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COMMERCIAL PROPERTY MARKET OUTLOOK

- Slowing GDP growth and Brexit fears are leading to uncertainty and reduced property returns
- Commercial property remains fairly priced relative to other markets, especially 10 year Gilts
- Occupier markets are not over-supplied
- Rental income growth and asset management initiatives replace yield compression as the main drivers of performance

13.8%

Total returns in 2015

6.5%

Forecast total returns in 2016

Source: IPD

The commercial property market is cooling

After total returns of 19.3% (IPD 2014) and 13.8% (IPD 2015), the property market has undoubtedly slowed, and we forecast total returns to slow further to c6.5% in 2016, due to Stamp Duty changes (versus our pre Budget forecast of 7%) Returns should stabilise around this level in subsequent years to 2020.

This market cooling is due to a number of factors. The slowdown in China and other developing economies is reducing world growth. Also, political uncertainty in the Middle East and global debt are adding to volatility, especially in emerging markets. UK GDP growth has slowed since mid-2015, and if the government's latest, reduced 2% target is not achieved, our rental growth assumptions may be pared back. Outside Central London, rental growth remains patchy.

Also, the looming Brexit Referendum is fuelling uncertainty, and the Chancellor's reference to "storm clouds" gathering, in addition to Stamp Duty changes in the March Budget, may dampen investor sentiment going forward.

However, in spite of capital growth slowing, commercial property still remains fairly priced. The case for direct property investment remains strong, as long as buyers carry out appropriate due diligence. With 10 year Gilts at c1.5% and an IPD income yield of c4.8%, there remains a healthy positive yield gap of 330bp, in stark contrast to the 2007 market correction. This indicates that property remains fairly priced and a more stable asset when compared to the recent and ongoing volatility in equities and other markets.

Furthermore, occupier markets do not appear to be over-supplied. Although Central London looks fully priced, fuelled by record levels of overseas investment seeking a safe haven, it does offer rental growth prospects.

Elsewhere, there has been limited speculative development in recent years. Many office and industrial markets are undersupplied with good quality space relative to demand, which should lead to stronger returns than retail.

More generally, future performance from direct property investment will need to come from the fundamentals of rental income growth and exploiting asset management initiatives. For example, lease restructuring and refurbishment, where the supply and demand metrics show a profit can be realised with minimal letting risk.

With this in mind, many property funds are developing a more defensive mind-set, especially maturing pension funds with a growing need to match assets to liabilities. For these property owners, the emphasis going forward is likely to focus on securing leases for as long as possible to fundable covenants and ensuring that liquidity of individual assets remains high should sales be required at a later date.

Offices

Income growth fundamental to returns

With the latest IPD data showing total returns of 17.5% and capital growth of 12.2%, offices were the top performer over the past year according to the IPD Monthly Index. Around half the growth came from yield compression, the rest from income growth and rental values, with the latter being strongest in London. Total returns from City offices (19%) are just ahead of Midtown/West End (18.7%).

Prime office yields (%)

End of	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	Yield Outlook
West End – core	3.50	3.50	3.50	3.50	**3.50**	↔
West End – fringe	4.00	3.75	3.75	3.75	**3.75**	↔
City – core	4.25	4.00	4.00	4.00	**4.00**	↔
City – fringe	4.50	4.25	4.25	4.25	**4.25**	↔
South East (M25)	5.25	5.25	5.25	5.25	**5.25**	↔
Provincial City	5.25	5.25	5-5.25	5-5.25	**5-5.25**	↔

Source: Cluttons

The yield outlook arrows for each sector indicate the short term trends on pricing.

For Central London, we forecast rental value growth will remain positive at c6% in 2016, half the level achieved in 2015. Also, the trend will be for rental value growth to lessen further going forward, becoming close to nominal by 2019. The balance of supply and demand during the forecast period will be influenced by numerous factors, including rising building costs, the global economic cycle, a slowdown in China, a possible Brexit scenario, and the availability of bank finance.

It is worth highlighting that London's growth has been tempered by infrastructure constraints (such as housing, transport, schools, etc.) and it is still not quite clear to what extent this may influence future speculative office building activity. For now, approximately 44% of space under construction is pre-let.

Investment activity in Central London is dominated by overseas investors and key deals include 5 Fleet Place, EC4 (£145m, 4.5% NIY) and 14 St George Street, W1 (£121.7m, 3.5% NIY) with both sold to Chinese investors. UK buyer John Lyons Charity bought 46 Kensington Court, for £22.6m (3.4% NIY). It is let for 10 years with rental growth prospects.

Outside London, Manchester and Birmingham remain the most attractive regional investment destinations, with occupier demand improving and prime rents reaching £34 psf and £30psf respectively. Deals include Innovation Court, Birmingham (£20.5m, 5.25% NIY) and 1 Byrom Place, Manchester where 10 year income achieved 5.5% NIY.

M25 offices continue to have rental growth potential. For developers this is necessary in order for new schemes to remain profitable, given rising building costs. Recent deals include 121 Kings Road Reading (£9.275m, 5.9% NIY) and Cassini Court, Leatherhead (£6.1m, 6% NIY)

We forecast total office returns of 6.6% in 2016, with capital growth of 2.3% and rental growth of 4.3%. London and the South East should outperform.

