UK, Q4 2014

COMMERCIAL PROPERTY MARKET OUTLOOK

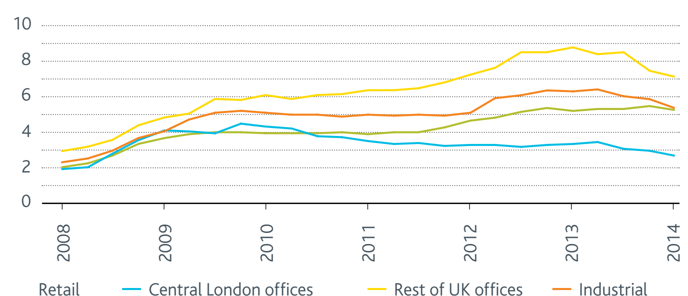
- Performance over the past quarter driven largely by yield compression.
- Some of the anticipated strong performance for 2015 may shift to Q4 2014
- Commercial property remains fairly priced, approximately 28% below 2007 peak
- Sheds may overtake offices as top performer in 2015

Market set to peak in 2015?
With the UK economy experiencing a rapid period of growth, investor appetite has shown little sign of slowdown. The volume of available stock is restricted by a reluctance of owners to sell into a rising market and this is adding to yield driven capital growth. We forecast that yield compression will continue into early next year, delivering exceptional All Property total returns of c.19% for 2014.

The significant yield spread which remains between property and bonds is adding to the overall attraction of commercial property. During Q3, overseas investors accounted for 43% of all UK purchases, rising to c.60% in London. Meanwhile UK institutions have doubled their market share to almost 20% of purchases in London since the start of 2014.

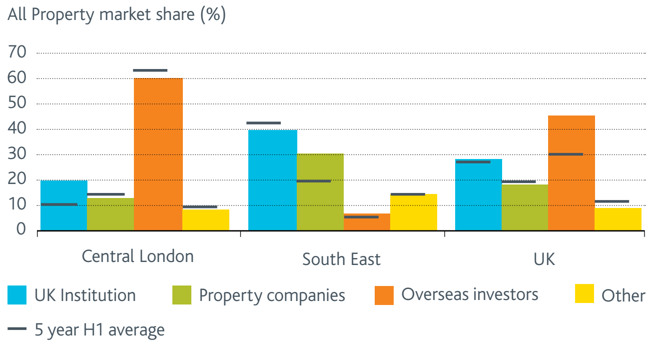
Recovery in best quality offices and industrials

Basis point yield gap (%)



Source: IPD, Cluttons

Overseas investors retain high market share



Source: Property Data, Cluttons

Prime Office Yields (%)

End of	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	Yield Outlook
West End – core	4.00	3.85	3.75	3.75	**3.50**	↘
West End – fringe	4.50	4.25	4.00	4.00	**4.00**	↘
City – core	4.75	4.75	4.50	4.50	**4.25-4.50**	↘
City – fringe			5.00	4.75	**4.50-4.75**	↘
South East (M25)	5.75	5.65	5.50	5.50	**5.50**	↘
Provincial City	6.00	5.75	5.75	5.50	**5.50**	↘

Source: Cluttons

The yield outlook arrows for each sector indicate the short term trends on pricing, with falling yields indicating capital growth.

Investor demand has started rippling out towards better regional office stock, especially those markets with strong supply demand fundamentals such as Leeds, Birmingham and Manchester.

Total returns from sheds are improving and are forecast to outperform offices in 2015, bucking the dominant trend of the office sector since 2009. Limited speculative development at a time of rising demand from internet retailers is attracting investors, especially in areas of strong supply demand fundamentals such as “The Golden Triangle” and the South East.

The yield compression that is taking place is in anticipation of stronger rental growth prospects going forwards, for office and industrial property in the best locations. By comparison retail rental growth is lagging, with any recovery confined predominantly to the wealthier towns.

Despite buoyant investment volumes and growing investor confidence, latest figures indicate a slowing in the wider economy. This is reflected in a lower PMI Index value for both manufacturing and business services.

However, property remains fairly priced against other asset classes and the strong returns forecast this year should maintain a healthy yield margin of c.400 basis points ahead of bonds and equities. Equities in particular have been subject to recent volatility.

According to IPD, capital values overall are still c. 28% off the peak levels of 2007 reinforcing the perception that the sector remains well priced at this point in the economic cycle.

Office

Offices still the strongest performer

Offices continue to be the best performing sector in the IPD Monthly Index, with latest annualised total returns (year on year to end September 2014) of 25.2% and capital growth of 18.4%. Central London continues to perform well, with diminishing availability leading to rental growth of 6.2%. The ‘ripple effect’ is demonstrated by a faster rate of capital growth improvement for south eastern (19.7%) and best regional offices, largely driven by investor competition leading to inward yield movement.

In the City, 103 Cannon Street sold for £17.2 million (4.6% NIY) and Woolgate Exchange for c. £320 million (5.1% NIY). In Midtown, 280 High Holborn achieved £86 million (4.3% NIY) and in Soho, 10 Great Pulteney Street achieved £57 million (4.4% NIY) and 52 Poland Street £26 million (2.5% NIY); although the latter had residential conversion and extension potential.

Investment in both the South East and regional city offices is growing. In Maidenhead, 80 Moorbridge Road sold for £6.9 million (5.7% NIY) with eight years unexpired, and 1 Piccadilly Gardens, Manchester sold for c. £75 million (5.7% NIY). If a prime building let to a top covenant with secure income over 10 years became available, a yield of 5.5% or lower is likely to be achieved.

