Investment, Development & Occupational Markets

M25 Offices

Issue 1 – The impact of COVID-19
July 2020

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FOREWORD

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In just a few short months, COVID-19 has had a profound impact on every facet of daily life. To varying degrees of severity, it has affected all businesses without exception. As restrictions begin to ease, focus is shifting to adaptation and recovery. How can businesses prepare for a different world of working? How will businesses change to thrive in a very different competitive landscape?

It is true though, that prior to the pandemic, structural shifts were already afoot and dictating the direction of market activity. Location had risen as a point of strategic significance and technological innovation was shaping a new operational reality for firms. The pace of these shifts will continue to accelerate coupled with a new phase of intense cost management.

The COVID-19 pandemic is unlike previous shocks. Its impact on the UK economy and real estate markets does not fit neatly into traditional models. Undoubtedly, we are now entering a period of significant change and thus great uncertainty. One characteristic of the M25 and wider South East market, that has been consistent throughout time, is the ability to adapt and reinvent. Moments of crisis have historically served as an impetus for innovation. A retrospective view in years to come, will again show this to be true.

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WHAT IS THE MARKET IMPACT?

Occupational Market

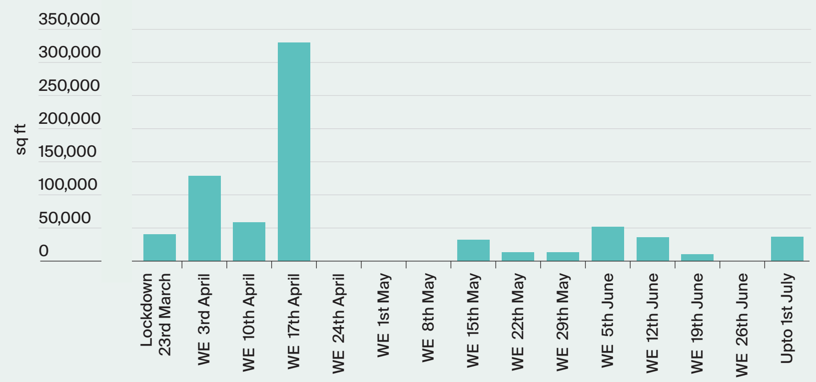
Unsurprisingly, transactions slowed from the onset of the UK lockdown as the scale of the unprecedented market disruption quickly unfolded. Some occupiers pressed ahead with strategies to expand or upgrade nonetheless, galvanised by a fear of not being able to secure space in markets of low supply. Take-up in the South East since the announcement of lockdown up to the end of Q2 is 713,400 sq ft. For context, this is 19% below a typical quarterly average. With only 22% of this total registered after April though, it is clear that the majority of transactions were close to finalising before capital expenditure halted and restrictions on movement hindered viewings and inspections.

Importantly, examples of deals completely withdrawn during the pandemic are few and mostly in the sub 10,000 sq ft category. Cancellations total just 55,000 sq ft over the period since lockdown, albeit 1.1m sq ft of requirements have gone on hold as occupiers take stock of the situation. Named demand is now at a record low of 4.0m sq ft, 1.7m sq ft lower than recorded immediately after the Global Financial Crisis.

Investment Market

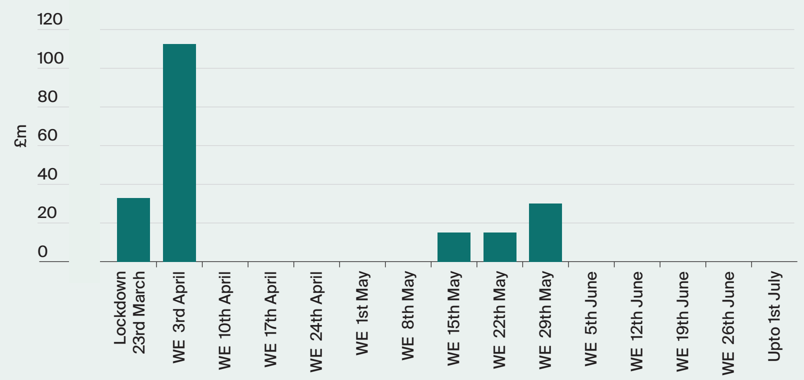
The practicalities of conducting due diligence have also proven prohibitive to investment activity. Since the 23rd of March, £205m of office stock has sold, with three sales amounting to £60m completing after April. Close to £52m of assets are under offer at the time of writing but investor sentiment in general is weak. This has meant low availability of stock for sale as investors hold assets, but also some discord exists with regard to expectations on pricing. In respect of the latter, market pricing does remain competitive, particularly for best in class assets where rental values are more stable. Secondary or higher risk assets, where there is a need for refurbishment and re-letting are most likely to be areas of correction. Any shift could ignite some buyer interest at this end of the market. Given that many forecasters are predicting a significant economic recession will be the result of the pandemic, a subdued market will prevail for some time to come, with any activity firmly focussed on quality.

