Investment, Development & Occupational Markets

Knight Frank

M25 Offices

Q1 2020

knightfrank.co.uk/research

KEY TAKEAWAYS

1

Take-up in the SE was 37% below the 10-year average and 26% less than at the same point in 2019.

2

The vacancy rate is low indicating oversupply post crisis is less likely.

3

Headline rents were unaffected in Q1, but will soften in the coming months.

4

Q1 Investment volumes were 55% ahead of the long term average.

5

Prime yields were unchanged at 5.00% although sentiment weakened before the end of the quarter.

EXECUTIVE SUMMARY

Covid 19 impedes occupier activity in Q1

With political unrest seemingly behind us and a solid Conservative majority in place, 2020 was meant to herald a period of relative calm meaning reassured firms would be able to enact both short and longer term occupational strategies. However, the global spread of Covid-19 and containment measures imposed, has quickly reversed optimism, altered business focus and hindered transactional ability – albeit in the closing stage of Q1.

Subsequently, take-up in the first quarter was low at 508,000 sq ft, 37% below the 10 year average and 26% less than recorded during the same period in 2019. This is the lowest quarterly take-up since Q2 2011, a period which coincided with fears of a double dip recession in the UK and debt default in the Eurozone. During the quarter, 36 deals completed, 16 fewer when compared with the 10-year quarterly average. Notably, the number of deals below 10,000 sq ft was 50% down, reflective of smaller businesses withdrawing requirements from the market or preferring shorter term, flexible solutions.

Oversupply less of a risk post Covid 19

A comparison with the last economic shock, the Global Financial Crisis (GFC), identifies a very different supply picture currently in South East. In 2008, vacancy in the South East was 7.9% at the onset of the crisis compared to 6.3% today. Between 2009 and 2010, 2.6m sq ft of space was delivered through the pipeline which, coupled with some tenant release space, fuelled a rise in vacancy to 10%. Today, completions scheduled for 2020 and 2021 amount to 1.4m sq ft, of which just 1m sq ft is speculative. This means that although vacancy is expected to breach 7% in 2021, because demand has slowed at the same time as supply, any market imbalance may not be as pronounced. Inevitably, the supply side provides some reassurance, but identifiable occupier demand will be key for developers.

Financial terms largely unaffected for now

Headline rents were unmoved or marginally up in some key centres, with rent free concessions also unchanged at 12-15 months for each 5 years committed. Expectations are that Q2 could see this position shift however, as pressure on landlords to aid cost reduction intensifies and lease flexibility is in greater demand.

Strong Q1 results mask difficult investment conditions ahead.

Investment volumes for the South East in Q1 2020 totalled £997m, 55% ahead of the long term average and the strongest Q1 for 15 years. Three business park transactions exceeding £100m bolstered numbers, with the largest being the sale of Building 7, Chiswick Park for £312m. Interestingly, this sale attracted over £1.5bn of bids from a number of overseas investors, thus demonstrating the breadth of interest and confidence in South East offices at the start of 2020.

UK Councils spending continues

UK council spending continued in Q1, with £47m committed across three deals. Although this represented only 5% of turnover for the quarter, these latest acquisitions meant that total spending between 2017 and 2020 by local authorities rose to £2bn. The subsector now represents 21% of investment volumes, meaning councils are the largest buyer group over this period. Whilst there remains some concern that this spending will be curbed in the mid-term, we believe ease of access to cheap debt may mean that local authorities are best placed to take advantage of opportunities that will arise in the short term.

Pricing to polarise?

Prime yields were unchanged at 5.00% in Q1, although some outward yield shift is anticipated over the next three months. Even so, previous market downturns have resulted in a flight to quality, both in terms of income and property fundamentals. As a result, we expect to see the best assets seeing the least outward movement. Secondary or higher risk assets, where there is a need for refurbishment and re-letting could see the largest correction, although the size of any shift maybe mitigated by the scale of interest from opportunistic buyers, particularly for buyers in core markets.

OCCUPIER MARKET

Leasing volumes in the South East fell well short of the 10-year quarterly average as Covid 19 forced firms to a defensive position. Business will now take time to evaluate what the pandemic will mean and how this will impact real estate strategies.

