

THE M25 REPORT



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Foreword

A focus on the occupier, demands a focus on fundamental drivers.



EDITOR

Emma Goodford
Partner, Head of National Offices



There is, of course, nothing more fundamental to market performance than the occupier.



In times of great uncertainty we are often reminded to focus on the fundamentals. In order to cut through the noise generated by geo-political change, competing visions of the economic future or disparate views regarding the true impact of technological change, we must connect to those fundamental principles on which the real estate market is formulated. There is, of course, nothing more fundamental to market performance than the occupier. Put simply, without the occupier there is ultimately no income and hence no investment performance.

This report therefore has an unstinting and unapologetic focus on the occupier. Through the following pages we address some of the key issues influencing the M25 market today;

- What is driving current market demand?
- From where will future demand emanate and what form will it take?
- How do the characteristics of demand align with the current and future supply on offer in the M25 office market?
- How should real estate investors, old and new, react to a new occupational dynamic?

This report points to a changing demand dynamic. We don't see value in assessing the occupier through an historic lens. The occupier is experiencing great change and at a pace far outstripping history. The strategic significance placed upon location and realisation that the real estate decision impacts on the greatest cost to the business – its people – poses multiple challenges for the occupier.

First, the competitive threat being instigated by disruptive technologies, across all industry sectors, means that simply maintaining the status quo is not an option. Traditional business models must respond to, and invest in, a new operational reality.

Second, there is a need to align strategic intent, and its associated investment, with a low growth operating environment. Although, by global measure, the UK economy is forecast to perform strongly during 2017 and 2018, GDP growth is low by historic standards and as a result occupiers will have little choice but to proceed with sensitivity to cost.

Finally, the very speed and frequency of change will require occupiers to strike a difficult balance between the pursuit of a dynamic strategic vision and a real estate portfolio which may limit the agility required to respond to changing circumstances.

As this report shows, there will be three characteristics of demand that will emerge in the M25 market against this back-drop:

1. A new phase of cost sensitivity but one which puts total occupancy costs in their broader perspective and demands efficiency which does not impede operational effectiveness.
2. The rising demand for flexibility and a willingness to pay for it.
3. New occupational models – notably the greater use of co-working spaces by corporate occupiers – in order to match real estate portfolios to emerging business models.

Change, particularly change that is brought on by technological transformation can be daunting. Yet if there is one characteristic of the M25 and wider South East market that has been consistent throughout the 31 years since the orbital motorway was constructed, it would be the ability to adapt. We remain confident in, and committed to, the M25 office market. The on-going transformation of business, in response to a digital age and beyond, will change the dynamic of the marketplace, the requirements placed on product and the basis on which that product is occupied. But the fundamental strength which derives from the diversity and abundance of occupiers within the market, and its connection to the enduring appeal of London, will remain.

Market evolution & significance

Infrastructure has been the long-term catalyst for the development of the M25 market; a trend that is set to continue as the Elizabeth Line takes effect.



Emma Goodford
Partner, Head of National Offices

First mooted in 1905, the idea of an orbital road around London predates widespread car ownership. After many iterations of the concept, Margaret Thatcher opened the final phase of the M25 some 81 years later in October 1986. Much maligned, the so called ‘road that goes nowhere’ has served to transform accessibility throughout the South East, both connecting and creating communities. Today, the M25 continues to serve as a vital component of economic growth in the UK.

The development of new commercial centres was a principal objective of this new infrastructure. The ease of access to new areas meant that business parks quickly gained prominence in the South East during the 1980’s. The first to begin development was Stockley Park in 1986. A former refuse site, the vision of Elliott Bernerd and Stuart Lipton would later become a two million sq ft business campus. Bernerd and Partners would later sell Stockley Park for £356m. The South East now boasts the highest concentration of business parks anywhere in the UK, with 22 currently in operation.

In part, a sharp rise in technology-based firms coming to the region in the 1990’s supported the success of the business park concept. Major IT firms such as Novel, Oracle, Sun Microsystems and Cisco all secured significant lettings during this period. In fact, the 750,000 sq ft taken by Cisco at Green Park, Reading remains the largest single occupier deal on record for the region.

Newly formed telecoms providers would also supplement demand. Deregulation of the industry in the preceding decade had created a widening pool of newly formed providers, many of which would establish their operations along the M4 corridor. Although the technology boom became bust in 2001, the proliferation of electronic devices and internet services since this point has meant that a new wave of high growth technology firms has developed. Importantly, the clustering nature of this type of firm means that the sector remains a major source of new demand in the South East today.

The internet bubble implosion in 2001 proved just the precursor to one of many periods of market turbulence. The terrorist attacks of





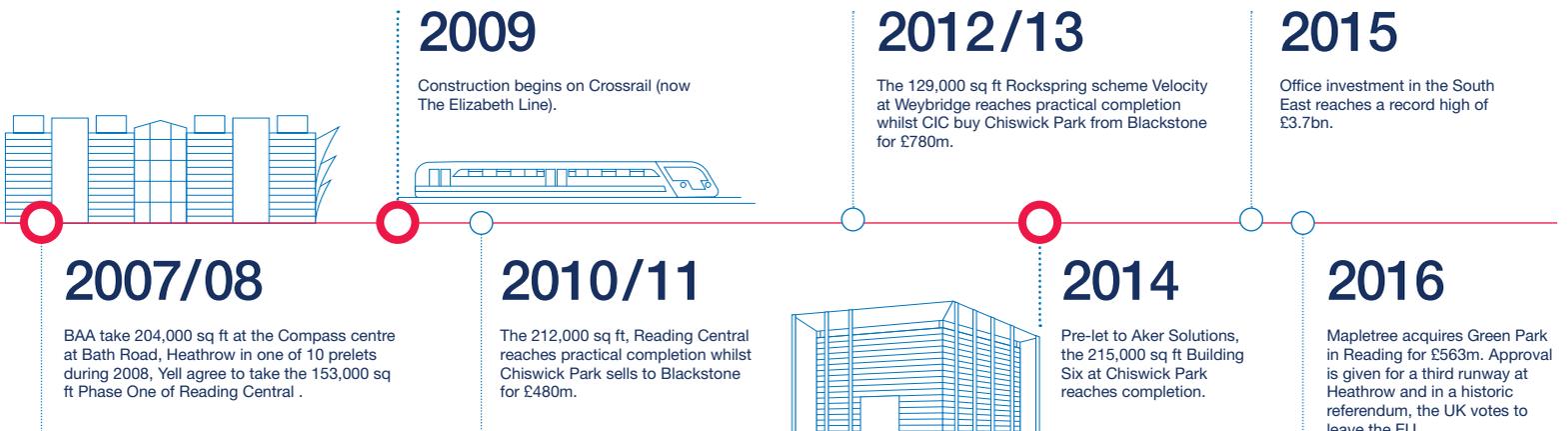
Margaret Thatcher opening the M25 in 1986

September 11th sent markets and economic projections worldwide into a tailspin. Interestingly, and reflective of the heightened security that followed, out-of-town centres in the South East accounted for the highest proportion of annual take-up on record at this time.

Other periods of disruption caused by externalities have served to shape the South East market over time. The global financial crisis of 2007/8 is perhaps the most significant of recent years. This ‘Black Swan’ event proved the catalyst to the lowest recorded level of occupier take-up in the South East. In addition, the subsequent seizure of capital markets also dramatically reduced the availability and longer term, affordability of debt for property development. Speculative completions measured over the five years from 2010, a period that marked the beginning of an economic recovery, were equivalent to just nine months of take-up.

Nonetheless, the trajectory of the South East office market from inception into the future is one of growth. Through continuous evolution shaped by infrastructure investment, regeneration and externalities, the market today supports and attracts a diverse array of occupier groups. Although trends fluctuate in singular years, over a 15-year period, no single business sector represents more than 20% of take-up.

The opening of the full Elizabeth Line in 2019 will be the latest ‘pivotal’ infrastructure moment. Locations along its 60-mile route have, and will continue to see transformation. Reading is a clear example where the development pipeline is one of the largest in the South East. Improvements to the M25, Western Rail Access to Heathrow (WRATH) and a third runway at Heathrow all add further potential to the market in the coming years. Whilst economic conditions, the business environment and market trends create peaks and troughs, the mainstay of long-term market growth will always be its infrastructure.



An abundance & diversity of occupiers

Large clusters of notable occupiers bring resilience and dynamism to the M25 market.



Roddy Abram
Partner, National Offices

The role of South East England as a dynamo for the UK economy has long been recognised. Home to more than 900,000 businesses – the large majority clustered within striking distance of the M25 orbital – the region contributes £249bn in economic output per annum, second only to Greater London and a contribution in excess of that delivered by the UK's eight core cities combined.

The region has a broad base of occupiers of all sizes and drawn from all industry sectors. The status of the immediate M25 market is one developed on the back of the rapid growth of the Telecommunications, Media and Technology (TMT) sector. Knight Frank research has

identified 67 occupiers employing more than 1,000 people on a single site within the core centres of the M25 market. Of these 23 – or almost 35% – are drawn from the TMT sector. They range from those companies that built reputations on the production of hardware – Cisco, Siemens, HP, Dell – or software – Microsoft – towards those that traditionally have been responsible for the creation and distribution of content – such as the BBC, Warner Brothers and Walt Disney – and whose operating environments have now been fundamentally transformed by the application of digital technology. While there may be continued talk of technology occupiers gravitating towards city centre locations, there is no denying that the

business park markets of the M25 continue to serve as significant technology hubs.

Diversity is also in evidence. Indeed the 67 significant employers identified in our research are actually drawn from across nine different industry groupings. Distinct clusters are apparent in the region focused on engineering (BAe systems, Thales, Mott MacDonald) and energy and utilities (BP, Centrica, British Gas, Thames Water). These are supported by further clusters of transport related activity around airports at Heathrow and Gatwick (British Airways, Virgin Atlantic, BAA). The public sector and the financial services sector – specifically retail banks – have also taken large amounts of space in the market historically.

