RESEARCH

M25 OFFICES

INVESTMENT, DEVELOPMENT & OCCUPIER MARKETS **Q3 2016**

SOUTH EAST TAKE-UP ON PAR WITH LONG TERM AVERAGE

HMRC SIGNS LARGEST DEAL OF 2016

BP HQ SOLD FOR £340M

FOREWORD

Four months on from the EU referendum and the shift between positive and negative headlines appears to be slowing, for now.

The most recent political and economic stories have brought mainly good news. UK GDP growth in Q3 was 0.5%, coming in ahead of expectations and exceeding the 0.3% figure for the Eurozone. Furthermore, the IMF also upgraded its UK GDP forecast for 2016 to 1.8% – the strongest rate of growth the IMF is predicting for a G7 nation.

The government has confirmed that the expansion of Heathrow Airport will proceed. This is not only a huge boost for the UK and the South East, but more specifically for the developers and investors who have taken a long term bet on the M4 corridor. Although this is just the beginning of a long process, this announcement does add some certainty to an unsettled marketplace.

In the interim, despite occupier and investor sentiment wavering in Q3, the 2016 numbers for the South East Office market are encouraging.

Occupier take-up is on par with the long-term average for the period following steady activity in the third quarter. Given the furore following the EU vote, a stable level of activity is reassuring.

Similarly, investor confidence is returning. Investment volumes for 2016 are already above our forecast for the year. Importantly, deals threatened by Brexit are now completing, albeit often, at a slightly reduced price. Nonetheless, we anticipate that the appetite for quality stock will remain strong and as such, pricing for prime assets will stay keen.

Clearly, the path ahead has many obstacles. The trigger for Brexit will be in 2017, bringing challenges, the size, and scale of which are unknown. For the time being, it is not quite business as usual for South East offices, but the market is proving resilient.

EMMA GOODFORD
Partner, Head of National Offices

MARKET IN BRIEF Q3 2016

SOUTH EAST TAKE-UP

778,300sq ft

▼12%*

TAKE-UP (SQ FT)			SUPPLY (SQ FT)		
M25	598,800	▼26.0%	M25	6.3m ▼5.6%	New and Grade A space 77%
M3	130,200	▲26.0%	M3	2.6m ▲2.6%	New and Grade A space 76%
M4	302,300	▼13.0%	M4	5.2m ▲1.0%	New and Grade A space 89%

SOUTH EAST TRANSACTION VOLUME

£719m

▼27%

£25m
Mean lot size

5.25%
Prime Net Initial Yield

£340m
Sale price of BP HQ in Sunbury

86%
Buyers from the UK

***Note:** Arrow indicators reflect percentage change from Q2 2016

"Q3 take-up has been better than sentiment would suggest meaning that rents and incentives have largely held firm."

EMMA GOODFORD
Partner, Head of National Offices

OCCUPIER MARKET

At the Q3 juncture, office take-up in the South East remains on par with the long-term average for the period. Availability continues to fall with vacancy in the M25 at the lowest level since 2001.

Take-up and demand

Despite market sentiment wavering in Q3, office take-up in the M25 was just 3% short of the long-term quarterly average with 598,000 sq ft transacted. Notably, this meant that total take-up for 2016 increased to just below 2 million sq ft. This is 9% above the 10-year average for the period. The 25-year lease of 183,600 sq ft taken by HMRC at Ruskin Square in Croydon was the largest deal of the quarter. This is one of six deals above 50,000 sq ft completed in the M25 during 2016 and represents the largest lease taken in the M25 catchment since 2012.

In the M4, total take-up fell by 13% in Q3 to 302,000 sq ft. Nonetheless, take-up for the year has now reached 1.1m sq ft, 5% higher than recorded over the equivalent period in 2015. The largest transaction of the quarter was the 50,000 sq ft letting to co-working firm The Office Group at 1 Lyric Square in Hammersmith. The TMT sector, however, remains the most active occupier group in the M4 accounting for five of 18 transactions in Q3 and 29 of 78 transactions during the year.