Leasing take-up timeline since lockdown



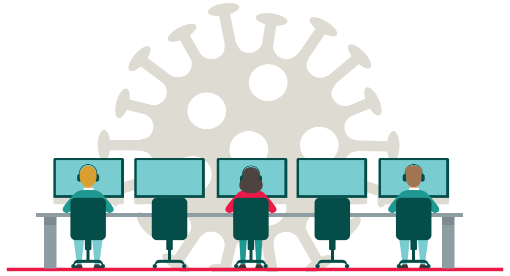
Source: Knight Frank Research

Investment timeline since lockdown



Source: Knight Frank Research Note: Deals Completed

WHAT NEXT?



01.

RETURN TO THE OFFICE WILL MEAN ISOLATION BEFORE COLLABORATION.

Even after lock down restrictions are relaxed, the return to physical spaces will be slow and gradual. Employees are likely to return to the office in stages and find capacity much reduced. For an interim period, circumstance will serve to modify interaction with space. Physical distancing will be inherent, as will a stringent cleaning regime, regimented human transit routes and staggered working patterns. This may mean that business parks prove more conducive to a quick return, with large floor plates more easily divisible to adhere to distancing.

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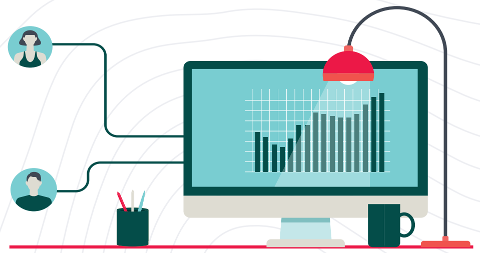
Initial predictions suggested that firms might need to take extra space to achieve many of these safeguarding requirements. With three months passing since lockdown however, few requirements of this nature surfaced as most companies have successfully transitioned to working from home. Moreover, given the uncertain longevity of the pandemic, most firms are understandably unwilling to invest in expanding their office footprint or spend significant sums on solutions potentially rendered redundant upon the discovery of a vaccine. A major objective of office occupiers will therefore clearly be to limit human contact in the next few months. A hybrid model whereby some employees are working from home and some are working from the office will prevail for now. A short reflection might suggest that this could be a hint on the future direction of travel for working practices and the workplace itself.

02.

A SLOW ROAD TO REOPENING OFFICES, BUT WILL OCCUPATIONAL DEMAND CHANGE?

Whilst practical steps within the workplace are achievable, the commute may ultimately dictate the ease of any return to the office. Public transport presents a clear area of vulnerability in terms of exposure to COVID-19 meaning a health crisis will severely affect not only the way we work together but also the way we co-exist in public. This may mean a shift in occupier preferences to locations of least reliance. In the South East outside of London, around 60% of journeys to work are by car. This leaning toward road use could in the immediate term, offer an easier route back to the office for some firms. Longer term, analysis regarding operational risk may conclude that locations predicated on easy car access such as business parks, offer the best form of resilience to any health emergency reoccurrence in the future. The 'Hub and Spoke' model could begin to carry favour within the office sphere potentially achieved through smaller regional footprints or flexible office membership. These are issues we will examine in more detail in future issues.



03.

WORK IS WHERE CONNECTIVITY, IS EVEN AFTER THE PANDEMIC.

As the forced shift to remote working reveals weaknesses in business continuity, digital transformation will clearly be a high business priority moving forward. The crisis has evidenced both improved business agility via technological means, and reminded of the important role that technology holds in current and future service delivery. The pandemic has served to expose vulnerability of some businesses who have previously off-shored operations. The problem? Employees have been unable to work from home due to weaknesses in internet connectivity and IT platforms beyond the office environment. This has meant that certain functions delivered off shore have ceased as a result. In the aftermath of COVID-19, businesses appetite toward the re-shoring of such business units is likely to solidify. For the most part, technology has been successful in keeping people within businesses connected, but the ability to sell services and products has been much more challenging. Digital infrastructure, whether at a country, city or building level, will therefore be a point of differentiation.

