RESEARCH

M25 OFFICES

INVESTMENT, DEVELOPMENT & OCCUPIER MARKETS **Q2 2014**

HIGHLIGHTS

Take-up was subdued in Q2 2014, although active demand has increased by 10% since the start of the year.

Supply continues to decrease. The M25 vacancy rate fell to a 12-year low of 6.4% in Q2.

Investment demand remains strong. Q2 volume was 59% above the five-year quarterly average.

DEMAND AND TAKE-UP

- Take-up was disappointing in Q2 2014, and contrasts with the improving business sentiment in the region. M25 take-up totalled 404,403 sq ft in Q2, down 46% from Q1 and 38% below the ten-year quarterly average (Figure 1).
- A large proportion of M25 take-up was accounted for by a sizeable freehold owner-occupier deal. Frazer-Nash purchased BOC Group's former complex at Windlesham, Surrey, totalling 128,000 sq ft and set in 50 acres. This follows a number of similar deals in recent years where occupiers have opportunistically purchased vacant campuses at attractive prices.
- M4 take-up was particularly subdued in Q2, at 62% below the 10-year quarterly average (Figure 2). Bracknell, Reading and Hammersmith all saw robust activity and made up the majority of M4 take-up. Of Hammersmith's five deals, Accor's 23,384 sq ft acquisition at 10 Hammersmith Grove accounted for Q2's highest agreed headline rent, at £46.50 per sq ft.
- M3 take-up in Q2 was 225,865 sq ft, although 56% of this was accounted for by Frazer-Nash's acquisition (Figure 3). Of the region's nine deals, the largest involving brand new space was Thompson Directories' 14,994 sq ft lease at 25 Templer Avenue, Farnborough, at an agreed headline rent of £22.00 per sq ft.
- Active named demand has increased by 10% from the beginning of 2014 to stand at 5.8m sq ft. A number of prominent new requirements have come into the market, altering the underlying sectoral share of demand. Retail Distribution & Transport now leads the demand profile with 21% of the total, closely followed by TMT, with 20% (Figure 4).

Q2's largest deal saw engineering consultancy Frazer-Nash purchase the freehold of BOC Group's former site at Windlesham, Surrey for their own occupation. Knight Frank sold the asset.

SUPPLY AND DEVELOPMENT

- Despite relatively subdued take-up in Q2, availability continues to ebb away across the main markets. The M25 vacancy rate fell to a 12-year low of 6.4% in Q2, and the M4 vacancy rate fell to a record low of 8.0% (Figure 5).
- For the first time since Q3 2012, Q2 saw no new-build speculative schemes delivered to the market. Q2 also saw an unusually low level of secondhand space return to the market – just 202,000 sq ft in the M25 area, 60% below the quarterly average.
- The extension of permitted development rights (PDR) has led to a significant tranche of poorer quality supply being removed from the market. 312,000 sq ft was acquired for change of use in Q2, taking the total over the past 12 months to 825,000 sq ft. Put into context this is equivalent to 32% of average annual take-up in the M25.
- Speculative development increased by 24% during Q2 to stand at circa 1.5m sq ft. Reading has emerged as a particular focus of development activity. 492,000 sq ft is now underway across five schemes in the town – equivalent to two years of annual Grade A take-up – with several additional schemes expected to come forward before year-end.

