RESEARCH

Q2 2009
M25 OFFICES
Investment, development & occupier markets
Knight Frank

HIGHLIGHTS

- Q2 take-up in the M25 decreased only 6% on the previous quarter but it was nonetheless the lowest quarterly total in nearly six years.
- Active named demand has been stable in 2009 following a strong fall in the second half of 2008. FBS' share of total demand fell this quarter to 14% from 18% while Construction & Engineering's share rose to 11% from 6%.
- The vacancy rate increased in each of the markets in Q2: in the M25 from 7.3% in Q1 to 7.6%, in the M4 from 10.6% to 11.0% and, in the M3, the steepest change, from 7.3% to 7.9%.
- Investment turnover increased threefold on Q1. For the first time in two years, prime yields have hardened as growing demand for prime assets has been met by a scarcity of such product.

Q2 2009

M25 OFFICES

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M25 market

- M25 take-up was 353,742 sq ft in Q2 2009, a fall of 6% on Q1 and the lowest quarterly total since Q3 2003. Of the 25 transactions in Q2, letting activity was focused in the North West quadrant along the M4 corridor, accounting for nearly 60% of total take-up.
- There were no pre-lets in Q2 and just five transactions involving new accommodation, all of which occurred in Chiswick. The largest comprised Harvey Nichols' 21,176 sq ft acquisition of 361/365 Chiswick High Road while Element Six's acquisition of 8,100 sq ft at Building 4, Chiswick Park also accounted for Q2's highest achieved headline rent, at £33.00 per sq ft.
- Active named demand remains relatively stable, reducing only 1% from Q1 to stand at 5.28m sq ft. The underlying source of demand is shifting, however, with Construction & Engineering demand increasing by 86% in the quarter, while FBS demand reduced by 24%.
- The M25 vacancy rate increased from 7.3% to 7.6%, with nine speculative completions accounting for 25% of total space released to the market in the quarter. For example, at Crossways, Dartford, Frogmore completed Waterside Court and Lakeview East and West collectively totalling 69,364 sq ft.
- At the end of Q2, the volume of speculative construction underway was down 60% from the Q3 2008 peak. This has resulted from the recent flurry of completions, combined with an absence of development starts over the last three quarters.

In Q2, Frogmore completed Waterside Court and Lakeview buildings East and West at Crossways Business Park, collectively providing 69,364 sq ft of Grade A space.

KNIGHT FRANK VIEW

- Q2 take-up is in line with our forecast for total take-up of circa 1.5m sq ft in 2009, or just under half the annual average. We expect take-up to remain at this subdued level until the second half of 2010. Until then, letting activity will be driven by market churn as opportunistic occupiers, mainly with lease events approaching, exploit market conditions.
- Across the key towns, net effective rents have fallen by an average 20% since Q2 2008. With landlords having already responded quickly to the market, further falls will be more muted over the next 12 months, averaging circa 10%. When growth returns in the economy, those towns undersupplied with quality space will see net effective rental values stabilising or even rising again, albeit from a low base.
- In contrast to the previous market downturn of 2002 to 2003, when reduced demand coincided with a flood of speculative completions, further anticipated increases in vacancy levels will be driven by the release of second-hand tenant committed space, as many occupiers right-size their accommodation needs.