In the M3, take-up increased by 26% during Q3 with 130,000 sq ft transacted. Despite the increase, 2016 has proved to be a slower year in terms of occupier activity in the M3. Total take-up for the year has now reached 450,000 sq ft, 32% less than the 10-year average for the period.

Supply

Supply levels in the M25 fell by 6% during Q3 to 6.3m sq ft. This meant that availability is now 32% below the 10-year average. Notably, at 4.8%, the vacancy rate has dipped to the lowest level since 2001.

In the M4, despite 215,400 sq ft of speculative space reaching practical completion, overall supply levels remained unchanged at 5.1m sq ft. This total is 19% below the 10-year average for the area.

Similarly, Overall availability in the M3 recorded a small increase (2.6%) to reach 2.6m sq ft at quarter end. Nonetheless, availability in the M3 catchment remains 20% below the 10-year average.

Across the markets (M25, M3, M4) a total of 3.3m sq ft of speculative space is set for delivery by mid-2018. Notably, over half of the schemes currently under construction (56%) will complete within the next six months. As a result, vacancy rates will rise particularly in the M4. The increase will be short lived, however, with the rate of completions slowing after this period.

HMRC leased 183,600 sq ft at 1 Ruskin Square, Croydon

Comparison to the 10-year average

3%	29%	1%
M25 take-up	M25 availability	SE active demand

FIGURE 1
M25 Take-up

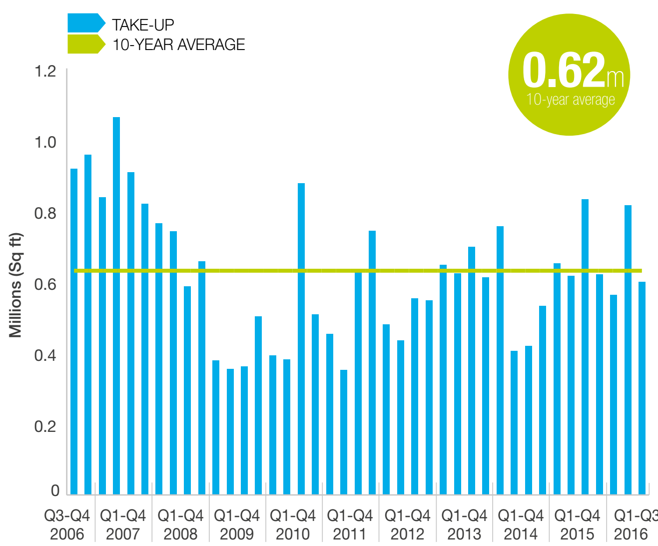
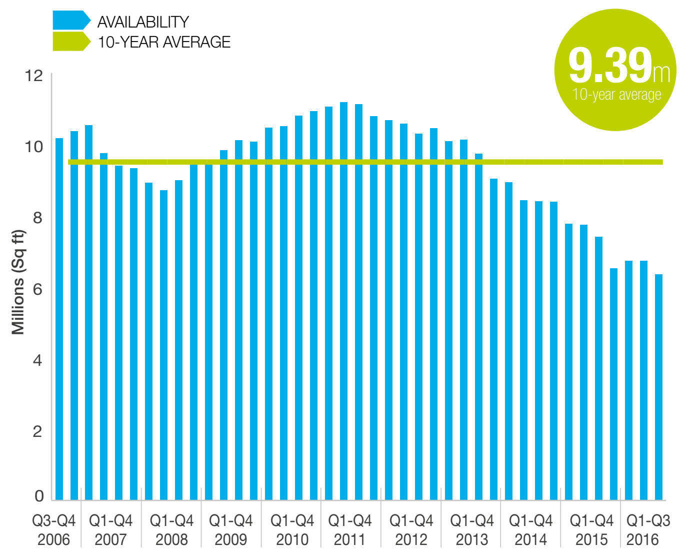


