RESEARCH

Q2 2012

M25 OFFICES

Investment, development & occupier markets

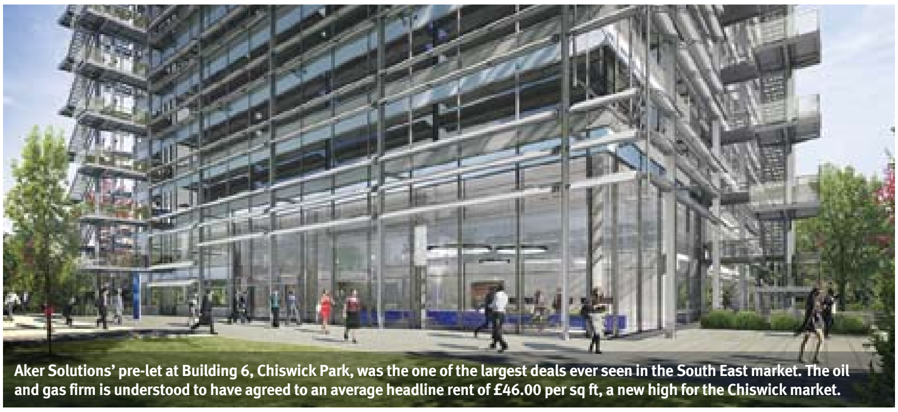
Knight Frank

HIGHLIGHTS

- Despite generally subdued occupier market activity in Q2, Aker Solutions' 215,755 sq ft pre-let at Chiswick Park boosted take-up in the M25 and particularly in the M4, where Q2 take-up was 11% above the 10-year quarterly average.
- The vacancy rate fell in the M25 and the M3 for a third successive quarter during Q2, to 8.1% and 8.7% respectively. The M4 vacancy rate remained stable at 10.7% during Q2, unchanged for three successive quarters.
- New-build construction activity in the M25 increased by 12% in Q2 to 823,000 sq ft, its highest level in over three years. Refurbishment activity also increased notably in Q2, rising by 118% in the M4.
- In the investment market, three large transactions lifted Q2 turnover to £390m, 19% above the five-year quarterly average. While yields for prime, 15-year income held steady at 6.00% in Q2, secondary and tertiary yields continued to soften in the quarter.

Demand and take-up

- M25 take-up was 433,839 sq ft in Q2 2012, 33% above Q2 2011's total but 32% below the 10-year quarterly average. Almost half was accounted for by Aker Solutions' 215,755 sq ft pre-let during construction at Building 6, Chiswick Park in West London, which was one of the largest deals ever seen in the South East. If pre-lets are discounted, Q2's take-up and average transaction size were among the lowest on record.
- The key centres in the Thames Valley again provided the main focus of activity. The Chiswick Park pre-let propelled M4 take-up to 450,956 sq ft in Q2, more than three times the Q2 2011 level and 11% above the 10-year quarterly average. Of Q2's 21 deals in the M4, Hammersmith saw five, including Winton Capital's 60,000 sq ft pre-let at The Grove, while Reading saw seven deals in the quarter.
- In the M3, following robust take-up in Q1, activity was subdued in Q2 with take-up of 111,584 sq ft, 52% below the 10-year quarterly average. Of the six deals in the M3, the largest was in Basingstoke, where Hampshire County Council acquired the freehold of the Vertex, totalling 48,350 sq ft.
- Set against subdued take-up, total named active demand rebounded by 12% during Q2 to stand at 6.62m sq ft, its highest level since Q2 2008. This was driven by a 20% rise in Financial & Business Services demand (1.65m sq ft) and a near doubling of demand in the Retail and Distribution sector (1.18m sq ft).



Aker Solutions' pre-let at Building 6, Chiswick Park, was the one of the largest deals ever seen in the South East market. The oil and gas firm is understood to have agreed to an average headline rent of £46.00 per sq ft, a new high for the Chiswick market.

Supply and development

- Supply has been edging down recently, reflecting limited development completions and lower than average Grade B space being released to the market. The sole completion in Q2 was Barratt Homes' Orion Gate, Woking, providing 51,340 sq ft of new office space.
- The M25 vacancy rate fell to 8.1% during Q2, its lowest level in over two years, while the M3 vacancy rate also fell for a third successive quarter, to 8.7%. In contrast, the M4 vacancy rate held at 10.7% in Q2, unchanged since Q4 2011. Although the M4 vacancy is relatively elevated, brand new space now accounts for only 22% of total availability, its lowest level since Q1 2009.
- New-build construction activity in the M25 increased to 823,000 sq ft in Q2, its highest level in over three years. However, Abstract's 100,000 sq ft Renaissance scheme, Croydon was the sole new speculative development start during Q2 and the first to come forward in either of the M25's eastern quadrants for four years.
- Refurbishment activity has also increased as landlords have responded to shortages of Grade A space in the resilient locations. At the end of Q2, 316,000 sq ft was under refurbishment in the M4, rising 118% from Q1, with new schemes including Griffin House, Hammersmith (55,735 sq ft) and Phoenix, Reading (51,255 sq ft).

