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Q3 2014

COMMERCIAL PROPERTY MARKET OUTLOOK

- Performance over the past quarter driven largely by yield compression
- Commercial property remains fairly priced, 31% below 2007 peak, with all offices -25%, all industrial -28% and all retail -36%
- Overall within the offices sector, Central London offices are still -4% below 2007 peak, although West End offices are up 5%
- As London becomes more expensive investor appetite for regional markets strengthens
- Sheds now competing with offices as performance leader

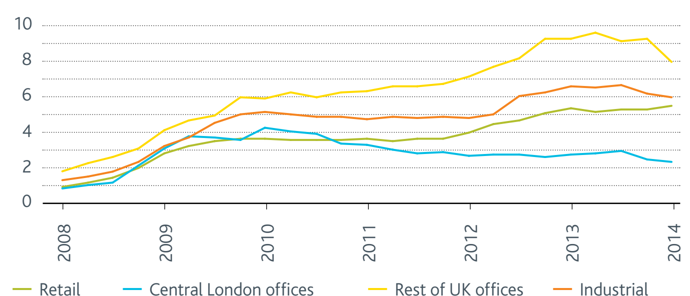
A good time to invest

Against a background of an improving UK economy, renewed investor and consumer confidence and continuing low interest rates, commercial property is looking attractive. Commercial property values are still c. 31% below the 2007 peak, which, combined with flat returns from other asset classes, especially bonds, means that the weight of money targeting commercial property is increasing.

Strengthening competition from buyers is compressing yields further, bolstering capital growth. This trend is likely to continue as the stock available is finite and some owners are reluctant to sell in a rising market, thereby exerting further upward pressure on prices.

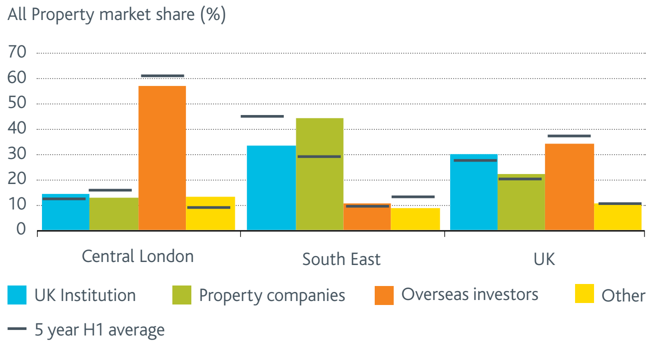
Best placed regional offices see sharp yield compression

Basis point yield gap (%)



Source: IPD, Cluttons

Property companies increase South East market share



Source: Property Data, Cluttons

Prime Office Yields (%)

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

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

The ripple effect of London's rising values continues to spread to the regions, leading to our all property total returns forecast for 2014 increasing to 15% from 12% at the end of March. This is due to yield compression, which is extending to regional offices and industrials in particular, with significantly lower yields achievable for better located secondary offices. This is now narrowing the gap between prime and secondary stock. Also, for the best offices, yields in major regional centres are now hardening and are similar to those of prime M25/South East offices. Retail continues to be the performance laggard.

Although rental growth has remained limited across most markets outside Central London and better parts of the South East, it is apparent that investors are anticipating greater rental uplift as rising business confidence is reflected in strengthening occupational demand.

Although now is a good time to buy, present levels of activity may be affected when interest rates start to rise, as current debt availability is less than in previous cycles. Also, an improving economy can lead to wage inflation which could affect how high interest rates may go, and, as a result, impact on both consumer and investor confidence. Ultimately for investors, the pricing balance will be determined by how rental growth prospects sit relative to rising interest rates. But that is in the future. Right now, the performance of commercial property is strong and offers returns well ahead of other asset classes.

Office

M25 and regional offices trending more strongly

Offices continue to be the best performing sector in the IPD Monthly Index, with latest annual total returns strengthening with capital growth rising to 16.3%. Although Central London continues to be the top performer, the ripple effect is demonstrated by a faster rate of capital growth improvement for South Eastern and best regional offices, largely driven by rising investor competition leading to inward yield movement.

In the City, 15 Bonhill Street sold for £63 million reflecting 4.7% NIY and in the West End, 14 Great Peter Street in Westminster achieved £32.4 million (3.6% NIY) and 33 Golden Square £23.5 million (3.24% NIY).

However, tenants remain cost conscious. Total occupation costs, including business rates, have led to 46 corporate tenants leaving the West End over the past three years heading eastwards, mainly to South Bank, Midtown and City fringes or outer London locations.

Investment in South East offices accelerated during Q2, with the weight of money forcing yields down for M25 offices. Meridien House, Watford sold for £19 million (5.9% NIY) with less than five years to break, and 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 prime regional offices in major cities have reduced, in anticipation of rental growth. Direct Line House in Manchester sold for £24.28 millions (5.6% NIY), with keener yields achievable for the best buildings with 10 years plus income from a strong covenant. Similarly, we are aware of secondary offices in Bristol, Manchester and Leeds all selling for prices well ahead of asking, so the secondary market in strong towns is now perceived to be offering good value, especially if there are residential conversion opportunities.