FIGURE 2
M25 Supply



Key leasing transactions Q3 2016

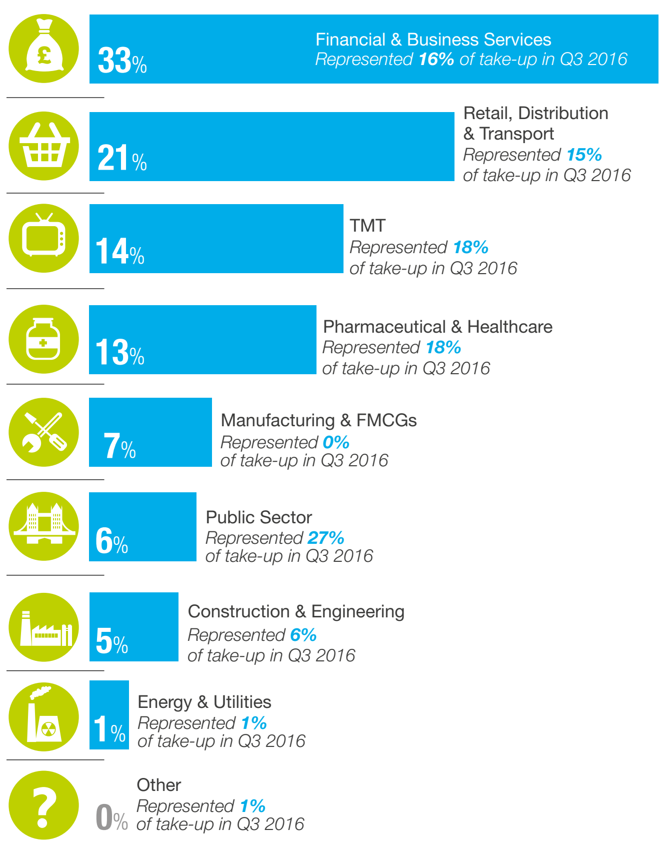
ADDRESS	SIZE (SQ FT)	OCCUPIER	RENT (PSF)
1 Ruskin Square, Croydon	183,600	HMRC	£33.50
1 Lyric Square, Hammersmith	50,000	The Office Group	Undisclosed
1030, Winnersh Triangle, Reading	43,500	Becton Dickinson	£33.50
2 Pinehurst, Farnborough Business Park, Farnborough	29,250	Fluor	£27.50
Building 7, Chiswick Park (10th flr), Chiswick	28,120	HH Saudi Research & Marketing	£56.00