These clusters of activity are being strengthened and extended as occupiers make new or further commitments into the region. The 10 most significant occupier deals seen in the M25 market over the last five years are shown in the table below. They serve to further illustrate the strength of the market as a base for occupiers drawn from the three sectors of energy and utilities, TMT and the public sector. The latter notably through the further concentration of national Government departments in Croydon as part of a wider decentralisation programme. This is not to suggest however, that the market is staid in terms of its occupier base. Indeed we are observing the growing presence of tech driven retailers taking significant facilities within the market as shown by Lidl and Ocado, and by the recent notable deal by on-line fashion retailer ASOS at Leavesden Park, Watford.

The heritage of the M25 market, and the technology skills base that it has grounded in the region, is one of its key strengths. As more sectors are disrupted by technology, those skills will be in great demand. But as the technology sector itself changes shape and focus, the very diversity of the occupier base within the market will also be a great source of resilience.

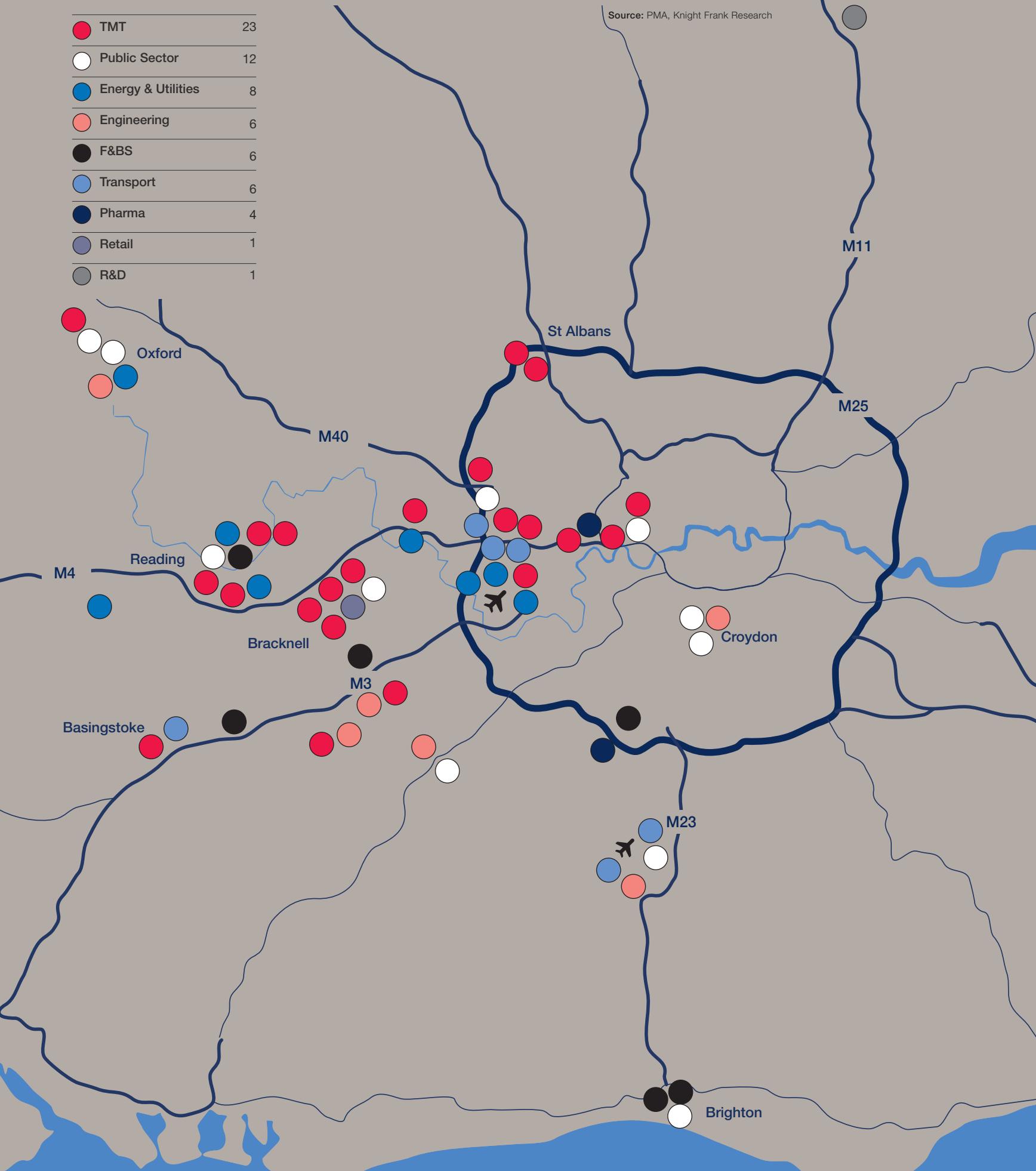
TOP 10 M25 OCCUPIER TRANSACTIONS (2012-2017)

| DATE | LOCATION | ADDRESS | SIZE (sq ft) | OCCUPIER | SECTOR |
|---------|---------------------|-------------------------------|--------------|----------------------------|----------------------------------|
| 2013 Q3 | Farnborough | Nokia Campus | 305,000 | BMW | Manufacturing & FMCG |
| 2016 Q4 | Tolworth / Kingston | Lidl site | 220,000 | Lidl | Retail, Distribution & Transport |
| 2012 Q2 | Chiswick | Building 6, Chiswick Park | 215,755 | Aker Solutions | Energy & Utilities |
| 2015 Q3 | Reading | 1 Forbury Place | 185,940 | Scottish & Southern Energy | Energy & Utilities |
| 2016 Q3 | Croydon | 1 Ruskin Square | 183,597 | HMRC | Public Sector |
| 2016 Q2 | Hatfield | 1 & 2 Hatfield Business Park | 148,275 | Ocado | Retail, Distribution & Transport |
| 2012 Q3 | Reading | 300 South Oak Way, Green Park | 139,239 | Huawei | TMT |
| 2013 Q1 | Heathrow | 2 New Square, Bedfont Lakes | 135,000 | BP | Energy & Utilities |
| 2014 Q2 | Windlesham | Chertsey Road | 128,067 | Frazer Nash | Construction & Engineering |
| 2013 Q3 | Hayes | Rackspace City / HPH 5 | 127,000 | Rackspace | TMT |

DISTRIBUTION OF SOUTH EAST OCCUPIERS EMPLOYING MORE THAN 1,000 STAFF ON A SINGLE SITE, BY SECTOR

| | |
|----------------------|----|
| ● TMT | 23 |
| ● Public Sector | 12 |
| ● Energy & Utilities | 8 |
| ● Engineering | 6 |
| ● F&BS | 6 |
| ● Transport | 6 |
| ● Pharma | 4 |
| ● Retail | 1 |
| ● R&D | 1 |

Source: PMA, Knight Frank Research



Decisions Decisions

Occupier decision making has become ever-more complex and business critical. For the investor, therefore, understanding the new dynamics of demand has never been more important.



Will Foster,
Partner, National Offices

The consistent strength and resilience of the M25 market is a function of its inherent ability to appeal to the often surprisingly similar needs of occupiers drawn from a wide range of industry sectors. There is a lot riding on the investment and location decisions made by occupiers and not just for the occupier. For the investor, understanding the dynamics shaping future decisions is essential in protecting income. We believe there are four features of contemporary real estate decision making that should be noted:

1. A DECISION OF STRATEGIC IMPORTANCE

The real estate decision is now a board room agenda item. Real estate is viewed as an instrument that supports and influences a range of wider strategic considerations such as CSR, operational productivity and efficiency, the promotion of brand and talent attraction and retention. This has three clear consequences. First, the occupier is more exacting about what they need, why they need it and are better informed about the market choice. Second, the time-scales over which decisions are made tend to be longer, given their gravity. We have seen the time from initial inspection to heads of terms lengthen across the market, and in some cases it is now 9-12 months before the legal process is documented. This should be balanced however against more dynamic requirements from fast growth businesses. The recent letting to ASOS at Leavesden Park, for example, has been driven by rapid expansion and supported by strong financial results. In this case only five months passed between first inspection and deal completion, despite considerable due diligence elements. Finally, the range of stakeholders in the decision making process has broadened to encompass not just the CEO, but also the CFO, the HR director, the IT director and existing staff.

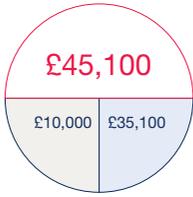
2. A DECISION ABOUT PEOPLE RATHER THAN BRICKS & MORTAR

The HR director is involved earlier in the real estate decision making process and has a powerful influence over the ultimate outcome. Again the reason is simple. People constitute around 55% of the cost base of any business and are its primary source of competitiveness. A poor location or real estate decision can create costly churn in the workforce – staff reinstatement costs run at circa 150% of salary. Recruiting the technical and creative talent required by business is costly, competitive and cannot be compromised. In this sense, real estate becomes part of a corporate talent strategy whereby the quality of the workplace, its vibrancy, amenity, services and its ability to accommodate different ways of working are all integral to winning the ‘war for talent’ and thus supporting business competitiveness. It is telling that all but five of the top 30 leasing transactions completed in the M25 market during 2016 saw the occupier move within 10 miles of their current location. This is reflective of the strong talent pool available within the M25 market and the desire by occupiers to retain these talents by making real estate decisions that are sensitive to potential impacts on the commutes of key staff.