FIGURE 1
M25 take-up

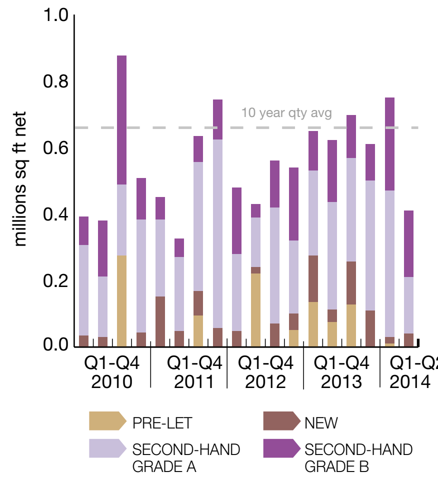


FIGURE 2
M4 take-up

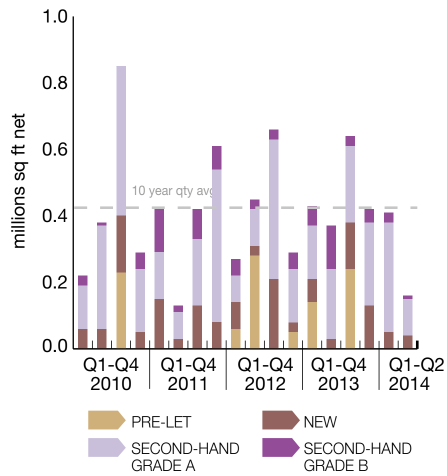
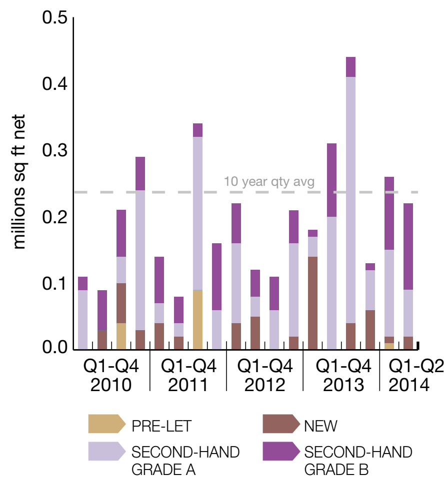


FIGURE 3
M3 take-up



Source: Knight Frank Research

MARKET STATISTICS

TABLE 1
Key town prime rents & forecasts

Town	Q2 prime rent (psf)	Rent free (months)
Basingstoke	£18.00 ▶	33 ▶
Bracknell	£22.00 ▲	33 ▼
Brentwood	£21.00 ▶	24 ▶
Chiswick	£52.00 ▲	18 ▼
Croydon	£24.50 ▲	21 ▼
Gatwick	£24.50 ▲	21 ▶
Guildford	£31.50 ▲	21 ▼
Hammersmith	£51.00 ▲	18 ▼
Heathrow	£31.50 ▲	24 ▼
Maidenhead	£33.00 ▲	21 ▶
Reading	£33.50 ▲	24 ▼
Slough	£25.00 ▶	27 ▶
Staines	£33.00 ▲	21 ▶
St Albans	£25.00 ▶	18 ▼
Uxbridge	£32.00 ▲	21 ▶
Watford	£24.00 ▲	24 ▶
West Malling	£21.00 ▶	21 ▶