Yields for good secondary offices in both M25 and major regional cities have similarly reduced in anticipation of rental growth. We are seeing investors looking actively at ‘value add’ opportunities, repositioning the asset through refurbishment in order to capture both rental and capital value growth. Currently Leeds has the strongest supply demand fundamentals of all the regional office markets, followed by Birmingham and Manchester.

With rental growth now extending beyond Central London, we are forecasting stronger 2014 total returns of over 23% for offices, up from 19% at the end of June.

Prime Retail Yields (%)

End of	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	Yield Outlook
Major high streets	4.75	4.50	4.50	4.50	**4.50**	↘
Very good secondary	6.25	5.75	5.50	5.50	**5.50**	↘
Shopping centres – dominant	6.25	6.00	5.75	5.50	**5.50**	↘
Shopping centres – good secondary	7.50	7.00	7.00	6.75	**6.50**	↘
Retail Warehouse – best open A1	5.15	5.15	5.00	4.75	**4.50**	↘
Retail Warehouse – best bulky goods	6.25	6.15	6.00	5.75	**5.75**	↘
Supermarket	4.75	4.75	4.75*	4.75*	**4.75***	↔

* Lower if geared to RPI

Source: Cluttons

Prime Industrial Yields (%)

End of	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	Yield Outlook
Best distribution	6.25	5.75	5.50*	5.50*	**5.25***	↘
Best SE industrial estate	6.00	6.00	5.75	5.75	**5.75**	↘
Regional Distribution	7.50	7.25	7.00	6.75	**6.50**	↘
Secondary industrial estate	10.00	9.50	8-11	7.5-10	**7.5-9.5**	↘

* Lower if geared to RPI

Source: Cluttons

Retail

Retail returns improving slowly, but not universally

Although consumer confidence has risen overall, and the high street property market has improved from the low point of the last property cycle, the recovery is confined to wealthier towns and a two-tier market is still with us. Latest indications are that the number of new shops opening in UK high streets dropped in the first six months of the year. Although retail sales are up, prices are down year on year and retailers' margins are continually being squeezed. The big supermarkets' market share is being attacked by Aldi and Lidl.

Examples of the stronger market include two deals at 97 and 130-137 New Bond Street where prices reflecting 2.1% and 2.5% NIY respectively were achieved in anticipation of rental growth. Also at 27/28 George Street, Richmond, a fund paid £5.85 million (4.68% NIY) which can be analysed to show 4.4% NIY on the shop and a higher yield for the upper parts. Similar yields were achieved at 111-112 High Street, Winchester and 52 George Street, Edinburgh.

In contrast, 2 High Street, Sheffield, let to Barclays until 2021 and sublet to Café Nero, is available at 7.5% NIY and ten years of income from Poundland, on a new lease in Gallowtree Gate, Leicester opposite Marks and Spencer is available at 7% NIY.

Yields have tightened by 0.25% over the quarter for the best retail warehouses. In High Wycombe, Next are taking a 25 year lease with RPI based uplifts, which presold at 4.5% NIY. However, yields are generally more stable for secondary, bulky goods parks, and Standard Life has recently seen 45% of external investors opting to leave its £800 million UK Retail Parks Trust, with several fund managers taking a cautious view on retail, and reducing their exposure to the sector. Similarly, supermarkets are less popular with investors, who see less scope for future rental growth unless backed by RPI increases, but yields remain stable.

We are forecasting stronger total returns of 14% for 2014, revised upwards from 12% at the end of June, mainly driven by yield compression.

Industrial

Yields continue to harden, driving capital growth

From the IPD Monthly Index, the latest year on year total returns from industrials have improved to 24.6% with capital growth rising to 16.3% on top of 7.2% income return. In the performance race, sheds have nearly caught up offices. This capital growth has been mainly due to falling yields rather than rental value growth (only 2.3%). With very little speculative development over the past seven years, coupled with an improving economy, there is a shortage of supply to meet growing demand from retailers servicing online sales.

Take up during Q1 and Q2 totalled nearly 16 million sq ft, well above long term averages, driven by distribution requirements, and around half of this figure was for Grade A stock. There is c.13 million sq ft of B1/B8 space under construction, most of it built to suit, rather than speculatively. This implies a growing supply demand imbalance.

Accordingly, investors are buying into future prospects for rental growth. The sector's lowest yields are achievable for modern distribution sheds geared to RPI. At One Park Royal, a 107,000 sq ft unit with 10 years unexpired at £11.75 psf, and five yearly reviews with uplifts between 0% to 3% pa sold to M&G for £22.6 million (5.25%NIY) and 17 years of BT income in Lutterworth with 3% pa annual uplifts achieved £45.4 million (5.1%NIY).

At Hinckley, a modern 98,000 sq ft unit let to a weak logistics covenant with 10 years unexpired sold at £7.78 million (6.47% NIY), which was 25 basis points better than asking price. In Milton Keynes, Stacey Bushes IE, a 1980's estate of 26 terraced units with 25% vacancy, sold for £9.2 million, reflecting 7.75% NIY or £43 psf capital value, having been marketed at £8 million.

Given the strong fundamentals for investment in industrials and the increased buying activity from property companies in particular, we are forecasting total returns of 22% for 2014, up from the 17% seen at the end of June. We are anticipating total returns for industrials to outpace offices during 2015 for the first time since 2009.

CLUTTONS

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