SOUTH EAST TAKE-UP

508k sq ft

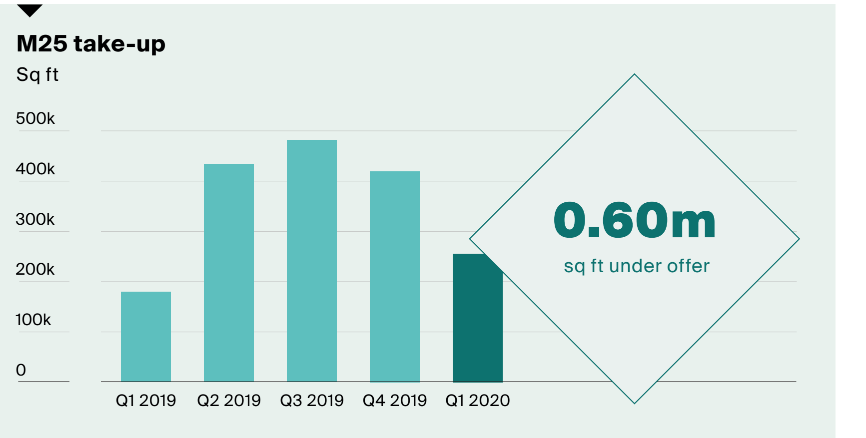
▼ -29%

40 Clarendon Road, Watford – part let to PWC

Take-up and supply
Q1 2020

	TAKE-UP (SQ FT)	TAKE-UP (VS Q4 2019)	SUPPLY (SQ FT)	SUPPLY (VS Q4 2019)	VACANCY RATE
M25	255,621	▼ -39%	6.9m	▲ 11% New and Grade A space: 78%	5.7% New and Grade A space: 4.5%
M3	175,214	▲ 37%	2.5m	▲ 3% New and Grade A space: 82%	6.5% New and Grade A space: 5.3%
M4	268,996	▼ -37%	5.9m	▲ 5% New and Grade A space: 81%	8.9% New and Grade A space: 7.2%

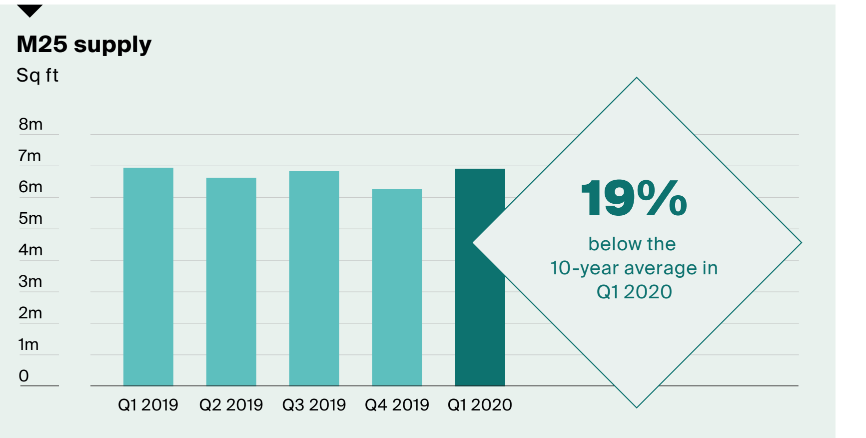
Source: Knight Frank Research



Source: Knight Frank Research

Emma Goodford

The end of the quarter witnessed occupiers reconsidering planned commitments as Covid-19 impacted. Despite the disruption ahead, the broad diversity of business located in the South East will be important, as some sectors will be less affected or even continue to show growth.



Source: Knight Frank Research

Roddy Abram

West London has performed strongly, with connectivity and sense of place key to this. The region now has a mature co-working offer, one which will assist business post Covid-19 who are looking for flexible arrangements.

