RESEARCH

Knight Frank

CARDIFF

OFFICE MARKET REPORT

2016

"Cardiff must continue to embrace change in order to achieve its desired global city status."

MATT PHILLIPS
Managing Partner,
Knight Frank Cardiff

FOREWORD

Whilst the last 12 months have been dominated by surprising election results, the regional real estate market has to date, held up well.

The only reaction in real estate terms was the period immediately post BREXIT, when some redemption-led distress was experienced from the major retail funds.

On the ground, the occupational and investment markets have proved largely resilient. Whether the economic uncertainty will start to influence occupier decision-making moving forward remains to be seen. Post the financial crisis, property has had a strong role and we see no sign of this ebbing. In a world where it has been difficult to find returns, property remains a relatively secure opportunity. Any recent hesitancy is about the right time to buy as opposed to any change in sentiment towards real estate.

Last year, we highlighted significant changes in location and type of office space that has seen demand by tenants. This has continued and is driven by what HR managers are calling "the war for talent". Real estate decisions are increasingly being based on staff recruitment and retention as opposed to a decision based purely on costs. This is impacting on location, building appearance and how the space can be fitted out for employees. This is resulting in the role of the HR Director become far more important in the decision making process. Activity, amenity and culture are now "strong pull factors" in the location choice of occupiers with the HR Director keen to secure and retain the most talented staff by offering the most attractive working environment.

From an investment perspective, UK property funds, overseas investors and high net worth investors continue to be attracted by Cardiff and the increase in Grade A available space helps to clearly demonstrate demand and rental growth.

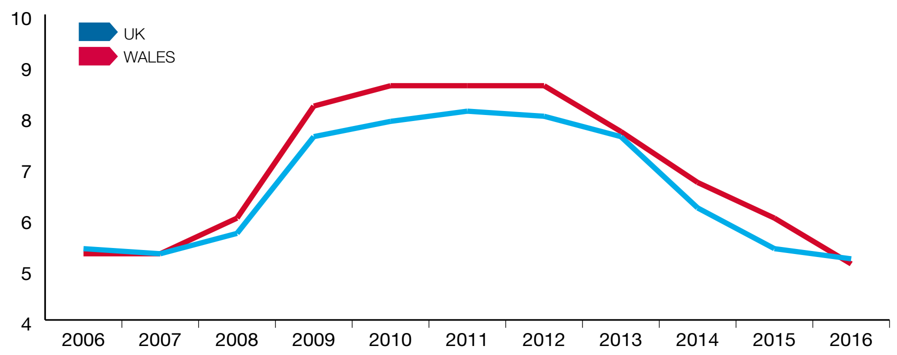
Cardiff has developed into a vibrant commercial centre whose profile continues to grow across the leisure, retail and business sectors. The renaissance is clear for all to see with cranes on the city's skyline providing a daily reminder of development progress, enabling new ventures to be opened across the city.

To build on these strong foundations Cardiff and the capital region must continue to keep building quality flexible workspace.

Cardiff's regional growth does come at a price and the daily commute for all of us is becoming more time consuming and frustrating. We desperately need the Welsh Government and Cardiff Council to address the transport infrastructure both to and around the City for it to continue to prosper.

The next decade will drive the future success of the Welsh Economy from a dynamic Cardiff Capital Region.

FIGURE 1
The rate of unemployment (%)



Source: ONS

OCCUPATIONAL MARKET

Occupier activity has remained brisk in 2016 supporting a high level of take-up. This demand for the prime office space has seen a new benchmark rent set for the city.

Take-up and demand

Overall leasing levels have remained on an upward trend in 2016 with take-up for the year reaching 485,456 sq ft at the end of Q3. Notably, this total is already above the 10-year annual average for the city and ahead of the equivalent point in 2015. The availability of newly developed stock at Central Square and Capital Quarter, in particular, has fuelled occupier interest. Driven by supply, Grade A take up in 2016 accounts for 28% of the transactions and although less than in 2015, this is much higher than the previous two years (2013 & 2014). The city centre remains the focus for the majority of occupiers with 66% of space transacted in the central business district.

