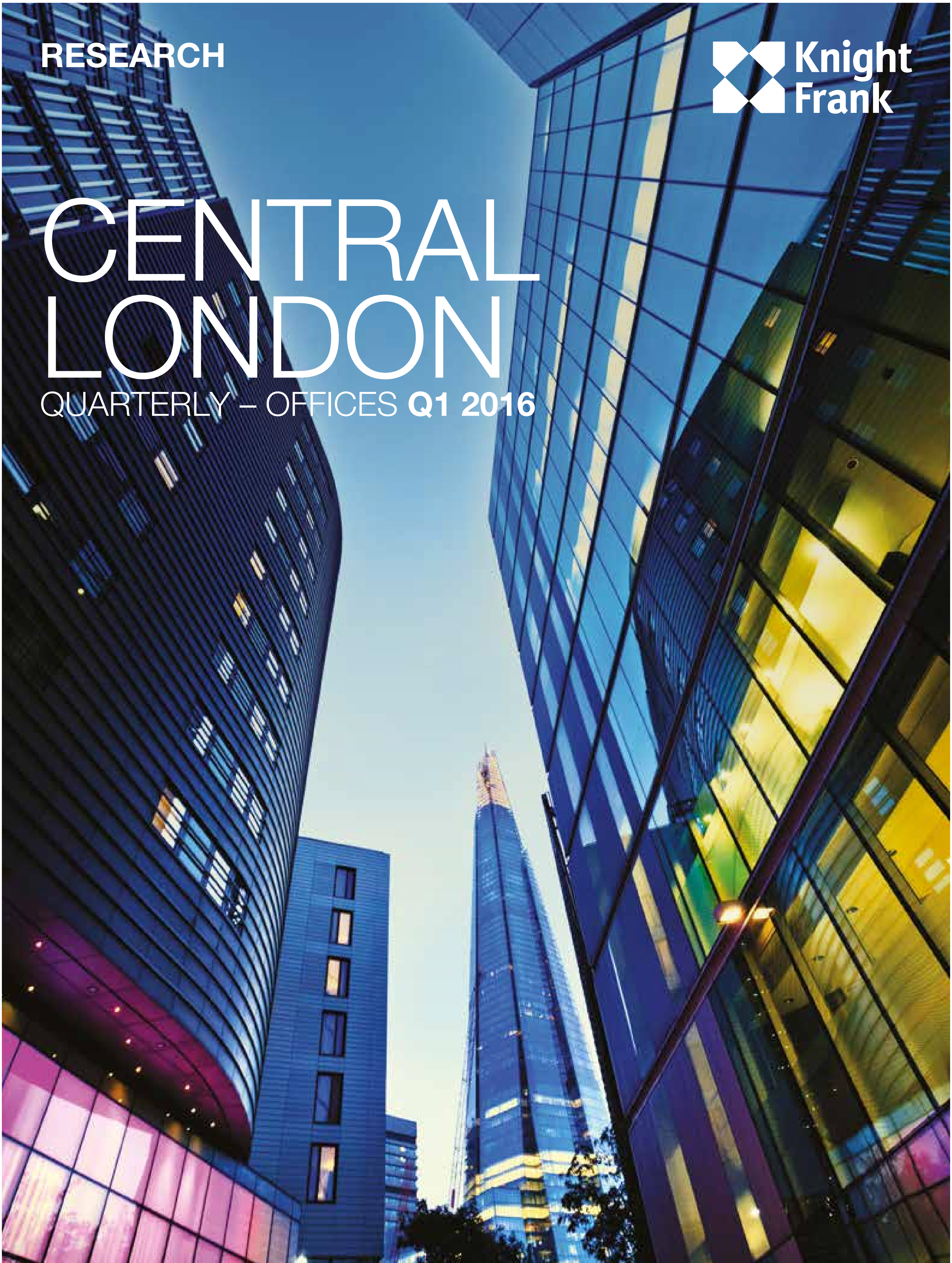
RESEARCH

Knight Frank

CENTRAL LONDON

QUARTERLY – OFFICES **Q1 2016**



SUPPLY REMAINS CONSTRAINED

RENTS IN MOST DISTRICTS AT HISTORIC HIGHS

PRIME YIELDS REMAIN STABLE

CHIEF ECONOMIST'S VIEW

The EU referendum campaigning is underway, and the Q1 figures for the Central London office market on a superficial reading look disappointing. Yet, how much of this can really be assigned to a Brexit effect?

"The referendum will come and go, but the supply issue is starting to look embedded."

JAMES ROBERTS
Partner, Chief Economist

To say there has been no effect from the referendum would be nonsense. At every presentation I give the referendum issue draws the most questions. Some tenants want to see the referendum result before signing leases, and similarly there are investors (mostly European and North American institutional buyers) who have moved temporarily to the sidelines.

Conversely, the slump in the value of the pound in the last year has caught a lot of attention, and in the smaller lot size market Middle Eastern and Far Eastern private investors are still active.

I brief as many overseas investors today as I did a year ago on Central London, and my reading of the situation is that a share of investment demand has moved into a holding pattern, and is now monitoring events. Foreign investors still want to own assets here, and I suspect that a 'remain' vote could be seen as an opportunity to buy. Consequently, the market might bounce in the second half of 2016. A vote to 'leave' may mean the holding pattern lasts longer, or that foreign investors might decide to look elsewhere.

However, it is when we turn to the occupier market that the EU referendum's effect becomes harder to gauge. Yes, leasing supply has risen, although only in the West End. Of that increase, 86% was second hand space returning to the market, mostly because tenants had moved to new buildings, so the increase is not connected to the referendum.