Source for all charts: Knight Frank Research

DEMAND

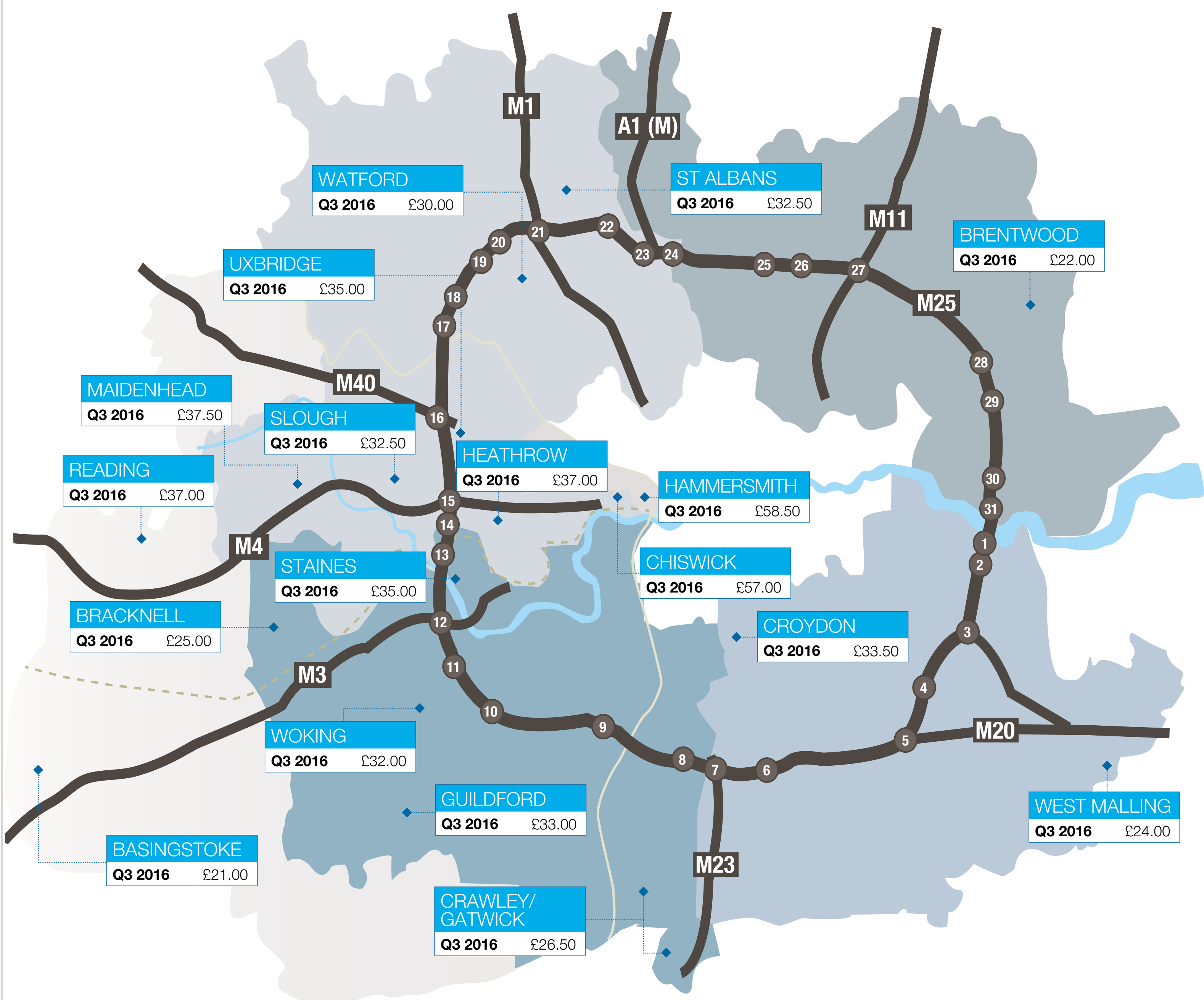
6.2m sq ft
OF ACTIVE NAMED DEMAND IN THE SOUTH EAST

Active named demand



0.5m sq ft
UNDER OFFER IN THE SOUTH EAST Q3 2016

Key town prime rents



Source for all charts: Knight Frank Research

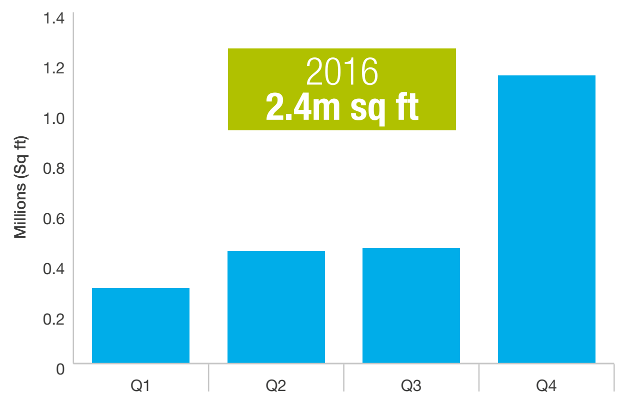
Rent assumes a new building let on a 10-year lease.

