RESEARCH

Knight Frank

M25 OFFICES

INVESTMENT, DEVELOPMENT & OCCUPIER MARKETS **Q3 2014**

HIGHLIGHTS

Despite subdued take-up, active named demand rises to its highest level since Q2 2008

Declining supply is prompting rental growth in prime locations, but speculative development is rising

Investment activity was strong in Q3, with turnover 37% above the 5-year quarterly average

DEMAND AND TAKE-UP

- M25 take-up was 418,399 sq ft in Q3, up 3% on Q2 but 22% below the five-year quarterly average. While there were no pre-lets or major deals to drive take-up, Q3 comprised 33 deals, which is above average and indicative of generally robust occupier sentiment.
- New space featured prominently in Q3, accounting for 34% of M25 take-up. The largest transactions involving new space were VMWare's lease of 61,854 sq ft at Flow 1 & 2, Staines, followed by Paribis Law's acquisition of 37,233 sq ft at Renaissance, Croydon.
- M4 take-up rebounded in Q3, reaching 409,951 sq ft, almost exactly in line with the five-year quarterly average. More positively, the region saw 34 deals, equalling the record for a single quarter. Hammersmith saw Q3's highest rent, where Philip Morris leased 34,240 sq ft at The South Building, 10 Hammersmith Grove for a headline rent of £50.00 per sq ft.
- Across the South East, active named demand increased by 17% during Q3 to reach 6.8m sq ft, its highest level since Q2 2008. Demand increased for the majority of sectors, although TMT recently replaced FBS as the most active sector, standing at an eight-year high of 1.5m sq ft.

Renaissance, Croydon is now entirely let-up following Paribis Law's acquisition of 37,233 sq ft in Q3. The scheme was developed by Abstract and completed in late 2013. Knight Frank acted for the landlord, M&G Real Estate.

SUPPLY AND DEVELOPMENT

- Across all markets, six speculative developments totalling c. 300,000 sq ft completed in Q3, the highest quarterly amount since Q2 2012. Two of the completions were in Staines, namely Boultbee Land's 'TWENTY' scheme (45,413 sq ft) and LIM / Bell Hammer's 'Strata' (89,893 sq ft).
- Despite an uptick in newly delivered supply, availability remains under pressure across the main markets. While the M25 vacancy rate stood unchanged during Q3 at a 12-year low of 6.4%, the M4 vacancy rate fell for an eighth successive quarter, reaching a record low of 7.5%, and the M3 vacancy rate fell to a 12-year low of 6.8%.
- Falling availability is partly explained by increasing rates of take-up, post-recession, but is also linked to the extension of Permitted Development Rights. During the past 12 months, almost one million sq ft has left the market for residential conversion, with a particular focus in Croydon, Slough, Bracknell and Crawley.
- At the end of Q3, 20 schemes were underway speculatively across the main markets totalling just under 2m sq ft, a rise of 23% from Q2. This is likely to expand further, with circa 700,000 sq ft expected to commence in Q4, mostly comprising redevelopment of existing buildings.
- However, development activity is focused within several key Thames Valley markets, with speculative development in the M4 rising to more than double its level 12 months ago. Reading has four schemes under construction totalling 480,000 sq ft, while three schemes are underway in Hammersmith, totalling 306,000 sq ft.