Key leasing transactions
Q1 2020

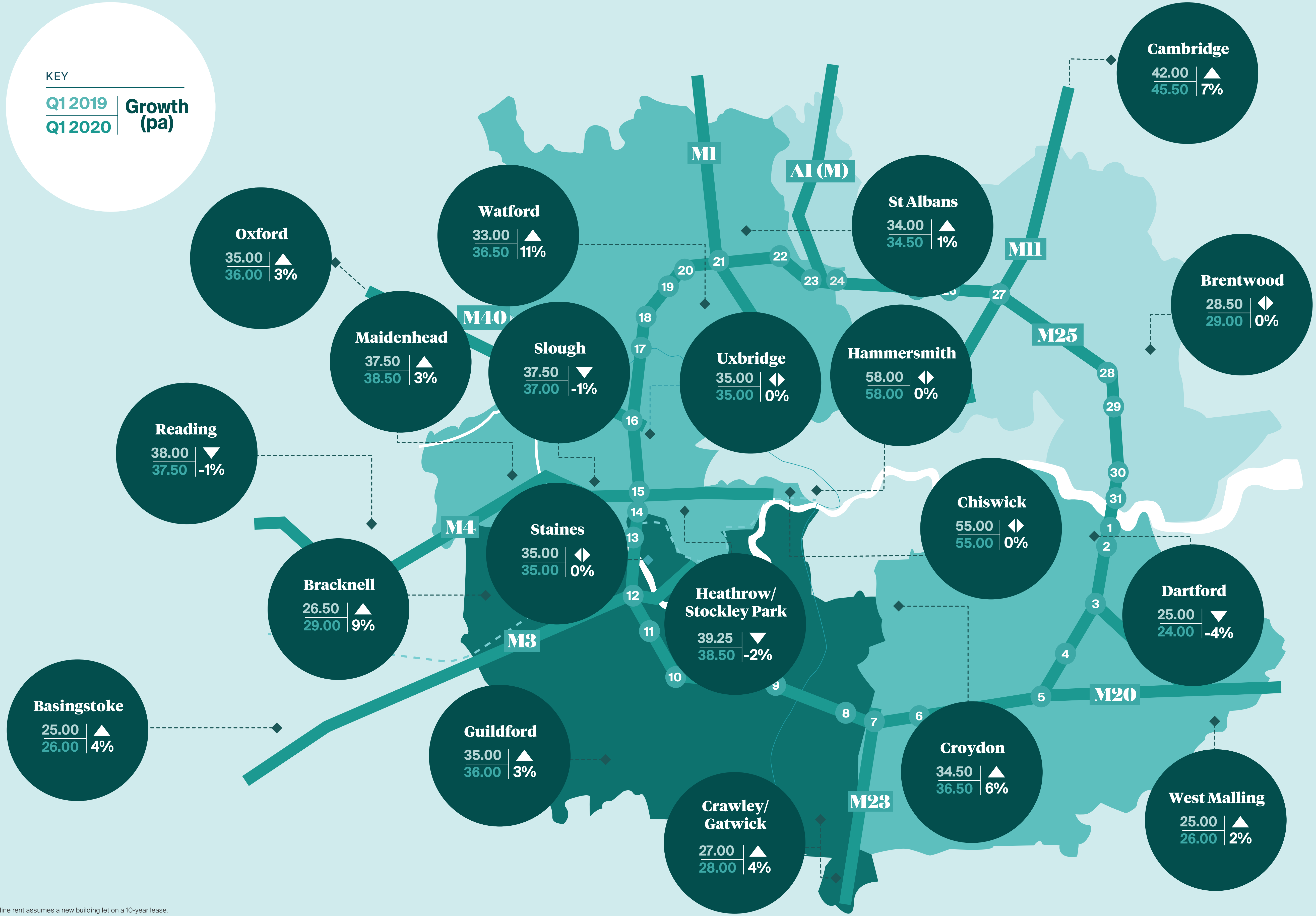
ADDRESS	SIZE SQ FT	OCCUPIER	RENT £ PER SQ FT
8 Arlington Square West, Bracknell	42,480	Eli Lilly	£29.00
Brook House, Woking	38,645	Asahi	£36.00
216, Cambridge Science Park, Cambridge	34,778	Amgen	£34.00
Metro Building (6th, 7th & 8th floors), Hammersmith	34,320	(Spec – Serviced Offices) – Mindspace	n/a
40 Clarendon Ave (2nd, 3rd & 4th floors), Watford	28,448	PWC	£36.50

Source: Knight Frank Research

M25 OFFICES, Q1 2020

PRIME RENTS

£ PER SQ FT



Headline rent assumes a new building let on a 10-year lease.
Headline rent assumes a transaction over 10,000 sq ft new office space.
Rents are stated per sq ft per annum NIA.

Source: Knight Frank Research

Chiswick Park

INVESTMENT MARKET

Although the Q1 numbers are positive, Covid-19 has quickly presented an immediate impediment to transactional activity. A 'wait-and-see' approach will now dominate the market as investors take stock on rapidly moving market conditions.

