RESEARCH

Knight Frank

M25 OFFICES

INVESTMENT, DEVELOPMENT & OCCUPIER MARKETS **Q4 2016**

HIGHEST ANNUAL TAKE-UP IN THE SOUTH EAST FOR THREE YEARS

LIDL HQ SUPPORTS UPLIFT IN TAKE-UP

10 HAMMERSMITH GROVE SOLD FOR £103M

FOREWORD

Roll the clock back 12 months; the most contentious issue at the turn of the year was seemingly the rise in rail fares. This time around, there are more pressing issues to contend with.

The economic news is thankfully better than anticipated. Early indications suggest growth of 0.6% in the final three months of 2016, a similar rate to Q3. This has led the Bank of England to raise its expectations for the coming year, albeit only slightly. The forecasts of economic disaster post the EU vote have for now, been buried.

This scenario is also true of the South East office market. Undeniably, market sentiment has still not recovered from the EU referendum result. Occupiers and investors are nervous, reflective of an uncertain outlook. But crucially, companies have remained on an expansionary path and this is supporting above trend levels of leasing activity.

In tandem, investors continue to find reassurance after the initial shock. Deal numbers have steadily risen in recent months although in truth, investment appetite toward ‘the right opportunity’ never really subsided. The high value sales completed in 2016 illustrate this. These ‘big ticket’ transactions have ensured that investment volumes for the year nudged £2.9bn, well above the long-term annual average.

The market numbers clearly defy concern but advice must be pragmatic as the triggering of Article 50 nears.

Turning attention to the year ahead, the property market begins the year with momentum. In the past, events such as the Brexit vote led to widespread market apathy. Although we can find examples this time around, occupier demand has largely held firm. The case for investment – value and security – remains compelling in the South East. Fundamentally, the offer has not changed, just perception.

There are countless forecasts for 2017 already published, many of which point toward a ‘bumpy ride’. How the year will actually unfold? Experience shows that temporary disruption can bring opportunities.

EMMA GOODFORD
Partner, Head of National Offices

MARKET IN BRIEF Q4 2016

SOUTH EAST TAKE-UP

945,000 sq ft

▲ 21%*

TAKE-UP (SQ FT)

M25	**671,700**	▲ 12.0%
M3	**136,400**	► 0.0%
M4	**431,100**	▲ 43.0%

SUPPLY (SQ FT)

M25	**6.8m** ▲ 7.1%	New and Grade A space 78%
M3	**2.5m** ▼ 4.0%	New and Grade A space 75%
M4	**5.6m** ▲ 8.3%	New and Grade A space 89%

SOUTH EAST TRANSACTION VOLUME

£657m

▼ 9%

£21m
Mean lot size

5.25%
Prime Net Initial Yield

62%
Buyers from the UK

***Note:** Arrow indicators reflect percentage change from Q3 2016

“Proposed development schemes with a completion date beyond Q2 2018 are few, as developers remain cautious. This means that although an increase in vacancy is anticipated in 2017, any rise will be brief.”

EMMA GOODFORD
Partner, Head of National Offices

OCCUPIER MARKET

In 2016, the South East recorded the highest level of office take-up for three years. Availability has begun to edge upward, although vacancy rates remain significantly below historical levels.

Demand

Take-up across the M25 catchment increased by 12% during Q4 to reach 671,700 sq ft, a total 10% above the 10-year quarterly average. The upturn in occupier activity in the final quarter meant that total take-up for the year finished on par with 2015. This is 9% above the 10-year average for the period.

In Q4, Lidl became the latest retailer to commit long-term to the South East. The supermarket chain has gained planning permission to build a new 220,000 sq ft office headquarters in Tolworth, Kingston with occupation expected in 2020. This deal represents one of three completed over 100,000 sq ft in the M25 during 2016, the same number as 2015.