FIGURE 1
M25 take-up

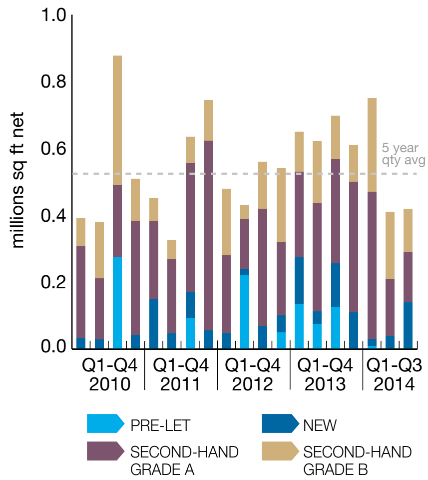


FIGURE 2
M4 take-up

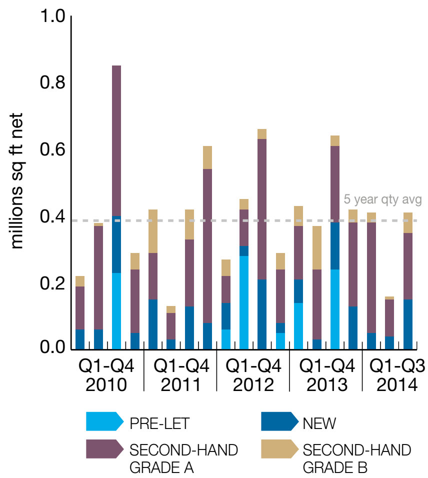
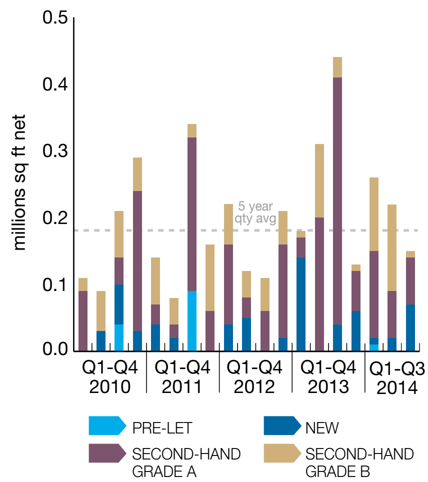


FIGURE 3
M3 take-up



Source: Knight Frank Research

MARKET STATISTICS

TABLE 1
Key town prime rents & forecasts

Town	Q3 prime rent (psf)	Rent free (months)
Basingstoke	£18.00 ▶	33 ▶
Bracknell	£23.00 ▲	27 ▼
Brentwood	£21.00 ▶	24 ▶
Chiswick	£52.00 ▲	15 ▼
Croydon	£24.50 ▲	18 ▼
Gatwick	£24.50 ▲	20 ▼
Guildford	£31.50 ▲	18 ▼
Hammersmith	£51.00 ▲	15 ▼
Heathrow	£32.50 ▲	21 ▼
Maidenhead	£33.00 ▶	21 ▶
Reading	£33.50 ▲	24 ▼
Slough	£26.00 ▶	27 ▶
Staines	£33.00 ▲	21 ▶
St Albans	£25.50 ▲	18 ▼
Uxbridge	£32.00 ▲	21 ▶
Watford	£24.00 ▲	24 ▶
West Malling	£21.50 ▶	21 ▶