Retail

Little growth outside prime

Retail remains the poorest property performer, with all retail delivering 8.7% total returns over the past year, with just 2.6% capital growth and a 5.9% income return. Outside Central London and a few preferred locations, rental growth has been negligible, and rental values have continued to fall in many secondary towns and pitches.

The gap between prime and secondary yields has continued to widen, with trade in more secondary locations being hit further. Margins remain squeezed as retailers' turnover is increasingly dependent on the sale of discounted goods. Online sales continue to undermine the need for stores except in the best locations. Even industry bellweathers like Marks & Spencer and Next have reported tough trading with sales down year on year.

This picture masks the fact that retail in most of Central London's main retail streets continues to show rental growth, and in James Street (Covent Garden) and Bond Street this has been spectacular, with international market leading brands driving rents to gain representation in the best existing and emerging pitches.

Prime retail yields (%)

End of	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	Yield Outlook
Major high streets	4.50	4.25	4.25	4.15	**4.00**	↔
Very good secondary	5.50	5.50	5.50	5.50	**5.50**	↔
Shopping centres – dominant	5.75	5.50	5.50	5.50	**5.75**	↑
Shopping centres – good secondary	7.00	7.00	7.00	7.00	**7.25**	↑
Retail Warehouse – best open A1	4.50	4.50	4.65	4.75	**5.00**	↑
Retail Warehouse – best bulky goods	5.75	5.75	5.75	5.75	**5.75**	↑
Supermarket	4.75*	4.85*	5.0*	5.0*	**5.0***	↑

* Lower if geared to RPI

Source: Cluttons

Prime industrial yields (%)

End of	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	Yield Outlook
Best distribution	5	4.75*	4.75	4.75	**4.75***	↔
Best SE industrial estate	5.5	5.25	5.25	5.25	**5.25**	↔
Regional Distribution	5.75-6	5.75	5.5	5.5	**5.5**	↔
Secondary industrial estate	6.75-9	6.75-8.5	6.5-8	6.5-8	**6.5-8**	↔

* Lower if geared to RPI or within M25

Source: Cluttons

Elsewhere, in Shoreditch, 15-29 Redchurch Street sold for £16.1m reflecting 3.40% NIY / 3.75% EY, well ahead of the £12.3m quoting price.

Examples of prime regional investment sales include 162-164 High Street, Cheltenham let to EE which is selling at £3.9m, 4% NIY and 42 George Street, Richmond at £2.675m reflecting 4.15% NIY.

Yields are also under pressure for Open A1 out of town retail. For example, Borehamwood Shopping Park sold for £104m (5.04% NIY) and Longwell Green Retail Park in Bristol sold for £12.6m (5.4% NIY). Despite this, better quality secondary solus units have sold well. For example, Homebase Bedford with 4 years income sold for £6.4m (6.81% NIY) and Wickes Bracknell with over 13 years income sold for £14.934m (5.75% NIY).

Supermarkets are now achieving 5% plus yields, unless they are well let and located in areas perceived to be prime. Amongst the few transactions, the Sainsburys in Benton Road, Newcastle with 26.5 years income with a 1.5% collar, sold for 4.8% NIY and the Waitrose in Crewkerne, Somerset, with only 13 years unexpired sold for £13.1m (5.05% NIY) rising to 5.75% in 2018.

> We are forecasting total returns of 4.8% for 2016, mainly driven by income return, with London and the South East to outperform.

Industrial/distribution

Rental growth ripples out across the regions

In the last year, the industrial/logistics sector has delivered a total return of 16.7% bolstered by capital growth of 10.1%, which was driven more by yield compression than rental growth. However, we expect the opposite is likely in 2016. This will be largely down to dwindling supply relative to demand.

The main factors affecting supply are limited stock, a lack of speculative development, planning constraints and, especially in London and the South East, competition for land from house-builders. With growing online demand, distribution has become the “new retail”, with the transfer of goods from shops to sheds to service domestic goods consumers, especially for same-day deliveries.

To illustrate this, we are aware of a rental uplift of 73% being achieved between 2009 and 2014 at rent review for a distribution unit in a London Zone 2 location. In contrast, for many northern UK locations, rental growth had been broadly static over the last five years. Over the past year, rental values for better stock grew nationwide, but more so in the South East, and investors have bought into this growth story.

Examples of strong prices, recently paid, include Bournemouth Aviation Business Park, where £23m (5.3% NIY) was paid for 20 year RPI income. Also, a 95,864 sq ft distribution unit in Gloucester, close to Junction 12 of the M5, let to a D&B 5A1 rated covenant, with 6 years unexpired. The unit was marketed at £7.3m and sold for £8m, reflecting sub 6% NIY.

Similarly, the new and speculatively developed and multi-let Letchworth Industrial Estate was marketed at £11.175m and was bought by Cresta Estates for £12.3m, reflecting 5.23% NIY.

However, in contrast to distribution, manufacturing production growth remains weak with volatility in global currencies and tough global trading hampering growth.

> We are forecasting total returns for the industrial sector overall of 7.5% in 2016, with capital growth of 1.9% and rental growth of 4%.

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