In the M4, take-up increased 43% in Q4 to 431,100 sq ft, 2% above the 10-year average. The quarterly rise meant that total take-up for the year reached 1.6m sq ft, an 11% year-on-year increase.
The largest transaction of the fourth quarter was the 71,000 sq ft letting to online fashion retailer Net-a-Porter at MediaWorks in West London. Notably, for the first time the retail sector accounted for the highest percentage of annual take-up across the South East, 30%.

By contrast, occupier activity has proved slow in the M3 market during 2016. A total of 136,400 sq ft transacted during the final quarter, a 4% increase when compared to Q3. Despite the rise, total take-up for the year reached 587,000 sq ft, 32% less than the 10-year average for the catchment.

Mitsui, Stanhope Plc & AIMCO’s development of White City Place.

Supply

Supply levels in the M25 increased by 7.1% during Q4 to 6.8m sq ft, marking the first rise for 12 months. This meant that the vacancy rate moved up marginally to 5.2%. Even so, availability remains 27% below the 10-year average.

The M4 catchment also recorded an increase. An uplift of 8% during Q4 meant that availability reached 5.6m sq ft with the vacancy rate moving out to 7.9%. Although this is the highest level of availability since Q2 2014, the Q4 total is still 11% below the 10-year average for the area. In contrast, overall availability in the M3 fell marginally (-4%) to reach 2.5m sq ft. This total is 22% below the 10-year average. The vacancy rate was unchanged at 6.1%.

Across the markets (M25, M3, M4) a total of 3.3m sq ft of speculative space is set for delivery by mid-2018. Notably, 2.7m sq ft of speculative space is due to reach practical completion within the next 12 months.
As a result, vacancy rates will rise in 2017.

Vacancy levels are expected to peak by Q1 2018 in the M25 at 5.6%. Development completions are few after mid-2018, meaning parity with the Q4 2016 rate will be reached before year-end 2018. In the M4, vacancy will peak in Q2 2018 at 9.5%, still well below the 10-year high of 12% recorded in 2010. Parity is forecast, here in 2019.

Comparison to the 10-year average

10% M25 take-up

27% M25 availability

4% SE active demand

FIGURE 1
M25 Take-up

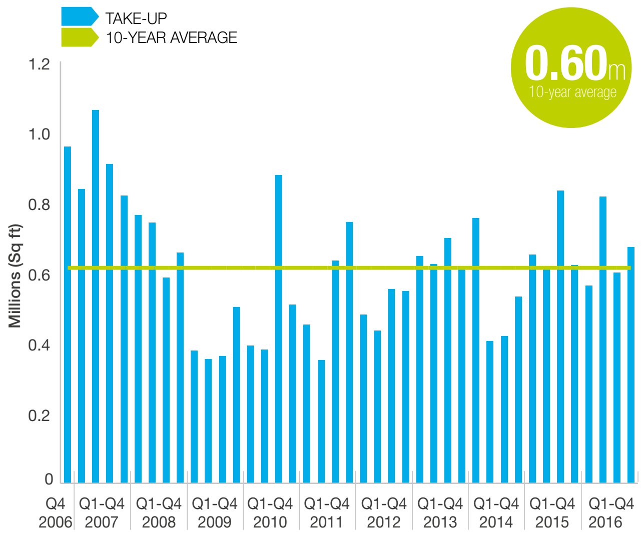
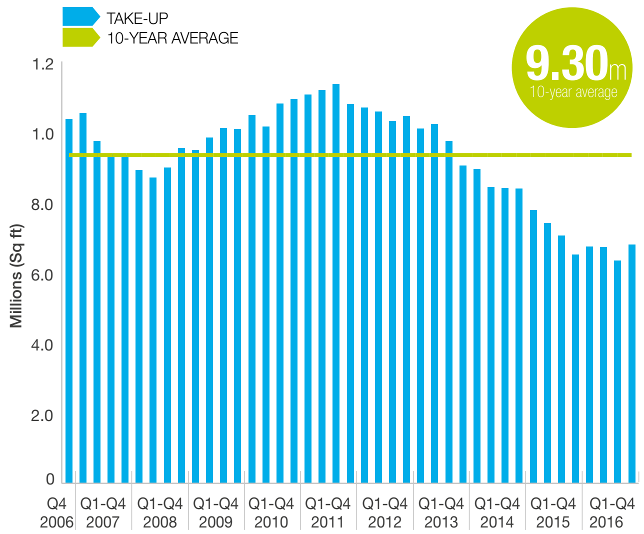