▲78%

£997m

South East transaction volume*

£43m

Mean lot size

5.00%

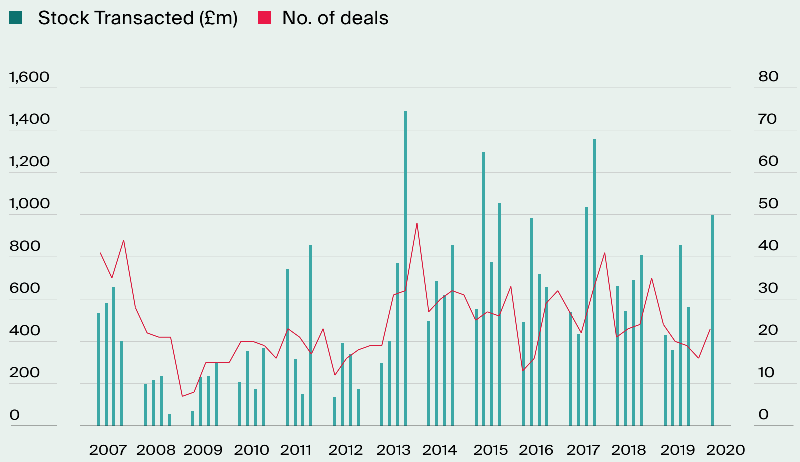
Prime net initial yield

24%

Buyers from the UK

* Percentage change reflects a comparison to Q4 2019

Investment volumes

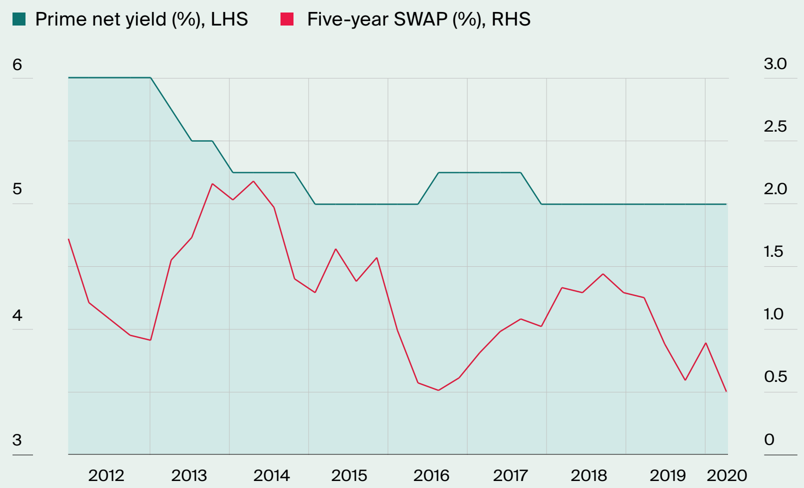


Source: Knight Frank Research

Simon Rickards

We are facing unprecedented times and the stark slowdown in activity since early March reflects this. Whilst the magnitude and depth of Covid-19 remains unknown, we believe that the South East office market is well positioned to weather the storm relatively well.

Prime net initial yield and finance



Source: Knight Frank Research

Tim Smither

With historically low vacancy rates, limited development, and assuming reasonable tenant demand, we believe the market is well placed to bounce back in the coming months, and are aware of significant amounts of equity looking to invest into the South East.

Key transactions

Q1 2020

ADDRESS	PRICE (£M)	NET INITIAL YIELD	VENDOR	PURCHASER
Building 7, Chiswick Park, Chiswick	£312.00	4.96%	Blackstone	Stanhope
Cisco, Bedfont Lakes, Heathrow	£135.00	7.41%	Evans Randall	Frasers
Arlington Business Park, Reading	£129.00	c. 7.00%	Patron Capital	Capita Land
300 Capability Green, Luton	£62.10	6.25%	AAIM	CitiBank
Power Road Studios, Chiswick	£41.58	4.70%	Helical Bar	UK Private

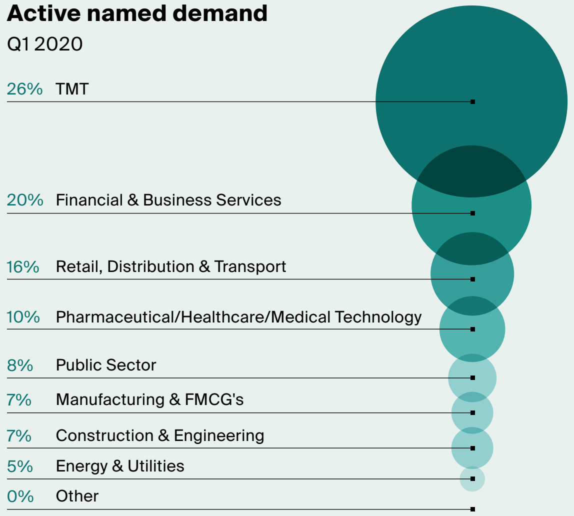
Source: Knight Frank Research

FUTURE GAZING

DEMAND: 4.3M SQ FT

Of active named demand
in the South East

Active named demand
Q1 2020



Source: Knight Frank Research

DEVELOPMENT: 1.2M SQ FT

Space under construction in the South East
*This includes pre-let (0.3m sq ft) and speculative space (0.9m sq ft)