Key transactions

The largest deal of 2016 to date has been the acquisition of 71,436 sq ft at One Central Square by MotoNovo Finance. The financial services company took the lower 5 floors of the building relocating to the city centre from out of town. This was one of eight deals in excess of 10,000 sq ft completed in 2016 (to Q3) compared with nine in 2015. S3 Advertising took a lease of 6,004 sq ft at One Central Square pushing prime rents to £25.00 per sq ft and along with deals to Julian Hodge Bank and RBS, occupancy has now reached 97%.

Other notable Grade A lettings included Opus Energy who joined Public Health Wales at JR Smarts Number 2 Capital Quarter taking a lease of 12,505 sq ft in Q1. The largest Grade B deal of 2016 was the letting of four floors at Brunel House to HMRC. The government occupier committed to a total of 54,587 sq ft as the first part of a major government consolidation in the city centre. Cardiff University leased 29,000 sq ft over three floors in Friary House. The tenant agreed to carry out a major fit out of the space to expand its capacity.

Availability

As at November 2016, Grade A availability had risen to 185,000 sq ft with 137,000 sq ft in the city centre. Although this is an annual rise of around 70%, the current level of available Grade A space equates to just over one-year's supply of Grade A take-up. New Grade A supply is limited to the space in Number 2 Capital Quarter (18,190 sq ft) and One Central Square (4,000 sq ft). The remainder comprises high quality refurbished space at 2 Kingsway (40,964 sq ft), 2 Callaghan Square (21,851 sq ft) and St Patricks House (51,675 sq ft) currently being marketed.

The development pipeline remains strong with speculative developments underway at Number 3 Capital Quarter (74,000 sq ft), One Canal Parade (54,000 sq ft) and Two Central Square (148,000 sq ft), alongside the 150,000 sq ft pre-let BBC Wales Headquarters. It is understood that 2 major pre-lets will shortly be announced in relation to 2 Central Square.

Headline rents

The recent lettings at Central Square have seen prime headline rents increase for the first time since 2012, from the £22.00 per sq ft achieved at 3 Assembly Square, Cardiff Waterside. The prime headline rent now stands at £25.00 per sq ft and current forecasts indicate that prime rents will rise to £26.00 per sq ft by the end of 2017 as more new developments complete.

Summary

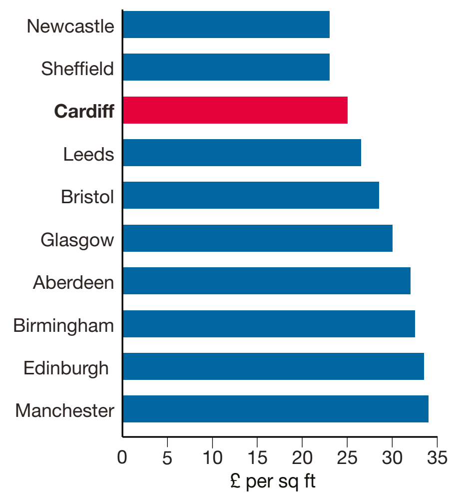
Over the past 2 years, development has increased significantly, with the current pipeline the highest of the past 10 years. Alongside amenity and connectivity improvement, a high calibre office environment forms an essential part of the offer that major occupiers are using to attract and retain talent. As such, in tandem with new development, the market for refurbishment is flourishing. The appeal of Cardiff continues to grow and on-going developments and future projects will further strengthen this position.