FIGURE 2
M25 Supply



Key leasing transactions Q4 2016

ADDRESS	SIZE (SQ FT)	OCCUPIER	RENT (PSF)
Tolworth, Kingston	220,000	Lidl	Confidential
MediaWorks, West London	70,508	Net-a-Porter	Confidential
30 Priestley Road, Surrey Research Park, Guildford	51,386	University of Surrey	Occupier purchase
TOR (1st, 2nd & 3rd flrs), Maidenhead	44,985	Rank Group	£33.50
Southern House (14th &15th), Croydon	23,381	Ministry of Justice	£21.50

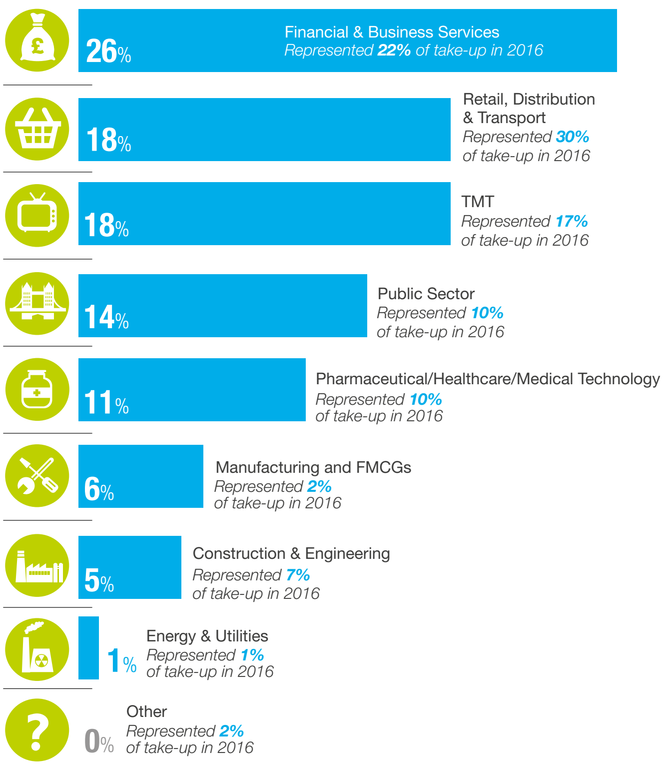
Source for all charts: Knight Frank Research