04.

WHAT ABOUT THE OTHER CRISIS? THE CLIMATE.

Understandably, the attention of all businesses is on COVID-19 at present, but the climate emergency remains an issue requiring equally comprehensive action. The built environment accounts for 45% of total UK carbon emissions and 32% of landfill waste comes from construction and demolition of buildings. COVID-19 will clearly bring challenges to reducing this burden not least from the expected tightening of budgets for businesses and developers. New development projects aimed at achieving zero carbon credentials may now question viability if lower rental growth is the result of weaker economic conditions for example.

The role of the built environment on achieving improvement cannot be underestimated though. The use of space is a topic now very much in the spotlight, with changes to occupier preferences likely to transcend the pandemic. Firms will be looking differently at the occupational footprint and developers will be increasingly conscious of positioning their product in a market of weaker demand. Alignment to changing demands incorporating systems that create a circular economy for instance – minimising waste, keeping products and materials in use for longer, and regenerating natural systems – will now be even more central to achieving sustainability gains whilst remaining cost-effective.

Does transport have a role to play?

Revision of plans aimed at mitigating climate change through traffic management quickly followed the announcement of lockdown. In Oxfordshire, the County Council and Oxford City Council moved the launch of the proposed Zero Emission Zone (ZEZ) until the summer of 2021. Whilst in Greater London, a short-term suspension of London's Ultra-Low Emission Zone (ULEZ), Low Emission Zone (LEZ) and Congestion Charge spanned from 23rd March, with reinstatement on 18th May. In the immediate term, the announcement of delays have coincided with the sharp fall in people travelling. This meant little impact. As employees return to work, the environmental implications of deferring start dates will become clearer.

The many facets of the built environment and adjoining infrastructure have the capacity to shape how we tackle climate change and achieve a sustainable future. In the aftermath of the last major economic shock of 2008, the green agenda took a back seat. Will the same be true in 2020?

Locations with easy car access such as business parks, offer the best form of resilience to any health emergency reoccurrence in the future.

FINAL THOUGHTS

What happens in the months ahead, and even if a COVID-19 vaccine becomes available, is a subject of much debate. People occupying an open space and sharing desks was embraced without question just a few months ago, but now seems contrary to safety, at least for now. The experiences of the pandemic will clearly have a long-lasting impact on the way we work and how our workplaces function. Working from home has proved effective stand-in for the office and will be a component of business operational structures moving forward. However, it is not a wholesale replacement. The role of the office was already transitioning away from being hubs of administration towards centres of collaboration, creativity and innovation. This trend will exacerbate in the post COVID-19 world and serve to make offices more important. With a significant business restructuring agenda upcoming, the office will be a focus of education, reshaping corporate culture and a pivot to drive digital transformation. The flight to quality will continue and markets that offer best in class will remain in strong demand.

M25 OFFICES, ISSUE 1 – THE IMPACT OF COVID-19

Market Summary

Q2 2020

OCCUPIER MARKET

COVID-19 restrictions severely affected occupier activity during the quarter, with take-up inflated by a single large pre-let. A cautious re-opening of offices is now beginning, with assessment of current and future space needs a principal focus.

SOUTH EAST TAKE-UP

534k sq ft

▲ +5%

Note: change compared to Q1 2020

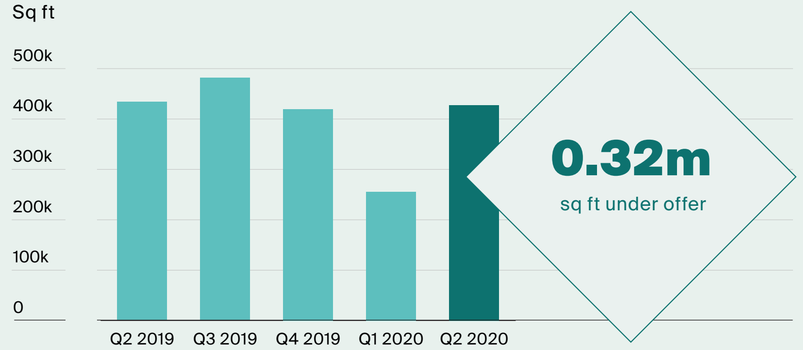
Two Ruskin Square Croydon. 330,000 sq ft Prelet by Stanhope to Government Property Agency