Key leasing transactions 2016

Building	Tenant	Sq ft	Rent	Date	Grade
Number 1 Capital Quarter	WSP	19,658	£19.25	Q1	A
Number 2 Capital Quarter	Opus Energy Limited	12,505	£20.00	Q1	A
Friary House	Cardiff University	29,000	N/A	Q2	B
Brunel House	HM Revenue & Customs	54,587	N/A	Q2	B
One Central Square	S3 Advertising	6,004	£25.00	Q2	A
One Central Square	MotoNovo Finance	71,436	£22.00	Q3	A
One Central Square	Julian Hodge Bank	16,663	£22.00	Q3	A

Source: Knight Frank Research

FIGURE 2
Prime rent as at Q3 2016 (£ per sq ft)



Source: Knight Frank Research

Please refer to the important notice at the end of this report

DEVELOPING A CAPITAL CITY

2006
England draw with Australia in the first Ashes test at the Swalec Stadium while St Williams House is sold by Rightacres for £30 million (6.14% net initial yield).

2007
MEPC/Rightacres complete the development of No 3 & 4 Callaghan Square. Headline rents remain static at £18.50 per sq ft.

2008
Wales win Six Nations Grand Slam and prime office rents finally move to £20.00 per sq ft.

2009
St Davids 2 opens and changes the face of retailing within Cardiff, while office rents rise to £21.00 per sq ft.

2010
Europe defeat USA in the Ryder cup held at Celtic Manor in Wales. St Williams House following a re-gear is sold again for £34.5 million to Schroders which reflects 6.75% net initial yield.

2011
BBC drama village completed in Cardiff Bay and Igloo Regeneration sell the investment to British Steel Pension Fund for £46 million (4.75% net initial yield).

2012
Cardiff City FC reach the final of the Carling Cup but are defeated by Liverpool. No 1 Callaghan Square acquired by Capital Trust from Cordia Savills for £25 million (6.5% net initial yield).

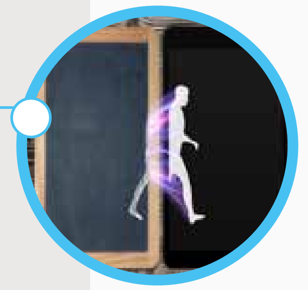
2013
JR Smart commences the development of No 1 Capital Quarter, while headline rents rise to £22.00 per sq ft.

2014
Admiral Insurances new Global Headquarters, funded by German Investor Union is completed while Crickhowell House, Wales's seat of Government is sold to Kuwaiti investor for £40.5 million (5.36% net initial yield).

2015
Cardiff's vision for the future delivered via Rightacres and Cardiff Council through their Central Square redevelopment. The estimated net development value is £400 million on completion is funded by Legal & General with part pre-let to BBC.

2016
No 1 Capital Quarter sold by Welsh Government to offshore investors for £21 million while No 2 Capital Quarter is completed by JR Smart. Headline rents move to a new high of £25.00 per sq ft.

SHAPING THE FUTURE



Enhance the Skill Base

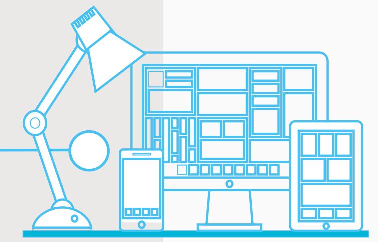
Cardiff's ambition of being a leading city for economic and cultural development in the UK is predicated on the availability of a flexible and highly skilled workforce. To be fully competitive, talent needs to be nurtured, developed further and most importantly, retained within region. Cardiff's excellent universities are already delivering the workforce of tomorrow. The city, however, needs to do better at delivering a career path for the best talent. This must include investment in amenity improvement, which will support Cardiff as a lifestyle choice for future graduates.

Deliver the Cardiff Capital Region

For the Cardiff city region to be a success, sensible and targeted investment is needed to ensure infrastructure proposals are delivered. Connectivity is necessary in two areas – high-speed fibre connectivity aligned to the needs of both households and businesses. Transport infrastructure across the capital region also needs to be faster, reliable and more frequent. These are both now critical factors in the locational analysis of major occupiers.

