UK Commercial Market in Minutes
Final surge towards another record year?

October 2015

Yields static before strong fourth quarter

■ Yields for all sectors that Savills monitor remained static in the month of September, meaning that the average prime yield remained at 4.65% for the second month in succession.

■ Overall average prime yields have shifted 18bps inwards in the last 12 months and remain 14bps off their previous nadir of 4.51% which was reached in May 2007.

■ However, with the fourth quarter of the year traditionally the highest in terms of investment volumes the sheer weight of capital targeting UK real estate will mean there is scope for May 2007 levels to be reached once more.

■ Indeed a resurgent retail sector and UK institutional interest in SE offices is exerting downward yield pressure on these sectors

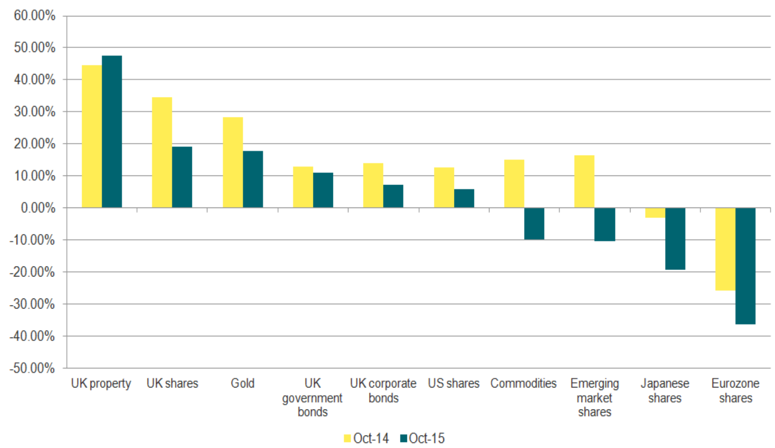
■ Whilst investors are wary of geopolitical shocks such as how the continued low oil price will impact oil dominated economies or the ongoing ramifications of the Greek bail out, it seems property as an asset class is confounding investor expectations.

■ This is illustrated by the Lloyds Bank Private Banking Investor Sentiment Index where UK property continues to be asset class of choice when it comes to investor sentiment. Indeed the index saw a 6 percentage point increase in sentiment in October, overall investor sentiment towards this asset class stands at 53%, far higher than the next highest, UK equities, at 24%.

■ The strong sentiment shown towards the sector should therefore mean that 2015 will be another record breaking year for investment into UK commercial property. By the end of the third quarter deal volumes have exceeded £50bn and should Q4 deal volumes reach the same levels as 2013 and 2014 then total investment volumes will top £70bn for the first time.

GRAPH 1

Investor sentiment favours UK property



Graph source: Lloyds Bank Private Banking Investor Sentiment index

TABLE 1

Prime yields

	Sep 14	Aug 15	Sep 15
West End Offices	3.25%	3.00%	3.00%
City Offices	4.50%↓	4.00%	4.00%
Offices M25	5.75%↓	5.00%↓	5.00%↓
Provincial Offices	5.75%	4.75%	4.75%
High Street Retail	4.75%	4.25%↓	4.25%↓
Shopping Centres	5.00%↓	4.25%	4.25%
Retail Warehouse (open A1)	5.25%↓	4.50%	4.50%
Retail Warehouse (restricted)	6.00%↓	5.50%	5.50%
Foodstores	4.25%	5.15%	5.15%
Industrial Distribution	6.00%↓	4.50%	4.50%
Industrial Multi-lets	5.75%	4.75%	4.75%
Leisure Parks	6.25%	5.25%	5.25%
Regional Hotels	6.75%	5.50%	5.50%

Table source: Savills

Policy interventions to impact regional markets

■ In the September edition of Market in Minutes we reported that close to 59% of investment activity took place outside of London last year and with the trend set to continue it is important to examine how recent policy announcements may impact regional markets.

■ Firstly key proposals of the Housing Bill were unveiled earlier in October. The key consideration relating to commercial real estate is that a temporary rule introduced in May 2013 allowing conversions of disused offices into homes without applying for planning permission will be made a permanent change – after almost 4,000 conversions were given the go ahead between April 2014 to June this year.

■ As well as being expanded to allow the demolition of office space the policy will also allow the conversion of light industrial space to residential. On the face of it this change should facilitate a dramatic surge in the conversion of un or under-used commercial space to much needed housing.

■ Historically there have been a large number of office buildings that were unsuitable for conversion, due to their construction or configuration. This will no longer be an issue, though the cost of conversion will still remain high, and we believe that it will only take place in locations where there is a substantial differential between the office and residential capital values.

■ This could in turn have a dramatic impact on rental growth and vacancy rates in both the secondary regional office and industrial markets as already constrained supply is removed from the market and occupiers compete for less better quality buildings, as demonstrated in graph 2.

■ Indeed, South East offices are expected to see rents increase by an average of 2.4% per annum until 2020 and industrials up to 3.2% over the same time horizon.

Business rates to stimulate growth?

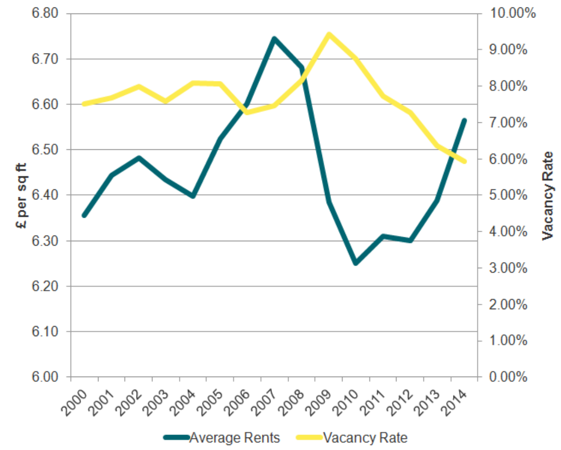
■ However a further twist to this initiative comes from the equally recently announced policy of allowing local authorities to set their own business rates, and to keep the proceeds from the rating system. This presents local councils with a real challenge - do they encourage the delivery of housing via the PDR system and potentially reduce their income from business rates, or do they seek to maintain or grow that income at the expense of housing delivery?

■ In all cases though the devil is in the detail and the impact on occupiers may not initially be beneficial as local authorities grapple with how to best apply the policy. Indeed, only local authorities with elected mayors can increase rates and even then they can only be in relation to infrastructure projects, such as Crossrail.

■ Moreover, as graph 3 demonstrates, business rates make an important part of UK tax revenues compared to other developed countries. We are therefore unlikely to see a regime where their importance is diminished.

GRAPH 2

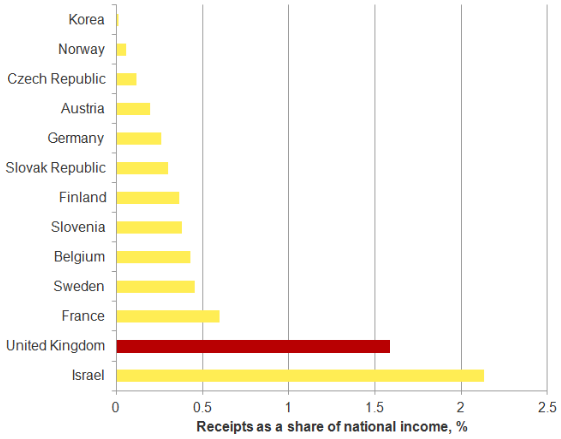
Industrial rents rising and vacancy rates falling



Graph source: Savills/PMA/IPD

GRAPH 3

Business rates as a proportion of GDP



Graph source: OECD

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