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

Note: ▲ = forecast for next 12 months

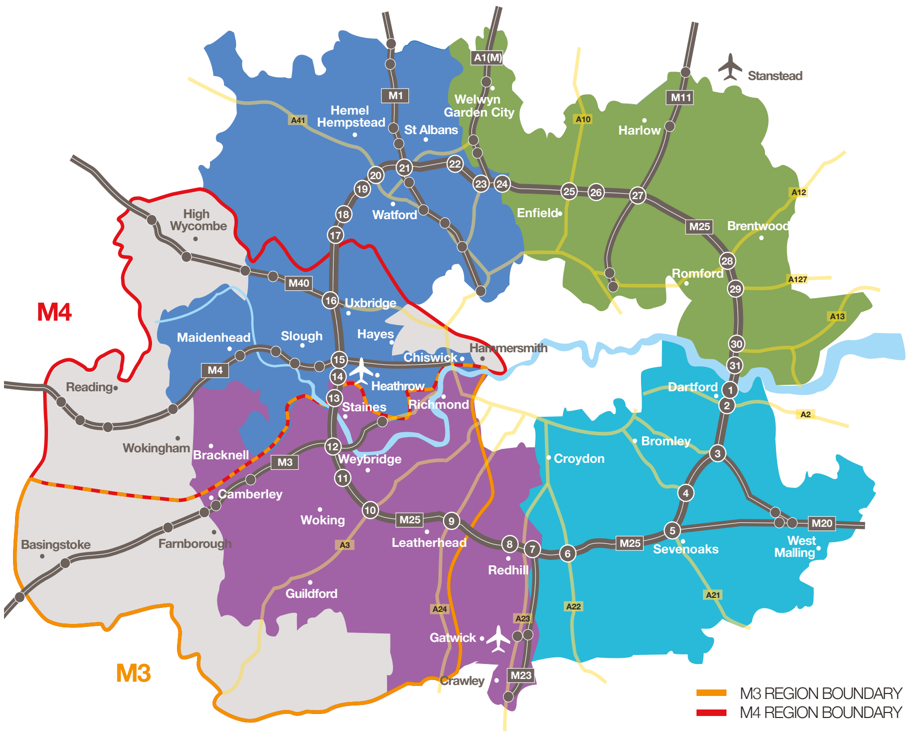


TABLE 2
Demand & Supply

Take-up	M25	NW	SW	NE	SE	M3	M4
sq ft	**418,399**	190,648	136,088	13,527	78,136	**140,940**	**409,951**
Change Q3 14 vs Q2 14	**3%** ▲	77% ▲	-47% ▼	100% ▲	95% ▲	**-38%** ▼	**154%** ▲
Change Q3 14 vs Q3 13	**-40%** ▼	-52% ▼	-2% ▼	-88% ▼	47% ▲	**-68%** ▼	**-36%** ▼
Q3 Pre-let (sq ft)	**0**	0	0	0	0	**0**	**0**
Q3 % New & Grade A (inc pre-lets)	**68%**	66%	75%	28%	70%	**96%**	**85%**
Year-to-date (m sq ft)	**1.58**	0.56	0.84	0.01	0.17	**0.63**	**0.99**
Forecast 2014 take-up (m sq ft)	**2.30**	**0.85**	**1.15**	**0.05**	**0.25**	**0.90**	**1.60**

Availability	M25	NW	SW	NE	SE	M3	M4
sq ft	**8,403,414**	3,826,367	2,917,356	373,424	1,286,267	**2,756,248**	**5,326,508**
Change Q3 14 vs Q2 14	**0%** ◀▶	-6% ▼	8% ▲	8% ▲	-4% ▼	**-5%** ▼	**-6%** ▼
Change Q3 14 vs Q3 13	**-14%** ▼	-7% ▼	-20% ▼	2% ▲	-20% ▼	**-14%** ▼	**-14%** ▼
Q3 % New	**15%**	13%	24%	15%	3%	**17%**	**19%**
Q3 % second-hand Grade A	**52%**	65%	43%	43%	36%	**49%**	**62%**
Q3 % second-hand Grade B	**33%**	22%	33%	42%	61%	**34%**	**19%**
Q3 vacancy rate (▲/▼ movement from Q2 14)	**6.4%** ◀▶	7.6% ▼	7.1% ▲	2.1% ▲	6.3% ▼	**6.8%** ▼	**7.5%** ▼

Under construction	M25	NW	SW	NE	SE	M3	M4
sq ft (net)	**1,091,631**	726,098	365,533	0	0	**277,271**	**1,740,585**
Change 12 months	**-19%** ▼	10% ▲	-12% ▼	0% ◀▶	-100% ▼	**-33%** ▼	**117%** ▲
Pre-let	**82,632**	51,132	31,500	0	0	**31,500**	**166,132**

Source: Knight Frank Research

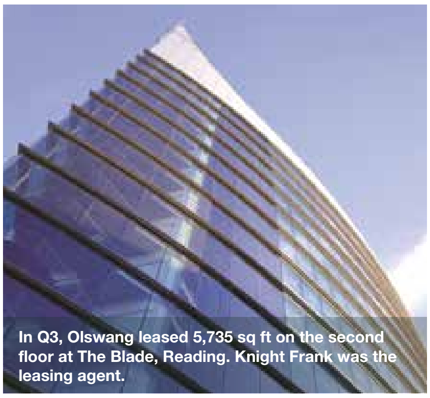
FIGURE 4

M25 active named enquiries by sector

TECHNOLOGY, MEDIA & TELECOMS	22%	▲
RETAIL, DISTRIBUTION & TRANSPORT	19%	▲
FINANCIAL & BUSINESS SERVICES	15%	▼
MANUFACTURING & FMCGS	14%	▼
PHARMACEUTICAL & HEALTH	14%	▲
CONSTRUCTION & ENGINEERING	6%	▲
PUBLIC SECTOR	6%	▲
ENERGY & UTILITIES	4%	▼

Active demand is 6.8m sq ft at Q3 2014

Note: % = current share of demand
▲ = Movement in last 12 months (absolute terms)



In Q3, Olswang leased 5,735 sq ft on the second floor at The Blade, Reading. Knight Frank was the leasing agent.