Figure 1

M25 take-up

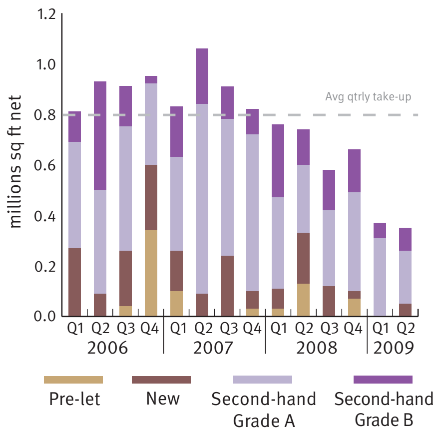


Figure 2

Space under construction in the M25

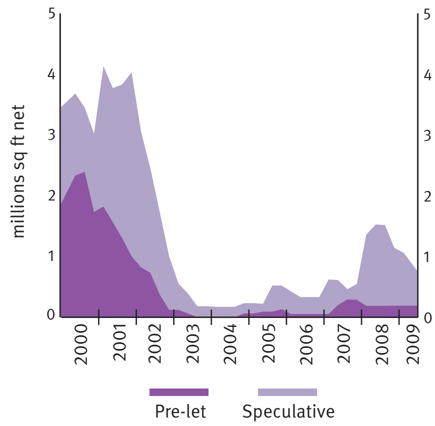


Figure 3

M25 active enquiries by sector

Manufacturing & Pharmaceuticals	24%
Retail, Distribution & Transport	17%
Financial & Business Services	14%
Public Sector	13%
Construction & Engineering	11%
ICT	11%
Other	10%

Source: Knight Frank Research

Market statistics

Table 1

Key town prime headline rents & forecasts

Town	Q2 prime rent (psf)	Rent free (months)
Basingstoke	£19.00 ▼	24 ▲
Brentwood	£22.00 ▼	24 ▶
Gatwick	£24.00 ▶	24 ▶
Guildford	£26.00 ▶	24 ▶
Hammersmith	£35.00 ▼	24 ▲
Heathrow	£25.00 ▶	30 ▲
West Malling	£22.00 ▼	21 ▶
Reading	£27.50 ▼	24 ▶
St Albans	£22.50 ▶	24 ▲
Uxbridge	£25.00 ▶	24 ▲
Watford	£21.00 ▶	24 ▶

