

F&C UK Property Fund

UK commercial property outlook – September 2015

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The drivers of capital values – is rental growth the next stage of the cycle?

Executive summary

- A well-established property market recovery has seen capital values move up strongly
- So far, the increase has been largely fuelled by investor demand pushing yields lower
- Rental growth is now starting to exert more of an influence, especially for offices and industrials and it is broadening beyond the capital
- We expect to see rental growth come into greater prominence in supporting capital values over the medium-term

The UK commercial property market recovery is now well-established. A stronger economy has helped support performance and capital values have risen in response.

The pace of change has varied, with a slight reversal during the Eurozone crisis of 2012, but recently capital values have moved forward at close to 10% per annum¹. There have also been wide variations by sector and region. So while West End offices, for example, have seen capital values exceed the pre-crisis peak, other parts of the market, although recording positive growth, are still registering capital values well below their pre-2007 levels². It is a very mixed picture.

To date, much of the improvement in capital values has been down to an inward shift in yields. This in turn has reflected strong demand from a wide range of investors for UK commercial property. This inward yield shift has occurred pretty much across the board – all sectors, all regions and for both prime and secondary stock. The demand for

Annual rental growth – industrial sector



Key: Green >2%, orange 0-2%, red <2%.

Source: IPD Quarterly Digest June 2015, BMO Real Estate Partners.

stock has led to yields in some parts of the market touching very low levels – this is particularly the case in London, driven often by overseas demand.

Property still remains attractively priced against gilts, however at some point the gap may erode and with gilts at very, very low levels, the scope for capital values to be boosted further by yield shift alone may be limited.

The property market cycle may have been investment-led, but the occupational market is also seeing something of a turnaround. Rental growth was badly hit during the recession with rental values falling some 9%².

London has led the way and Central London shops and offices have seen rental growth since 2010. Elsewhere, it has taken longer for the improvement in the nation's fortunes to encourage occupiers to take new space and for rental growth to re-emerge.

The South East office market was the first major non-London sub-market to move into positive growth, back in 2012, and it has maintained that path since then, recording a rental advance of more than 8% over three years¹. Office rental growth has been muted on average and uneven, but winners have included Brighton, Bristol and Cambridge with rental growth of more than 5% in the year to June 2015³. The industrial market returned to growth in 2013 with all regions having recorded positive rental growth for three consecutive quarters to June 2015².

This leaves retail property. Here rental growth has been patchy outside Central London. There is still rental decline in some weaker centres and some large cities too, but there are a few bright spots, such as Winchester, Guildford and York, as well. Retail still faces significant challenges from online and in the well-publicised grocery sector. There are too many retailers chasing a limited, albeit improving, sales market but with the rise in real earnings coming through, the consumer is now better positioned to boost sales. Despite these headwinds, data from Colliers shows retail rents stable or rising in 89% of retail locations in the year to end-May 2015⁴ and with the industry consensus pointing to rental growth of the order of 2.7% per annum over the five years to 2019⁵.



“Since 1981 rental growth in Basingstoke offices has been below 1% per annum compared to 4% per annum in Cambridge – the importance of town and stock selection.”

There may be scope for some further uplift in values from yield shift, but momentum is shifting towards rental growth as the driver behind capital value growth. Rental growth is broadening but it is not ubiquitous. This implies a renewed, and probably welcome, focus on the fundamentals of supply and demand in the occupier market supporting a property's performance. We believe that prime property in established locations offer the best prospects for out-performance. The quality and length of the income stream and a building's attractiveness to a wide range of occupiers is critical and superior stock selection is key.

¹ As at 30.6.15 source: IPD UK Quarterly Digest Q2 2015. ² Source: IPD UK Quarterly Digest Q2 2015. ³ Source: IPD Quarterly Key Centres Q2 2015. ⁴ Source: Colliers International Midsummer Retail Report 2015. ⁵ Source: Investment Property Forum UK consensus Forecasts August 2015.

Past performance should not be seen as an indication of future performance. Stock markets and currency movements may cause the value of investments and the income from them to fall as well as rise and investors may not get back the amount they originally invested.