Certainly, I am surprised more construction starts are not occurring given the low level of supply, but many developers are complaining about high construction costs. This, rather than fear of a Brexit, is the bigger issue.

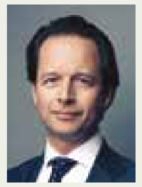
Turning to demand though, there is more evidence of an effect, with take-up down quarter-on-quarter in both the City and West End. However, I am reluctant to say this is purely due to the referendum. Throughout Q1 we saw a rollercoaster ride for the financial markets, prompted by fears over the strength of the global economy, with commodity prices particularly hard hit. This has impacted business confidence, particularly for firms in the energy and mining sectors, who are prominent occupiers of space in the West End.

For occupiers at the moment there are several reasons to delay a property decision, one of which is the referendum. However, the low supply figure and obsolescence of existing buildings remain the landlord's friend. The referendum will come and go, but the supply issue is starting to look embedded.

FIGURE 1
Exchange rate US$ into Sterling

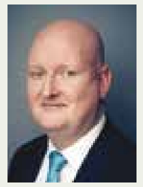
Source: Bank of England

CENTRAL LONDON VIEW



STEPHEN CLIFTON
HEAD OF CENTRAL LONDON OFFICES
"There is caution in the market, but overall the fundamentals remain solid. In the aftermath of the 23rd June referendum we shall discover whether the uncertainty ends or continues into next year. If it is the former, I believe we will see a next wave of leasing and investment demand."

DAN GAUNT
HEAD OF CITY AGENCY
"City take-up hit the long-term average in Q1, a sign of underlying strength, given the uncertainty introduced by the referendum. The market faces headwinds in the short-term, but the vacancy rate is at a 15 year low and we expect it to fall further."



IAN MCCARTER
HEAD OF WEST END AGENCY
"The volatile financial and commodities markets have hit the West End's hedge funds and energy firms, and office demand has cooled. However, the pipeline is thin, which should keep supply constrained."

NICK BRAYBROOK
HEAD OF CITY CAPITAL MARKETS
"Transaction volumes have clearly been hit by the referendum. However, in our view a healthy occupier market should result in further investment demand post-June."

ANTHONY BARNARD
HEAD OF WEST END CAPITAL MARKETS
"The West End is seeing continued interest from overseas private investors, who are targeting small lot sizes. Two thirds of Q1 deals signed after the referendum announcement, which shows demand is robust."

RICHARD PROCTOR
HEAD OF CENTRAL LONDON TENANT REPRESENTATION
"In some locations the market has moved briefly back in the occupier's favour, as a slower economy has cooled demand. However, this is a brief window of opportunity, as supply will shrink further due to a lack of development."

WEST END

"Despite the first quarters increase in availability, property fundamentals of the West End market remain strong, with the vacancy rate below the long-term average and a thin development pipeline."

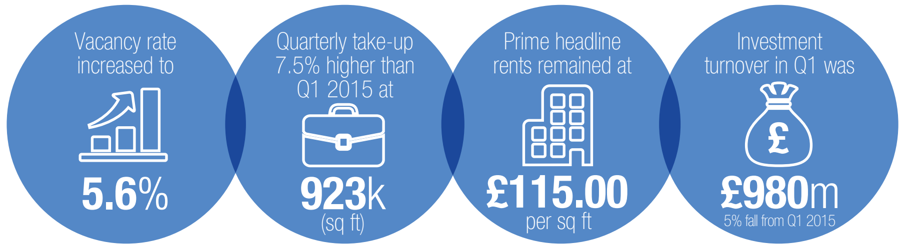


FIGURE 1
West End availability
Q1 2015-Q1 2016 (million sq ft)

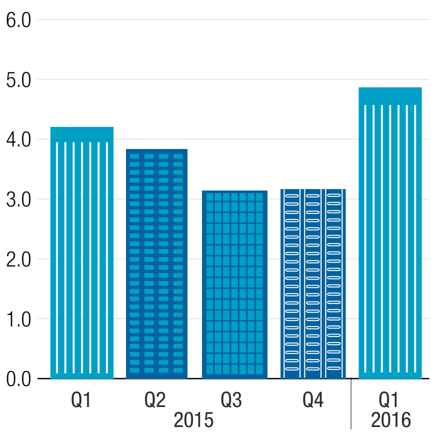
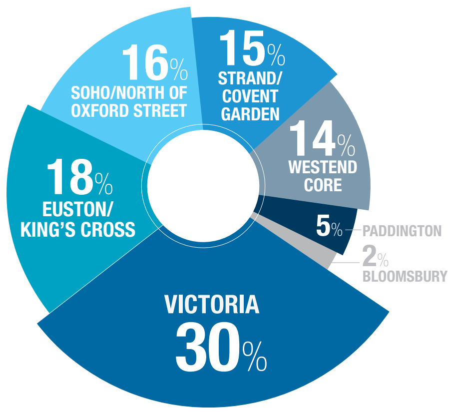


FIGURE 2
West End Under Construction by submarket
Q1 2016



Demand

Following a strong close to 2015, the commencement of 2016 has been met with softening demand characterised by a lack of impetus. Take-up in the first quarter of 2016 fell to 923,000 sq ft, the second lowest result since 2012. This was primarily due to a decline in take-up of new and refurbished space. Despite this, levels remain 7.5% higher than the corresponding quarter in 2015 and broadly in line with the long term average. As a result, demand is expected to gain momentum throughout the course of 2016. The Business to Business sector, which includes serviced offices, was noticeably active, and was represented in the largest transaction for the quarter; WeWork's acquisition of 2 Eastbourne Terrace, W2 totalling 106,812 sq ft.