Grow Office, Retail & Leisure Facilities

The provision of high quality office accommodation is in place but should extend further. Employers and employees consider both amenity provision as well as the office environment. This begins within the office with facilities such as gyms, bicycle facilities and breakout areas. Outside, the retail and leisure offering of a city is a significant factor in location choice. Cardiff has progressed well in recent years, but success can be short-lived. Investment in this area needs to be maintained in order to harness trend changes and for the city to stay current and competitive.



Establish Cardiff as a UK Media & Creative Hub

The creative industries are the fastest growing sector globally. Cardiff is already the home of three major broadcasters alongside being the established home for independent TV production companies and digital media clusters. This city needs to embrace TMT firms more, providing the appropriate infrastructure in addition to the right type of space. The city has an extensive talent base aligned to digital companies. This requires on-going encouragement through education and business support. Success in this goal will establish Cardiff as a major centre for creative industry activity in the UK.

Conclusion

Cardiff is on the EDGE of becoming both a regional power within the UK and a global capital city. To reach this goal we need to embrace and deliver on many objectives. Public and private sector collaboration is critical in achieving a strong economic and social foundation for the city.

We are entering a time of rapid change on a political, business and social level. To enable Cardiff to become a truly global capital, the city needs to harness and adapt to the changing order. Intelligent investment made now will mean that South Wales and Cardiff will reap the benefit for years to come.

We stand on the EDGE and must not fail

1 Central Square

INVESTMENT MARKET

In a year dominated by politics rather than property deals, it is unsurprising that transactional activity in 2016 has been more subdued when compared to 2015.

Total office investment sales recorded from Q1 to Oct 2016 amount to £106.3m. Although this is 55% less than the full year total for 2015, if measured against the same period historically the 2016 total is 29% above the 10-year average.

The acquisition of 3 & 4 Callaghan Square for £32m by Deutsche Asset & Wealth Management is the largest transaction to complete in 2016 to date. The properties are located in Cardiff's central business district and current tenants include British Gas, the British Transport Police Authority and Zurich Insurance. This is one of four transactions over £10m to complete in 2016.

The sale of No 1 Capital Quarter to an overseas investor for circa £21.75m is the second largest transaction to complete. Sold by the Welsh Government, tenants include Finance Wales, WSP and Network Rail. Other sales exceeding £10m include the £18.1m acquisition of One Kingsway by a private investor and the £13.5m sale of Churchill House to Oval Real Estate. Notably, at the same point in 2015 only one transaction over this threshold had completed.

As at November 2016, overseas investors account for 57% of investment turnover. This represents the highest concentration of overseas investment in the city since 2011 (the year Credit Suisse and Union acquired their first office holdings in Cardiff). Notably, private money is the second highest source of investment in Cardiff in 2016 accounting for 22%. UK property companies account for 20%, with UK institutions largely absent.

Driving the shifts in purchaser profile is the globalisation of capital, with equity increasingly focussed toward opportunities outside their traditional target markets of Central London and the South East. Improvement in both the retail and leisure offering alongside infrastructure has helped establish Cardiff as one of the top target locations for global investors. The on-going pipeline of office development complements the wider program of city improvement. This means that major occupiers are attracted and thus, investment in the city's assets become more appealing.

In order to elevate the status of Cardiff further, the city must continue to improve its connectivity and infrastructure. Welsh Governments acquisition of Cardiff Airport in 2013 is starting to deliver results, but it is essential that further routes around Europe and the UK be established. The electrification of the rail line is set to decrease journey times to London, which is positive, although the road and rail infrastructure in the city region need to continue improving. The £1.4 billion rail metro system and M4 relief road would be another significant step, if fully implemented.

Looking ahead to 2017 and beyond, the outlook for the investment market in Cardiff is promising. Following a dip in sentiment before and after the EU referendum, confidence is returning buoyed by the strength of the occupational and development market. Rental growth is forecast which will further support the future income potential of assets in Cardiff.

