The Continued Ascent

Traditional Property Drivers Push Market to Recovery

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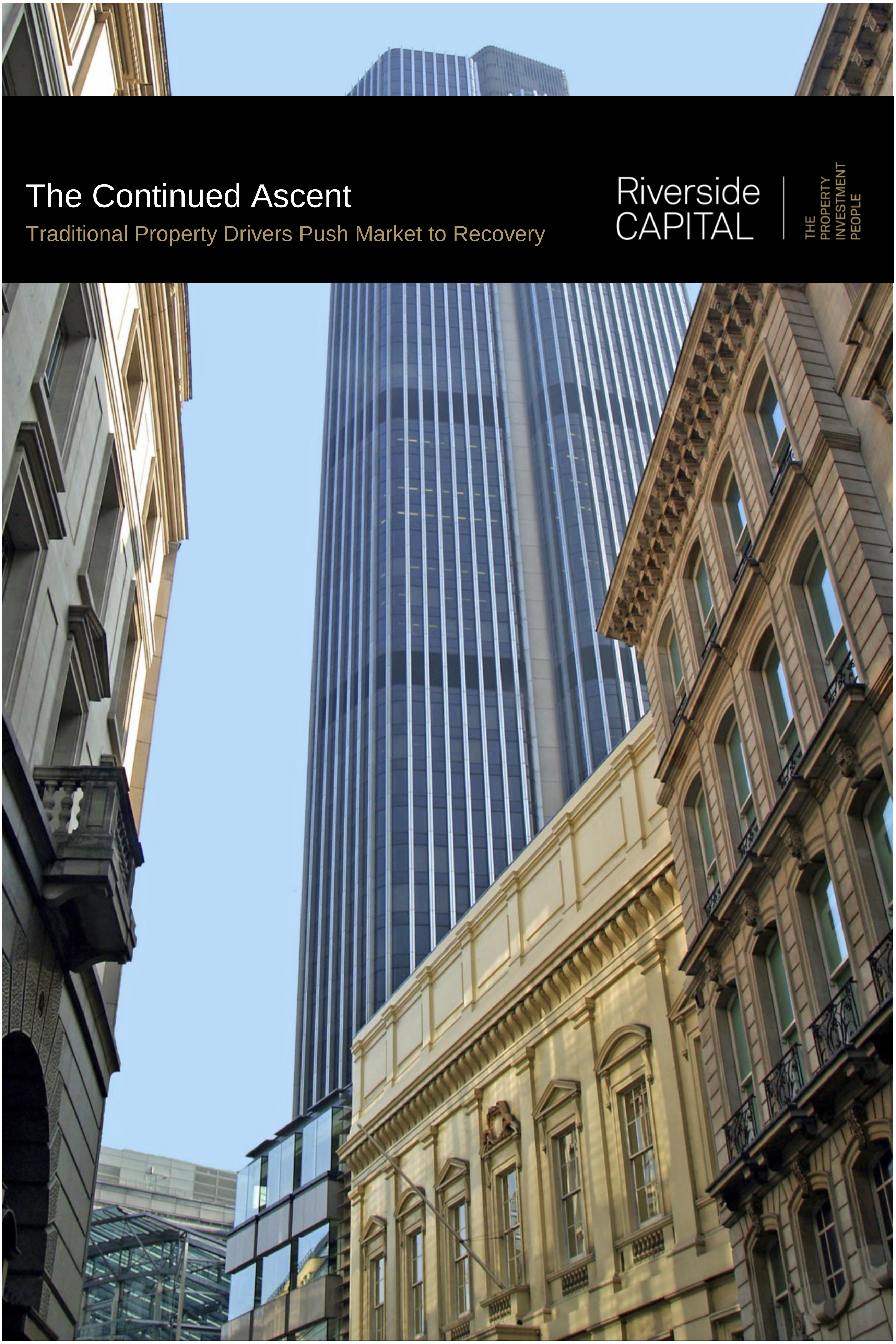

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Traditional Property Drivers Push Market to Recovery

The latest IPD figures show a slight moderation in returns, which may be symptomatic of the traditional summer slowdown. Commercial property values in the UK rose by 0.9% in August, slightly less than the 1.1% growth seen in July. In addition, the monthly rise in values fell back below 1% for the first time since April 2014; but the recovery that began in May 2013 is still continuing, albeit at a moderating pace.

UK commercial real estate returned 1.4% for the month, with income return standing at 0.5%. This compared unfavourably with the performance of other asset classes in August, with bonds returning 2.8% and equities 2.0% (JP Morgan 7-10 year/MSCI UK). This was the first month in which both bonds and equities have outperformed UK commercial real estate since July 2013.

Phil Tily, Executive Director & Head of UK and Ireland, IPD, said: “The August figures confirm that the UK commercial property market is easing back a little in terms of rates of growth, but this remains a strong market buoyed by positive investor sentiment.”

According to the IPD UK Monthly Property Index, values have now risen by 12.8% over 16 months of consecutive growth, although overall they are still nearly 30% below the peak levels of 2007.

Yield adjustment remained the principal driver of rising values across the country. In August yield compression added 0.9% to values across the UK market as a whole.

The average UK equivalent yield of 6.7% at the end of August compares to its recent highest position of 7.5% in May 2013, but is still well above the level of 5.4% registered at the height of the boom in February 2007.

A rise in interest rates is expected early in 2015 and this will more than likely take some of the momentum out of the market. However, as evidenced by the continued inflows of capital into the UK property market, the underlying market sentiment for commercial property is currently strong with both domestic and international investors.

Historically, income has been the key component of total returns and going forward we see no change here. The continuing strength of investor demand for UK property is being underpinned by a solid rental market, with market rental values still rising in August, albeit by a moderate 0.2% for all property. For the market as a whole, rental values have now risen continuously for 13 months.

The last few years have seen returns driven by yield compression (large inflows of money has seen prices go up) however, now we are seeing evidence of strong occupier demand helping to support rental growth.

The office market has been a major beneficiary of the economic recovery and improving business confidence. Companies are now more comfortable making long term plans for growth. In a report issued by DTZ in August, office occupancy figures showed availability continuing to fall as economic confidence returns and this now stands at 25% below the same point last year and over a third lower than ten years ago.

On top of increased occupational demand we are also seeing a significant increase in the number of office buildings being removed from the market and earmarked for conversion into residential use. There was a 500% increase in office to residential planning applications in the second half of 2013 after the new rules came in to force.

At the moment, conversions undertaken within the new rules need to be completed by May 2016; however, the government is now seeking to extend this to May 2019. More importantly, whilst Central London is currently largely exempted, new proposals would remove these exemptions, increasing the opportunities for converting offices in Westminster, the City and surrounding boroughs to high end residential use.

Decreasing choice for tenants is leading to an increase in pre-completion lettings and driving up rents, as well as take-up outside the traditional City and West End boundaries. This reflects a welcome return to the traditional drivers of commercial real estate growth, increasing income due to rental growth as well as capital growth, a trend we see continuing into 2015 and beyond.

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