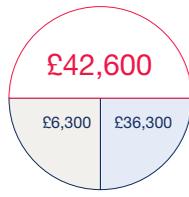
3. A DECISION THAT IS INCREASINGLY COST SENSITIVE

At the time of writing the most optimistic UK GDP growth forecasts for 2017 stand at 2%. Although strong by current global standards, this growth rate is moderate by historic measure. Businesses are cutting their cloth accordingly, and are seeking to protect margins by addressing costs. Although no more than 15% of an occupier’s cost base, real estate is a tangible cost that can be scrutinised. Cost sensitivity will shape market demand going forward, not

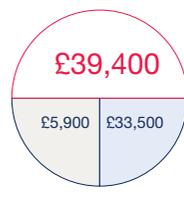
TOTAL ANNUAL STAFF AND PROPERTY COSTS ACROSS THE KEY M25 CENTRES



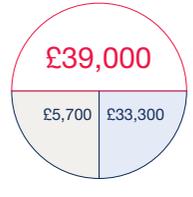
Hammersmith



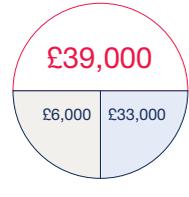
Heathrow



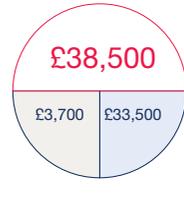
Uxbridge



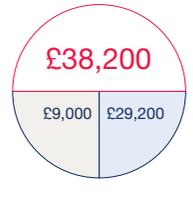
Slough



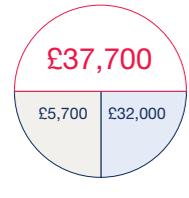
Maidenhead



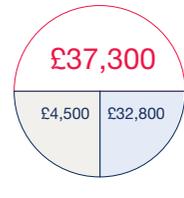
Staines



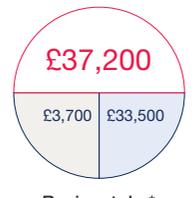
Chiswick*



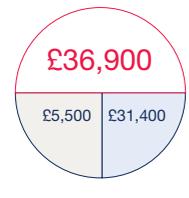
Cambridge



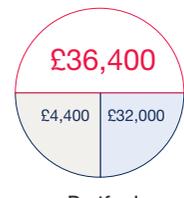
Crawley / Gatwick



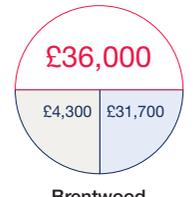
Basingstoke*



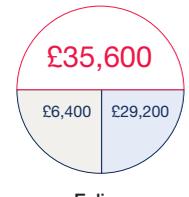
Croydon



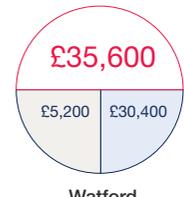
Dartford



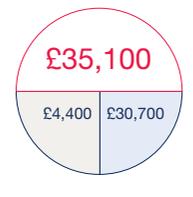
Brentwood



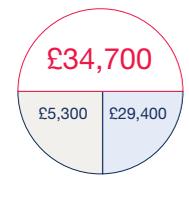
Ealing



Watford



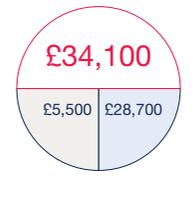
Bracknell



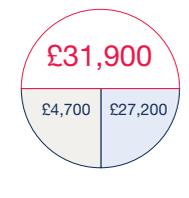
St Albans



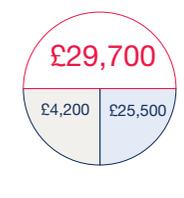
Reading



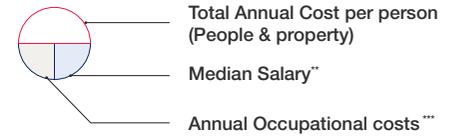
Guildford



Oxford



West Malling



* Chiswick straddles two administrative boundaries. The London Borough of Ealing has been used for this analysis given the location of the Chiswick Park

** Data relates to Median Salary achieved by full time workers by workplace and quoted at local authority district level; Gross Annual Pay as at 2016.

*** On the basis of 110 sq ft per person

Source: ONS, Knight Frank Research

least because of the on balance sheet impact of leasing ushered in by IFRS16 from 2019. But there are two clear distinctions from the past; first, occupiers will focus firmly upon total occupational costs not just rental cost. Second, real estate costs will not be considered in isolation. We will not return to such an attack on costs that staff productivity is compromised. Businesses will be more accepting of real estate costs where a clear linkage can be made to mitigating costs in other areas of the business, notably in terms of the cost of lost output or talented staff. This dynamic is evident in the M25 market where we have witnessed occupiers paying record rents to secure the right product at the Pearce Building in Maidenhead, Thames Tower in Reading, and Prospero in Redhill, amongst others. In addition, occupiers will focus intently upon working the space harder, driving greater occupational density, adopting smart working practices and utilising 'free' landlord delivered communal space and amenity.

4. A DECISION WHICH CAN SHAPE CORPORATE CULTURE

Businesses continue to respond to the disruptive effects of both digital and emerging technology. This is also emboldening new market entrants across a range of sectors. Established companies require transforming – a transformation in the talent pool driving the business, as well as one altering the underlying corporate culture. Real estate matters in this respect. For example, many established businesses need to respond to more collaborative work-practices as well as the need for more innovative behaviours within the business. The configuration, character and style of the workplace are essential in embodying and facilitating this transformation.

What at first glance appears to be a relatively simple decision making process is an ever more complex one. Real estate decision making is strategically significant, balancing costs against operational needs, and is at the very forefront of attempts to transform the workforce and culture of business. This must be recognised and responded to if the M25 market is to maintain its impressive track-record of securing occupiers.

The talent factory

The fundamental strengths of the South East labour market point to its continuing success as an office market.

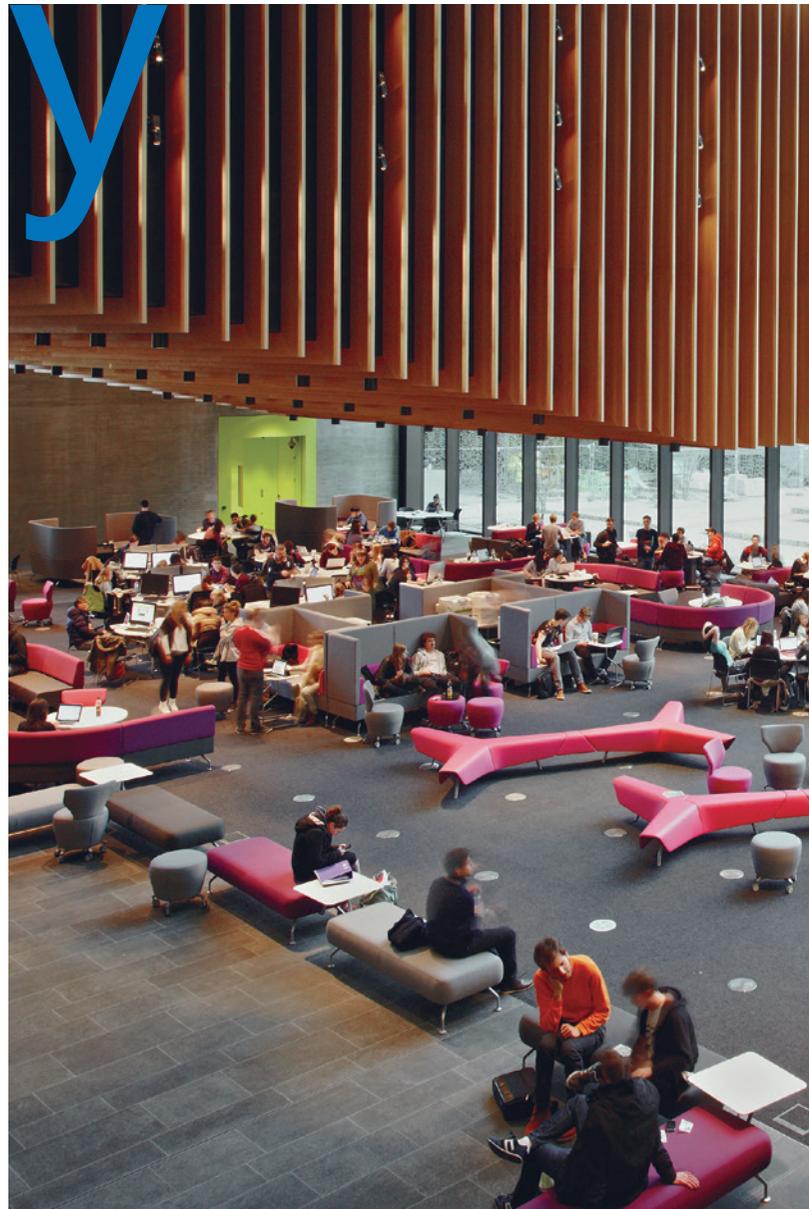


Dr. Lee Elliott,
Partner, Head of
Commercial Research

It is often hard for seasoned real estate professionals to see beyond property. But for the modern office occupier, drawn from what have become collectively known as the knowledge industries, the key ingredient for corporate competitiveness is sustained access to technical and creative talent. Brain power, fresh and innovative thinking are their greatest need. Even in this age of emerging robotics and automation, skilled people represent the difference between businesses that excel and those that struggle. Accordingly, locations that provide such talent are those that consistently win through. Even more so in a UK labour market, which is operating at historic highs in terms of employment levels.

A HIGHLY SKILLED, VOLUMINOUS LABOUR MARKET

In this regard the South East is well placed. Not only is the South East the most populous region of the UK but, crucially, it is second only to London in terms of the quantum and quality of the skills base it presents office occupiers. The region has more than 2.3 million people educated to NVQ Level 4 or above. On this measure the region provides access to 15% of those with the highest levels of academic attainment in the country. Concentrations of these skills within the knowledge industries are also impressive with almost 300,000 people employed in the burgeoning information and communications sector and almost half a million more employed in what are classified as



“

The South East has more than 2.3 million people educated to NVQ Level 4 or above.