Speculative development
Sq ft due to complete before Q1 2022

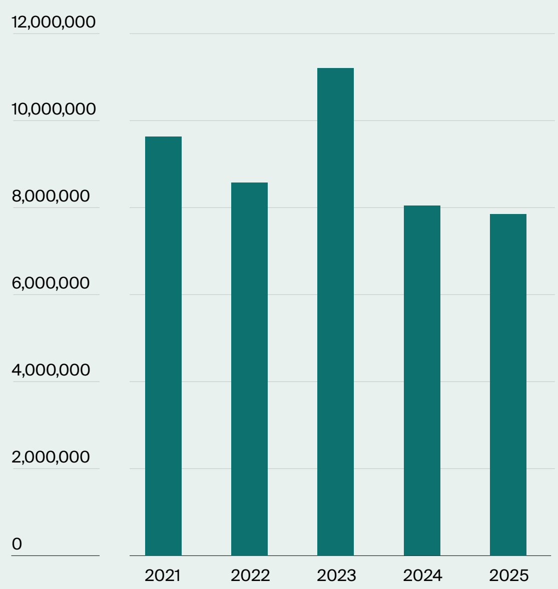
Source: Knight Frank Research

OCCUPIERS: DEFER OR PRESS ON?

While businesses take stock of the increasingly challenging business environment, a likely strategy with regard to future real estate needs will be to defer any major decisions. Instances of requirements being placed on hold will certainly increase albeit for some, an impending lease event will make decision making more pressing. Even in these uncertain times, the tight supply environment will mean that some occupiers will still activate searches in order to secure the best space. The number of breaks and expiries scheduled for 2021 will be at the highest since 2016, meaning difficult choices ahead. Hold over, extend or negotiate new terms at existing occupation or engage in the market.

Those that have provisionally agreed on space being developed in particular, may now encounter delay and this could create a gap between the exit timetable under the existing lease and the commencement of a new occupation. In practical terms interim space provision may be needed. This could mean a rise in short term contracts or lease extension. In the very short term though, focus will be adapting the workplace to Covid 19. How will Landlords deliver a door to desk environment and how can occupiers enable social distancing. These questions could mean a longer period of working from home or rotating office space use.

South East Lease Events
2021 – 2025 (sq ft)



Source: Knight Frank Research

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(Y)OUR SPACE

TECHNICAL NOTE

- Knight Frank defines the M4 market as extending from Hammersmith, west to Newbury, incorporating Uxbridge and High Wycombe to the north and Staines and Bracknell to the south. Reading is also included.
- The M3 market incorporates the main South West London boroughs and encompasses Leatherhead, Guildford and Basingstoke extending north to the M4 boundary described above. Farnborough and Camberley are also included.
- The figures in this report relate to the availability of built, up-and-ready office/B1 accommodation within the M25 market. Vacant premises and leased space which is being actively marketed are included.
- All floorspace figures are given on a net internal area basis (as defined by the RICS).
- A minimum 10,000 sq ft (net) cut-off has been employed throughout. Major and minor refurbishment have been treated as new and second-hand respectively. Data is presented on a centre and quadrant basis. Classification by centre relates to the locational details contained within the marketing material for available properties. Classification in this manner is clearly somewhat arbitrary.
- Vacancy rate data is based on a total M25 stock measure of 121m sq ft (net), an M4 market stock of 66m sq ft (net) and an M3 market stock of 39m sq ft (net). Please note that a revision to total market office stock figures was applied in Q1 2017 to reflect ‘change of use’ permitted through the Town and Country Planning Order 2015.
- Second-hand floorspace has been sub-divided into A and B grade accommodation, reflecting high and low quality respectively. Whilst subjective, this categorisation is based on an assessment of each property’s age, specification, location and overall attractiveness.
- The South East is defined as the market area shown in the map on pages 6 & 7.
- Pre-let = The letting of proposed schemes not yet under construction and those let during the construction process.
- All data presented is correct as at 31st March 2020.

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