With rental growth in Central London now rippling out to best South East offices, we are forecasting stronger total returns of 19% for 2014 for offices overall, up from 14% at the end of March.

Prime Retail Yields (%)

	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	Yield Outlook
Major high streets	5.00	4.75	4.50	4.50	**4.50**	↘
Very good secondary	6.50	6.25	5.75	5.50	**5.50**	↔
Shopping centres – dominant	6.50	6.25	6.00	5.75	**5.50**	↔
Shopping centres – good secondary	7.75	7.50	7.00	7.00	**6.75**	↔
Retail Warehouse – open A1	5.25	5.15	5.15	5.00	**4.75**	↔
Retail Warehouse – bulky goods	6.50	6.25	6.15	6.00	**5.75**	↘
Supermarket	4.75	4.75	4.75	4.75*	**4.75***	↔

* Lower if geared to RPI

Source: Cluttons

Prime Industrial Yields (%)

	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	Yield Outlook
Best distribution	6.25	6.25	5.75	5.50*	**5.50***	↘
Best SE industrial estate	6.25	6.00	6.00	5.75	**5.75**	↘
Regional Distribution	7.75	7.50	7.25	7.00	**6.75**	↘
Secondary industrial estate	10.00	10.00	9.50	8-11	**7.5-10**	↘

* Lower if geared to RPI

Source: Cluttons

Retail

Retail improving, but still lags other sectors

Latest figures from BRC reveal that online shopping now accounts for 13.5% of all retail sales and pricing pressure from the internet is leading to huge price cuts, particularly on clothing and footwear, down 13.7% on last year. Whilst the high street has suffered from the impact of online retailing and insolvencies (La Senza being the latest), retail property values are recovering, albeit at a slower pace than the office and industrial sectors.

Overseas purchasers dominate investment in London's prime shopping streets. For example, two shops on Kensington High Street, let to Telefonica and The Kooples, with tenant break options in 2015 and 2016, sold for £8 million (4.1% NIY).

Increasing confidence, as a result of the broadening recovery in the UK economy, has led investment demand to focus on assets with rental growth potential. In Brighton, on the corner of North and West Streets, £8 million (4.9% NIY) was paid for 12 years of income and in Newbury, a prime unit let to Pret for 15 years sold for £1.6 million (5% NIY). Investors are also targeting the affluent London suburbs, with seven years of Gap income in Hampstead High Street selling for £4.4 million (4.7% NIY) and a small unit in The Quadrant, Richmond upon Thames, let to fashionable mother & baby brand JoJo Maman Bébé for a further seven years, selling at a price reflecting c. 4.75% NIY.

Yields have tightened by -0.25% over the quarter for retail warehouses, with Ignis buying the Leamington Spa Retail Park for £72 million (4.4% NIY) and The Link Retail Park in Thanet, Kent for £17.1 million (5.7% NIY).

Supermarkets remain popular with the Institutions, especially those with RPI increases. A Waitrose in Cardiff let for 20 years with fixed uplifts sold to F&C for £15.3 million (4.7% NIY) while a Waitrose in New Malden (Greater London) with 25 years and fixed uplifts, sold for £24.5 million (3.84% NIY) . Also, a Sainbury's in Spilsby, Lincolnshire, let for a further 15 years with RPI rent increases, has just sold for £3.6 million (5.5% NIY).

We are forecasting total returns of c.12% for 2014, with minimal rental growth outside Central London.

Industrial

Competing with Offices as performance leader

Over the past quarter, based on the IPD Monthly Index, the latest annual total returns from industrials have increased dramatically with capital growth rising to 13.8% on top of 7.5% income return. In the performance race, sheds have almost caught up offices. This capital growth has been mainly due to falling yields rather than rental growth (only 1.9%). With very little speculative development over the past six years, coupled with an improving economy and growing demand for online retailing, it is unsurprising that many buyers have increased their weighting in this sector.

The lowest yields are achievable for new distribution sheds geared to RPI. At Milton Keynes, 940,000 sq ft, prelet to Waitrose with 30 years unexpired and five yearly reviews with uplifts between 1.5% to 2% pa, sold to L&G for £114 million (4.6% NIY) and 25 years of Morrisons income in Sittingbourne with a 2% cap achieved £97.8 million (5.2% NIY). Even 15 year income to AirWair located between Northampton and Kettering, has achieved 5.75% NIY and 15 years to Saint–Gobain in Croydon achieved 5.5% NIY.

For estates, Slough Interchange has recently sold at £6.25 million (6.3% NIY), Meteor Park in Birmingham achieved £18.2 million (6.25% NIY) and the Bonhams unit with 14.5 years unexpired in Park Royal is believed to be under offer at c. £7 million (c.4% NIY) with a reversionary yield of 5% plus.

Given the strong fundamentals for investment in industrials and the increased buying activity from property companies in particular, we are forecasting total returns of over 17% for 2014 as the supply / demand imbalance persists.

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