”

professional, scientific or technical activities. In fact the four employment groups at the heart of the knowledge economy employ in excess of a fifth of the regions labour force.

A STRONG ACADEMIC INFRASTRUCTURE

But as important to the regions on-going economic success is its ability to cultivate new talent. In this respect, the region has an unrivalled academic infrastructure. Our research points to 34 universities within the South East region with a student population of almost half a million in the academic year 2014/15 – and that excludes the extensive student population found in close proximity within central London. By any measure this is a sizeable future work-force on which to draw. As universities themselves become ever more entrepreneurial and commercial, there is a clear move by occupiers to locate close to the region's major seats of learning. The emergence of science parks and business incubators, not just in Cambridge and Oxford, but across the region,

represents a key catalyst in the region's growth. At a social level, as London living becomes increasingly expensive and is scrutinised on the basis of well-being by the younger generation, the prospects for the South East capturing greater flows of talent further improves.

TALENT MAGNETS

As the popular social scientist Malcolm Gladwell has noted, 'Innovation – the heart of the knowledge economy – is fundamentally social.' In this sense, the existing concentration of more than two million highly skilled workers, coupled with a voluminous and world-leading academic infrastructure, creates the community on which the South Eastern knowledge economy can flourish. It is against this skills base that the dynamics of property come into effect. The market must create spaces which entrap and excite the knowledge worker. Locations and workplaces that act as talent magnets will be of increasing interest to office occupiers and bring out-performance to real estate investors.

STUDENTS

34

universities in the South East with a student population of

490,000

EMPLOYMENT

49.7%

of the South East's workforce is classified as being highly skilled

Total workforce jobs in Arts, Entertainment & Recreation **152,000**

Total workforce jobs in Information & Communications **281,000**

Total workforce jobs in Financial & Insurance Activities **139,000**

Infrastructure, service and amenity

Five of the UK's top 20 major shopping centres are the South East

Opened in 2008 at a cost of £4bn, T5 handles 33 million customers per year

With 22, the South East has the highest concentration of business parks in the UK

6% more people commute into a key town in the South East than outward

Around 1 in 5 passengers travel through Gatwick on business with the airport serving 46 of the 50 top business destinations in Europe



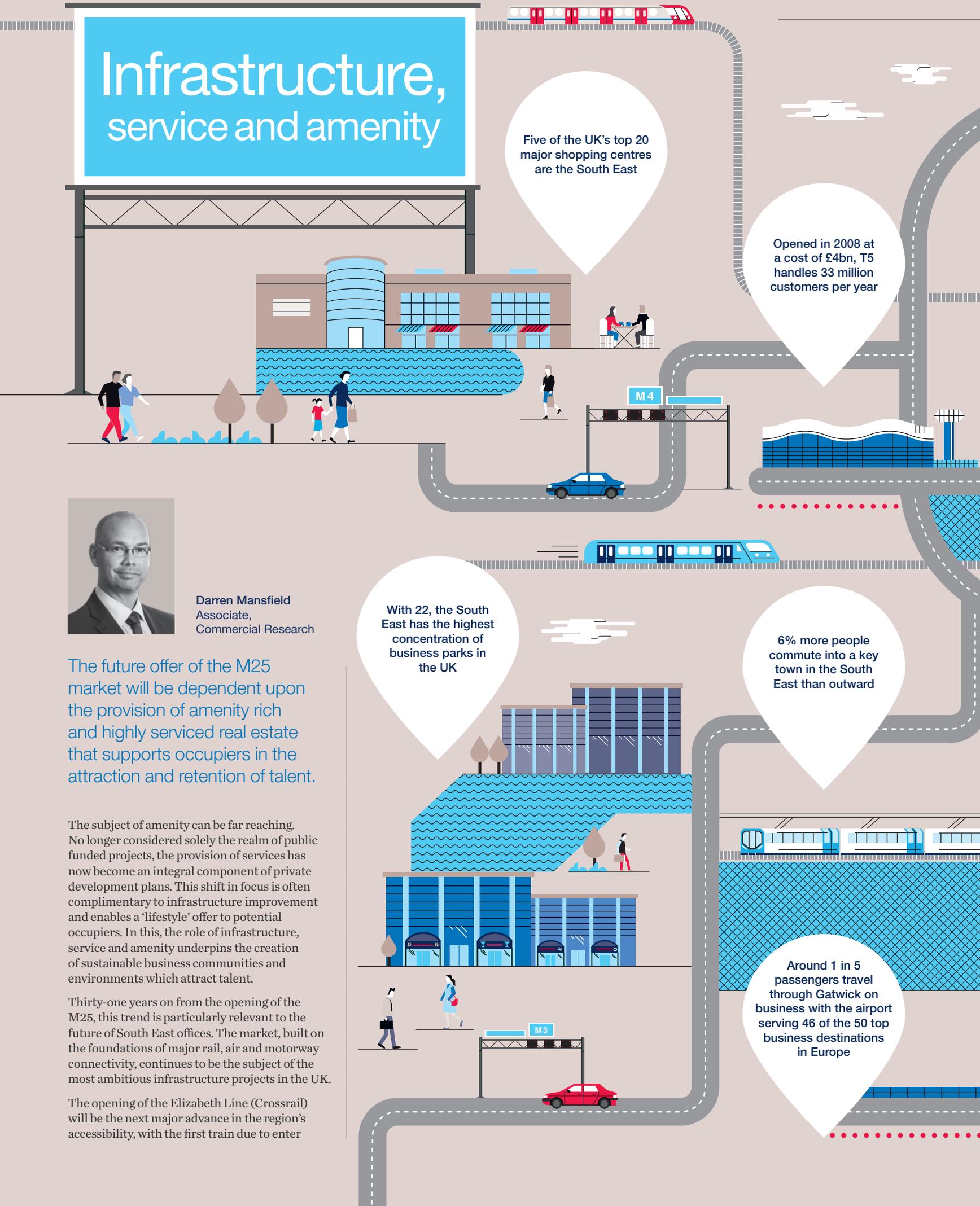
Darren Mansfield
Associate,
Commercial Research

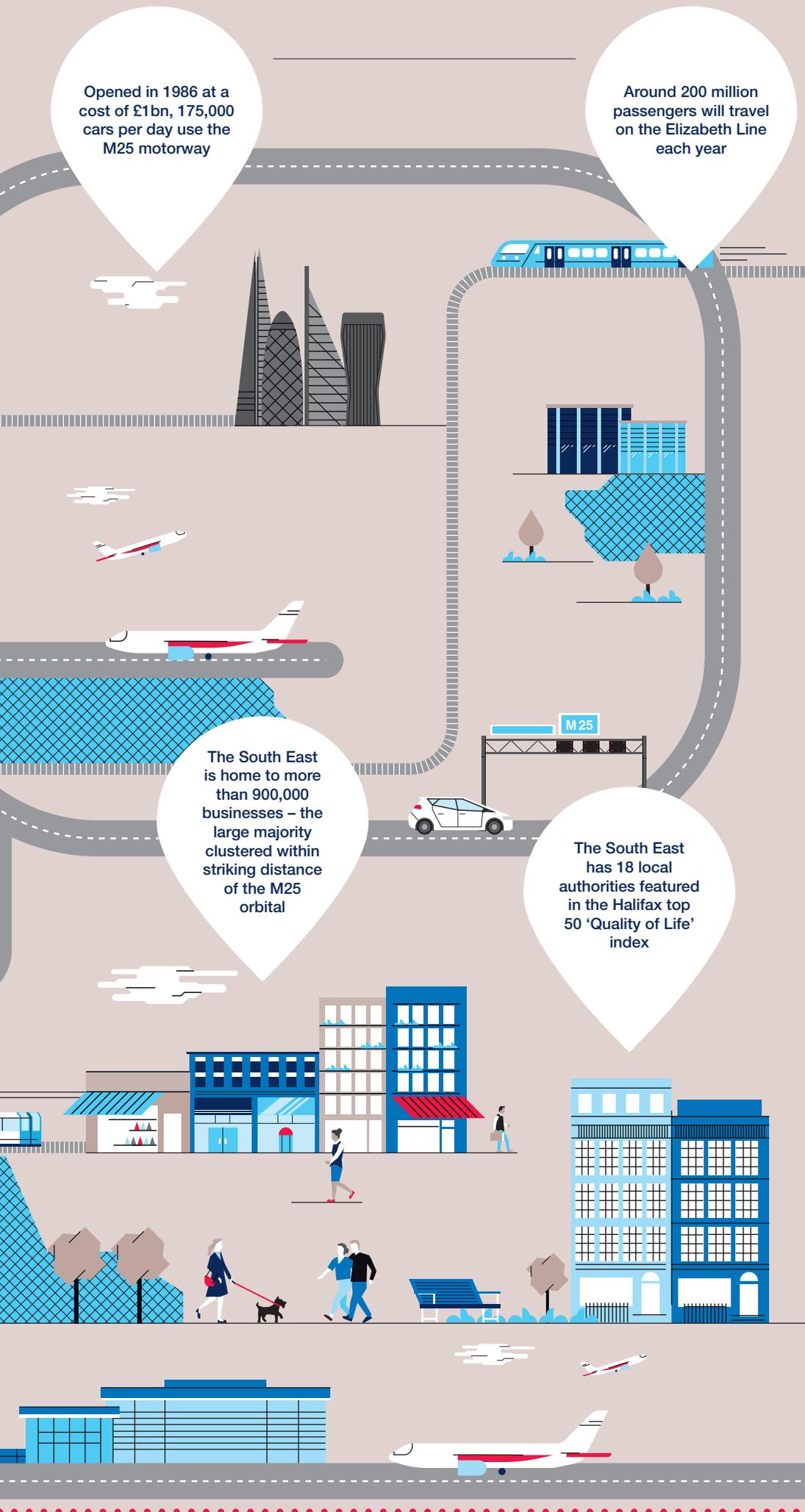
The future offer of the M25 market will be dependent upon the provision of amenity rich and highly serviced real estate that supports occupiers in the attraction and retention of talent.

