RESEARCH

Q3 2011

M25 OFFICES

Investment, development & occupier markets

Knight Frank

HIGHLIGHTS

- A number of large deals in Q3 prompted a strong rebound in take-up. In the M25, Q3 take-up was more than double the Q2 total and 7% higher than the 10-year quarterly average. Activity was concentrated in the Thames Valley, accounting for 90% of Q3's recorded deals.
- Reflecting a combination of healthy take-up in the Thames Valley and very little space being brought to the market, the M4 vacancy rate fell from 11.6% to 11.1% during Q3. However, the M25 vacancy rate increased for a fifth consecutive quarter, rising marginally from 8.6% to 8.7%.
- Active named demand was broadly stable in Q3, rising by 4% to stand at 5.70m sq ft. While Financial & Business Services demand increased by 31% in Q3, the rise was offset by reduced demand in ICT and Pharma & Healthcare sectors.
- The South East investment market has become increasingly polarised. Prime yields moved in from 6.25% to 6.00% during Q3, while secondary yields drifted outwards, reflecting investors' aversion to letting risk associated with poorer quality stock.

Demand and take-up

- Total take-up in the M25 was 708,659 sq ft in Q3, more than double the Q2 total and 7% above the 10-year quarterly average. However, deal size rather than frequency was key to performance, averaging 29,500 sq ft in Q3 compared with a long term average of c.19,000 sq ft.
- The Thames Valley markets dominated activity in Q3, accounting for 35 of the 40 recorded transactions. In the M4, Q3 take-up rebounded from Q2, with take-up of 421,000 sq ft across 27 transactions, the highest seen in a single quarter since Q3 2008. Reading was particularly active, with nine transactions totalling 108,611 sq ft, the largest being Atos Origin's lease of 47,065 sq ft at Building 1020, IQ Winnersh.
- The M4's West London markets, including Hammersmith, Chiswick and Heathrow, also saw a flurry of transactions, with the most notable being International SOS' acquisition of 41,000 sq ft at Building 4, Chiswick Park, at an agreed rent of £39.00 per sq ft.
- In the M3, several large deals pushed Q3 take-up to 343,792 sq ft – over four times the Q2 level and 47% above the 10-year quarterly average. In Kingston, Saipem secured a 93,623 sq ft pre-let at Conquest House and Kings House, while Astellas' lease of 100,142 sq ft at 2000 Hillswood, Cherstey, was the largest deal in the M3 market since Q4 2008.
- Active named demand is broadly stable, rising by 4% during Q3 to stand at 5.70m sq ft. However, the underlying source of demand has changed, with Financial & Business Services (FBS) demand increasing by 31% during to Q3 to 1.7m sq ft, set against a 16% contraction of ICT demand, to 0.8m sq ft.

Leading pharmaceuticals company Astellas acquired 100,142 sq ft at 2000 Hillswood, Chertsey. Knight Frank was the acquiring agent.

Supply and development

- The M25 vacancy rate increased for a fifth successive quarter, rising marginally from 8.6% to 8.7%, its highest level since Q2 2005. However, New and Grade A space as a proportion of total availability continues to decline, falling from a peak of 71% in Q2 2010 to its current level of 63%.
- The M4 vacancy rate saw a notable fall in Q3, reducing from 11.6% in Q2 to 11.1%, its lowest level since Q2 2009. This is largely explained by the fact that just 200,000 sq ft of space was placed on the market in the quarter, the lowest amount seen in the M4 for over five years.
- Conversely, the M3 vacancy rate increased sharply, rising from 8.0% to 9.2% during Q3. A record 760,000 sq ft of additional supply was brought to the M3 market in the quarter, of which over 70% is collectively accounted for by Sun MicroSystem's former HQ at Sun Park, Camberley and Nokia's former campus at Summit Avenue, Farnborough.
- New speculative development has been unchanged since Q1 2011 and remains confined to a small number of schemes in the Thames Valley. However, several refurbishment projects have commenced over the past six months, such as Henderson's Windsor House in High Wycombe (c.42,000 sq ft) and PRUPIM's Sygnus Court, Maidenhead (c.21,000 sq ft).