Take-up and supply
Q2 2020

	TAKE-UP (SQ FT)	TAKE-UP (VS Q1 2020)	SUPPLY (SQ FT)	SUPPLY (VS Q1 2020)	VACANCY RATE
M25	427,623	▲ +67%	7.0m	▲ 1% New and Grade A space: 78%	5.8% New and Grade A space: 4.5%
M3	86,489	▼ -51%	2.6m	▲ 4% New and Grade A space: 80%	6.7% New and Grade A space: 5.4%
M4	77,112	▼ -71%	6.0m	▲ 3% New and Grade A space: 80%	9.1% New and Grade A space: 7.2%

Source: Knight Frank Research

M25 take-up
Sq ft

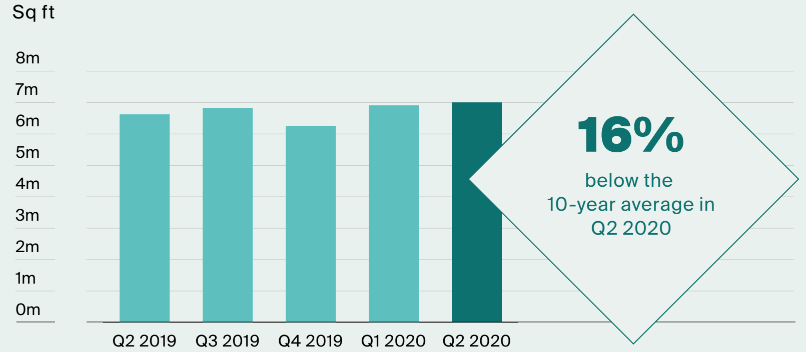


Source: Knight Frank Research

Emma Goodford

Encouragingly, few deals have withdrawn during the pandemic so far. New enquiries have fallen sharply though as firms reassess future space needs.

M25 supply
Sq ft



Source: Knight Frank Research

Roddy Abram

The tight supply landscape and a general flight to quality will mean that headline rents hold firm despite the fall in transactional activity.

Key leasing transactions
Q2 2020

ADDRESS	SIZE SQ FT	OCCUPIER	RENT £ PER SQ FT
Ruskin Square, Croydon	330,000	The Government Property Agency	Confidential
18 Rankine Road, Basingstoke	32,241	R. W. Armstrong	Confidential
210, Winnersh Triangle, Reading	31,743	Hewlett Packard	£28.00
Birchwood House (ground floor), Leatherhead	17,050	Hyundai	£27.50
Q4, The Square, Leatherhead	14,639	Aviva	£29.00

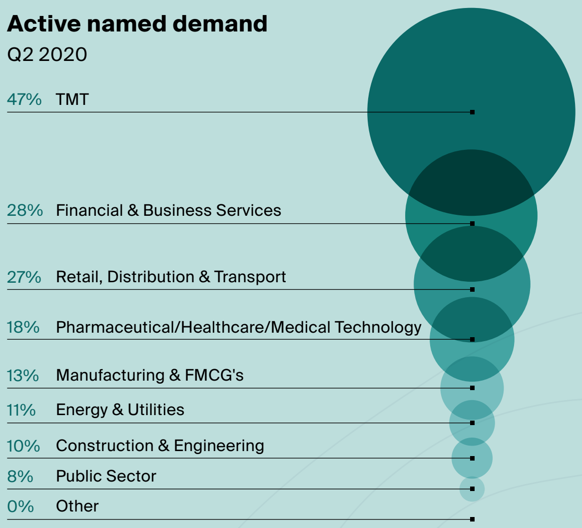
Source: Knight Frank Research

DEMAND: 4.0M SQ FT

Of active named demand in the South East

Active named demand

Q2 2020



Source: Knight Frank Research

DEVELOPMENT: 1.2M SQ FT

Space under construction in the South East

*This includes pre-let (0.3m sq ft) and speculative space (0.9m sq ft)