The subject of amenity can be far reaching. No longer considered solely the realm of public funded projects, the provision of services has now become an integral component of private development plans. This shift in focus is often complimentary to infrastructure improvement and enables a 'lifestyle' offer to potential occupiers. In this, the role of infrastructure, service and amenity underpins the creation of sustainable business communities and environments which attract talent.

Thirty-one years on from the opening of the M25, this trend is particularly relevant to the future of South East offices. The market, built on the foundations of major rail, air and motorway connectivity, continues to be the subject of the most ambitious infrastructure projects in the UK.

The opening of the Elizabeth Line (Crossrail) will be the next major advance in the region's accessibility, with the first train due to enter





Opened in 1986 at a cost of £1bn, 175,000 cars per day use the M25 motorway

Around 200 million passengers will travel on the Elizabeth Line each year

The South East is home to more than 900,000 businesses – the large majority clustered within striking distance of the M25 orbital

The South East has 18 local authorities featured in the Halifax top 50 'Quality of Life' index

service in May 2017. The annual economic benefit across the route it serves will be circa £1.24 billion. A third runway at Heathrow, approved by government in 2016, is now also set to follow. The consultation process has begun with the new runway expected to become operational in 2025.

In addition, access improvement to both Heathrow and the wider western M25 is on the agenda. Consultation has begun on a £500m 'Smart Motorway' scheme between J10-J16. If approved, work will begin in 2019. Also proposed is the plan to build a new rail tunnel to link the Great Western Mainline to London Heathrow Terminal 5. Known as WRaTH, direct trains will run between Reading, Slough and Heathrow with the new route allowing 20 per cent of the UK population access into Heathrow via just one interchange.

In the coming years, the South East is the subject of further infrastructure investment. The region is of course the starting point for HS2, and Crossrail 2 is already in advanced planning. Undoubtedly, this can only support further growth of existing business hubs and create new opportunities.

Whilst infrastructure improvement acts as a catalyst for regeneration and speculative property development, connectivity improvement alone is insufficient to attract new occupiers. The 'War for talent' necessitates high quality amenity to gain competitive advantage.

Occupier preferences in this subject have quickly become a critical component of the decision making process. It is now commonplace for property developers and owners to include provisions such as café areas, cycle storage, changing facilities and co-working space. The recent comprehensive refurbishment of the Charter Building, Uxbridge is good example with 'in building' amenity supported by the modern day prerequisite, high-speed internet connectivity.

The preference toward amenity has also led to a structural transformation of business parks. The 'community feel' typically found in town or city centres is being recreated. Chiswick Park is illustrative of the changing focus where on-site provisions now include, restaurants, bars, convenience stores and wellness facilities to compliment high quality office space.

In addition, the provision of services is an increasingly significant factor in the location choice of occupiers. The range is extensive but typically includes reception, security and housekeeping to more personalised requirements such as a gym, changing facilities and concierge. In an increasingly competitive marketplace, landlords who provide a holistic package are gaining advantage.

The lifestyle offer both in and out of town will of course, be central to this future growth. The need for occupiers to align their property provision with aspirations of their staff is now well entrenched. With current and future infrastructure unrivalled in the UK and future development aligned to the needs of occupiers, the South East and M25 is a location supporting modern business.

5 sources of new demand



Where will the next wave of M25 office occupiers come from?



Dr. Lee Elliott,
Partner, Head of
Commercial Research

The sheer diversity of companies that call the M25 market 'home' represents one of its greatest strengths. The international connectivity afforded by both London Heathrow and London Gatwick has made it a key destination for international companies seeking a foothold in the UK market place, while at a sector level the software and hardware revolution of the late 1990s onwards has established a strong spine of household technology names in the area. This is a market that has been consistently in demand.

Yet the demand dynamic is changing. The next wave of office occupiers for the market will be drawn from different sectors or sub-sectors, while against a Brexit backdrop the volume and origin of inward investment will undoubtedly alter. In a changeable environment, here are five sources of future office demand to monitor.



1

Emerging market PLC

As the axis of global economic power continues to shift towards the emerging markets, sizeable corporate interests from markets such as India, China and Brazil will seek access to the UK. The opportunity for consumer based electronics, evidenced by Huawei's occupation in the M25 market, will continue but look out for other service based operations spinning out of the emerging markets as they seek scale and the diversification of risk away from domestic markets but with strong connectivity back to home.





3

Mainstream businesses seeking digital transformation

Traditional businesses of all shapes, sizes and drawn from all sectors are being disrupted by digital technology. They have no choice but to transform their structures and processes to embrace digital. They often lack the skills to do so. Cue the emergence of 'digital transformation teams' charged with bringing accountants, consultants, lawyers, insurers, retail banks and the like into the digital age. Significantly, these teams often function separately from the main business and actively seek out environments conducive to the innovation and creativity they are seeking to spawn.

4

Sector convergence spawning new alliances

An emerging business dynamic is the creation of new alliances – either formal or looser collaborative relationships – across traditional distinct sector boundaries. Think automotive companies and insurers, or traditional media companies and creative, cutting-edge software companies. Convergence and collaboration is an operational reality and, for many, a necessary survival strategy. And it will generate entirely new businesses in need of space.



5

Frontier-tech companies

The next wave of technological innovation will spawn a new roster of household names. Automation, robotics and artificial intelligence will all create new technology powerhouses which have at their operational heart a need for the technical engineering skills on which the M25 market has historically flourished.

2

Further Retail therapy

We expect to see the further continuation of a recent trend where retailer HQ's are taking root in the M25 market. The cost profile of the market, particularly relative to central London, is in keeping with such functions. M25 locations also offer retailers with strong connectivity to both consumer and supplier markets, as well as their own network of stores. Tech focused retailers or those going through a digital transformation also represent a source of market demand.



Whilst the dynamics of investment ebb and flow, the South East office market benefits from solid foundations created through investor diversity, value and opportunity.

Investment market dynamics



Tim Smither
Partner,
Capital Markets



Anthony Duggan
Partner,
Commercial Research

Last year ended up surpassing expectations with transaction volumes significantly above where most were expecting in the weeks immediately following the European Referendum and any pricing weakness disappearing as demand recovered. Can this momentum continue?

LEARNING FROM 2016

2016 saw a number of interesting themes in the M25 office market. Firstly, there was a lack of smaller deals; 'big ticket' transactions made up nearly half of the annual transaction volume. This was a sign of both new entrants looking to deploy significant capital and the absence of the UK funds whose buying volumes were down 40% year-on-year. Secondly, and linked to this, we saw a wave of buying from overseas investors chasing everything from long-term secure income through to opportunistic assets. Thirdly, local councils continued to grow as an established investor in the M25 market, and cannot be ignored; they accounted for a fifth of all transactions in 2016.

So what does this mean for the months ahead? We expect overseas investors and local councils to remain active and they are increasingly being joined by the previously absent UK funds as well as further buying from residential developers looking at permitted development plays. This all leads to a very competitive playing field.

GLOBAL APPEAL

Global investors will continue to see the UK as a key market with Middle Eastern buyers particularly active for long-term secure income. However, they will be in hot competition with the local councils, who are looking at the same product and, subject to any central government policy changes, will remain a strategic buyer group. This is leading them to amend their investment criteria to consider shorter lease terms in order to buy in a less competitive environment.

The US private equity funds continue to actively stalk the market, seeking value-add opportunities of scale that can deliver their required mid-teen IRRs. With deep under-bidder lists for the large sales transacted over the last few months we are monitoring a significant volume of unfulfilled capital that is still to be deployed.

DOMESTIC IN THE DRIVING SEAT

So, overseas investors remain acquisitive across the risk spectrum. However, they are competing with a deep and active pool of UK capital chasing the M25 market.

As well as strong demand from the councils, UK property companies and residential developers, the UK Institutions are back in the market. While the retail funds are strategically maintaining a higher cash balance than pre-referendum, these funds are again a key buyer group for the M25 and wider UK marketplace. In addition to existing vehicles, a number of new mandates have been raised and have significant capital to deploy.

RARE COMMODITY

In terms of asset types, defensive buyers will continue to hunt for long-income opportunities. This will remain a very competitive market and suitable assets will be hard to find. A key issue is that with fewer occupiers committing to longer leases these assets are not being created at the same pace as in the past. This is driving intense competition from a wide group of investors who are all looking for income and security.

ACTIVE ASSETS

Those working higher up the risk curve have the ability to take advantage of this trend of shorter and more flexible leases. Buying into short income in strong locations provides additional yield and, in markets where the re-letting prospects are strong, the opportunity

CAPITAL FLOWS INTO THE SOUTH EAST (2012-17)

Source: RCA, Knight Frank Research



£8.7bn

United Kingdom



£1.5bn

United States



£790m

Singapore



£780m

China



£770m

Middle East



£330m

Australia



£210m

Europe



£130m

Malaysia



£100m

Hong Kong



£460m

Other Overseas

£13.8bn

total South East
office investment
between
2012 – 2017.

Overseas money
accounts for

37%

to use asset-management expertise to drive additional value. Add in the benefit of local-area regeneration strategies and/or new infrastructure improvements (such as the Elizabeth Line) and locations with skilled labour-pools and there are very compelling reasons to see strong performance from those willing to take on occupational risk in the right locations.