FORECAST AT A GLANCE

Take-up:

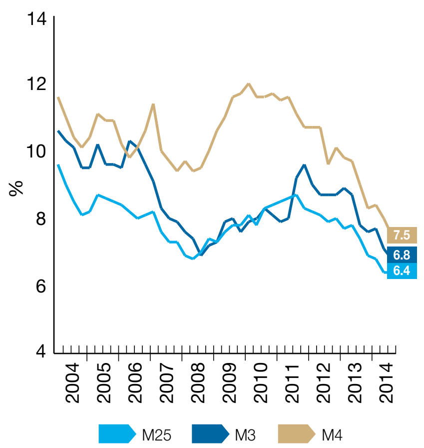
- Take-up has been disappointing over the past six months and runs contrary to the largely positive economic backdrop seen throughout 2014. Despite recent concerns about growing economic headwinds Eurozone, the latest PMI business survey for the South East region stands at a healthy 59.7 (above 50 denotes expansion) which is indicative of positive occupier sentiment.
- The statistics on underlying demand also paint a positive picture for activity moving forward – current space under offer stands 32% above its long-run average, at 1m sq ft, while active named demand has increased to a six year high. A key challenge is converting this positive sentiment into actual transactions, with some major occupiers delaying relocations in favour of more flexible and cost-effective solutions.
- Despite expectations of robust take-up in Q4, we have revised our forecast for M25 take-up down to 2.3m sq ft in 2014. This is below the five year high of 2013 but 10% above the five-year annual average. In light of a very subdued Q2, the downward revision is more significant in the M4, with 2014 take-up forecast at 1.6m sq ft, closely in line with the five-year annual average.

Supply and rents:

- The M25 vacancy rate is expected to reach its floor in the coming months, before rising gradually during 2015. This reflects, on the one hand, a slowdown in the amount of space being taken out of the market for residential conversion (via the changes to Permitted Development Rights) and, on the other, the delivery of development completions to the market.
- Speculative development has increased sharply within the M4 and is expected to rise further in the coming quarters to reach c. 2m sq ft. A high proportion of this development comprises refurbishment of existing space, as landlords and investors look to capitalise on evidence of rental growth by repositioning buildings to prospective tenants.
- This development is predominantly focused in several locations, particularly Reading and the West London markets. It could be reasoned that this will stymie headline rental growth, but recent evidence from key transactions in these markets indicates that occupiers are willing to pay the necessary price for the best quality space.

FIGURE 5

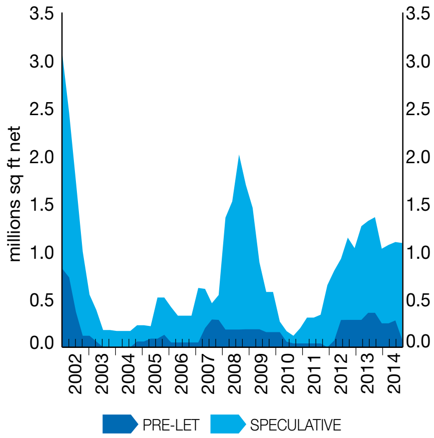
Vacancy rates



Source: Knight Frank Research

FIGURE 6

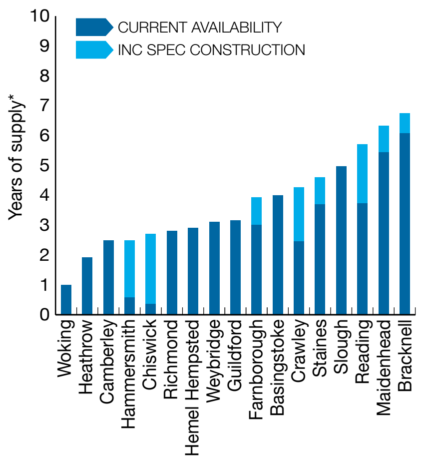
Space under construction in the M25



Source: Knight Frank Research

FIGURE 7

Years of New & Grade A supply



Source: Knight Frank Research

*Based on 10 year average New & Grade A take-up vs current New & Grade A availability

INVESTMENT MARKET

TABLE 3
Key investment transactions Q3 2014

Building	Size (sq ft)	Price	Net Initial Yield	Vendor/ Purchaser
Dukes Court, Woking	224,431	£61.50m	6.83%	IMV Immobillen / Aerium
Imperial Place, Borehamwood	226,425	£40.00m	8.00%	Schroders / Valad
Market House, Maidenhead	75,400	£39.00m	5.35%	Gatehouse / Tesco Pension Fund
64 Clarendon Road, Watford	66,871	£24.75m	6.21%	IM Properties / M&G
Hunton House, Uxbridge	24,826	£10.75m	5.76%	Farmglade / Aviva