Based on new/Grade A building:
10,000 sq ft, 10 yr lease with no breaks

Source: Knight Frank Research

Note: ▲ = forecast for next 12 months

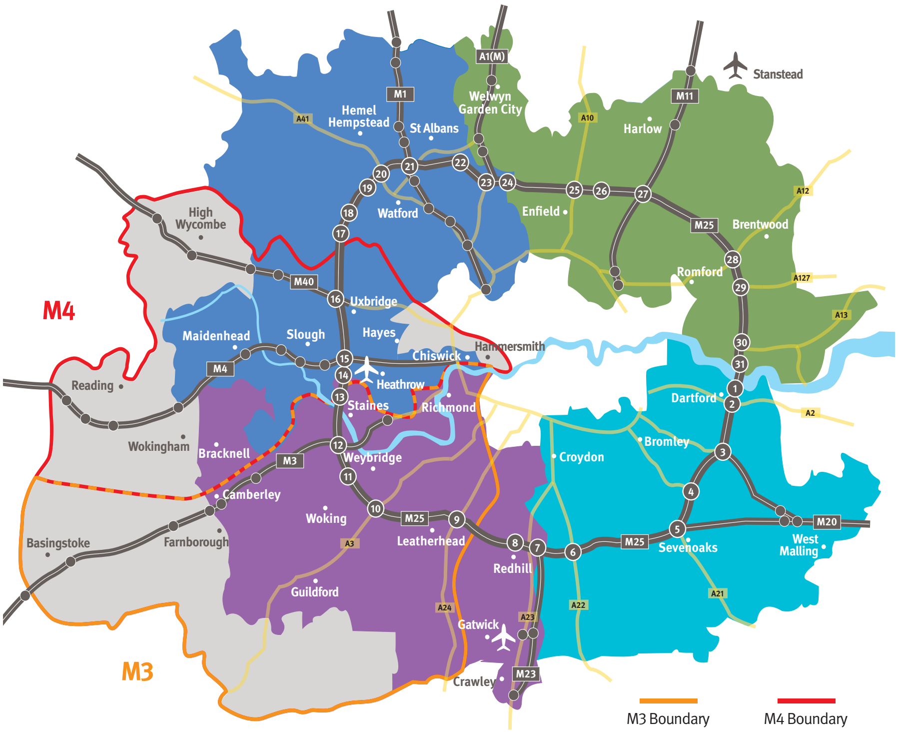


Table 2

Demand & Supply

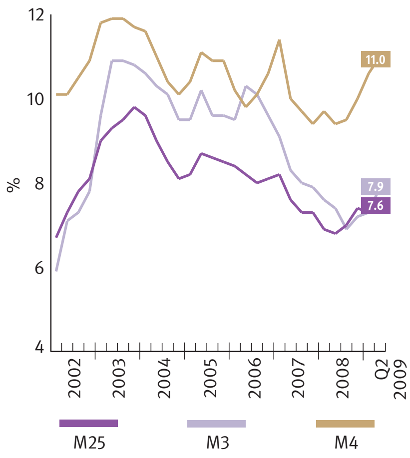
Take-up	M25	NW	SW	NE	SE	M3	M4
Sq ft	**353,742**	236,019	51,921	14,533	51,269	**48,222**	**275,244**
Change 3 months	**-6%** ▼	146% ▲	-74% ▼	-15% ▼	-19% ▼	**-71%** ▼	**28%** ▲
Change 12 months	**-52%** ▼	-6% ▼	-83% ▼	-66% ▼	-62% ▼	**-85%** ▼	**-33%** ▼
Q2 pre-let (sq ft)	**0**	0	0	0	0	**0**	**0**
Q2 % take-up new & pre-let	**15%**	23%	0%	0%	0%	**0%**	**20%**
Forecast 2009 take-up (m sq ft)	**1.5**	–	–	–	–	**0.6**	**1.0**

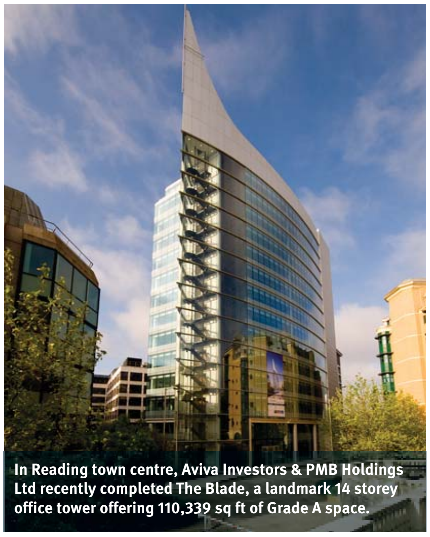
Availability	M25	NW	SW	NE	SE	M3	M4
Sq ft	**9,834,990**	4,766,756	3,724,995	442,782	900,457	**3,332,206**	**6,997,402**
Change 3 months	**4%** ▲	-2% ▼	11% ▲	4% ▲	7% ▲	**9%** ▲	**4%** ▲
Change 12 months	**13%** ▲	10% ▲	21% ▲	-3% ▼	10% ▲	**8%** ▲	**18%** ▲
Q2 % new	**17%**	18%	17%	16%	9%	**21%**	**24%**
Q2 % SH Grade A	**51%**	60%	50%	8%	29%	**42%**	**57%**
Q2 % SH Grade B	**32%**	21%	33%	76%	62%	**37%**	**19%**
Q2 vacancy rate (▲/▼ movement from Q1)	**7.6%** ▲	9.5% ▼	9.1% ▲	2.5% ▲	4.4% ▲	**7.9%** ▲	**11%** ▲

Under construction	M25	NW	SW	NE	SE	M3	M4
Sq ft (net approx)	**760,674**	316,784	342,161	0	101,729	**276,835**	**1,229,593**
Change 12 months	**-50%** ▼	-57% ▼	-55% ▼	–	65% ▲	**-26%** ▼	**-26%** ▼
Pre-let	**188,306**	100,000	30,000	0	58,306	**240,000**	**479,000**

Source: Knight Frank Research

Figure 4
Vacancy rates




In Reading town centre, Aviva Investors & PMB Holdings Ltd recently completed The Blade, a landmark 14 storey office tower offering 110,339 sq ft of Grade A space.

