MARKET IN MINUTES
Savills Research

Market in Minutes

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2025 - The recovery continues

At the start of 2024, we predicted that investment volumes would be up year-on-year, and that “some selective hardening in prime yields” was to come. A generous marking of our homework would say that we were completely correct, but as the chart below shows, office yields showed no sign of turning the corner.

So, what might change in 2025 that will continue the modest recovery that we saw last year in some sectors, and drive a turning point in the prime office markets? The simple answer is that we expect both purchasers and vendors to be more optimistic as base rates slowly fall, economic growth gently recovers, and rental growth continues to be solidly positive.

The very sharp-eyed regular reader of this report will notice that our prime South East office yield has moved in a quarter point this month, which brings our all sector prime yield down to 5.96%, its lowest level since September 2023. We also have downward arrows on 10 out of 14 sectors, indicating that we believe that the next yield movement will be downwards.

As retail and logistics yields have hardened, this leaves prime offices looking increasingly cheap. This is particularly true when you look at the recent trends in prime office rental growth, which is running at around double the long-term average levels in some submarkets, due to the lack of development activity. We dig into the reasons behind this strong rental growth in a little more detail overleaf, but our top-level view is that the lack of speculative development that we are seeing across the country is unlikely to change in the short term. This alone will ensure that rental growth remains solid.

Savills prime yields

	January 2024	November 2024	January 2025
West End Offices	4.00%	4.00%↓	4.00%↓
City Offices	5.25%	5.25%	5.25%
South East Offices	7.50%	7.75%↓	7.50%
Provincial Offices	7.00%	7.00%↓	7.00%↓
High Street Retail	7.00%	6.50%	6.50%
Shopping centres	8.25%	7.75%↓	7.75%↓
Retail Warehouse (open A1)	6.00%	5.25%↓	5.25%↓
Retail Warehouse (restricted)	6.50%	5.75%↓	5.75%↓
Foodstores (OMR)	5.50%	5.50%↓	5.50%↓
Ind/ Distribution (OMR)	5.25%	5.00%	5.00%
Industrial Multi-lets	5.25%	5.00%↓	5.00%↓
Leisure Parks	7.75%	8.00%	8.00%↓
London Leased (core) Hotels	4.75%	4.50%↓	4.50%↓
Regional Pubs (RPI)	6.50%	6.50%↓	6.50%↓

Source Savills

Key Stats

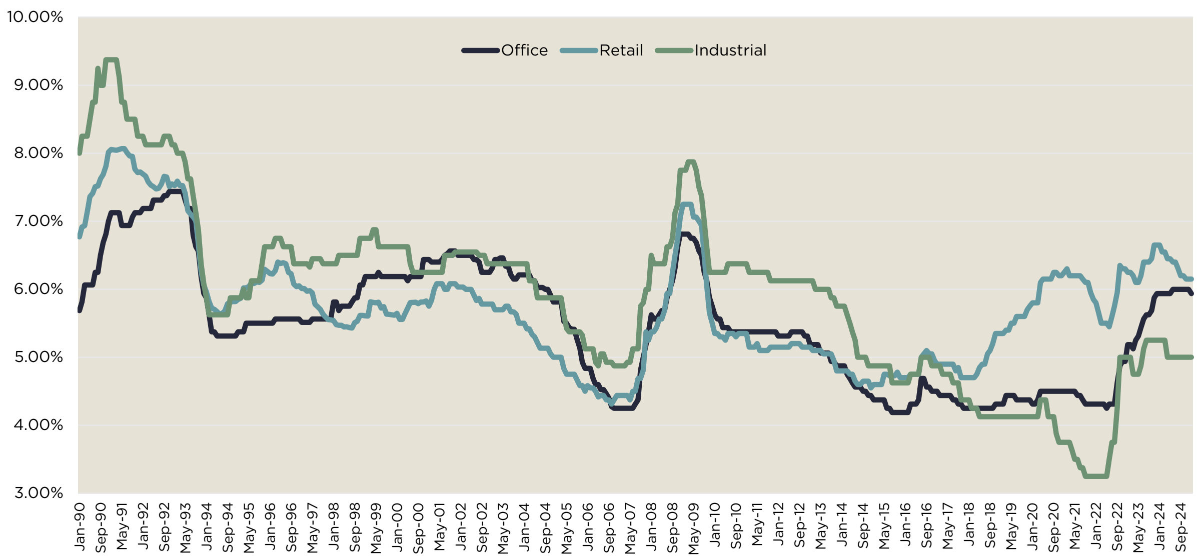
5.96%

The Savills All Sector Prime Yield at end January 2025

10

Number of sectors with a downward trend arrow for pricing

Prime yields have turned on retail and logistics. 2025 will see the office yield do the same



Source Savills

Time to buy offices?

Office investors have had a hard run in recent years, and views on the outlook for the sector remain highly polarised. The doubters point to the twin threats of accelerating technical obsolescence and working from home (WFH), and there is no doubt in our minds that both of these factors are relevant when considering an office asset.