Based on new/Grade A building:
10,000 sq ft, 10 yr lease with no breaks

Note: ▲ = forecast for next 12 months

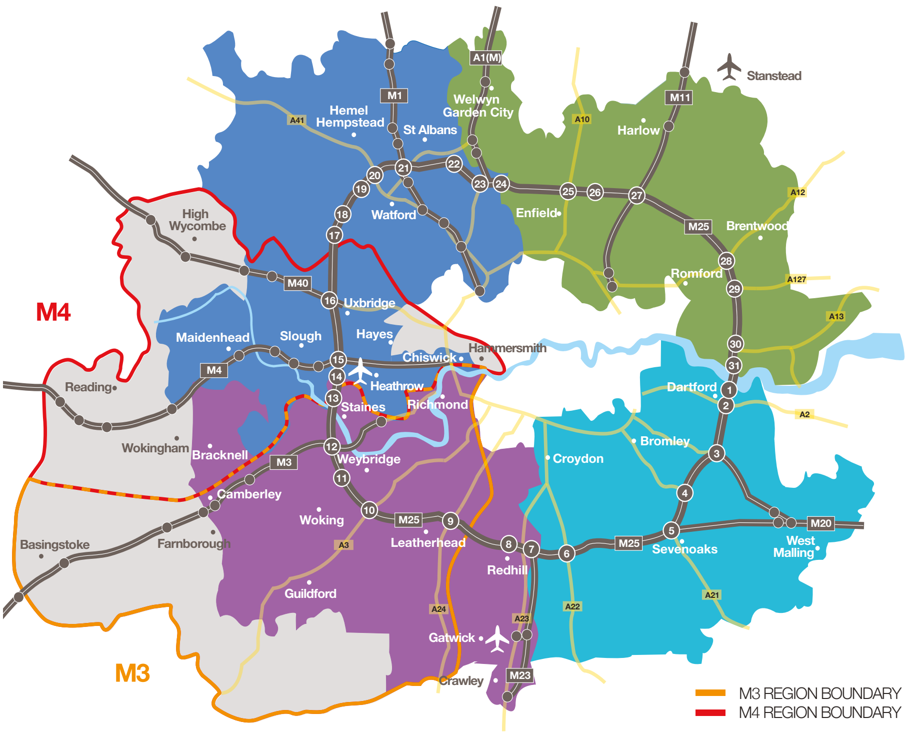


TABLE 2
Demand & Supply

Take-up	**M25**	NW	SW	NE	SE	M3	M4
sq ft	**404,483**	107,624	256,834	0	40,025	**225,865**	**161,612**
Change Q2 14 vs Q1 14	**-46%** ▼	-58% ▼	-43% ▼	100% ▼	-18% ▼	**-14%** ▼	**-61%** ▼
Change Q2 14 vs Q2 13	**-35%** ▼	-38% ▼	-29% ▼	100% ▼	-45% ▼	**-26%** ▼	**-57%** ▼
Q2 Pre-let (sq ft)	**0**	0	0	0	0	**0**	**0**
Q2 % New & Grade A (inc pre-lets)	**52%**	65%	39%	0%	100%	**43%**	**93%**
Forecast 2014 take-up (m sq ft)	**2.70**	**1.20**	**1.05**	**0.20**	**0.25**	**0.80**	**2.00**

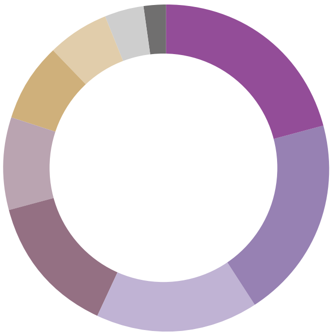
Availability	**M25**	NW	SW	NE	SE	M3	M4
sq ft	**8,434,068**	4,058,220	2,690,783	346,363	1,338,702	**2,891,061**	**5,653,905**
Change Q2 14 vs Q1 14	**-6%** ▼	-3% ▼	11% ▼	10% ▲	-6% ▼	**-8%** ▼	**-5%** ▼
Change Q2 14 vs Q2 13	**-17%** ▼	-8% ▼	-28% ▼	7% ▼	-20% ▼	**-20%** ▼	**-14%** ▼
Q2 % New	**15%**	13%	24%	16%	7%	**14%**	**19%**
Q2 % second-hand Grade A	**52%**	62%	43%	47%	36%	**55%**	**62%**
Q2 % second-hand Grade B	**33%**	25%	33%	37%	59%	**31%**	**19%**
Q2 vacancy rate (▲/▼ movement from Q1 14)	**6.4%** ▼	8.0% ▼	6.6% ▼	2.0% ▲	6.6% ▼	**7.1%** ▼	**8.0%** ▼

Under construction	**M25**	NW	SW	NE	SE	M3	M4
sq ft (net)	**1,097,414**	726,627	334,972	0	35,815	**474,682**	**1,525,299**
Change 12 months	**-20%** ▼	0% ◀▶	7% ▲	0% ◀▶	-87% ▼	**52%** ▲	**83%** ▲
Pre-let	**282,255**	250,755	31,500	0	0	**31,500**	**390,755**

Source: Knight Frank Research

FIGURE 4

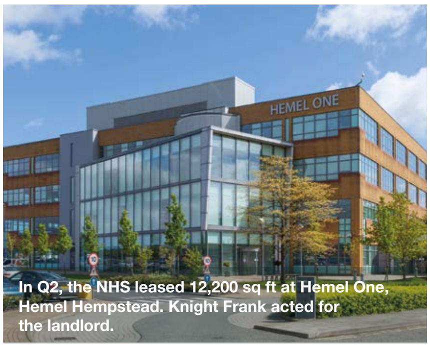
M25 active named enquiries by sector



RETAIL, DISTRIBUTION & TRANSPORT	21%	▲
TECHNOLOGY, MEDIA & TELECOMS	20%	▲
MANUFACTURING & FMCGS	16%	▼
FINANCIAL & BUSINESS SERVICES	14%	▼
PHARMACEUTICAL & HEALTH	9%	▼
CONSTRUCTION & ENGINEERING	8%	▲
PUBLIC SECTOR	6%	▲
ENERGY & UTILITIES	4%	▼
OTHER	2%	▼

Active demand is 5.80m sq ft at Q2 2014

Note: % = current share of demand
▲ = Movement in last 12 months (absolute terms)



In Q2, the NHS leased 12,200 sq ft at Hemel One, Hemel Hempstead. Knight Frank acted for the landlord.

