RESEARCH

UK MARKET OUTLOOK MAY 2014

REGIONAL OFFICES IN THE CROSSHAIRS

On Twitter the Estates Gazette editor last week noted that based on column space, regional property appeared to be drawing more interest than central London. This concurs with the experience of Knight Frank's research department, which is fielding more and more requests for data and analysis on regional office markets. The fortunes of the regions have turned, but can the momentum last?

The market in a minute

Prime regional office yields down 90 bps on a year ago*

UK economy grew by 0.8% in Q1

Investment volume y-t-d was £12.7 bn, vs £12.9 bn for same period of 2013**

Regions account for 59% of investment volume this year**

* Based on Knight Frank's Yield Guide.
** Based on Property Data figures

The case for regional offices is strong. Let us start with economic indicators.

The regional breakdown of Markit's UK PMI business activity index, shows the economic recovery firmly established outside of London. The convention of the index is that a reading of over 50 equates to growth, and all of the UK regions have been above 50 for the last ten months.

Turning to property market indicators, regional property has accounted for the majority of investment in the UK this year, which is the first time since 2011. This owes much to the rebound in buyer interest in industrial, a strong sector in the last six months. In contrast, the regions in 2014 have accounted for just 28% of investment in offices, with London still dominating.

However, Knight Frank's latest ROMP report showed the ten leading regional cities had their best Q1 for investment volume since 2010, with deals totalling £735 m. Moreover, prime yields for regional city centre offices have hardened by 90 bps in the year to May. This leads us to believe that the larger regional cities are now in vogue with investors who have drawn confidence from the strength of the UK economic recovery, and are viewing the gap between regional and central London yields as an arbitrage opportunity.

There are compelling reasons for buyers to continue targeting regional offices. Prime yields for most of the major centres are 75 to 100 bps higher than their Q1 2007 level, although this ignores the very different interest rate environment in 2007 compared with today. Benchmarking office yields against ten year Gilts – which stood at just over 4.8% in Q1 2007, compared to around 2.6% today – highlights the opportunity.

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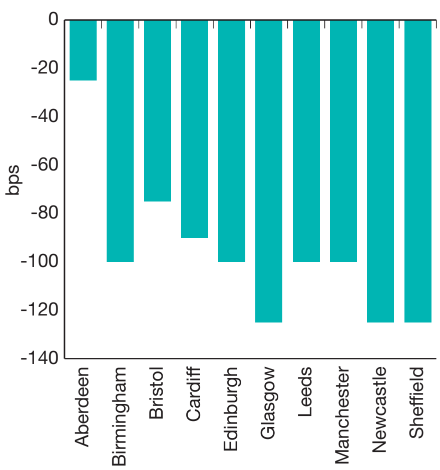
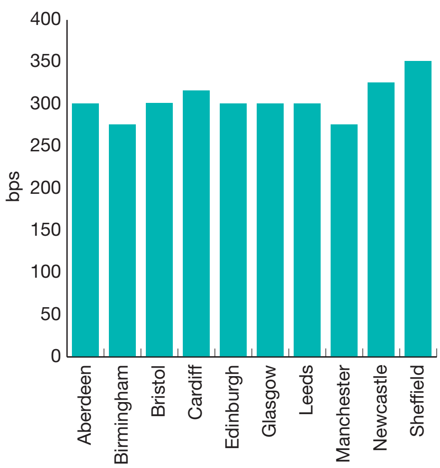
FIGURE 1
Office yields
Discount to 10 yr Gilts Q1 2007



Source: Knight Frank / FT

FIGURE 2
Office yields
Premium over 10 yr Gilts Q1 2014



Source: Knight Frank / FT

The cities covered by our ROMP report are presently offering a premium of between 275 and 350 bps over the ‘risk free’ option of Gilts. This is in marked contrast to the 2007 situation where prime office yields were below Gilt yields, which demonstrates the difference in pricing today compared to the top of the last cycle.

So given the upbeat picture, why has this note begun by asking whether momentum can be maintained? The answer is stock and liquidity. The ten cities covered by ROMP have a combined office stock of 138 m sq ft, so average out at just under 14 m sq ft per city, compared to 220 m sq ft for central London. Development activity in the regions has unsurprisingly been sporadic since 2007, which means the stock of prime or even ‘nearly prime’ assets has been dwindling.

Investors could move beyond those ten leading business centres to secondary regional cities, but this becomes a braver move. These are the markets we would expect to lag the recovery, and where liquidity becomes more of an issue, given they are significantly smaller cities. Moreover, the trend in many advanced economies is for second tier cities to become almost ‘super suburbs’ for the larger urban centres, making retail, leisure and distribution perhaps better options for the property investor.

Consequently, the key regional city centres could see rapid movement in prices, coupled with an equally speedy run down in available stock for sale. This does not mean they will shut down as markets, but investors could quickly find themselves in a situation where they have to consider asset management, short income, fringe locations, and development.

All of these options require rental growth (or the expectation it is coming), and freer availability of finance. This is where concern over continued momentum looms large, as a move into asset management and development requires investors to speculate on the cycle running its normal course. On current sentiment and economic news it is easy to see the normal cycle scenario playing out, but the last six years have been far from ‘normal’ in the property market. If investors become nervous again about the outlook, and do not target lesser quality regional assets, then expectations for pricing of prime assets will need to move upwards.

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