LACK OF PRODUCT

One major issue we expect to remain at the forefront of the market dynamics is the lack of suitable product available on the market to purchase. We anticipate that sales will remain constrained until the summer with few investors looking to exit. Sales that do come through will be driven by profit-takers and end-of-fund-life triggers. There will be some selected trades from retail funds looking to rebalance or flex cash positions.

PRICES TO RISE

This supply/demand imbalance will see prices hardening further over the next few months as investors compete for suitable assets. This inflation will ultimately convince more sellers to come forward into the second half of the year to take advantage of the depth of pent-up demand and for opportunistic investors to exit at pricing levels attractively ahead of their business plans.

CONTINUED MOMENTUM

Overall, we see the momentum recorded in the market over the last nine months continuing as a diverse range of investors look to the M25 market for both value and opportunity. The lack of available assets to buy will drive pricing which, in turn, will bring more sellers to the table as the year progresses.

The development landscape

2017 represents the peak of the current M25 office development cycle but context rather than concern is what is required.



Darren Mansfield
Associate,
Commercial Research

In 2017, the office development pipeline in the South East will reach its peak of the current cycle. Over 800,000 sq ft of speculative space reached practical completion is the first quarter. A further 1.9m sq ft is due for delivery before year-end. This means that the current year will see the highest level of development completions since before the global financial crisis.

At first appearance, the high level of development in 2017 might seem a statistic for concern. Put in context however, it signals the delivery of new stock that is long overdue. Between 2010 and 2014, just 2.6m sq ft of speculative space completed in the South East with the lack of development finance, high construction costs and increased risk aversion all contributing as prohibitive factors. Consequently, new availability has been falling, a trajectory that culminated in mid 2016 with vacancy reaching the lowest level since 2002.

Although market vacancy has now begun to edge up because of the recent higher level of completions, from 2018, the number of development schemes due to complete is more limited. Around 1m sq ft of speculative space across 16 schemes is due to complete next year of which, only 700,000 sq ft is currently under construction. Beyond this, just 740,000 sq ft of speculative space across five schemes is due by 2020. At the time of writing however, only one of the schemes was under construction. This means that any rise in vacancy would be short lived if current demand levels prevail.

By 2022, potential activity could add a further 3.8m sq ft to the South East development pipeline. Macro factors and the dynamics of each individual market will ultimately dictate whether any development will commence. However, schemes that include the correct mix of amenity and connectivity, such as the best business parks and town centres schemes along the Elizabeth line offer the greatest potential. A growing market imbalance in well connected locations north and south of the M25 also supports a development response.

DEVELOPMENT PIPELINE - KEY CENTRES (2017 -2022)

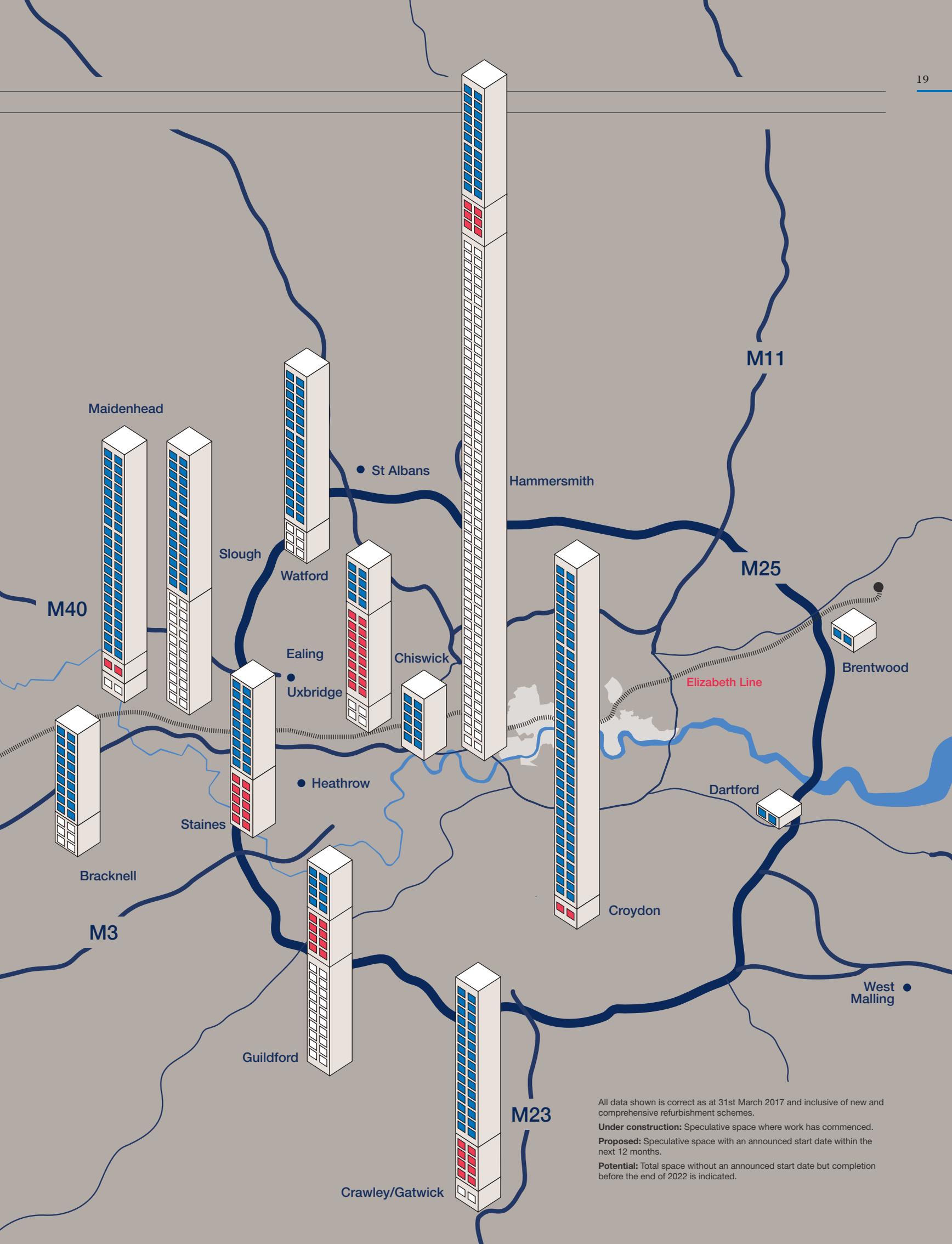
| | Under construction (sq ft) | Proposed (sq ft) | Potential Pipeline (sq ft) |
|-----------------|----------------------------|------------------|----------------------------|
| Basingstoke | 60,500 | 0 | 72,500 |
| Bracknell | 68,900 | 0 | 173,700 |
| Brentwood | 0 | 0 | 31,800 |
| Chiswick | 0 | 0 | 137,000 |
| Crawley/Gatwick | 26,600 | 63,500 | 292,300 |
| Croydon | 0 | 44,800 | 578,300 |
| Dartford | 0 | 0 | 11,200 |
| Ealing | 51,900 | 170,000 | 84,800 |
| Guildford | 171,500 | 78,000 | 94,600 |
| Hammersmith | 966,400 | 80,000 | 270,000 |
| Heathrow | 0 | 0 | 0 |
| Maidenhead | 21,600 | 20,000 | 403,900 |
| Reading | 496,300 | 0 | 801,800 |
| Slough | 214,700 | 0 | 266,700 |
| St Albans | 0 | 0 | 0 |
| Staines | 0 | 93,800 | 157,600 |
| Uxbridge | 0 | 0 | 0 |
| Watford | 65,000 | 0 | 285,000 |
| West Malling | 0 | 0 | 0 |

M4

Reading

Basingstoke





All data shown is correct as at 31st March 2017 and inclusive of new and comprehensive refurbishment schemes.

Under construction: Speculative space where work has commenced.

Proposed: Speculative space with an announced start date within the next 12 months.

Potential: Total space without an announced start date but completion before the end of 2022 is indicated.

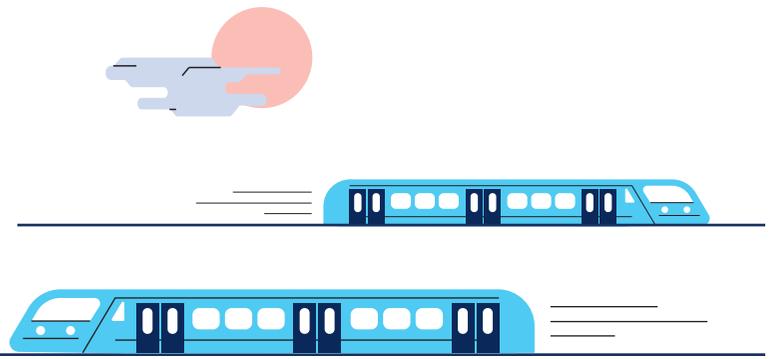
Market hotspots

5 winning locations worthy of closer attention

1

Elizabeth Line Winners

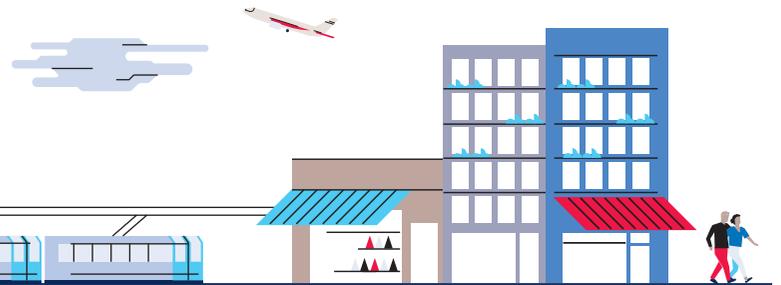
As the Elizabeth Line moves closer to completion, with the section running from Heathrow and Paddington opening in 2018 and full services from Reading by late 2019, there will be enhanced office market performance across all disembarkation points. We would however call out three specific out-performers: Maidenhead, Reading and Ealing. The former will continue to push on from what is currently the highest achieved rent in the South East market at almost £40 per sq ft, although the town centre will require a refresh if occupier appeal is to be sustained. In Reading, concern about levels of supply look a little misplaced, given that current speculative supply equates to less than two years of average office take-up and market demand will be further stimulated by more than 1.7 million sq ft of upcoming lease events in the next three years. Ealing offers no new supply and limited grade A stock and rental levels have the potential to grow considerably.