M4 & M3 markets

- Q2 take-up in the M4 was 275,244 sq ft, an increase of 28% on Q1 and only 33% below the Q2 2008 total. However, Canon Europe's sizeable 93,055 sq ft acquisition at 3 The Square, Stockley Park alone accounted for 34%.
- Despite this, the M4 vacancy rate increased from 10.6% to 11.0% in Q2, with new development completions totalling 238,073 sq ft accounting for 40% of total space delivered to the market.
- Q2 saw the completion of The Blade in Reading town centre, a landmark office tower developed by Aviva Investors & PMB Holdings Ltd which provides 110,339 sq ft of Grade A space. Elsewhere in the M4, Frogmore completed buildings 7 and 8 in Foundation Park, Maidenhead, collectively totalling 45,138 sq ft.
- With only four transactions, M3 take-up in Q2 was a mere 48,222 sq ft, down 71% on Q1 and 85% below the Q2 2008 total. Of these deals, none involved new accommodation, while the largest comprised Kelt Bray's 23,754 sq ft freehold purchase of St Andrew's House in Esher for £2.89m.
- The steepest rise in the vacancy rate was seen in the M3, increasing from 7.3% in Q1 to 7.9%. Here, tenant release space accounted for a significant 60% of total space added to the market. For example, in Chineham Park, Basingstoke, Motorola have brought Redwood 2 and 3 to the market totalling 112,309 sq ft.

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- Within particular towns along the M4 corridor, such as Maidenhead and Bracknell, the supply of new and Grade A space is equivalent to five years of average annual take-up. Consequently, landlords are having to compete for what limited occupier demand exists by offering extremely generous terms and incentives to prospective tenants.
- In the M3 corridor, the significant volume of tenant released space hitting the market over the last 12 months has placed increased downward pressure on headline rental levels. Although the M3 has a low proportion of new supply compared with the M4 and a very limited development pipeline, rents here remain under severe pressure due to extremely low levels of demand.

Figure 5
M3 take-up

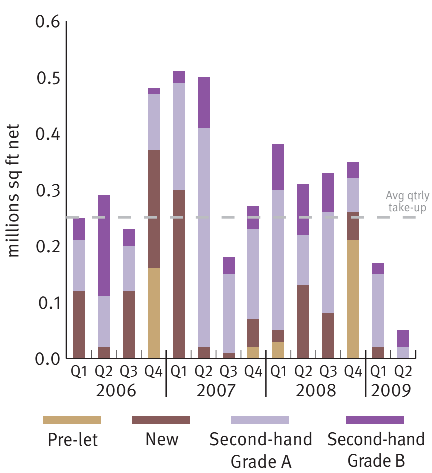


Figure 6
M4 take-up

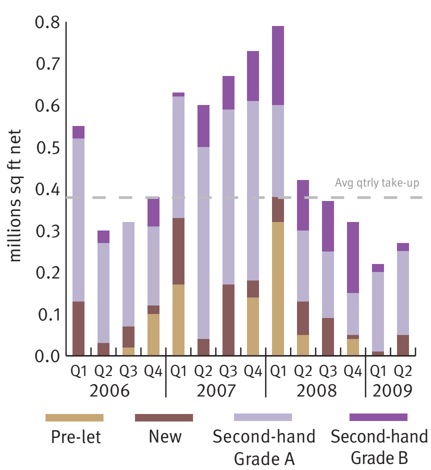
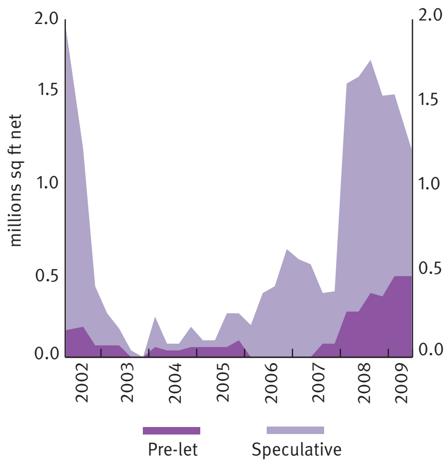


Figure 7
Space under construction in the M4



Source: Knight Frank Research

Investment market

Table 3
Key investment transactions Q2 2009

Building	Size (sq ft)	Price	Net initial yield	Vendor/ Purchaser
Solent Business Park, Fareham	258,323	£55.50m	7.75%	Goodman / Blenheim Properties Group
Building 2, Vanwall Bus Pk, Maidenhead	76,662	£26.27m	7.56%	Aviva Investors / Rockhopper
IHG Group HQ, Broadwater Park, Denham	97,223	£25.50m	7.85%	Invista / Private syndicate of Smith Gore
200 Hammersmith Road, Hammersmith	67,855	£24.55m	8.73%	BlackRock / BP Pension Fund
Surrey House and Lever House Kingston-upon-Thames	165,202	£20.45m	7.70%	APIA Fund / Salmon Harvester
Metro Point, Croydon	40,591	£10.56m	7.25%	New Star Asset Management / Private

