UK, Spring / Summer 2015

COMMERCIAL PROPERTY MARKET OUTLOOK

- With an average income return of 6%, it's still a good time to invest in property
- With prime yields now stabilising across most markets, income growth is replacing yield compression as the primary driver of future performance
- Spectacular growth in Central London's fringe office markets
- 'Tricky' secondary property remains hard to sell across all market sectors

Income growth fundamental to returns

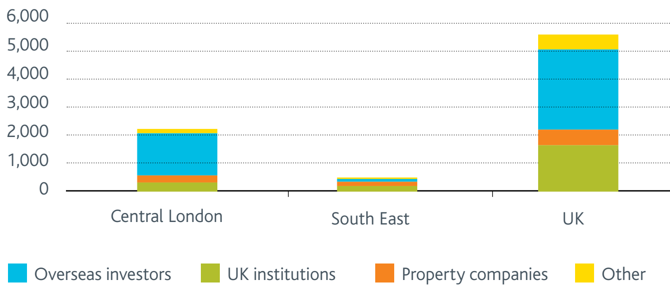
The last 12 months have seen a marked shift in the property market, powered by improved economic fundamentals which drive the underlying occupier base. The broad based improvement in economic growth, aided by low inflation, has seen improvements in both consumer and business confidence, which should lead to rental growth where demand outstrips supply.

These positive dynamics are showing themselves in the yields that investors are prepared to pay, with demand extending to markets and sub-sectors formerly considered off-radar. That said, the market is not universally buoyant. In London high land values underpin prices, but outside the capital, property values are more dependent on the core fundamentals of use, covenant and lease length. Given this, retail property remains the performance laggard, with generally flat rental value growth outside Central London and the weakest capital growth overall. Some high streets in secondary towns may be in terminal decline and never recover their former position. Returns from industrial property remain high, just above offices.

The prime Central London market, whether office or retail, remains a special case. Given economic and geo-political uncertainty in the Eurozone and beyond, prime assets are expected to retain their status as a preferential home for overseas capital. However, we expect this capital will continue its migration beyond the "super prime" core over the coming year. The structural shift in the dynamics of Central London's Fringe markets has seen an eclectic

All property investment by area

Q2 2014 – Q1 2015



Source: Property Data, Cluttons

Prime office yields (%)

End of	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	Yield Outlook
West End – core	3.75	3.75	3.50	3.50	**3.50**	↔
West End – fringe	4.00	4.00	4.00	4.00	**4.00**	↔
City – core	4.50	4.50	4.25-4.50	4.25-4.50	**4.25**	↔
City – fringe	5.00	4.75	4.50-4.75	4.50-4.75	**4.50**	↘
South East (M25)	5.50	5.50	5.50	5.5-5.25	**5.25**	↔
Provincial City	5.75	5.50	5.50	5.5-5.25	**5.25**	↔

Source: Cluttons

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

mix of occupiers willing to pay rents at levels which were previously the preserve of the core, driving total returns of c30% achieved in 2014, which are unlikely to be repeated.

Looking ahead, inflation is expected to remain low for the remainder of the year, moving into deflationary territory for a while, with an upward move in base rates likely to be deferred until 2016. This expectation is seen in exceptionally low gilt yields and Swap rates, with the 10 year gilt currently sitting at c1.47% and 10 year swap at c2.02%. Sporting an average income return of 6% (IPD Monthly Index) over the past 12 months, property will maintain its investment appeal. We forecast an average all property total return of 11.7% in 2015.

While competition from buyers will continue to exert upward pressure on prices for those assets with robust underlying fundamentals, we expect close to half of the performance to be derived from income, compared to less than a third in 2014.

Office

Central London fringes take front stage

With total returns of 22.9% and capital growth of 16.8%, offices have just pipped industrials in the performance league, according to the latest IPD Monthly index. However, this masks the fact that Central London and the fringe markets in particular continue to out- perform. Supply in the capital has reduced with net absorption doubling over the past year.

The fringe markets were initially viewed as an affordable central option by the TMT sector, but more recently have been joined by a fusion of sectors including traditional professional services firms. The pressure of demand, and growing appeal due to future Crossrail stations, has driven spectacular rental growth. For example, in Clerkenwell, at 145-157 Farringdon Road, lettings were achieved on newly refurbished space in the same development at £52.50 psf in June 2014, £57.50 psf in October 2014, with the latest current letting achieving £62.50 psf; a rise of 19% in 9 months. We are aware of similar increases in Goswell Road and other locations, including Shoreditch which have risen by 23% over the past year. So it is unsurprising that, combined with yield compression, London's northern fringe submarkets have produced year on year total returns in excess of 30%. This structural shift in rental values has narrowed the gap with core City which stands at £65-£70 psf

Few investments have been sold in the City this quarter, although on the South Bank, 1 America Street / 29 Great Guildford Street sold for c£30m (4.8% EY with an imminent rent review). In the West End, 1 Chapel Place sold for c£59m (3.6% NIY) and a record price of c£262m, or £2,250 psf was paid for 6 St James's Square.