Furthermore, encouraged by the recent fall in the value of sterling, overseas buyers will continue to play a prominent role. This coupled with relatively attractive yields when compared to the other major regional markets means Cardiff will continue to attract strong interest, particularly for prime assets.

The market for secondary assets may remain more challenging given a weaker appetite to risk. However, an increasing amount of US private equity continues to target opportunities in this spectrum, particularly lot sizes in excess of £10m. Return expectations are high meaning suitable opportunities are few, but when marketed then will attract strong bidding.

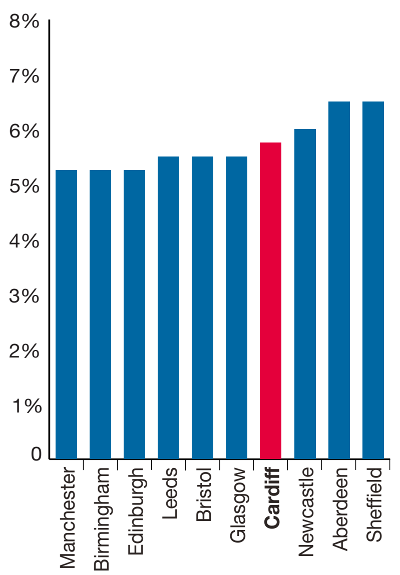
Notwithstanding market anomalies, we anticipate that prime yields will stay at 5.75%. This is now unchanged for almost 2 years. At this level yields remain 75 basis points above the market peak of 5.00% recorded in 2007.

Key investment transactions 2016

Address	Price £m	Purchaser	Yield %
Callaghan Square, 3 & 4	£32.10m	Deutsche Asset & Wealth	6.13
Capital Quarter, 1	£21.75m	Undisclosed	6.65
One Kingsway	£18.15m	Charitable foundation	6.58
Churchill House	£13.50m	Oval Real Estate	8.20

Source: Knight Frank Research

FIGURE 3
Prime yields as at Q3 2016



Source: Knight Frank Research

KNIGHT FRANK VIEW

Creating a creative capital?

The UK's creative and high tech industry is expanding rapidly. The GVA contribution to the UK economy from this sector is now worth £81bn or 5% of GDP. Firms from a Technology, Media and Telecom (TMT) background are certainly having an influence in Cardiff. Moving away from its industrial past and status as a core for public sector occupiers, the city is now quickly becoming one of the UK's major digital hubs. The TMT sector in Cardiff is worth just over 3% of the digital GVA contribution to the UK economy. Around 1,700 TMT businesses are located in Cardiff employing around 7,000 people across information and communication related disciplines.

Fundamental to growth of the sector is access to talent. Cardiff's three universities provide digital businesses with an established pipeline of graduates. Technology start-ups also have access to extensive business growth support. Facilities such as Tramshed Tech, Welsh ICE, Indycube and GloWorks alongside Cardiff's business technology centres provide expertise and an environment that encourages co-working, innovation and collaboration. Government financial support in the form of a digital development fund is available and allocated exclusively to technology companies.

It is clear that TMT occupiers, both large and small, consider Cardiff as a city in which they can build and grow their business. The support of digitally focused government schemes compliments the built environment. Demand for office space is already at a high level. For this to grow further Cardiff, as a city needs to accept the changing order and prepare to create the lifestyle offer that appeals strongly to this type of occupier. In doing so, Cardiff intelligently, is embracing the growth industry of tomorrow.

BBC Drama Village, Port Teigr

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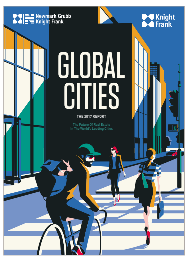

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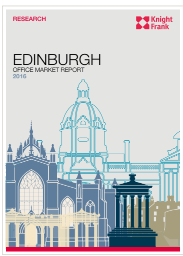

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