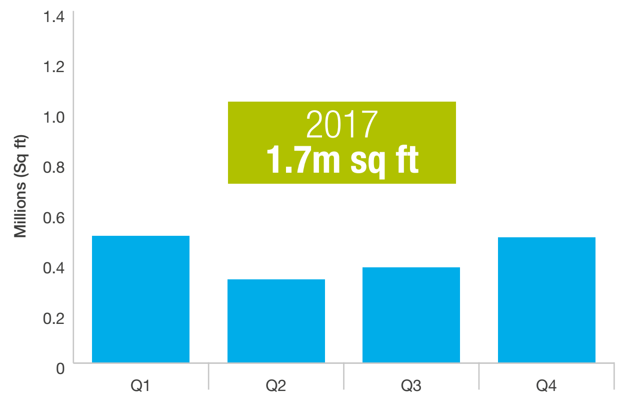
DEVELOPMENT

3.9m sq ft*
UNDER CONSTRUCTION IN THE SOUTH EAST

*Pre-let and speculative

Speculative completions in the South East





Speculative Development (sq ft)

Due to complete before the end of 2017

M25	M3	M4
2.0m	0.7m	2.3m

INVESTMENT MARKET

As the third quarter progressed, market confidence showed steady improvement, with buyers returning to the market. As a result, investment volumes during Q3 finished at £719m, well above the long-term average.

"After a difficult start to Q3, sentiment and transaction numbers improved albeit deliverable stock remains limited."

TIM SMITHER
Partner, Head of National Offices Investment

Sentiment at the beginning of Q3 was particularly negative, following the decision to leave the EU the week before. Most retail funds closed to prevent further outflows and deals that had been under offer before the EU vote fell away or prices reduced markedly.

However, as the quarter progressed, so the market rallied, with a number of high profile transactions completing and different types of buyers entering the market. The majority of Retail funds have now re-opened and the outlook is far more positive than 3 months ago.

Total volumes for the quarter stood at £719m, across 29 transactions. This is 42% ahead of the long- term average. Total volumes for the year have now reached £2.2bn. This is the second highest total at the Q3 mark since 2006, last year being the highest. However, half of this total is across three very large transactions which arguably mask lower trading volumes for 'core' assets.

Spelthorne Council's acquisition of the BP Campus in Sunbury is a good example of this; at £340m, it accounts for almost half of the Q3 volumes. Councils have become the largest buyer in the market, taking advantage of cheap debt from Central Government, and are bidding particularly aggressively for long income.

Prime 15-year yields stand at 5.25%, a quarter of a point softer than at the beginning of the year. Middle Eastern investors are particularly hungry for this type of income, benefitting from a dip in the value of sterling as well as competitive debt terms and relative political stability. However, they are being held back by a lack of available stock.

The other area that has seen increasingly aggressive bidding is that of short let/ vacant buildings that will benefit from Permitted Development rights. Residential developers are able to outbid their commercial rivals in many markets for this type of stock.

U.K. Funds remain broadly neutral, adopting a 'wait and see' approach, and we expect the retail funds to maintain a higher than usual cash position in the event of any further political or economic shocks.

It is likely that total volumes will approach £3bn for the year, assuming a reasonable Q4, well up on the long-term average, and almost ignoring the significant shockwaves felt by the market over the summer.

The Forum, Solent Business Park, Fareham

Change 12 months (Q3 2015 - Q3 2016)