DEMAND

5.8m sq ft

OF ACTIVE NAMED DEMAND IN THE SOUTH EAST

Active named demand

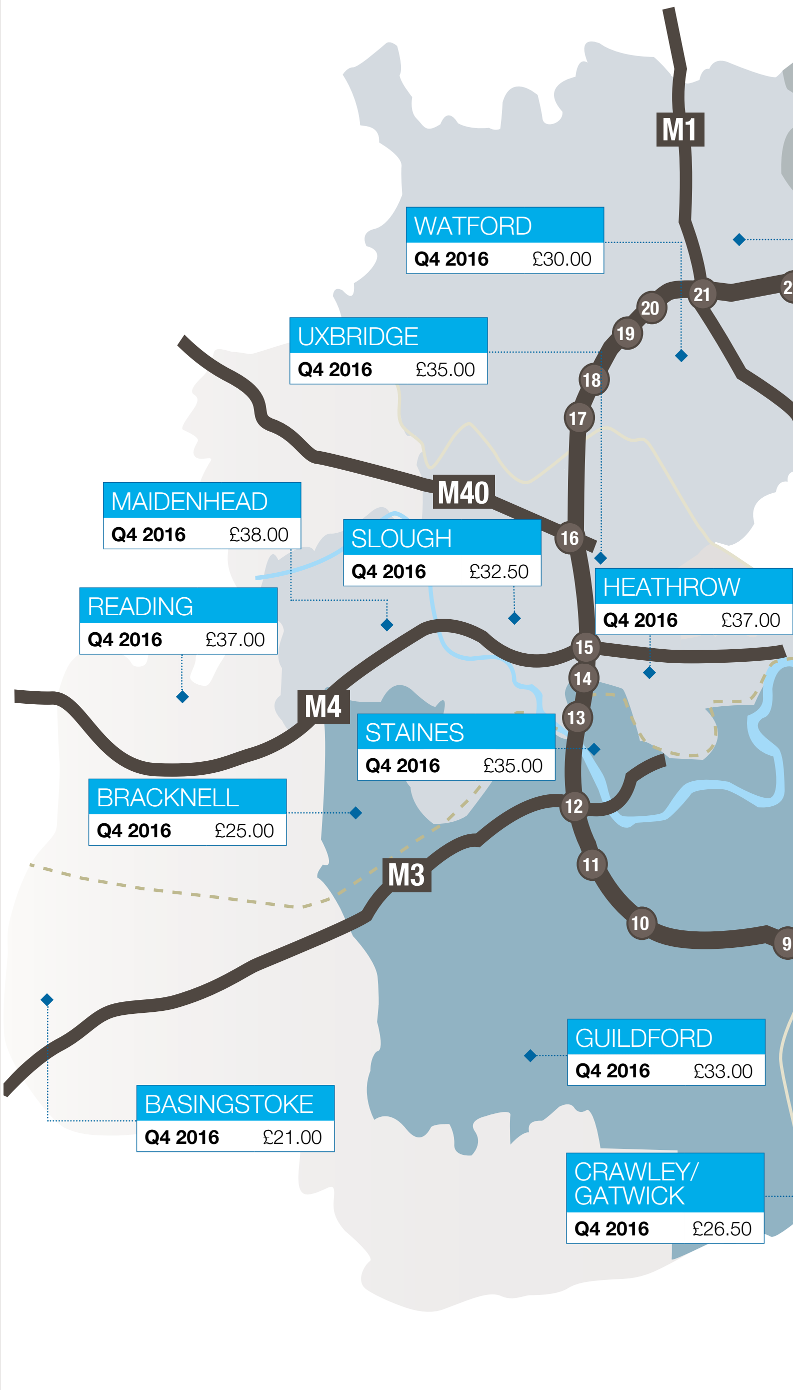


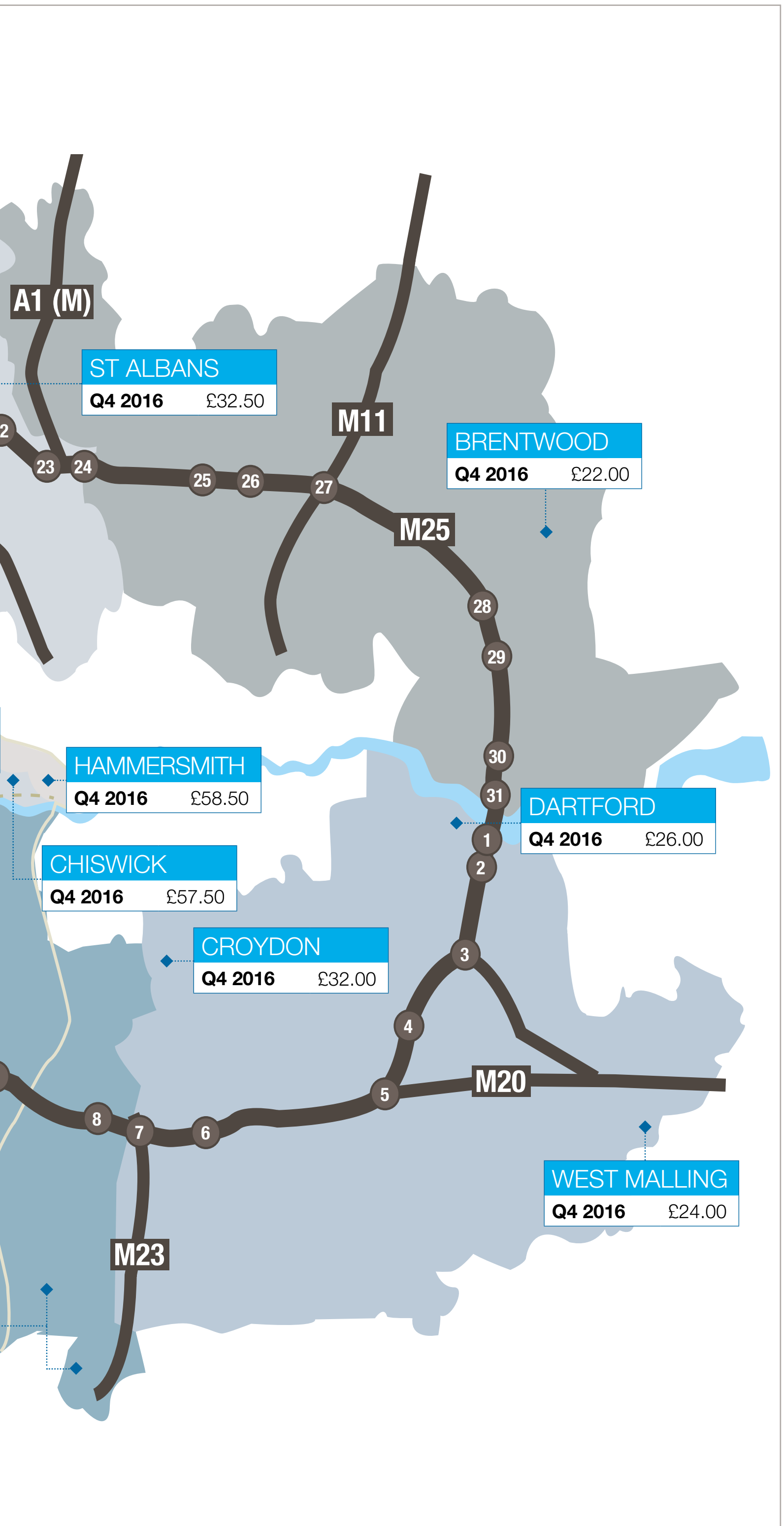
0.6m sq ft

UNDER OFFER IN THE SOUTH EAST Q4 2016

Source for all charts: Knight Frank Research

Key town prime rents





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

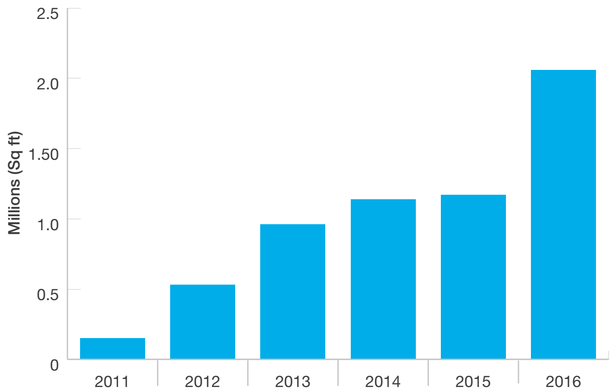
DEVELOPMENT

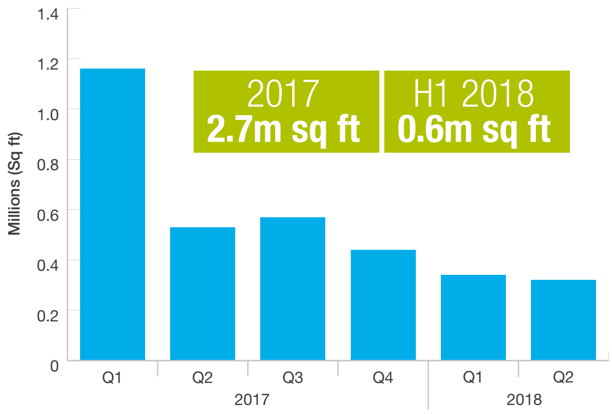
4.0m sq ft*

UNDER CONSTRUCTION IN THE SOUTH EAST

*Pre-let and speculative

Completions in the South East





Speculative Development (sq ft)

Due to complete before the end of 2017

M25	M3	M4
1.4m	0.7m	2.4m

INVESTMENT MARKET

After a slow start, the South East office investment market showed significant improvement in the second half of 2016, with buyer confidence returning to the market after the EU referendum.

"We anticipate more sellers will return to the market as confidence improves. The additional stock should stimulate further increases in transaction levels."