Total take-up for the year ending Q1 2016 was 4.8 m sq ft, 15% above the long-term average. Demand for new and refurbished space was particularly robust throughout the year with more than 2.0 m sq ft of space let, the highest annual total since 2000.

Supply

Over the course of Q1 2016, availability in the West End increased by 56% to 4.9 m sq ft. This is mainly attributable to a number of schemes due for completion in Q3 2015 entering the supply figures. The release of tenant space through relocations was also a contributor to the increase in availability. As a result, the vacancy rate in the West End increased from 3.4% to 5.6%, the highest since the first quarter of 2013. However, it should be noted that this remains 20 basis points below the long term average.

The volume of speculative space under construction in the West End contracted by 6.2% on a quarter-on-quarter basis with levels now 25% lower than the same point last year. Looking further ahead, the limited pipeline, particularly in 2017, should keep supply levels in check.

Rental Profile

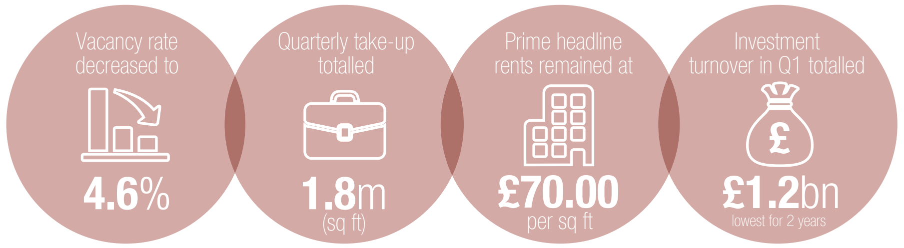
The Prime Core headline rent remained at a record high £115.00 per sq ft for a fifth consecutive quarter, with prime rents unchanged across all West End submarkets. Over the year ending Q1 2016, the Paddington, North and Noho submarkets experienced the most significant rental growth. Rent free periods have remained stable during the quarter at 15 months on a typical 10-year term certain.

Investment

Investment turnover in the first quarter of 2016 noticeably slowed to £980 m from a record high result in the final quarter of 2015. However, volumes were down a minor 5% from the corresponding quarter in 2016 and were 16% above the long term average. This indicates that whilst a cautious attitude is a factor of the market, there is still a considerable volume of capital targeting London. There were four sales in excess of £100 m during the first quarter, the largest being Tishman Speyer's purchase of The Economist Plaza, SW1 for £125 m. Aberdeen Asset Management sold two assets over the quarter totalling £224.7; 1 Welbeck Street, W1 for £103 m and 14 St George Street, W1 for £121.7 m. The largest share of market activity was in the West End Core, contributing to 60% of total investment volumes. Overseas purchasers dominated the purchaser profile in the first quarter, accounting for 77% of transactions by volume. The prime yield remained stable for the fifth consecutive quarter at 3.50%.

CITY

"Take-up fell to 1.8 m sq ft in the first quarter, 13% down on Q4 15 and the lowest for two years. However, take-up is at long-term average levels and the sentiment remains solid."



Demand

Quarterly take-up totalled 1.8 m sq ft in the first quarter, down 13% on the previous quarter but in-line with long-term average levels and a sentiment that remains solid. The largest share of market activity was located in the City Core, contributing to 53% of total take-up. This included the largest transaction for the quarter; Investec's acquisition of 30 Gresham, EC2, totalling 150,277 sq ft. The financial sector was particularly active, accounting for 32% of total transactions, followed by IT & Telecoms with 25%. Take-up of new and refurbished stock totalled just 881,937 sq ft in the first quarter, 22% below the long-term quarterly average.

Active requirements

Active requirements have fallen for the third consecutive quarter to 3.6 m sq ft, a 20% fall year-on-year and 14% below the long-term average. Financial occupiers accounted for 24% of active searches, followed by professional with 18%.

Supply

Availability across the City fell by 10% from 5.9 m sq ft to 5.4 m sq ft in the first quarter. Levels of supply are now 43% below the long-term average of 9.5 m sq ft. The vacancy rate contracted to 4.6% over the quarter, its lowest level since Q2 2001. The level of new and refurbished space decreased in the first quarter, down 16% totalling 2.1m sq ft. This is 40% below the long-term average level. There is just one building in the Core that could provide an occupier with 100,000 sq ft of new and refurbished space within the next six months.

There has been a notable reduction in the availability of large units; this time last year in the City there was in excess of 1.8 million sq ft in 100k+ units on the market. In Q1 2016, there is just 931,000 sq ft.

There is currently 8.7 m sq ft of space under construction in the City, albeit almost 50% is already pre-let. There is 945,000 sq ft that is speculatively under construction in the Core that will complete by the end of 2016. Just two of these schemes are over 100,000 sq ft, One Angel Court, EC2 and Creechurch Place, EC3.

Rental Profile

The prime rent remained unchanged at £70.00 per sq ft for the second consecutive quarter, although this reflects a 7.7% rise on the year. Rent free periods have remained stable during the quarter sitting between 18 and 21 months on a typical 10-year term certain.

Investment

Investment turnover in the first quarter totalled £1.2 bn, 37% below the long-term average level and the lowest for two years. However, there are five buildings totalling more than £1.8 billion, which have been under offer since the end of 2015 and are due to transact soon. Whilst Chinese purchasers accounted for the two largest investment deals by volume, the next five largest deals were undertaken by UK property companies or funds.

Prime City office yields remained at a record low 4.00% for the fifth consecutive quarter. The market witnessed a premium for smaller sub-£40 million assets, while larger lot sizes have carried a discount in some cases. Overseas investors dominated purchaser profile, accounting for 54% of all transactions. Despite this, UK purchasers remained very active in the smaller lot size bracket and accounted for 60% of total deals over the quarter.