FORECAST AT A GLANCE

Take-up:

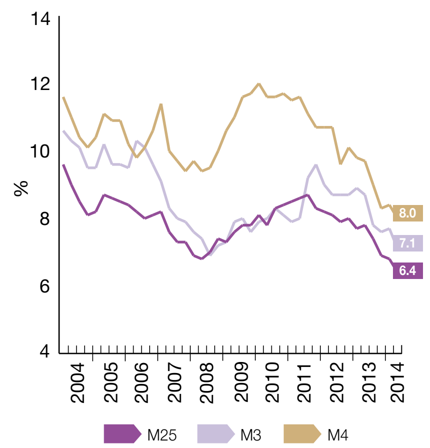
- Q2 take-up was below expectations and contrasted with the strong run of activity seen over the previous 12 months. The underlying economic fundamentals are positive for the market – latest official figures show that the UK economy is now back to its pre-recession level following robust growth in Q2, while growth in service sector employment continues apace.
- Take-up is expected to return to trend in Q3 2014, boosted by a number of prominent long-standing requirements transacting. While the expansion of total named demand during H1 also paints a positive picture for the year ahead, Q2's disappointing take-up figures are nonetheless likely to lead to a slight downward revision to our forecast for 2014 when we report on Q3.
- It is notable that the vast majority of space currently under offer is within New and Grade A buildings. While recent new build developments will continue to let-up up well, we also expect certain locations that are well-supplied with Grade A space – such as Bracknell and Slough – to benefit, as lease terms remain relatively competitive.

Supply and rents:

- Vacancy rates are expected to fall even further before bottoming out by the end of 2014, reflecting limited development completions and the conversion of redundant stock to residential. Indeed, Knight Frank research on office to residential via PDR reveals that circa 3.5m sq ft of stock – equivalent in size to the Slough market – is now subject to potential conversion across the M25 region.
- The continuing erosion of supply, in tandem with increasing occupier confidence, has put the South East office market firmly into a new cycle of rental growth. Rental growth has already been significant in the west London markets and is expected to spread to other markets in the Thames Valley and key markets within the M25, with new headline rents rising in St Albans, Reading and Staines during Q2.
- In theory, future rental growth prospects are strongest in locations where current supply is restricted with regard to typical rates of take-up (Figure 7). However, VM Ware's lease at Flow, Staines (at £33.00 per sq ft) in Q3 demonstrates that markets with seemingly elevated levels of supply are able to see rental growth, reflecting the wider regional scarcity of high quality, large floorplates available to relatively footloose corporate occupiers.

FIGURE 5

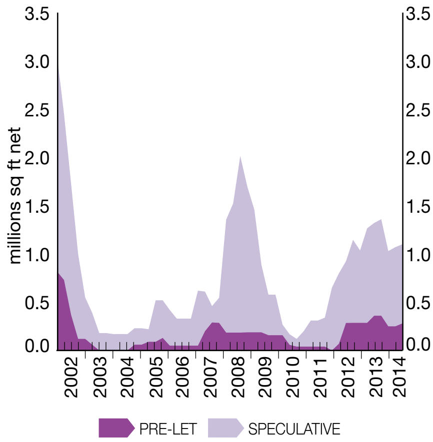
Vacancy rates



Source: Knight Frank Research

FIGURE 6

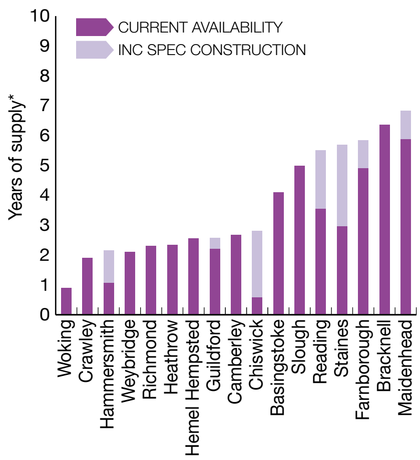
Space under construction in the M25



Source: Knight Frank Research

FIGURE 7

Years of New & Grade A supply



Source: Knight Frank Research

*Based on 10 year average New & Grade A take-up vs current New & Grade A availability