Figure 1
M25 take-up

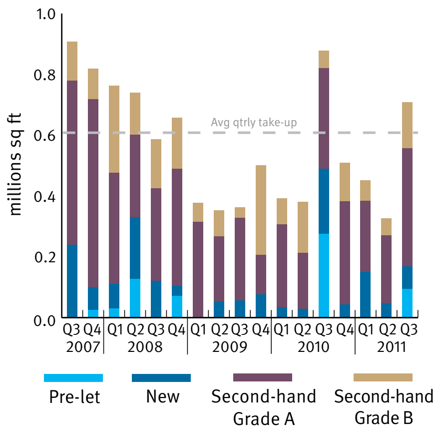


Figure 2
M4 take-up

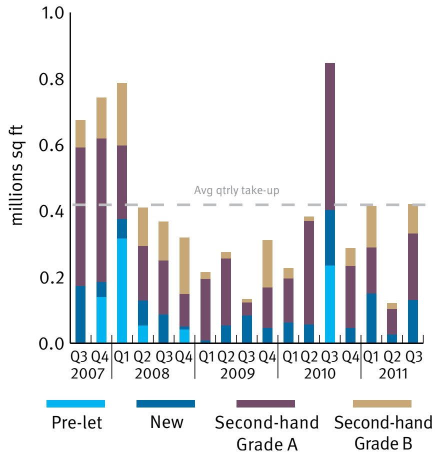
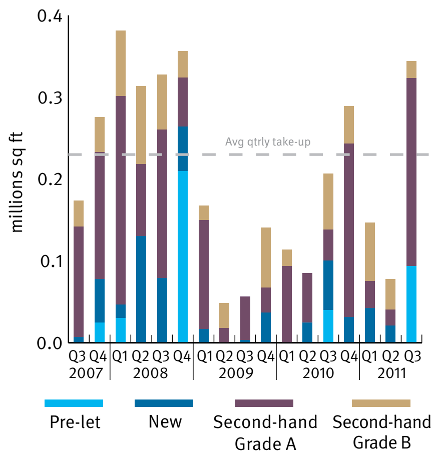


Figure 3
M3 take-up



Source: Knight Frank Research

Market statistics

Table 1
Key town prime rents & forecasts

Town	Q3 prime rent (psf)	Rent free (months)
Basingstoke	£17.50 ▶	33 ▲
Bracknell	£20.00 ▶	39 ▶
Brentwood	£21.00 ▶	24 ▶
Chiswick	£40.00 ▲	21 ▶
Croydon	£17.50 ▲	33 ▶
Gatwick	£21.50 ▶	30 ▲
Guildford	£27.50 ▲	24 ▶
Hammersmith	£37.50 ▲	21 ▶
Heathrow	£27.50 ▲	30 ▶
Maidenhead	£30.00 ▲	24 ▼
Reading	£30.50 ▶	24 ▶
Slough	£25.00 ▶	30 ▶
Staines	£28.50 ▲	21 ▶
St Albans	£22.50 ▲	24 ▶
Uxbridge	£28.00 ▲	24 ▶
Watford	£22.00 ▶	27 ▶
West Malling	£20.50 ▶	27 ▶