FIGURE 1
City take-up
Q1 2015-Q1 2016 (000's sq ft)

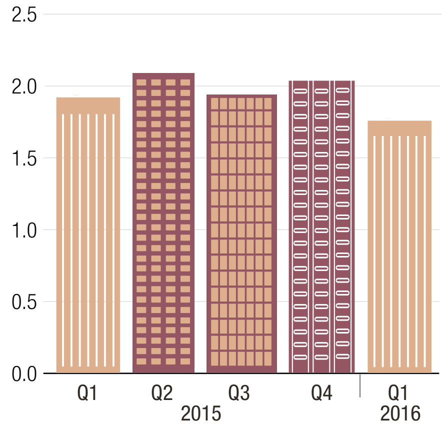
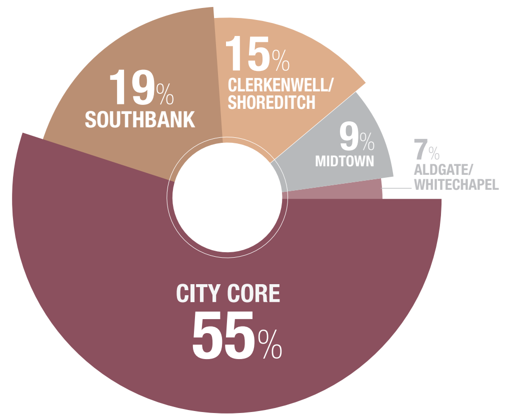
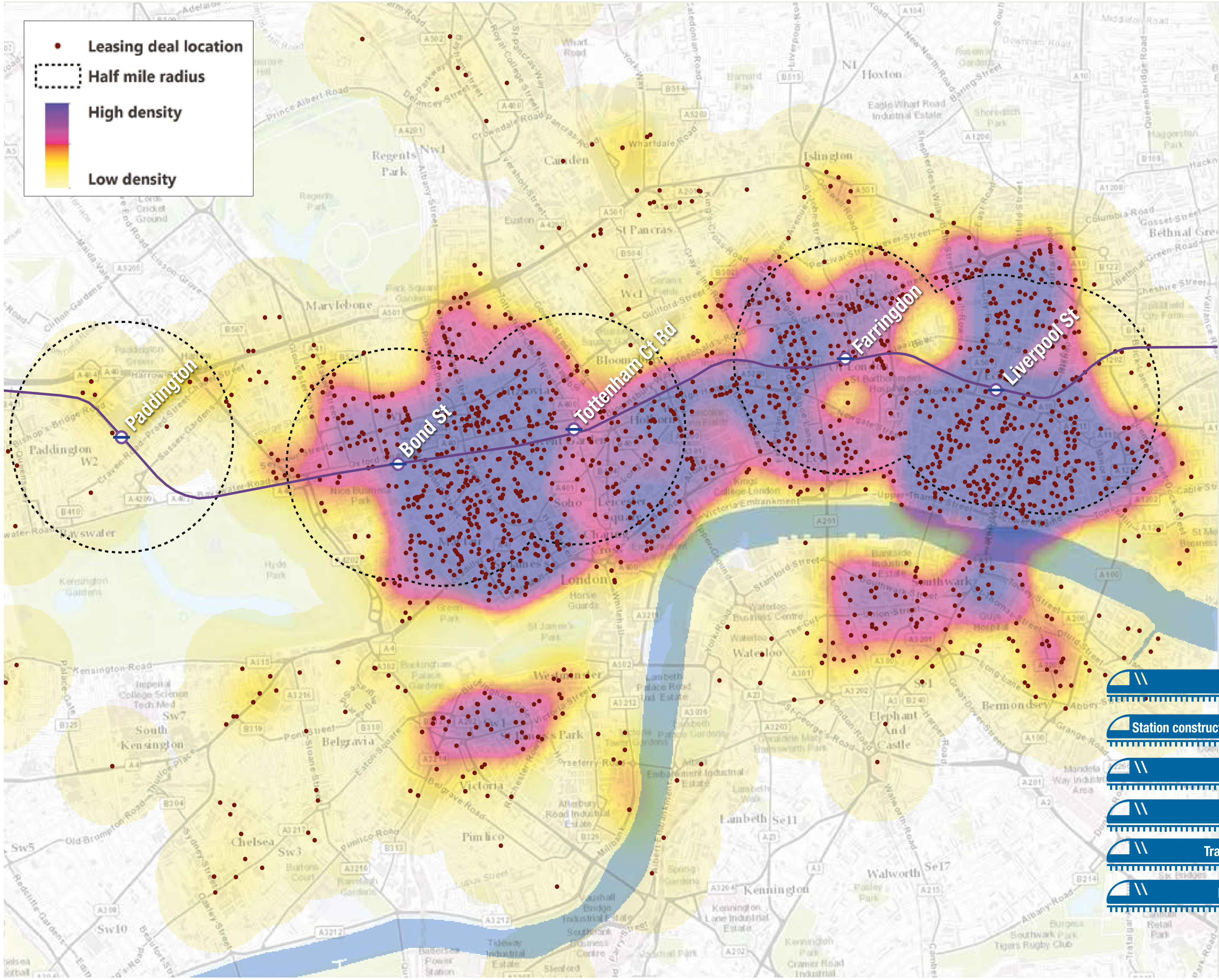


FIGURE 2
City under construction by submarket
Q1 2016



CROSSRAIL AND THE CENTRAL LONDON LEASING MARKET



ALL CHANGE!