TIM SMITHER
Partner, Head of National Offices Investment

Investment volumes in 2016 reached £2.9bn. Although behind the record £3.7bn in 2015, this is well ahead of the long-term average of £2bn.

That said, over £1.3bn was made up of four large transactions; namely AEW's acquisition of Bath Road Frontage, Slough; Mapletree's acquisition of Green Park, Reading; Spelthorne Council acquiring the BP Campus in Sunbury and in Q4, the sale of 10 Hammersmith Grove for £103m to Tai United Holdings.

Councils have become a major buyer in the market, taking advantage of a low cost of capital 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 2016, albeit we expect this could sharpen through the first half of 2017. In addition to councils, 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.

We expect major UK Funds to be acquisitive in Q1 2017, many with capital to be deployed. Additionally, we anticipate the retail funds to maintain a higher than usual cash position in the event of any further political or economic shocks. This will be a watching brief, largely dictated by inflows and outflows.
The suggestion at this stage is that they are relatively neutral.

Looking forward, we expect continued demand for good quality assets in core locations. We expect investors to be more positive on the occupational market, and therefore prepared to take on occupational risk and potential capital expenditure liability.

The demand for long income looks set to continue through the year, fronted by councils and overseas investors. The start to 2017 will remain characterised by a continued lack of stock, although we do expect some parties to take advantage of the depth of demand, and exit at pricing levels well ahead of their business plans.

Centrica Global HQ, Windsor.

Change 12 months (Q4 2015 - Q4 2016)