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

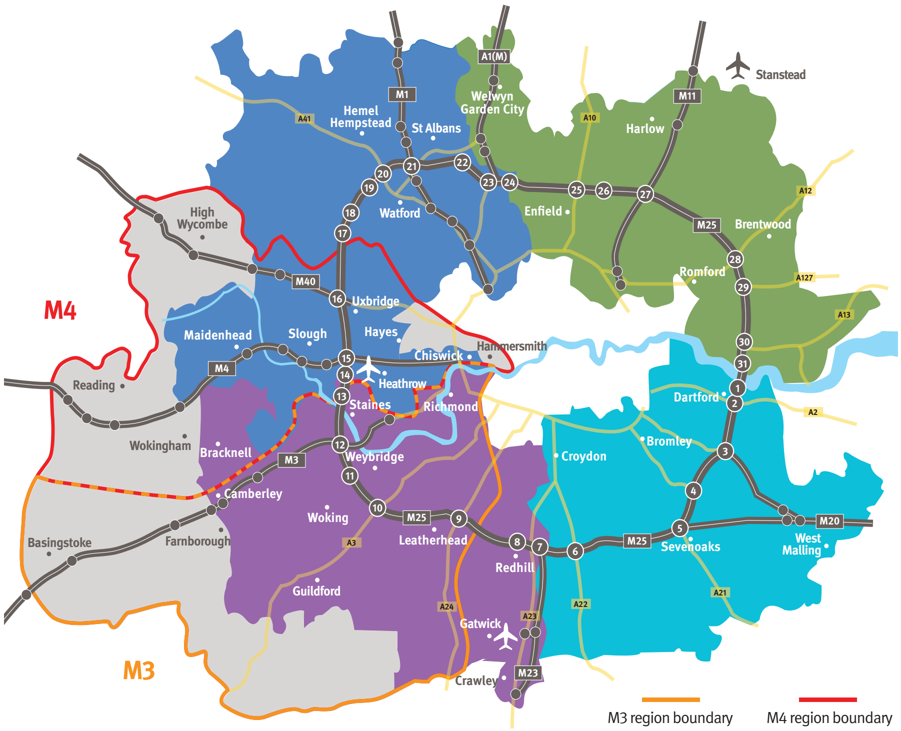


Table 2
Demand & Supply

Take-up	**M25**	NW	SW	NE	SE	**M3**	**M4**
Sq ft	**708,659**	317,862	387,632	0	3,165	**343,792**	**421,027**
Change Q2 11 vs Q1 11	**117%** ▲	164% ▲	259% ▲	-100% ▼	-90% ▼	**343%** ▲	**251%** ▲
Change Q2 11 vs Q2 10	**-19%** ▼	-48% ▼	89% ▲	-100% ▼	-94% ▼	**66%** ▲	**-50%** ▼
Q3 pre-let (sq ft)	**93,623**	93,623	0	0	0	**93,623**	**0**
Q3 % take-up new & pre-let	**78%**	58%	95%	N/A	100%	**94%**	**79%**
Forecast 2011 take-up (m sq ft)	**2.0**	–	–	–	–	**0.7**	**1.4**

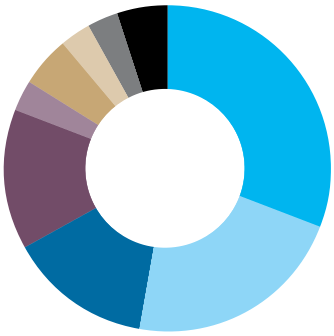
Availability	**M25**	NW	SW	NE	SE	**M3**	**M4**
Sq ft	**11,366,556**	4,993,289	4,528,971	487,667	1,356,629	**3,388,037**	**7,250,024**
Change Q2 11 vs Q1 11	**2%** ▲	-5% ▼	2% ▲	5% ▲	32% ▲	**15%** ▲	**-4%** ▼
Change Q2 11 vs Q2 10	**5%** ▲	1% ▲	3% ▲	12% ▲	33% ▲	**11%** ▲	**-2%** ▼
Q3 % new	**12%**	12%	15%	11%	5%	**11%**	**22%**
Q3 % second-hand Grade A	**51%**	60%	51%	26%	23%	**50%**	**57%**
Q3 % second-hand Grade B	**37%**	28%	34%	63%	72%	**39%**	**21%**
Q3 vacancy rate (▲/▼ movement from Q2 11)	**8.7%** ▲	9.9% ▼	11.0% ▲	2.8% ▲	6.7% ▲	**9.2%** ▲	**11.1%** ▼

Under construction	**M25**	NW	SW	NE	SE	**M3**	**M4**
Sq ft (net approx)	**281,368**	160,394	80,974	0	0	**120,974**	**160,394**
Change 12 months	**252%** ▲	100% ▲	102% ▲	–	–	**51%** ▲	**100%** ▲
Pre-let	**40,000**	0	40,000	0	0	**40,000**	**0**

Source: Knight Frank Research

Figure 4

M25 active named enquiries by sector



Active demand is 5.71m sq ft at Q3 2011	
Financial & Business Services	31%
Manufacturing & FMCG's	22%
ICT	18%
Retail, Distribution & Transport	11%
Pharmaceutical, Healthcare & Medical	6%
Public Sector	6%
Utilities	5%
Construction & Engineering	2%
Other	6%

In Q3, ASOS acquired the first floor of the People Building, Hemel Hempstead, totalling 25,113 sq ft. Knight Frank acted for the tenant.