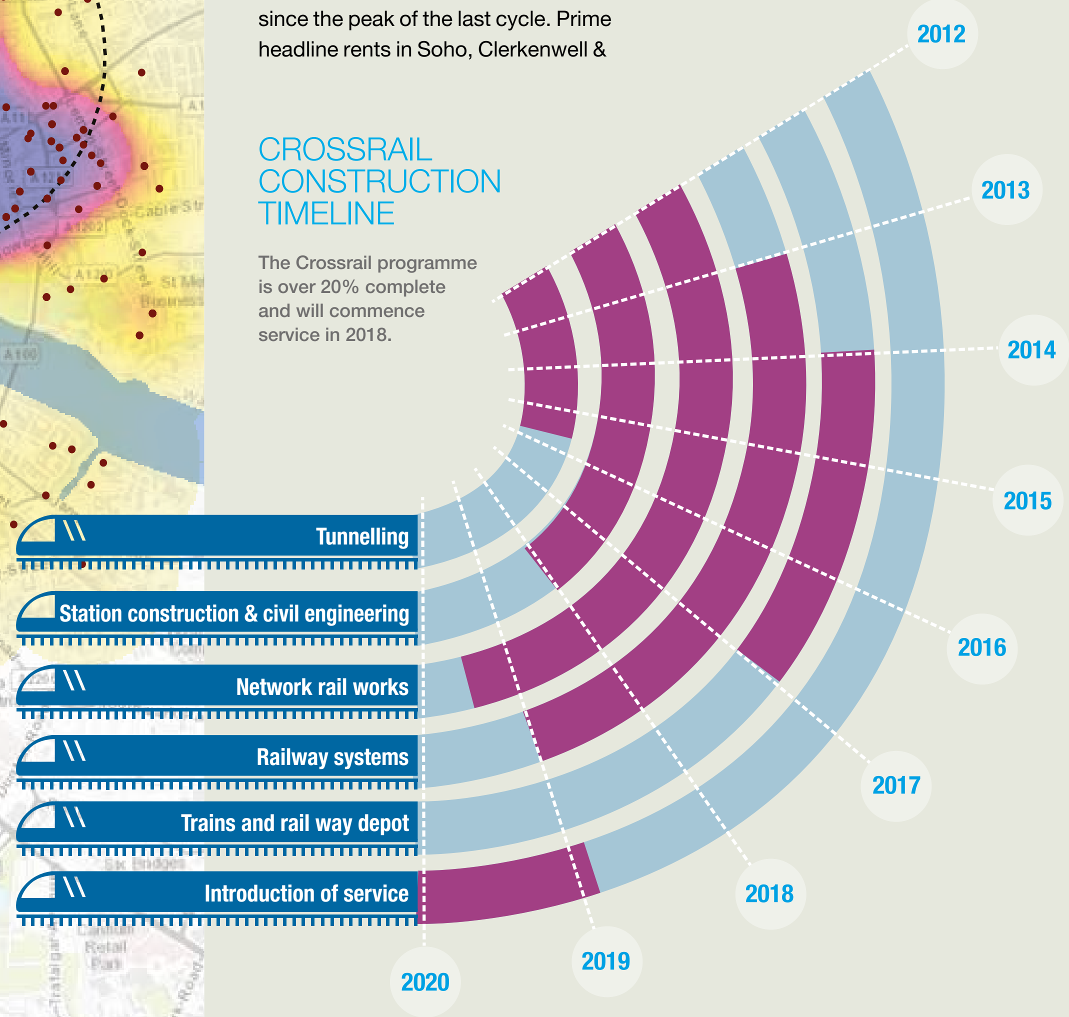
Latest estimates suggest that Crossrail will be delivered on time, will significantly reduce journey times into the heart of the City and West End, and is expected to add an estimated £42 bn to the UK economy. The areas around the future Crossrail stations have been attracting significant tenant demand and have benefited from the densest clustering of occupiers.

In addition, the areas surrounding Tottenham Court Road and Farringdon stations have been amongst the top performers in terms of rental growth since the peak of the last cycle. Prime headline rents in Soho, Clerkenwell & Shoreditch, and Noho have risen by 22%, 40% and 48% respectively, which is significantly higher than the West End and City Core markets of 5% and 10%.

Approximately 75% of all leasing transactions by volume in the City and West End during 2014 and 2015 were within 0.5 miles of a Crossrail station, a trend that we expect to continue as the date of the first services in 2018 moves ever closer.

CROSSRAIL CONSTRUCTION TIMELINE

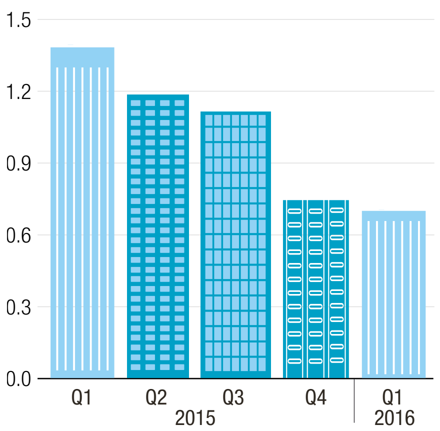
The Crossrail programme is over 20% complete and will commence service in 2018.



DOCKLANDS

"The Docklands market continues to represent real value when prime headline rents in the rest of London are at record levels, and will continue to attract strong occupier interest."

FIGURE 1
Canary Wharf availability
Q1 2015-Q1 2016 (million sq ft)



Demand

There was a strong start to the year in the Docklands market as 361,382 sq ft was transacted, well above the long-term average of 257,000 sq ft. However, as is characteristic of the Docklands market, the take-up level was heavily influenced by a single, large letting.