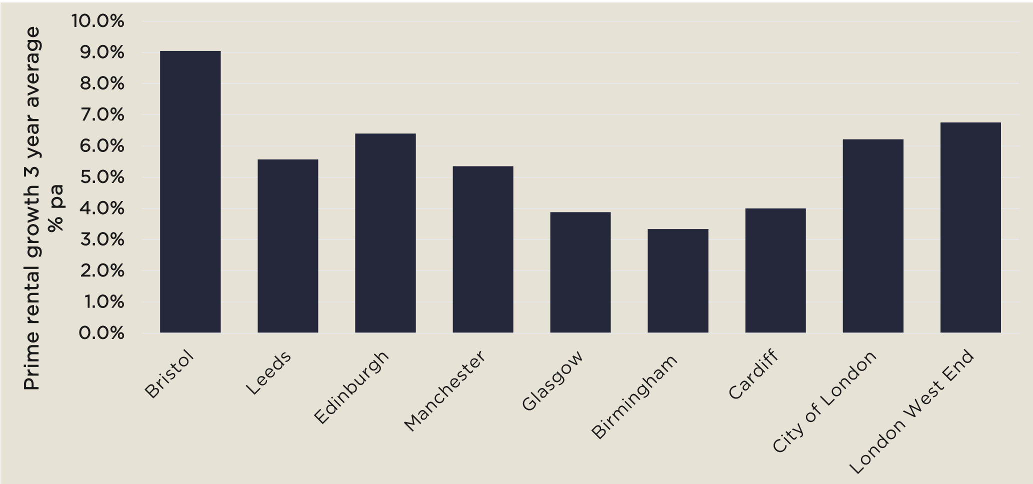
The pro-office camp would point to higher than normal levels of prime rental growth (see below), unnaturally restrained development pipelines, and a gently positive demand side outlook that is connected to the wider economic recovery.

Occasional WFH is here to stay, but we now have enough evidence to show that its impact on the demand for office space has been significantly less than some expected. For example, in central London, the current level of requirements is 23% higher than average, with 54% of companies looking for more space than they currently occupy.

The key question about the investibility of offices is whether tenants who want to move will find the space they need, and given the state of development viability at present, the answer for the next couple of years is a firm 'no'. The rental growth levels that we show below have been driven by a lack of supply, not booming demand, and we do not expect the lack of prime supply to change in 2025/6. Demand, however, should continue to improve in line with the economy (albeit at a slightly weaker rate than we had expected due to the hike in employers' National Insurance contributions that comes in this year).

All of this means that we enter 2025 with prime yields at historically high levels, and the prospects for rental growth accelerating. The buy signals are there, but so are the risks. Our tenant-rep teams are reporting that occupiers are more selective on both location and quality than they have been for years, and this means that forensic stock selection will be key.

Prime office rental growth has been strong over the last three years



Source Savills Research

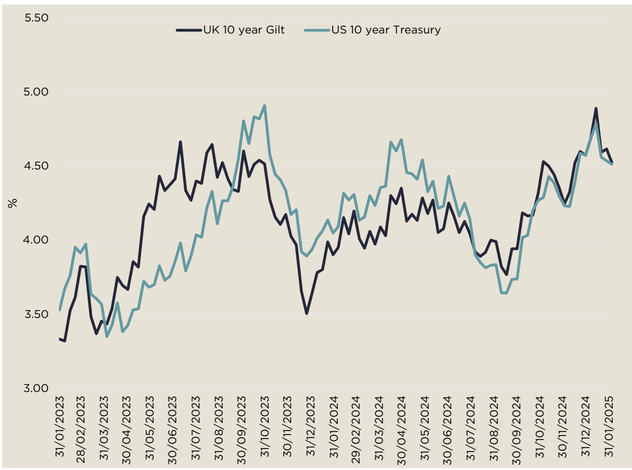
Will bond market turbulence derail the recovery in real estate values?

One of our overarching themes for the market in 2024 and 2025 was the prediction that the UK base rate would peak in 2024, and then fall from late 2024 onwards. With two interest rate cuts under our belts, this view still looked solid at the beginning of 2025, but the steady rise in the UK ten year gilt yield since then has suggested that the bond markets are either less convinced that base rates will fall than we are, or that they are taking an activist view on the viability of the new government's fiscal policy.

The chart on the right indicates why we are less convinced by the theory that the recent rise has been a vote on the new government, mainly because it seems unlikely that that would have an effect on the US Treasury yield! Indeed, it is probably more likely that the upward movement in US Treasuries (due to the expectation that US rates are not going to come down as fast as some expected) is having an effect on UK bonds.

So, what does all this mean for UK commercial property investment? The main impact is that this volatility has injected a new area of uncertainty into investors' minds, just at the time when we had been feeling a little more confident about the future. Vendors or purchasers who were poised to return to the market in Q1 2025 may well persuade themselves to wait and see for a bit longer, and this means that overall transaction volumes are likely to be a touch lower than our original forecast of £57bn for 2025. However, we still expect them to be up at least 10% on 2024, and we also still expect to see further cuts in the UK base rate over the course of both 2025 and 2026.

US and UK bond yields have moved in sync



Source LSEG

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