher than the long term average of £10bn.

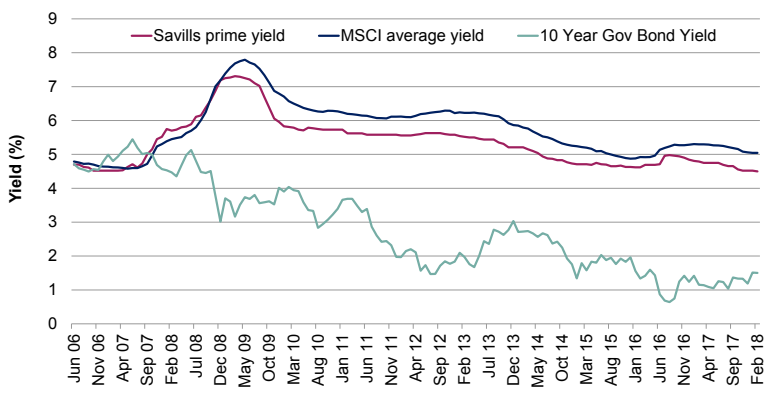
■ All eyes will now turn towards global macro economic factors such as Global interest rate rises, Brexit negotiations, US trade tariffs and other geopolitical issues such as North Korea and Russia how they will impact the markets.

■ The US Federal Reserve raised interest rates in March by a quarter of a point to a range of 1.5% to 1.75, which is the sixth increase since 2015. This appears to signal that the era of historically low interest rates that began during the Global Financial Crisis is to be coming to an end. With the Bank of England also guiding that rates are expected to rise this could alter the spread between commercial real estate and risk free rate with UK 10 year gilts currently trading at 1.5%.

■ March also saw the agreement between the UK and EU on a transitional deal on the UK's withdrawal from the EU which we expect will give further confidence to both occupiers and investors.

GRAPH 1

Gap between real estate and bonds remains wide



Graph source: Savills MSCI investing.com

TABLE 1

Prime yields

	Feb 17	Jan 18	Feb 18
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%↓	4.75%	4.75%
High Street Retail	4.00%↑	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)	5.75%	5.25%	5.25%
Foodstores	5.00%	4.50%	4.50%
Industrial Distribution	5.00%	4.50%↓	4.25%
Industrial Multi-lets	4.75%	4.25%	4.25%↓
Leisure Parks	5.00%	5.00%	5.00%
Regional Hotels	5.25%	4.50%	4.50%

Table source: Savills

Where next for Industrial?

■ 2017 was a record year for Industrial property in the UK. £11bn was invested into the sector making it the highest total volume ever recorded. This capital deployment also accounted for 17% of all investments into UK commercial real estate, again the highest proportion of the market ever recorded.

■ Moreover during the first quarter of 2018, Savills prime yields for industrial properties reached the lowest level ever recorded at 4.25% for both multi-let estates and distribution warehouses. MSCI have also reported that total returns for Industrials in 2018 reached 20% 90bps higher than its nearest competitor, the Alternatives sector. This has led some commentators to suggest that the sector is starting to overheat and investors will return to previous weightings in other sectors.

■ Continued medium term rental growth will be key to maintaining the investment performance of the sector and there are many reasons to suggest this will continue. Whilst the rate of growth for online retail is slowing, it is crucially, still growing and in November 2018 accounted for 19.8% of all retail sales, setting yet another record.

■ The UK also remains, on a per capita basis an "under-warehoused country" with just 7.61 sq ft of warehousing per head. The UK warehousing stock would need to increase by 26 times to reach the same level as the USA at 39 sq ft of warehousing per head.

■ And therein lies the problem, as the supply of warehousing in the UK is at record low levels and even with huge levels of logistics occupier demand development has remained muted and vacancy rates have remained steady for the last four years at around 6.5%, falling to around 3% in London.

■ There are less that 200 sites in the country capable of delivering large scale units and many are in the control of a small number of developers, meaning that supply will be controlled and carefully match occupier demand. And whilst we expect to see increased speculative development in 2018 of up to 5 million sq ft, take up levels remain strong with the first quarter of 2018 expected to reach 13m sq ft, the best quarter of take-up ever recorded.

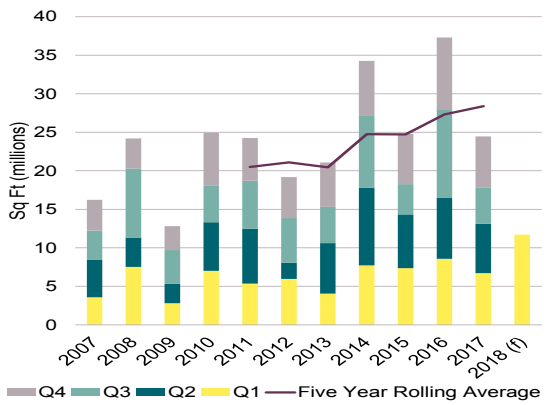
■ Further parallels with the USA are also important as many markets share similar characteristics. According to research from Savills Studley, the Greater Bay Area of San Francisco has a vacancy rate of ~1.5% with rental growth of 30.2% achieved in the last two years.

■ Logistics also remains a key global asset class with a weight of capital targeting the sector. Indeed the latest INREV investor intentions report from January 2018 states that 64.3% of Global investors view Logistics as their preferred sector.

■ Lastly, whilst a Brexit led economic downturn could have ramifications for the health of other sectors the logistics sector could see an increase in demand. Recent research from the UK Warehousing Association details a scenario where grocery and manufacturing supply chains are placed under increased time pressures, therefore requiring more inventory to be stored in the UK. Again, in a supply constrained market, this will put increased pressure on rents. ■

GRAPH 2

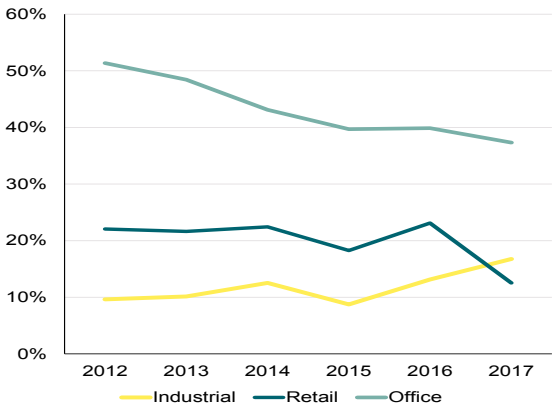
UK logistics take up could reach record levels in Q1



Graph source: Savills Research

GRAPH 3

Industrial accounts for highest proportion of total investment



Graph source: Savills Property Data

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