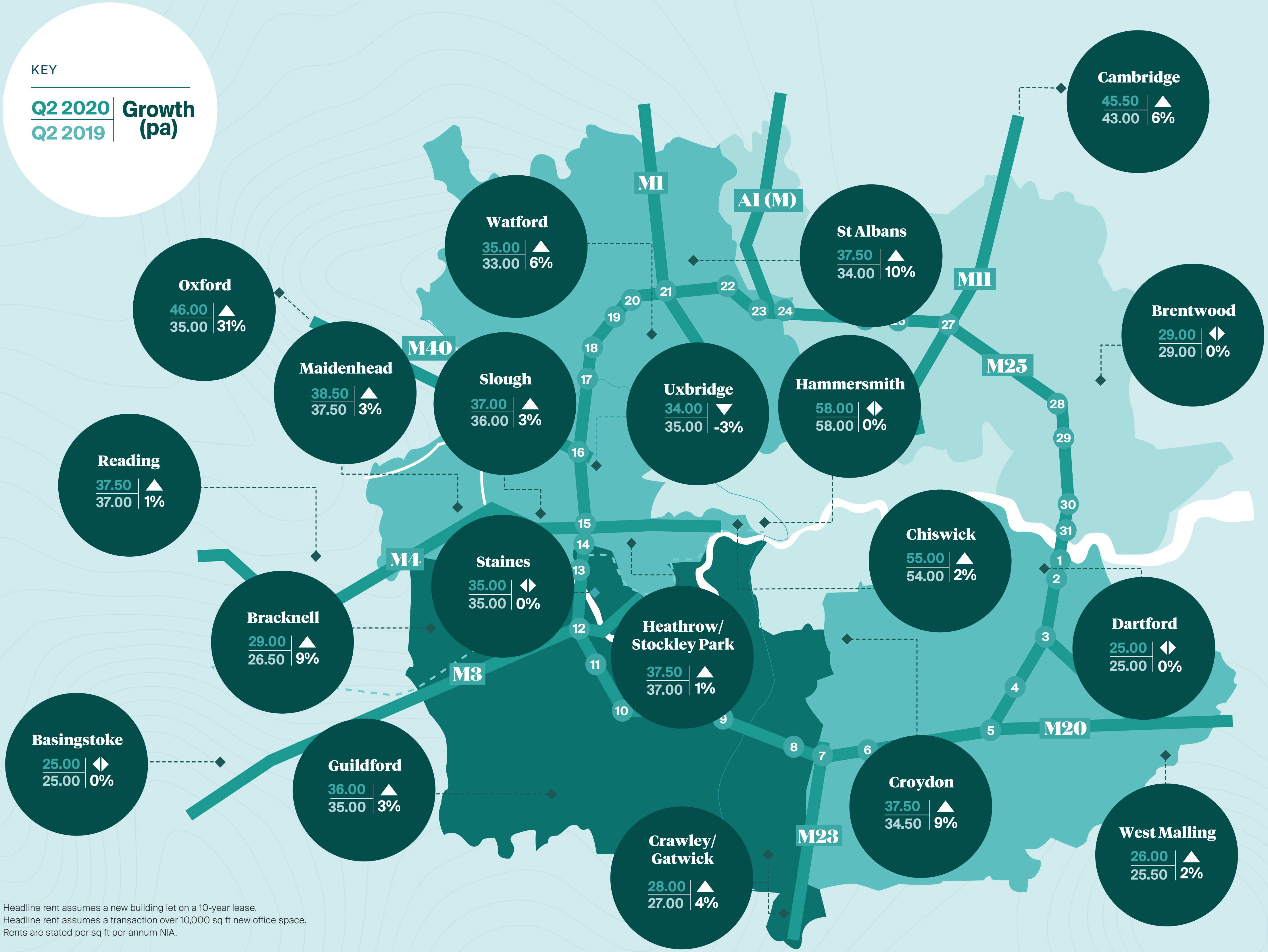
Speculative development

Sq ft due to complete before Q1 2022

Source: Knight Frank Research

PRIME RENTS

£ PER SQ FT



Headline rent assumes a new building let on a 10-year lease.
Headline rent assumes a transaction over 10,000 sq ft new office space.
Rents are stated per sq ft per annum NIA.

Source: Knight Frank Research

Harwell Campus, Harwell

INVESTMENT MARKET

COVID-19 quickly meant adoption of a 'wait-and-see' approach was the preferred stance for most. Market interest is beginning to return but sellers are few, with investors choosing to hold assets for longer.