Figure 1
M25 take-up

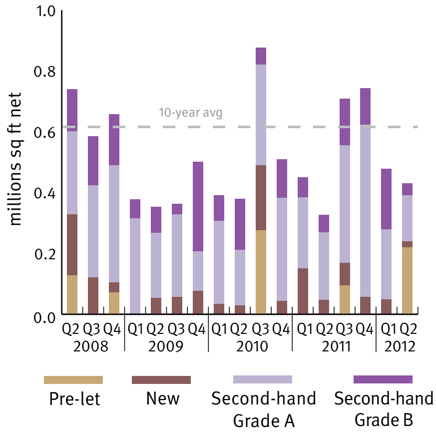


Figure 2
M4 take-up

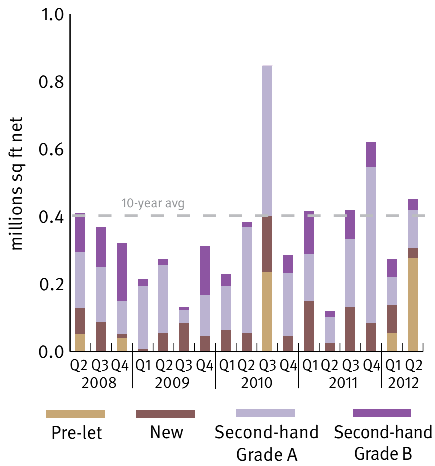
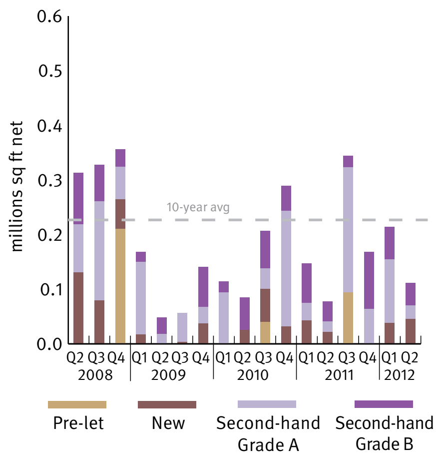


Figure 3
M3 take-up



Source: Knight Frank Research

Market statistics

Table 1
Key town prime rents & forecasts

Town	Q2 prime rent (psf)	Rent free (months)
Basingstoke	£17.50 ▶	36 ▶
Bracknell	£20.00 ▶	36 ▶
Brentwood	£21.00 ▶	24 ▶
Chiswick	£46.00 ▲	18 ▼
Croydon	£22.00 ▲	33 ▶
Gatwick	£22.50 ▶	30 ▲
Guildford	£27.50 ▶	27 ▶
Hammersmith	£37.50 ▲	21 ▼
Heathrow	£27.50 ▶	30 ▶
Maidenhead	£30.00 ▶	24 ▶
Reading	£30.50 ▶	30 ▶
Slough	£21.00 ▶	32 ▶
Staines	£30.00 ▲	21 ▶
St Albans	£22.50 ▶	24 ▶
Uxbridge	£30.00 ▲	24 ▶
Watford	£22.00 ▶	30 ▶
West Malling	£20.50 ▶	30 ▶

Based on new/Grade A building:
10,000 sq ft, 10 yr lease with no breaks
Note: ▲ = forecast for next 12 months