7%	16%	25bps
Transaction volume	Mean lot size	Prime NIY

FIGURE 3
Investment volumes

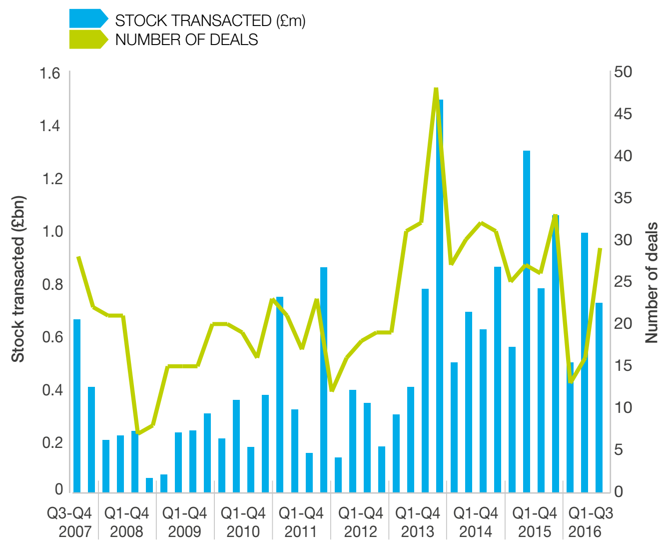
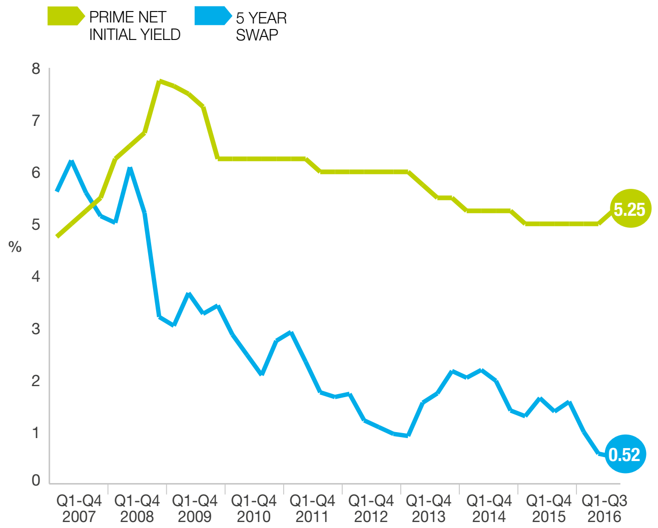


FIGURE 4
Prime net initial yield & finance



Key investment transactions Q3 2016

BUILDING	SIZE (SQ FT)	PRICE (£M)	NET INITIAL YIELD	VENDOR	PURCHASER
BP HQ, Sunbury	620,000	£340.00	4.50%	BP	Spelthorne Borough Council
10 Hammersmith Grove, Hammersmith	122,744	£86.30	6.07%	Aberdeen Asset Management Ltd	Brockton Capital LLP
The Forum Campus, Fareham	252,981	£43.00	7.63%	M&G Real Estate	Tristan Capital Partners
Wey House, Guildford	46,000	£22.65	5.10%	Columbia Threadneedle	Guildford Borough Council
4 Victoria Square, St Albans	51,373	£16.25	6.53%	Columbia Threadneedle	Knight Frank Investors

Source for all charts: Knight Frank Research

TECH IN THE SOUTH EAST

The UK's creative and high tech industry is expanding rapidly. The GVA contribution to the UK economy from this sector is now worth £81bn or 5% of GDP.

Notwithstanding any reduction during the Dot-Com crash and the 2008 Financial Crisis, overall tech employment has grown by more than 50% in the past 20 years. It is of little surprise therefore, that technology companies now feature more prominently in office demand schedules, as operational growth increases headcount.

Although, many regional UK cities can cite strong growth from this sector in recent years, the largest creative clusters have built up in London and the South East. In central London, occupiers with a Technology, Media or Telecoms (TMT) background have accounted for on average 29% of annual office take-up since 2011. Notably, this is the highest representation of any sector in central London over this period.

It is a similar picture in the wider South East office market. The proportion of office take-up allocated to the TMT sector has risen from 18% in 2011 to 30% in 2015. This again is the largest representation of any occupier group. Most notably, the amount of space required is growing. The TMT sector has been responsible for 25% of South East deals over 50,000 sq ft completed over the past five years. This compares to just 12% between 2006 and 2010.

Fundamental to demand growth in the South East is the benefit of clustering. Similar businesses are able to collaborate, co-work and share information, which is crucial in developing new products and winning new business. Most importantly, being able to access a critical mass of creative workers is the principal driver for this trend.