-73%

£172.5m
South East transaction volume*

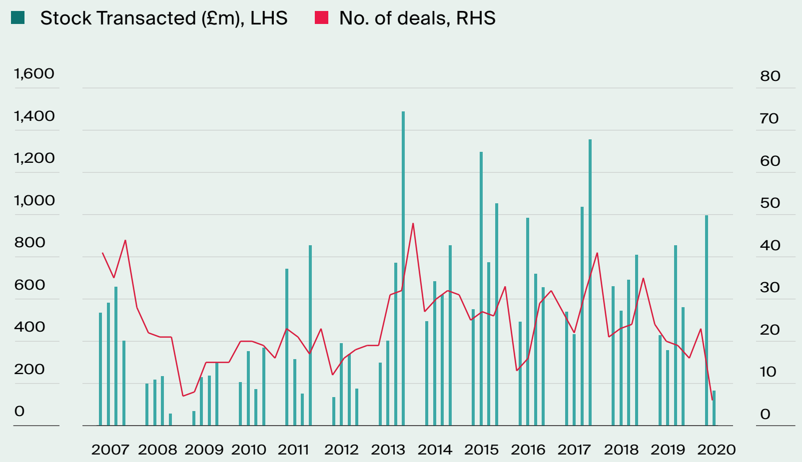
£34.5m
Mean lot size

5.25%
Prime net initial yield

30%
Buyers from the UK

* Percentage change reflects a comparison to 10yr quarterly average

Investment volumes

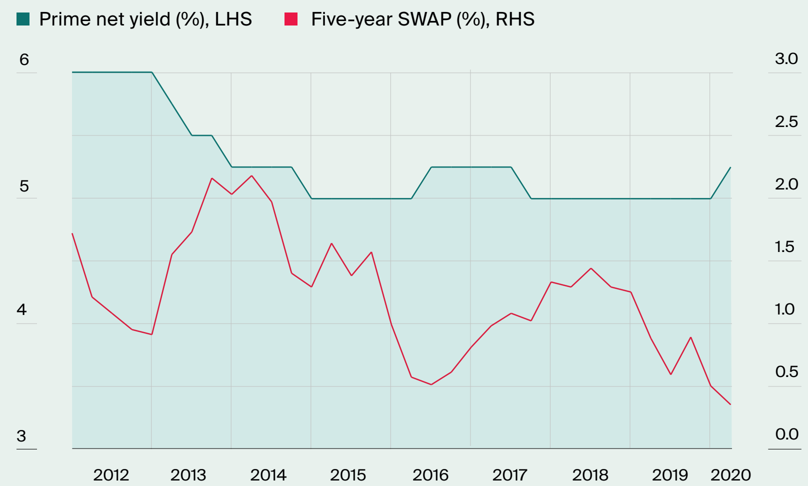


Source: Knight Frank Research

Simon Rickards

Market activity in Q2 understandably stalled as investors focussed on their existing portfolios but we have seen signs in recent weeks of improved investor sentiment, and some deals now transacting.

Prime net initial yield and finance



Source: Knight Frank Research

Tim Smither

There is a significant weight of money looking to invest into the South East, typically focussing on core property fundamentals, with the better centres usually the first to bounce back after an economic shock.

Key transactions
Q2 2020

ADDRESS	PRICE (£M)	NET INITIAL YIELD	VENDOR	PURCHASER
Reading International (exchanged)	£120.00	7.25% (on income)	EPF Group/ Deutsche Asset Management	Tristan Capital Partners
Harwell Campus, Harwell	£112.50 (50% stake)	N/A	U&I	Brookfield
Lynch Wood Park, Peterborough	£22.00	7.10%	Columbia Threadneedle	Ipswich Borough Council
The Gate, Uxbridge	£8.00	8.00%	Vantage/BA Pension Fund	Monster Energy
The Quays, Uxbridge	£15.00	14.00%	Deutsche Asset Management	BYM Capital

Source: Knight Frank Research

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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.
- 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.
- 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.
- 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 121m sq ft (net), an M4 market stock of 66m sq ft (net) and an M3 market stock of 39m sq ft (net). Please note that a revision to total market office stock figures was applied in Q1 2017 to reflect 'change of use' permitted through the Town and Country Planning Order 2015.
- 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 30st June 2020.

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