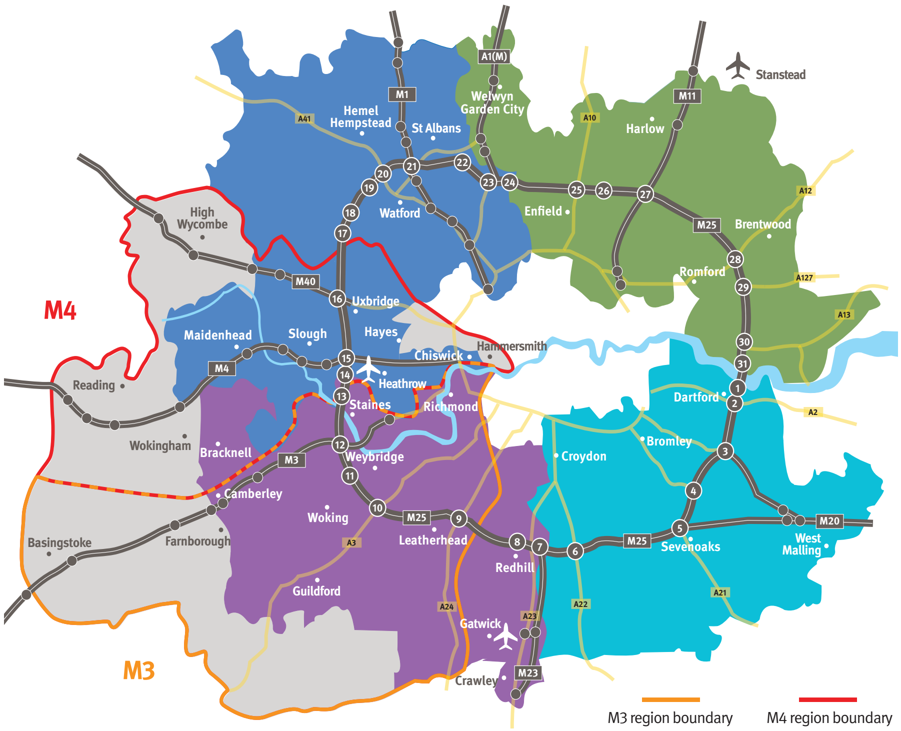


Table 2
Demand & Supply

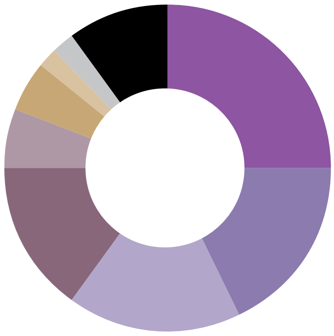
Take-up	M25	NW	SW	NE	SE	M3	M4
Sq ft	**433,839**	346,899	75,799	0	11,141	**111,584**	**450,956**
Change Q2 12 vs Q1 12	**-10%** ▼	91% ▲	-52% ▼	-100% ▼	-76% ▼	**-48%** ▼	**65%** ▲
Change Q2 12 vs Q2 11	**33%** ▲	188% ▲	-30% ▼	-100% ▼	-80% ▼	**44%** ▲	**276%** ▲
Q2 pre-let (sq ft)	**215,755**	215,755	0	0	0	**0**	**275,755**
Q2 % New & Grade A (inc. pre-lets)	**90%**	90%	86%	N/A	100%	**64%**	**93%**
Forecast 2012 take-up (m sq ft)	**2.1**	–	–	–	–	**0.6**	**1.5**

Availability	M25	NW	SW	NE	SE	M3	M4
Sq ft	**10,579,076**	4,723,316	4,026,565	444,687	1,384,478	**3,704,502**	**6,947,257**
Change Q2 12 vs Q1 12	**-1%** ▼	-2% ▼	0% ◀▶	0% ◀▶	-1% ▼	**-3%** ▼	**0%** ◀▶
Change Q2 12 vs Q2 11	**-5%** ▼	-10% ▼	-9% ▼	-4% ▼	35% ▲	**9%** ▲	**-8%** ▼
Q2 % new	**13%**	13%	17%	12%	4%	**10%**	**22%**
Q2 % second-hand Grade A	**50%**	58%	51%	30%	26%	**59%**	**59%**
Q2 % second-hand Grade B	**37%**	29%	32%	58%	70%	**31%**	**19%**
Q2 vacancy rate (▲/▼ movement from Q1 12)	**8.1%** ▼	9.4% ▲	9.8% ◀▶	2.5% ◀▶	6.8% ▼	**8.7%** ▼	**10.7%** ◀▶

Under construction	M25	NW	SW	NE	SE	M3	M4
Sq ft (net approx)	**822,771**	372,546	351,142	0	0	**311,642**	**482,103**
Change 12 months	**206%** ▲	132% ▲	224% ▲	–	–	**187%** ▲	**201%** ▲
Pre-let	**215,755**	215,755	70,000	0	0	**70,000**	**215,755**

Source: Knight Frank Research

Figure 4
M25 active named enquiries by sector



Active demand is 6.63m sq ft at Q2 2012		
Financial & Business Services	25%	▲
Retail, Distribution & Transport	18%	▲
Manufacturing & FMCG's	17%	▼
ICT	15%	▲
Construction & Engineering	6%	◀▶
Public Sector	5%	▲
Utilities	2%	▼
Pharmaceutical & Medical	2%	▼
Other	10%	▲

Note: % = current share of demand
▲ = 12 month change (absolute terms)

Griffin House, Hammersmith is currently being refurbished by LIM and will be ready for occupation by Q4 2012.