Thomson Reuters acquired in excess of 315,000 sq ft at 5 Canada Square, E14 on a sublease from Credit Suisse until 2027. Thomson Reuters will consolidate, moving staff from a number of existing Central London locations. There were no other transactions in excess of 15,000 sq ft during the quarter. As availability continues to tighten across the rest of Central London, Docklands will attract increasing interest from occupiers as the area represents real value when compared to other sub markets..

Supply

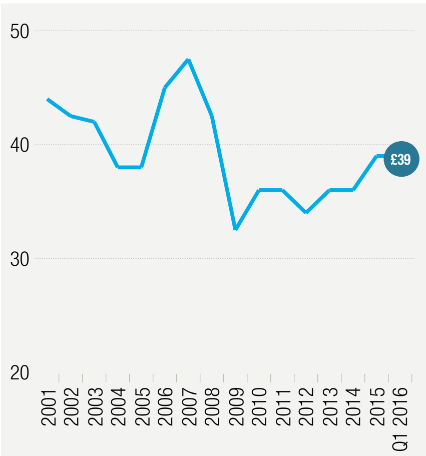
Docklands availability fell for the sixth consecutive quarter to 708,107 sq ft, a fall of almost 50% year-on-year and more than 50% below the long-term average. The vacancy rate is now 3.5% for the wider Docklands market, and 3.3% in Canary Wharf. This is well below the Central London vacancy rate of 4.9%.

As has been the case for some time, the development pipeline remains extremely thin. There is one scheme under construction, which is scheduled for completion at the beginning of 2019. 1 Bank Street, E14, will deliver almost 420,000 sq ft of new speculative space, along with 281,000 sq ft of space already pre-leased to Societe Generale.

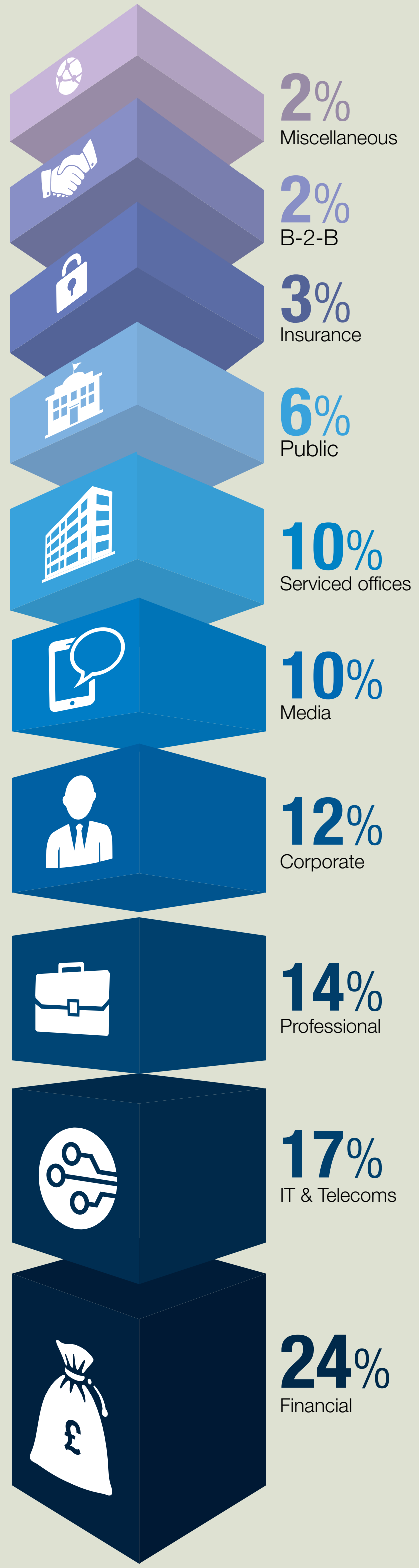
Rental Profile

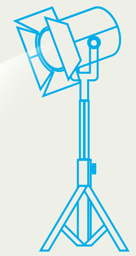
The prime headline rent remained stable at £39.00 per sq ft for the third consecutive quarter. We expect upward pressure on prime rents during the remainder of the year as supply continues to tighten across Central London.

FIGURE 2
Canary Wharf prime headline rents
£ per sq ft



Central London Take-up by Business Sector
12 months rolling

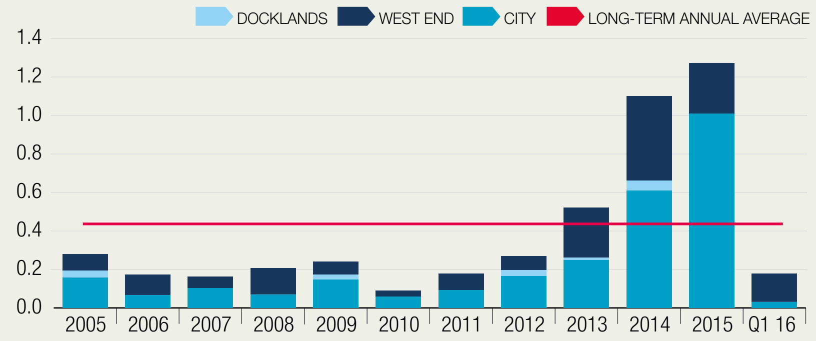




SPOTLIGHT ON… SERVICED OFFICES

The flexible office market has really taken off in recent years. Last year the sector accounted for 10% of total Central London take-up. The explosive growth is self-evident in the chart below, specifically over the last three years and most noticeably in the City.