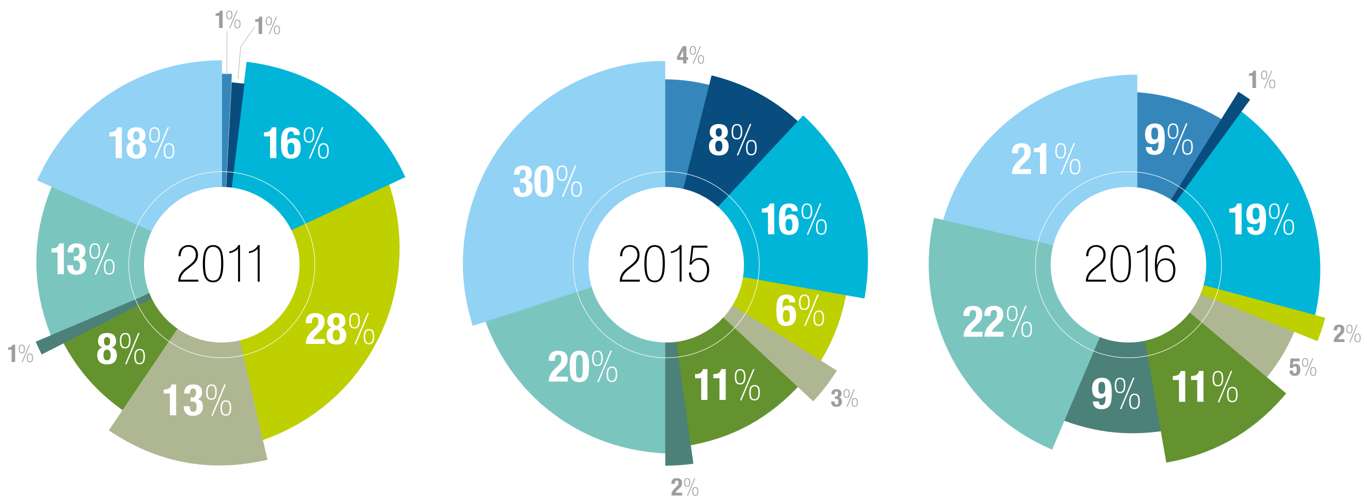
In the South East market, this is most evident in the M4 corridor. Long since regarded as the UK's Silicon Valley, the M4 corridor retains a standing attraction to tech occupiers. The area is home to the country's largest cluster of digital businesses outside London. The M4 can boast of housing global brands such as Oracle, Cisco, Microsoft, and Huawei.

In particular, the towns of Slough, Reading and Bracknell alongside the Heathrow area have a long kinship with the tech industry. These four locations alone account for 34% of TMT office take-up since 2011. The ecosystem created is spreading outward with recent deals completed in Maidenhead, Hayes and Chiswick.

Although TMT demand in the South East is not restricted to the M4 catchment – notable deals have completed in Basingstoke, Staines and Cambridge – the clustering nature of TMT firms means that these locations will always feature highly in locational analysis of occupiers. The arrival of the Elizabeth line will only further strengthen TMT interest in the Thames Valley.

In 2016, the M4 accounts for two thirds of space taken by TMT occupiers. Overall, the sector accounts for 21% of all take-up. In this, we can conclude that despite market disruption from mainly political events, TMT demand has not faltered.

FIGURE 5
Take-up by Sector



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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. Existing built office stock in the M4 market totals 72m 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 132m sq ft (net), an M4 market stock of 72m sq ft (net) and an M3 market stock of 42.0m 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.
- 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 Sep 30th 2016.
- **Front Cover: The Bower, Stockley Park**

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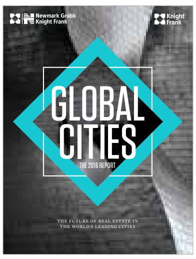

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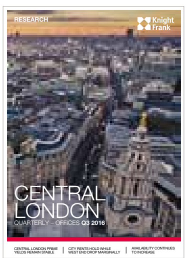
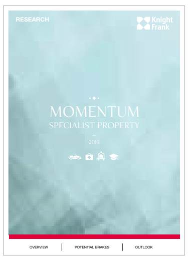


Central London
Quarterly Q3 2016



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