FORECAST AT A GLANCE

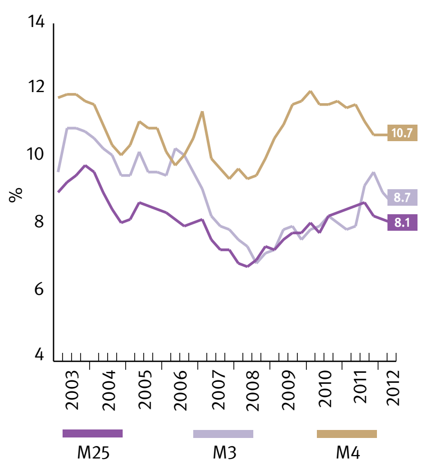
Take-up:

- While Aker Solutions' substantial pre-let gave an air of respectability to Q2 take-up, it masked what was in reality a very quiet period for the market. However, with 939,000 sq ft presently under offer – its highest level since Q3 2007 – 2012 is likely to follow a similar course to 2010 and 2011, with subdued activity in the first half of the year followed by a more active second half.
- Knight Frank's take-up forecast for 2012 remains on track, at 2.1m sq ft for the M25, 15% below the 10-year annual average. Positively, however, with 80% of space currently under offer located in the Thames Valley markets, M4 take-up in 2012 may exceed its 10-year average of 1.65m sq ft, surpassing our initial forecast of 1.5m sq ft.
- While the weak short-term economic outlook is unlikely to support occupier demand through business growth, our analysis of lease breaks and expiries points to heightened levels of churn-related take-up from 2013 onwards. Between 2013 and 2015, notable hotspots of lease event activity within Grade B buildings include Heathrow, Bracknell, Guildford and Gatwick.

Supply and rents:

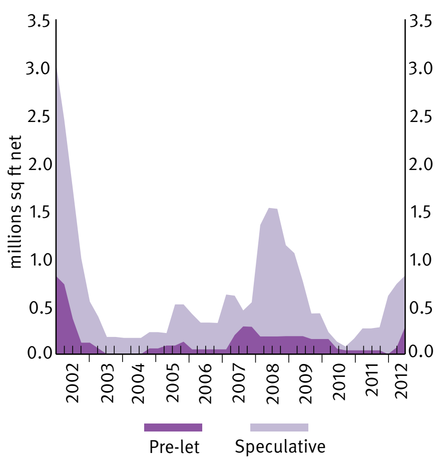
- Several instances of pre-lets this year are indicative of a growing shortage of available Grade A supply in the most sought after locations, namely Hammersmith and Chiswick, in West London. While the recovery in headline rents seen during 2011 has largely run its course, rents remain under upward pressure in and around west London, with Aker Solutions' deal in Chiswick driving west London rents to a new high.
- The rise in refurbishment activity in the M4 also demonstrates that landlords are taking advantage of rising rental levels through re-positioning existing buildings and preserving parking standards. With banks and developers cautious of new speculative development, we can expect a higher prevalence refurbishment activity over the next 24 to 36 months.
- Abstract's recent speculative construction start at Renaissance, Croydon reflects developers' growing willingness to consider 'less obvious' markets outside of the western corridor. Croydon, Gatwick, St Albans and Woking are several markets where anticipated Grade B lease events significantly outweigh current levels of New and Grade A availability.