2

Covet Croydon

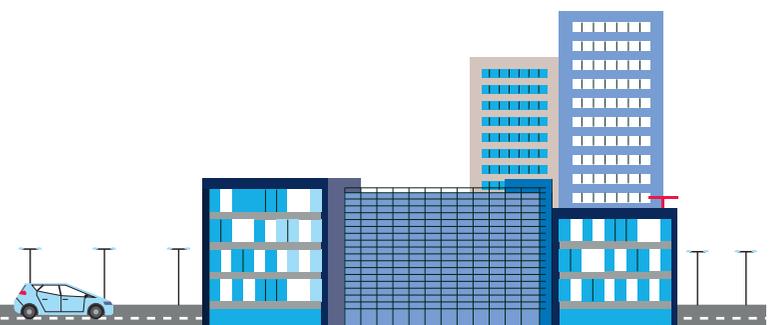
The Government's aim to further rationalise its occupied portfolio and deliver public services through fewer but larger regional hubs plays to a hand traditionally held by Croydon. When coupled with the continued upgrading of the urban realm and amenity, notably via the next phase of the Ruskin Square development, there are strong reasons to covet Croydon. The opportunistic should look for schemes previously sold for residential conversion which, unrealised, now have renewed viability as commercial schemes as office rents push into the mid £30s per sq ft.



3

Why Watford?

Having secured, as at April 2017, in excess of 100,000 sq ft of take-up against a long-term annual volume of 137,000 sq ft, there is evident momentum in the Watford market. This is further reflected in strong latent demand from a diverse range of occupiers. Consequently the market has seen rental growth of some 13% over the last twelve months and we believe there is further headroom for growth. However, do carefully monitor supply dynamics which have the potential to change markedly and rapidly.





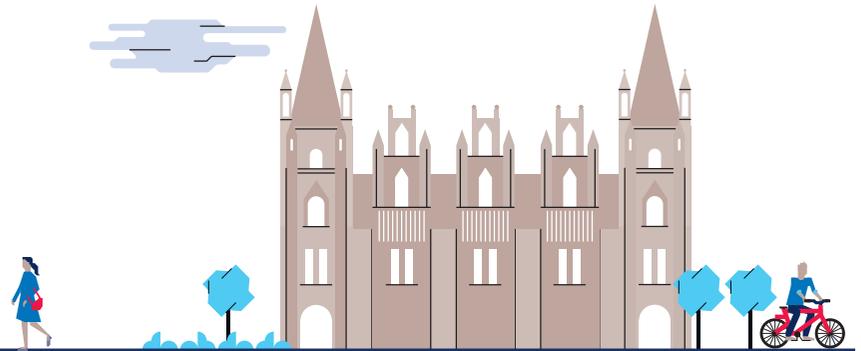
Emma Goodford
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Richard Claxton
Partner, Capital Markets

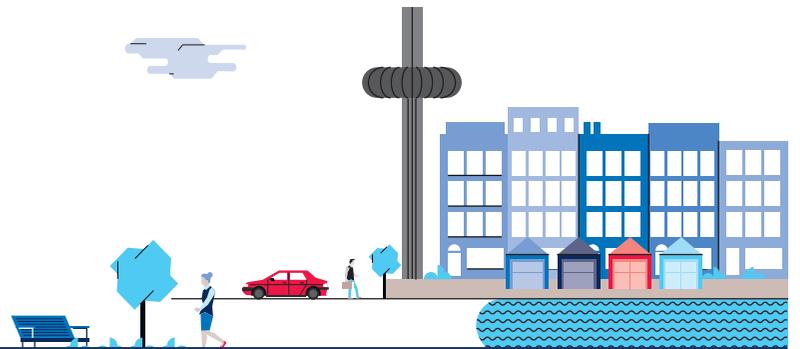
4 Aim for Oxbridge

Globally renowned as seats of learning, Oxford and Cambridge are office markets at the vanguard of the knowledge economy. Continued R&D investment from industries such as pharmaceuticals and motorsport ably illustrate this. But whilst sharing the common currency of talent, it is important to recognise the differing dynamics of each market. Oxford has constrained site supply restricting development potential, so one must be mindful of the growing competition from developments in the city's hinterland. Cambridge, on the other hand, has already shown strong performance in achieved rents and its appeal is reinforced by outstanding connectivity back to London.



5 Brighton Rocks

As a market which has long represented South Eastern urban cool, Brighton has had a sustained life-style appeal to tech and creative talent, and traditionally tightly bound office supply. There is a lot to admire about Brighton. Add into the mix a strong academic infrastructure and a base of well-established and recognised occupiers and we see a market that has all the potential to produce premier league performance going forward, with headline rents heading above £30 per sq ft and a massively constrained supply pipeline.



Predictions for the next 12 months (and beyond)

The changing dynamics of demand will bring three specific market trends into sharper focus

1 RIDING THE TIDAL WAVE OF TALENT:

As the affordability and desirability of Central London living is questioned by younger talent, and as university graduates start to prioritise life-style and well-being over employment choices, South East England will be a core beneficiary. A tidal wave of talent will continue to be attracted to and retained across the region. Those urban centres which have been transformed through regeneration projects to offer amenity, a sense of place, cohesion and a strong identity will win through as talent magnets and hence major commercial centres.

2 A FOCUS ON FEWER, LARGER CENTRES:

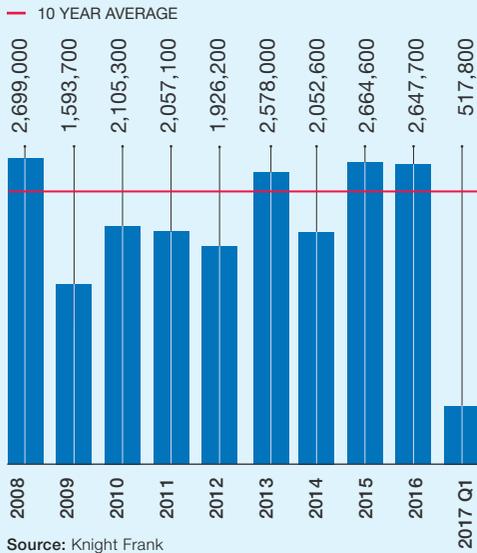
Linked to this trend will be the concentration of growth in fewer, larger centres within the market – Tier 1 Towns. It will be those centres that present critical mass – markets such as Reading, Brighton, Slough, Croydon – which will reach new heights as they attract in new occupational demand and talent.

3 RE-SETTING THE STATUS OF THE BUSINESS PARK:

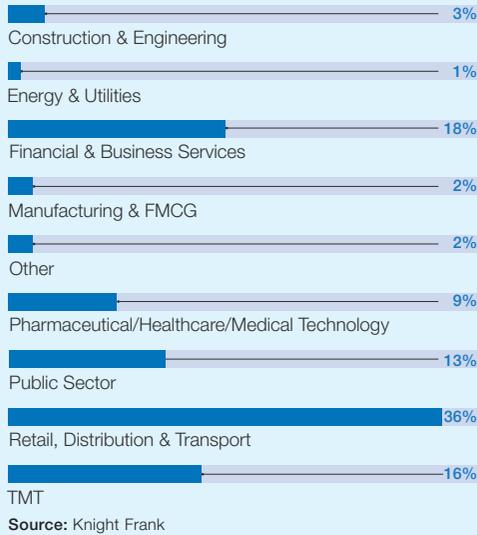
It has been easy to dismiss the business park as a relic of a bygone age given prevailing demographic, social and business trends. But we see future strength in the revolutionised business park, one showing an intent focus upon the creation of highly curated, serviced and connected environments. Longer-term, the evolution of autonomous and environmentally friendly transportation will remove one of the key critiques typically aimed at the business park.