Outside London, occupier demand is improving in most locations. In Bristol, Birmingham, Leeds and Manchester in particular, strong demand for quality space is matched by a diminishing supply. Hardman Square, Spinningfields, Manchester sold for £91.7m, (5.8% NIY), while in the Thames Valley, Grenfell Island, Maidenhead, achieved £90.2m (5.9% NIY) and Wytham Court in Oxford sold for £4.61m (6.15% NIY).

We are forecasting total returns of 14% for 2015 for offices overall. While London is still expected to outperform we do not forecast a significant difference between regions, reflecting the underlying drivers described above.

Prime retail yields (%)

End of	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	Yield Outlook
Major high streets	4.50	4.50	4.50	4.50	**4.50**	↔
Very good secondary	5.50	5.50	5.50	5.50	**5.50**	↔
Shopping centres – dominant	5.75	5.50	5.50	5.50	**5.25**	↔
Shopping centres – good secondary	7.00	6.75	6.50	6.50	**6.50**	↔
Retail Warehouse – best open A1	5.00	4.75	4.50	4.50	**4.50**	↔
Retail Warehouse – best bulky goods	6.00	5.75	5.75	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	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	Yield Outlook
Best distribution	*5.50	5.50*	5.25*	5.25	**5.0-5.25**	↘
Best SE industrial estate	5.75	5.75	5.75	5.75	**5.50**	↘
Regional Distribution	7.00	6.75	6.50	6.0-6.5	**5.75-6.5**	↘
Secondary industrial estate	8-11	7.5-10	7.5-9.5	7.5-9.5	**6.75-9.0**	↘

* Lower if geared to RPI or within M25

Source: Cluttons

Retail

Retail stable, but lagging the market overall

Apart from the London 'hotspots' a two-speed market persists, with latest IPD performance results showing flat retail rental growth at a national level and capital value growth falling below 1% over the past 3 months. Despite rising sales volumes, prices remain static. Secondary towns and retail pitches continue to struggle, with some landlords biting the bullet and agreeing to lease renewals at lower rental levels in order to preserve income.

This picture masks the fact that retail in Central London remains strong, with international market leading brands driving rents to gain representation in the best pitches. With historical low yields in play, overseas investors dominate the market, accounting for 55% of transactions by value in the 12 months to the end of March. Recent sales include the Rolex unit at 100 Knightsbridge at £22m (1.7% NIY), a mix of occupiers including NatWest Bank at 55-61 Kensington High Street for £19.6m (2.84% NIY) and the J Crew unit at 19 Marylebone High Street for c3% NIY.

The key prime regional investment transaction of the quarter was the sale of 1-17 Spurriergate, York let to Zara and other multiples at £36m (4% NIY). In contrast, we now believe some towns to be ex-growth and require much higher yields in order to sell. At 69/71 New Street, Huddersfield, Boots renewed its lease for a 5 year term at a rent 40% below the previous rental level. The investment was subsequently sold at 8.65% NIY.

Yields have remained flat for out of town retail. Aberdeen Asset Management acquired the Next unit at Hedge End, Southampton, with 20 years unexpired for £31m (4.4% NIY) and Blackrock bought Staples Corner for £59.6m (5.9% NIY).

Supermarkets are seeing diminished investor interest, especially where rent reviews are pegged to market rents and yields are softening. However, yields remain stable for 20 year, inflation backed income, as evidenced by the purchase of the Morrisons' sale and leaseback portfolio of stores in Reading, High Wycombe and Darlington at c£100m (4.35% NIY overall) by Aberdeen Asset Management and USS.

We are forecasting total returns of 9% for 2015, mainly driven by income return, with standard retails in London and the South East significantly outperforming the rest of the market.

Industrial

Yields fall with rental growth in best locations

The industrial sector has delivered a total return of 22.7% (IPD, March 2015) bolstered by capital growth of 15.1%, driven primarily by yield compression. As we forecast last year, sheds have closed the gap on offices. Prime logistics take-up has improved over the past year, driven by manufacturers (especially in the automotive sector) and retailers with supply constraints in key locations.

With low Gilt and Bond yields, more Life, Pension and Annuity Funds are seeking long dated secure income to match liabilities. Reflecting this, L&G recently paid £68.5m for a 702,500 sq ft development in Doncaster, pre-let to Next for 25 years with annual RPI linked uplifts.

With limited land supply especially in London, investors are buying into future prospects for rental growth or for relocating occupiers. At Wembley, Cargiant paid £38m (4.1% NIY), while Waterway Park, Hayes is under offer, ahead of the asking, at a price believed to be in the region of £24m (5.2%NIY) and Skyline 120 in Braintree, Essex, sold for £17.9m (6.2% NIY).

Sales of more secondary estates include Milford, Reading, at £4,344m (6.75% NIY) and a South East portfolio of estates in Worthing, Ashford, Princes Risborough, Luton and Swanley for c£19m (7.4% NIY).

Investor interest in forward funding opportunities is growing. Apart from the strong supply/demand fundamentals aided by supply shortages due to a lack of speculative development in recent years, the case for investment in the industrial sector is helped by low obsolescence and the squeeze on land supply from higher land value uses. This is especially the case in London and the South East. We are forecasting total returns for the industrial sector overall of 14.2% in 2015.

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