Figure 5
Vacancy rates



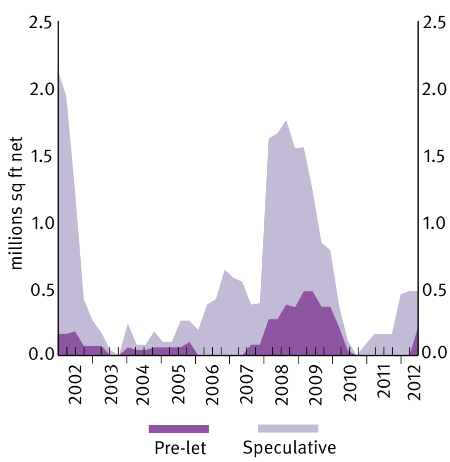
Source: Knight Frank Research

Figure 6
Space under construction in the M25



Source: Knight Frank Research

Figure 7
Space under construction in the M4



Source: Knight Frank Research

Investment market

Table 3
Key investment transactions Q2 2012

Building	Size (sq ft)	Price	Net Initial Yield	Vendor/ Purchaser
Granta Park, Cambridge	475,000	£126.8m	8.00%	MEPC / BioMed Reality Trust
IQ, Farnborough	415,159	£90.10m	8.90%	SEGRO / Harbert
Unilever House, Leatherhead	179,457	£61.15m	6.88%	SWIP / London & Stamford
Costain House, Maidenhead	36,973	£14.70m	7.00%	Aviva Investors / Private
Forbury One, Reading	37,717	£11.56m	7.00%	Aviva Investors / Canada Life

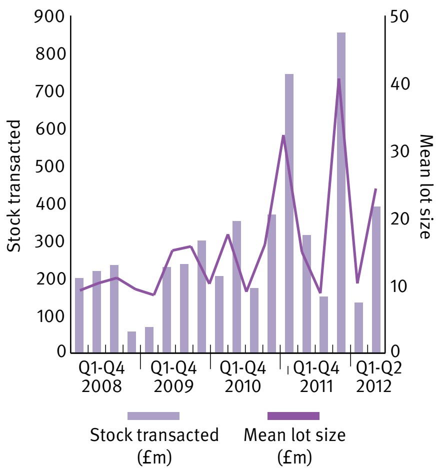
	Transaction volume	Mean lot size	Mean NIY
Q2 2012	£390.04m	£24.38m	8.11%
Change 3 mths	209% ▲	132% ▲	11bps ▲
Change 12 mths	24% ▲	63% ▲	-20bps ▼

INVESTMENT VIEW

- Total turnover in Q2 was £390m, more than three times Q1's level and 19% above the five-year quarterly average. However, with only 16 deals transacting during the quarter, the increase was largely due to three large transactions which together accounted for 70% of total volume.
- The purchases of IQ, Farnborough and Granta Park, Cambridge demonstrate the continuing appetite among overseas investors for large lot-sizes, with such assets offering relatively attractive income and the potential to enhance value through asset management. Q2 also saw London & Stamford return to the market, following their purchase of Unilever House, Leatherhead.
- The market is becoming ever more polarised. Although sentiment softened slightly in light of the ongoing difficulties in the Eurozone, yields for prime, 15-year income held steady at 6.00% in Q2, unchanged for a third successive quarter, while 5-year income also held steady at 7.00%.
- Conversely, yields for secondary and tertiary assets continued to drift during Q2, reflecting a combination of investor's views on risk, banks' unwillingness to provide debt and a growing supply of such stock to the market. However, deals continue to take place in this sector, albeit at heavily discounted prices.

In Q2, London & Stamford purchased Unilever House, Leatherhead from SWIP for £61.15m, reflecting a net initial yield of 6.88%. Knight Frank acted for the vendor.

Figure 8
£m investment volumes and lot size



Source: Knight Frank Research

Figure 9
Mean initial yield & finance

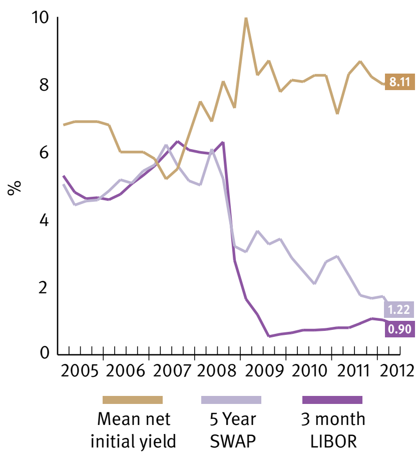
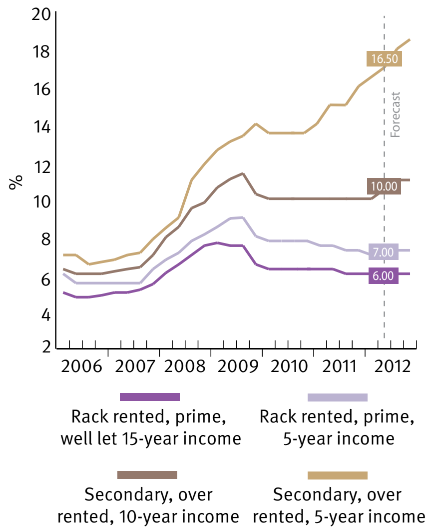


Figure 10
Yield forecasts



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Technical Note

- Knight Frank define 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. 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 2012.

Front cover image: The Blade, Reading

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