	Transaction volume	Mean lot size	Mean NIY
Q3 2014	£619.75m	£19.4m	6.49%
Change 3 mths	9% ▼	15% ▼	45bps ▼
Change 12 mths	20% ▼	20% ▼	223bps ▼

INVESTMENT VIEW

- Investment in the South East office market remains strong, with Q3 turnover reaching £620m, 37% above the 5-year quarterly average. Q3 activity comprised 32 deals, taking the total for the first nine months of 2014 to 89, the highest seen at this point of the year since 2007.
- The market remains dominated by domestic investors and institutions, which together accounted for 26 of Q3's deals. This is particularly relevant with regard to well-located, multi-let assets, with overseas interest weighted more towards single-let opportunities.
- The weight of money seeking South East offices continues to put pricing under pressure. At the end of Q3, yields for prime 15-year income stood at 5.25%. Meanwhile, strong appetite for short income stock has seen its discount to long income reduce by 50bps during the last 12 months, to stand at c. 5.75% for prime 5-year income.
- A strong finish to 2014 is expected – buyers are keen to spend before the year end, and there are indications that an increasing number of opportunities are becoming available as a number of vendors sense an opportune moment to exit.

In Q3, M&G Real Estate purchased 64 Clarendon Road, Watford from IM Properties for £24.75m, reflecting a net initial yield of 6.21%.

FIGURE 8
Investment volumes

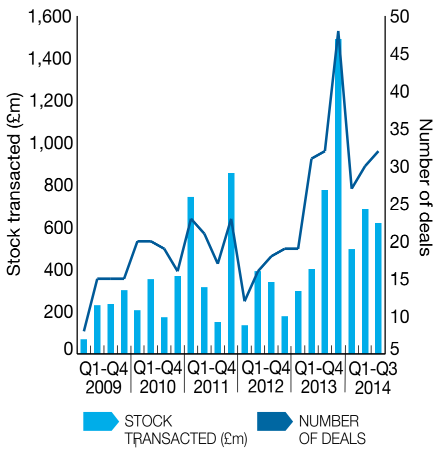


FIGURE 9
Mean initial yield & finance

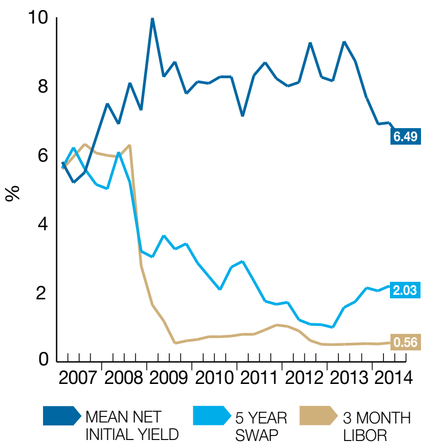
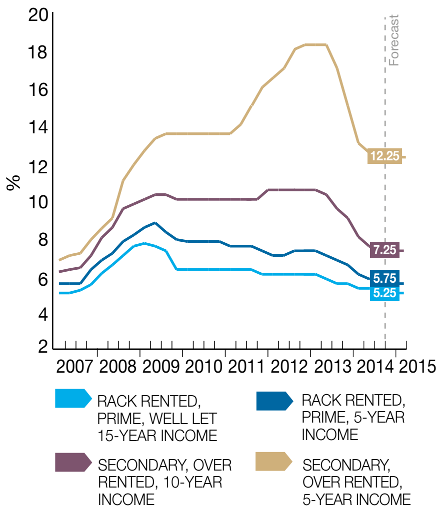


FIGURE 10
Yield forecasts



Source: Knight Frank Research

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TECHNICAL NOTE

- Knight Frank define the M4 market 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 69.4m 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 42.0m 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 130m sq ft (net), an M4 market stock of 69.4m 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 September 30th 2014.

Front cover image: 101 Park Drive, Milton Park, Oxon. The asset is owned by MEPC.

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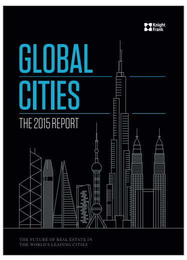

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