Central London flexible office take-up by area (million sq ft)



After just one quarter of take-up, flexible office providers have already taken just under 180,000 sq ft – which is 70% ahead of the long-term quarterly average level.

There has been a significant increase in the number of people who now work for themselves either as freelancers or contractors, as well as people who have taken advantage of reduced barriers to entry to start up their own businesses. According to the Professional Contractors Group (PCG), there are 1.4 million British freelancers working across all sectors, a figure that has grown 14% in the past decade. Figures published by the Office of National Statistics (ONS) say self-employment is now higher than at any point over past 40 years. For many, the transparency of costs and the flexibility to grow, contract or indeed terminate licence/membership agreements is very appealing.

The provision of the office-as-a-service also eliminates many of the real estate responsibilities that come with taking a conventional lease, which ultimately take valuable time away from people who would much rather spend that time running and growing their businesses.

The flexible office space market encompasses more traditional serviced office operators, like Regus, LEO and i2, as well as co-working space providers like WeWork, Huckletree, Second Home and Central Working. The latter group have evolved the traditional serviced office model to deliver environments that satisfy more of the demands of the modern worker, like workplace designs which promote opportunities to interact and collaborate with fellow occupiers of the space.

Landlords occasionally struggle with the youth of co-working businesses, which gives rise to concerns about their covenant strength, due to the inability to satisfy traditional covenant tests. But we have seen an increasing number of landlords offset these concerns, against the value of letting a proportion of larger schemes to a co-working provider as they breathe life into a scheme early on in the letting campaign.

KEY STATISTICS

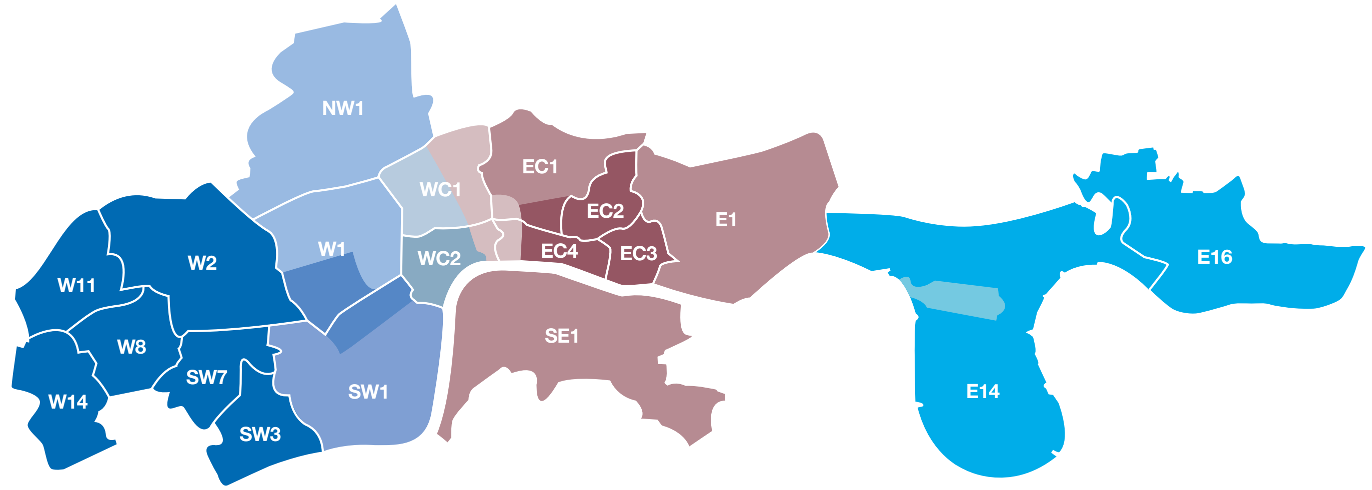
Central London office market

		Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	% CHANGE 3 mths	% CHANGE 12 mths	Long-term quarterly average
AVAILABILITY (sq ft)	West End	4.2 m	3.8 m	3.1 m	3.1 m	**4.9 m**	58.1%	16.7%	5.3 m
	City	6.8 m	6.0 m	6.0 m	5.9 m	**5.4 m**	-8.5%	-20.6%	9.5 m
	Docklands	1.4 m	1.2 m	1.1 m	1.0 m	**0.7 m**	-30.0%	-50.0%	1.5 m
	Central London	12.5 m	11.1 m	10.3 m	10.1 m	**11.0 m**	8.9%	-12.0%	16.2 m
VACANCY RATE		Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	3 mths	12 mths	
	West End	4.6%	4.2%	3.6%	3.6%	**5.6%**	n/a	n/a	5.8%
	City	5.7%	5.1%	5.2%	5.1%	**4.6%**	n/a	n/a	8.2%
	Docklands	6.5%	5.5%	5.7%	3.9%	**3.5%**	n/a	n/a	7.0%
	Central London	5.4%	4.8%	4.6%	4.4%	**4.9%**	n/a	n/a	7.2%
TAKE-UP (sq ft)		Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	3 mths	12 mths	
	West End	0.9 m	1.2 m	1.3 m	1.4 m	**0.9 m**	-35.7%	0.0%	1.2 m
	City	1.9 m	2.0 m	1.9 m	2.1 m	**1.8 m**	-14.3%	-5.3%	1.8 m
	Docklands	0.1 m	0. 6 m	0.2 m	0.3 m	**0.4 m**	33.3%	300.0%	0.3 m
	Central London	2.9 m	3.8 m	3.5 m	3.7 m	**3.1 m**	-16.2%	6.9%	3.2 m
ACTIVE SEARCHES (sq ft)		Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	3 mths	12 mths	
	West End	1.6 m	1.6 m	2.3 m	2.6 m	**2.4 m**	-7.7%	50.0%	1.8 m
	City	4.5 m	4.2 m	4.4 m	3.7 m	**3.6 m**	-2.7%	-20.0%	4.2 m
	Docklands	1.0 m	1.0 m	0.7 m	0.9 m	**0.3 m**	-66.7%	-70.0%	0.3 m
	Central London*	1.7 m	1.8 m	1.3 m	0.7 m	**1.1 m**	57.1%	-35.3%	1.5 m
	TOTAL Central London	8.8 m	8.6 m	8.7 m	7.9 m	**7.3 m**	-7.6%	-17.0%	7.8 m
UNDER CONSTRUCTION (sq ft)		Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	3 mths	12 mths	
	West End	2.5 m	2.4 m	2.4 m	3.0 m	**2.9 m**	-1.7%	16.4%	n/a
	City	5.1 m	6.2 m	8.3 m	8.6 m	**8.7 m**	1.7%	71.5%	n/a
	Docklands	0.0 m	0.7 m	0.7 m	0.7 m	**0.7 m**	0.0%	0.0%	n/a
	Central London	7.6 m	9.3 m	11.4 m	12.2 m	**12.3 m**	0.8%	62.3%	n/a
INVESTMENT		Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	3 mths	12 mths	
	West End	£1.0 bn	£2.3 bn	£1.4 bn	£2.8 bn	**£980 m**	-64.6%	-5.1%	£1.2 bn
	City	£2.3 bn	£3.3 bn	£1.9 bn	£3.4 bn	**£1.3 bn**	-64.4%	-46.2%	£1.9 bn
	Docklands	£0.00	£19.3 m	£235.0 m	£196.1 m	**£0.00**	-100.0%	0%	£477.8 m
	Central London	£3.3 bn	£5.4 bn	£3.6 bn	£6.4 bn	**£2.2 bn**	-65.5%	-33.4%	£3.4 bn