FORECAST AT A GLANCE

Take-up:

- Despite the improvement in take-up in Q3, our forecast for total M25 take-up in 2011 stands at 2.0m sq ft – some 25% below the 10-year annual average. Take-up is expected to remain below average in 2012, reflecting the more downbeat forecasts for UK economic growth and ongoing uncertainty in the Eurozone, with occupier activity driven by churn and consolidation rather than expansion.
- While the outlook is subdued at the aggregate level, key markets to the west of London should continue to see robust demand over the next 12 months, putting further pressure on levels of Grade A supply. Equally, a number of markets where Grade A supply is both plentiful and attractively priced should start to see increased take-up, with notable examples including Bracknell and Slough.
- Given the uncertain economic outlook, a key strength of the South East market is the diversity of its occupier profile, including global brands, manufacturing and service-related companies. The strong presence of ICT-related occupiers in the South East means the region is well-placed to capture the anticipated growth associated with the development of new technologies, such as cloud computing and advanced telecommunications.

Supply and rents:

- Following a dearth of new construction activity over the past three years, a number of refurbishment projects and new development starts are expected to progress within the next six months. Totalling in excess of 500,000 sq ft, the schemes are all located in core South East markets where demand has been relatively resilient, including Reading, Chiswick and Maidenhead.
- However, this round of new development is relatively muted, and by the end of 2012 a number of key markets may offer little or no choice of good quality accommodation. Consequently, we believe developers and investors should carefully consider refurbishment opportunities which can be delivered to the most active markets two years from now, by which time occupier market conditions should be more buoyant.
- One advantage linked to falling Grade A supply is rental growth. We have already seen some indication of a supply-led recovery to headline rents in key Thames Valley markets, such as Chiswick, Uxbridge and Hammersmith. As Grade A supply is eroded, we expect a host of other markets in the Thames Valley area to witness a degree of rental growth 12 months from now.

Figure 5

Vacancy rates

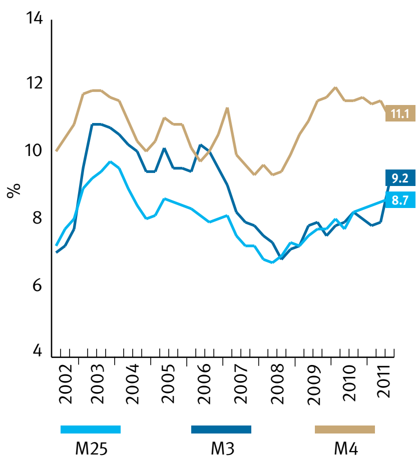


Figure 6

Space under construction in the M25

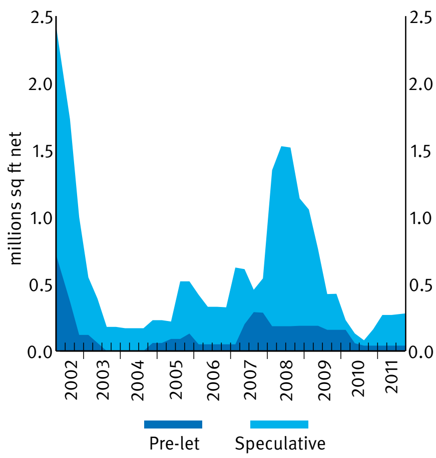
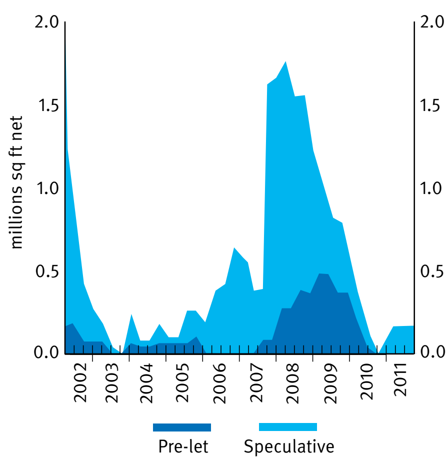