15%	23%	25bps
Transaction volume	Mean lot size	Prime NIY

FIGURE 3
Investment volumes

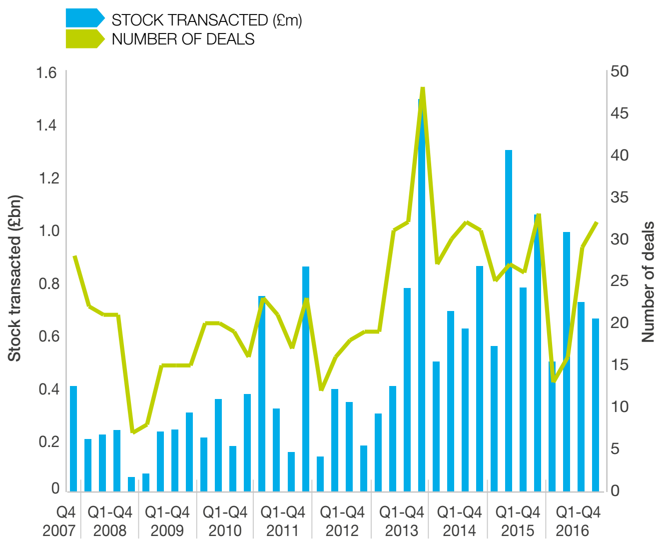
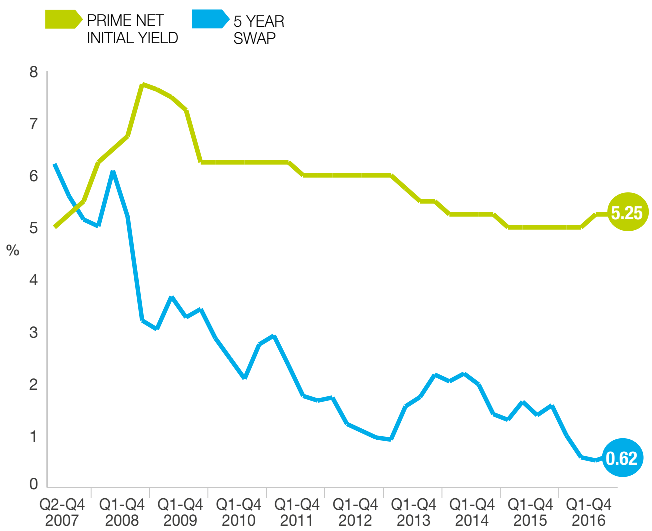


FIGURE 4
Prime net initial yield & finance



Key investment transactions Q4 2016

BUILDING	PRICE (£M)	NET INITIAL YIELD	VENDOR	PURCHASER
10 Hammersmith Grove, Hammersmith	£103.50	5.06%	Brockton Capital	Tai United Holdings
50/60 Station Road, Cambridge (Land sale)	£85.40	6.00%	Brookgate	Aviva
Centrica Global HQ, Windsor	£56.25	5.71%	TH Real Estate	Gatehouse
Atkins, Epsom	£46.70	4.10%	James Boot	Legal & General
Waterside House, Bracknell	£35.20	5.64%	Aviva	Palmer Capital

Source for all charts: Knight Frank Research

KNIGHT FRANK VIEW

RYAN DEAN
With over 50% of South East take up in 2016 being sub 10,000 sq ft, landlords may consider splitting buildings and floors. There will be more deals in 2017 but with business rates rising, closing out voids quickly and gaining letting momentum will be key.

RODDY ABRAM
There was an initial shift in power following the EU Vote giving the occupier an opportunity to negotiate more favourable terms. Since then, the Landlord's position has strengthened. Rental tones are holding firm with under supplied towns such as Brighton, Reading, Hemel Hempstead and Maidenhead recording record rents in 2016.

WILL FOSTER
Permitted development has removed millions of square feet of potential pipeline from the market. This, combined with continued investor/developer caution, will constrain the future development pipeline meaning vacancy will remain close to the low level seen in 2016.

TIM SMITHER
There is plenty of money looking to invest into the South East, particularly for long income and good quality, multi-let stock in markets continuing to witness rental growth. Dollar denominated overseas buyers, councils and residential developers were the hottest buyers in the market in 2016 and we expect them all to remain active this year plus we should see the funds return for select opportunities.

SIMON RICKARDS
£2.9bn of transactions concluded during the course of last year. With solid demand from investors we expect another good outturn for 2017 although a lack of deliverable stock is likely to hold volumes back, particularly during the first half of the year. We believe the lack of stock and strong levels of demand mean prime yields are likely to harden from 5.25% during the course of the year.

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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 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.
- 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 December 31st 2016.
- **Front Cover: White City Place and Television Centre, West London**

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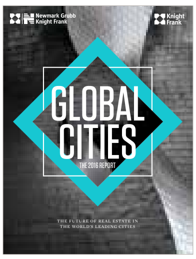

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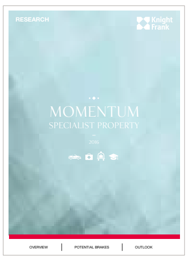

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