Data dashboard

M25 TAKE-UP (sq ft)



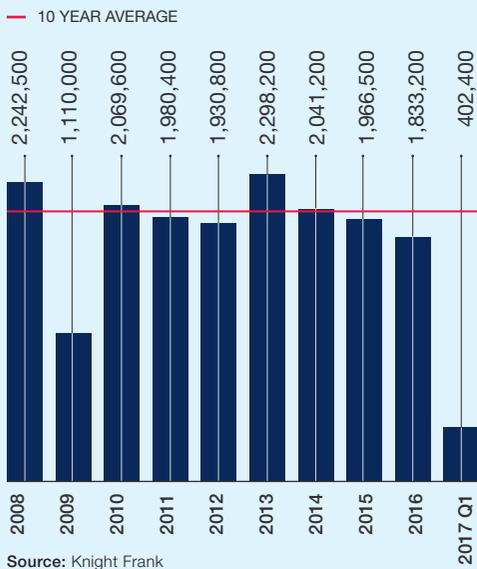
M25 - BY SECTOR (last 4 quarters)



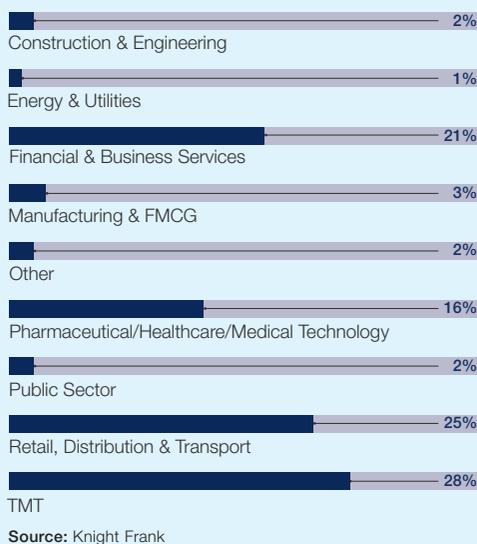
M25 - SUPPLY



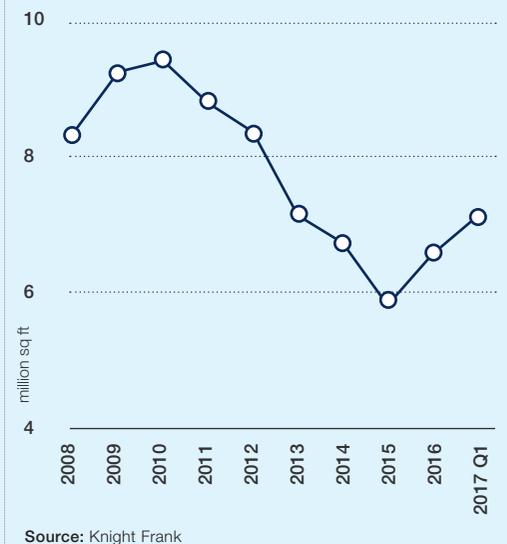
THAMES VALLEY - TAKE UP (sq ft)



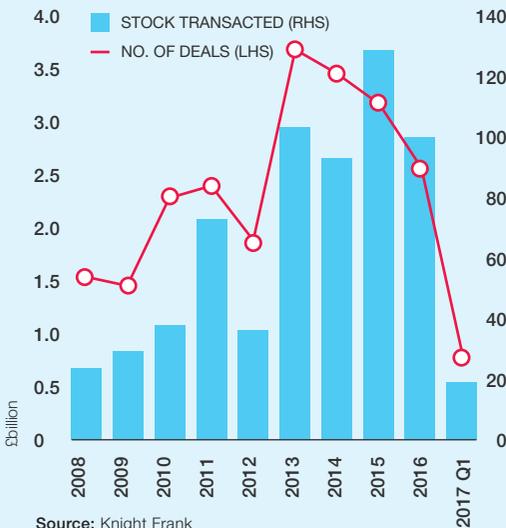
THAMES VALLEY - BY SECTOR (last 4 quarters)



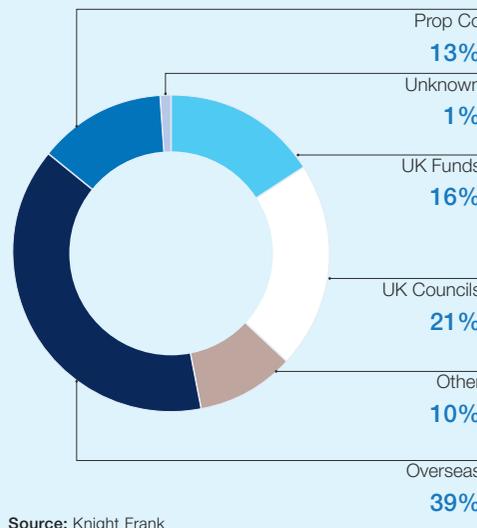
THAMES VALLEY - SUPPLY



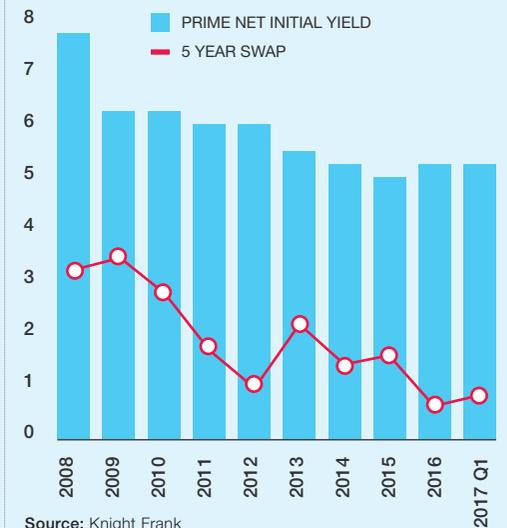
INVESTMENT VOLUMES

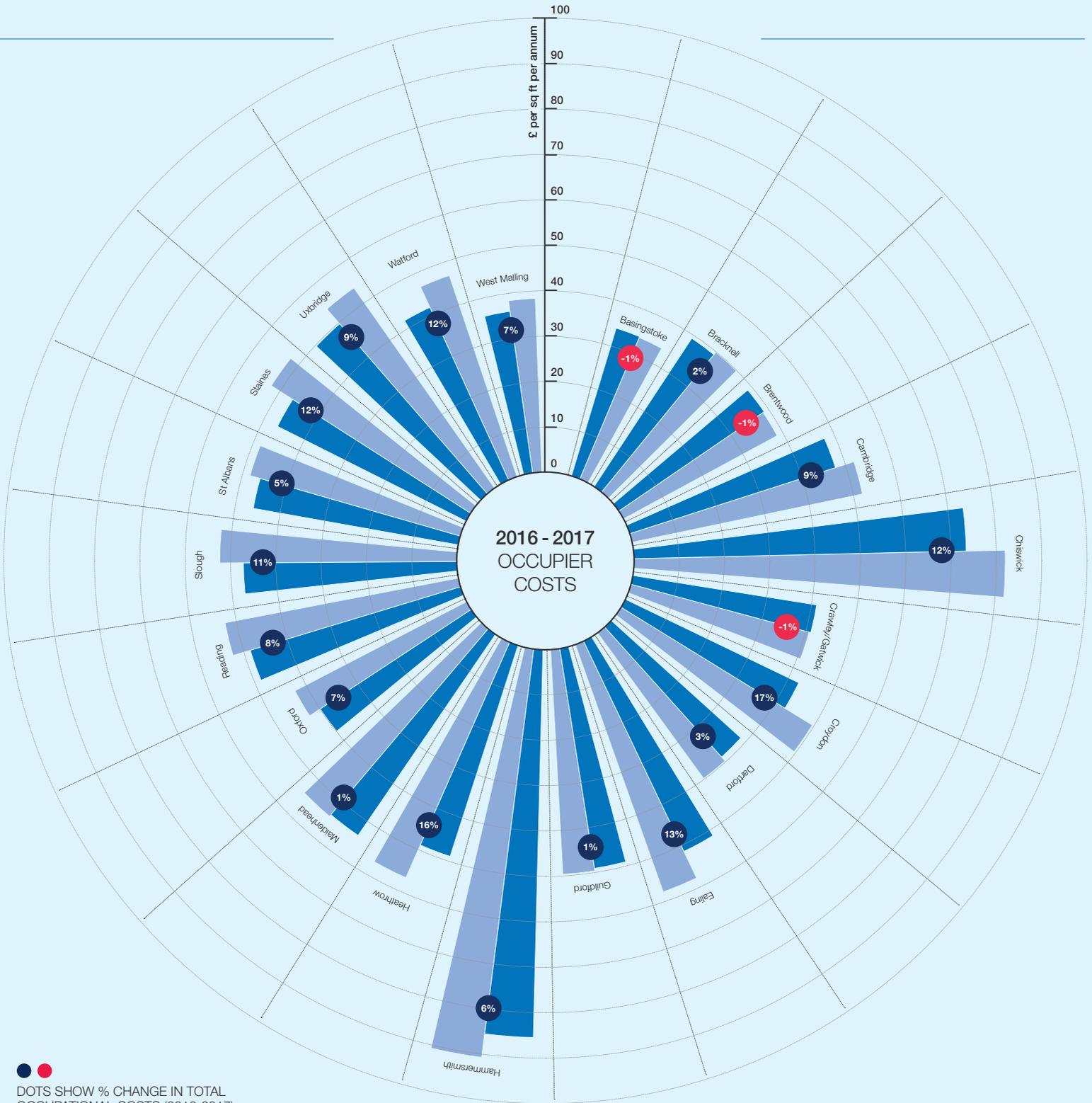


INVESTMENT BY PURCHASER (last 4 quarters)



PRIME YIELDS %





● ●
 DOTS SHOW % CHANGE IN TOTAL OCCUPATIONAL COSTS (2016-2017)

FIGURES BELOW ARE £ PER SQ FT PER ANNUM

| | 2016 | 2017 | | 2016 | 2017 | | 2016 | 2017 |
|-----------------|-------|-------|-------------|-------|-------|--------------|-------|-------|
| Basingstoke | 34.14 | 33.94 | Dartford | 38.70 | 39.86 | Reading | 48.61 | 52.59 |
| Bracknell | 39.28 | 39.98 | Ealing | 51.50 | 57.97 | Slough | 47.23 | 52.44 |
| Brentwood | 38.97 | 38.68 | Guildford | 49.16 | 49.70 | St Albans | 46.08 | 48.42 |
| Cambridge | 47.80 | 52.08 | Hammersmith | 85.64 | 90.87 | Staines | 46.72 | 52.36 |
| Chiswick | 73.51 | 82.10 | Heathrow | 48.97 | 56.86 | Uxbridge | 49.81 | 54.11 |
| Crawley/Gatwick | 41.20 | 40.84 | Maidenhead | 53.85 | 54.34 | Watford | 41.95 | 46.93 |
| Croydon | 42.59 | 49.70 | Oxford | 40.00 | 42.81 | West Malling | 36.08 | 38.44 |

Source: Knight Frank

Footnote: % change are inclusive of rental growth and changes to business rates. Measure was taken in April 2017.

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