* unspecified

Source: Knight Frank Research

THE CENTRAL LONDON OFFICE MARKET



The West End

Mayfair/St James's
Mayfair and St James's refers to the area bounded by Oxford Street, Regent Street and Park Lane in W1 and by Green Park, St James's Park and The Mall in SW1.

Soho/North of Oxford Street
Soho/North of Oxford Street refers to NW1, and W1 (excluding Mayfair).

Victoria
Victoria refers to SW1 (excluding St James's).

Paddington/Kensington
Paddington/Kensington refers to SW3, SW7, W2, W8, W11, W14.

Bloomsbury
Bloomsbury refers to the area of WC1 bounded by Southampton Row, New Oxford Street, Tottenham Court Road and Euston Road.

Strand/Covent Garden
Strand/Covent Garden refers to the area of WC2 bounded by Kingsway, Aldwych, Victoria Embankment, Charing Cross Road and New Oxford Street.

The City

Core
Core refers to EC2 (excluding EC2A), EC3, EC4 (excluding EC4A and EC4Y), and EC1A.

Fringe
Fringe refers to SE1, E1, EC1 (excluding EC1A and EC1N), and EC2A.

Midtown
Midtown refers to EC1N, EC4A, EC4Y, WC1 (excluding Bloomsbury), and WC2 (excluding Strand/Covent Garden).

Docklands

Canary Wharf
Canary Wharf refers to the area comprising Canary Riverside, Westferry Circus, Columbus Courtyard, Cabot Square, Canada Square, Blackwall Place and Heron Quays (East).

Rest of Docklands
Rest of Docklands refers to E14 and E16 including The Royals Business Park (excluding Canary Wharf).

General Note

This report has been prepared by Knight Frank Research, the research and consultancy division of Knight Frank. Knight Frank Research gratefully acknowledges the assistance given by the West End, City and Docklands Offices in the compilation and presentation of this material. Certain data sourced from LOD. All graph data sourced by Knight Frank.

Technical Note

The following criteria have been adopted in the preparation of this report.

i. All floorspace figures quoted in this report refer to sq ft net.

ii. Take-up figures refer to space let, pre-let, or acquired for occupation during the quarter.

iii. Availability refers to all space available for immediate occupation, plus space still under construction which will be completed within six months and which has not been let.

iv. Availability and take-up are classified into three grades:

New/refurbished: Space under construction which is due for completion within six months or space which is currently on the market and is either new or completely refurbished.

Second-hand A Grade: Previously occupied space with air-conditioning.

Second-hand B Grade: Previously occupied space without air-conditioning.

v. Demand figures quoted in this report refer to named requirements for over 10,000 sq ft.

vi. Under construction figures quoted in this report refer to developments of over 20,000 sq ft which are currently underway. They do not include properties undergoing demolition.

vii. Investment figures quoted in this report refer to accommodation where the majority of income/ potential income is from office usage and comprises transactions of £1 m and above.

The data includes standing investments, site purchases and funding transactions.

viii. This report is produced to standard quarters.

Quarter 1: January 1 – March 31,
Quarter 2: April 1 – June 30,
Quarter 3: July 1 – September 30,
Quarter 4: October 1 – December 31

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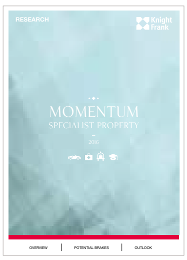

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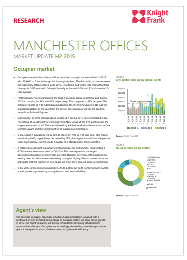

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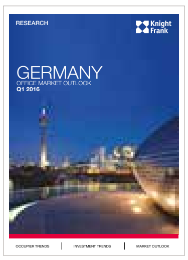

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