Figure 7

Space under construction in the M4



Source: Knight Frank Research

Investment market

Table 3
Key investment transactions Q3 2011

Building	Size (sq ft)	Price	Net initial yield	Vendor/ Purchaser
Davidson House, Reading	128,499	£42.85m	6.45%	Hermes & Aviva / Schroders
Abbey Gardens, Reading	150,199	£19.00m	16.70%	Private Overseas / Hermes & Bellhammer
Ashbourne House, Guildford	35,606	£10.72m	7.85%	BlackRock / Standard Life
40 Clarendon Road, Watford	49,393	£9.95m	9.50%	Aviva / Threadneedle
Unit 140, Cambridge Science Park	26,238	£6.35m	7.80%	UK Private / Mayfair Capital

	Transaction volume	Mean lot size	Mean NIY
Q3 2011	£150.76m	£8.87m	8.69%
Change 3 mths	-52% ▼	-41% ▼	38bps ▲
Change 12 mths	-13% ▼	-2% ▼	42bps ▲

INVESTMENT VIEW

- Despite Q3's 17 investment deals in the South East market, lot sizes were relatively small and carried a combined sales volume of £150m, the lowest since Q1 2009. While summer is normally a quiet period for the market, investors have become more cautious in light of renewed uncertainty linked to the Eurozone debt problems.
- With PRUPIM's £415m sale of Green Park, Reading yet to conclude, Q3's headline deal comprised Schroders' £42.5m purchase of Davidson House, Reading, reflecting 6.45% NIY. The rack-rented multi-let building attracted multiple bids among UK Funds, illustrating the strong appetite which continues to be seen for prime stock.
- The market is becoming ever more polarised. Prime yields hardened to c. 6.00% in Q3, reflecting the strength of demand for defensive plays and a lack of available product. In search of higher yield, UK Funds and property companies are actively seeking prime stock offering shorter income, albeit they are restricted to the tightest markets where letting risk is relatively low.
- Conversely, the market for secondary product is proving very challenging. Heightened risk aversion among investors is leading to a continuing softening in yields, a trend which is likely to continue, particularly as we expect more bank-owned stock to be released to the market over the next six months.


In Q3, Schroders purchased Davidson House, Reading, from Hermes and Aviva for £42.85m, reflecting a net initial yield of 6.45%.

Figure 8
£m investment volumes and lot size

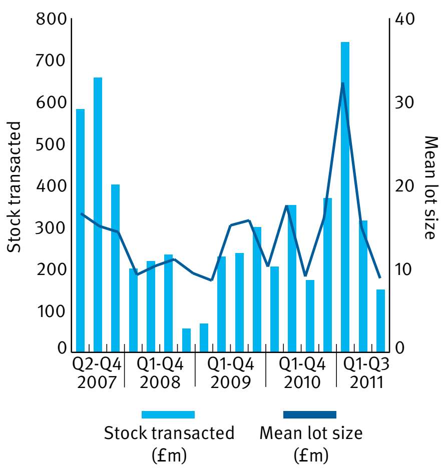


Figure 9
Mean initial yield & finance

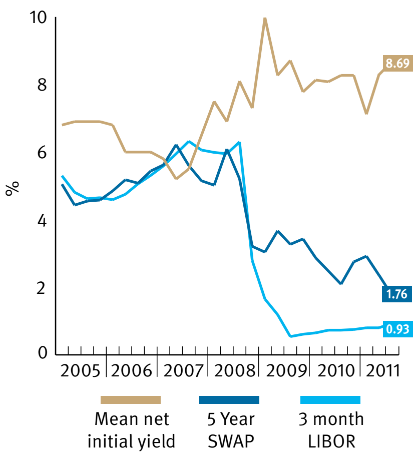
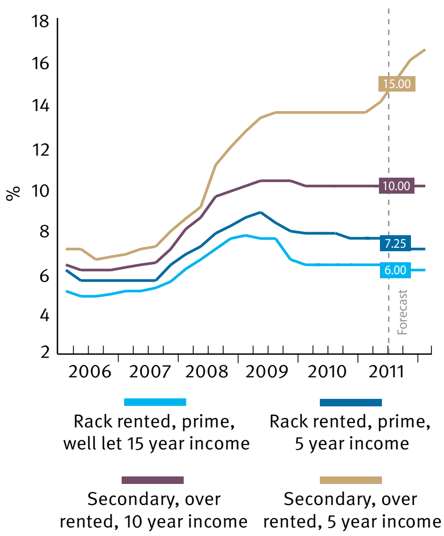


Figure 10
Yield forecasts



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 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 130m sq ft (net), an M4 market stock of 65m 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 2011.

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