	Transaction volume	Mean lot size	Mean NIY
Q2 2009	£229.0m	£15.20m	8.27%
Change 3 mths	234% ▲	77% ▲	-171bps ▼
Change 12 mths	5% ▲	47% ▼	+40bps ▲

BP Pension Fund purchased 200 Hammersmith Road in Hammersmith from BlackRock for £24.55m, reflecting a net initial yield of 8.73%.

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- Total investment turnover in Q2 was more than three times the level seen in each of the previous two quarters, buoyed by five deals in excess of £20m. However, the number of transactions will remain at low levels while debt remains restricted and a shortage of available prime assets persists.
- Considering the fragility of the occupational market, investment interest remains defensive, focused on prime, long income buildings in strong locations. However, the return of UK institutional investors to the market has been met with an acute shortage of such assets. Consequently, prime yields hardened in Q2, for the first time in two years.
- Nevertheless, given the lack of prime town centre product and an increased pressure to spend among those active in the market, investors will have to consider assets currently perceived as less attractive such as prime business parks and multi-let office buildings offering greater yield.

Figure 8
£m investment volumes and lot size

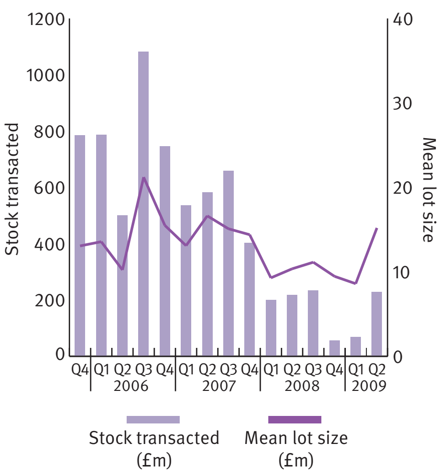


Figure 9
Mean initial yield & finance

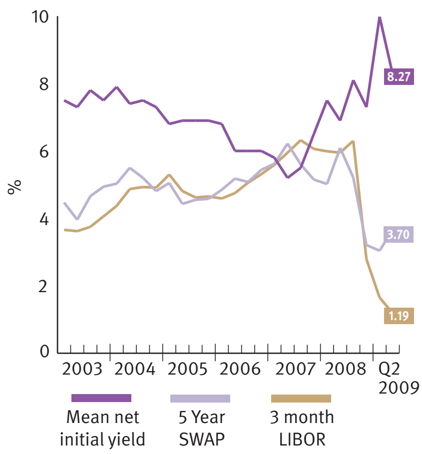
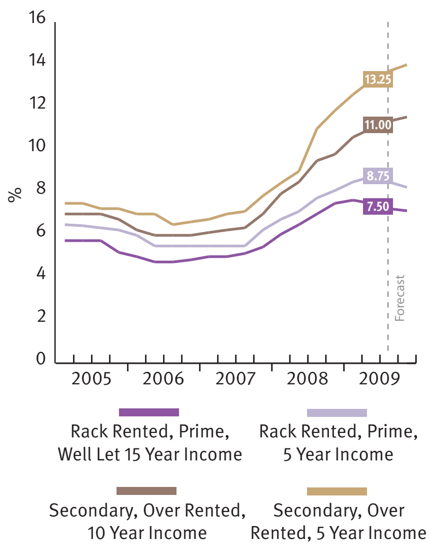


Figure 10
Yield forecasts



Source: Knight Frank Research

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Technical Note

- Knight Frank define the M4 market 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. Existing built office stock in the M4 market totals 62,392,070 sq ft.
- 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. Existing built office stock in the M3 market totals 41,927,373 sq ft.
- 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.
- The market definition used, shown in the map on page 3, is based on Local Authority District boundaries.
- 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 128m sq ft (net), an M4 market stock of 63m sq ft (net) and an M3 market stock of 42m sq ft (net).
- 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.
- 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 June 30th 2009.

Newmark
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