INVESTMENT MARKET

TABLE 3

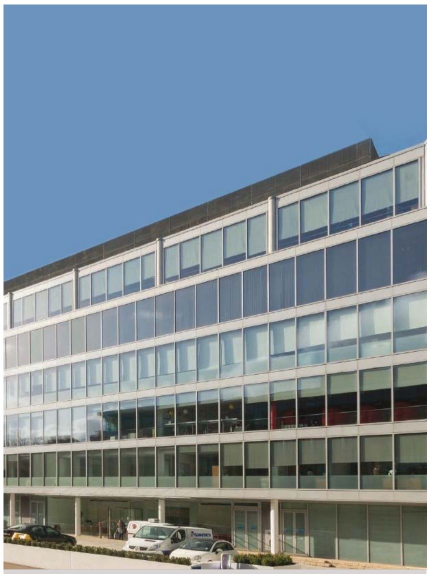
Key investment transactions Q2 2014

Building	Size (sq ft)	Price	Net Initial Yield	Vendor/ Purchaser
Trident Place, Hatfield	472,000	£136.00m	6.80%	Goodmans / AEP Investment Management
Breakspear Park, Hemel Hempstead	321,887	£60.60m	7.70%	Catalyst Capital / Threadneedle
Landsdowne Building, Croydon	109,335	£31.50m	6.50%	BNP Paribas / Blackrock
Meridien House, Watford	59,977	£19.01m	5.89%	IVG UK Ltd / M&G Real Estate
Hollywood House, Woking	43,440	£15.02m	6.40%	M&G Real Estate / Standard Life

	Transaction volume	Mean lot size	Mean NIY
Q2 2014	£690.7m	£22.8m	6.94%
Change 3 mths	40% ▲	26% ▲	4bps ▼
Change 12 mths	72% ▲	77% ▲	236bps ▼

INVESTMENT VIEW

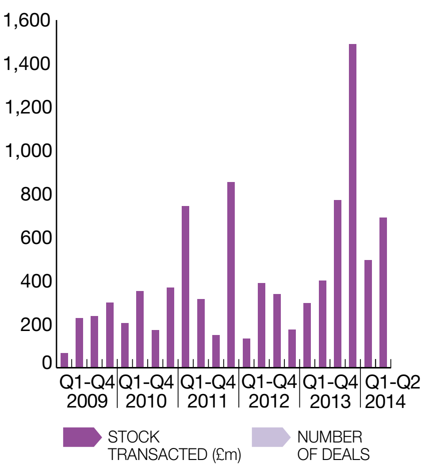
- Reflecting the ongoing strength of investment demand for South East office stock, Q2 volumes reached £691m, 59% above the five-year quarterly average. Activity during H1 2014 comprised 57 deals, the second highest half-yearly total since H2 2007.
- While the market remains dominated by domestic institutional investors, it was notable that Q2's largest deal involved an overseas buyer – a new entrant to the market from Singapore. AEP Investment Management's £136m purchase of Trident Place, Hatfield reflects the increasingly global attraction of the South East office market for buyers looking to secure large lot-sizes at a discount to central London.
- The substantial weight of money seeking South East offices is expected to put further pressure on pricing over the remainder of 2014, with strengthening competition for short income stock. Prime yields are expected to harden by a further 25bps to 5.00% by the year end, as domestic and overseas investors chase a very limited pipeline of prime stock.
- With clear evidence of rental growth coming forward in the tightly supplied markets of the Thames Valley and West London, we also expect investors to increasingly consider high yielding opportunities where there is scope to reposition buildings through refurbishment and re-letting.



In Q2, M&G Real Estate purchased Meridien House, Watford from IVG UK Ltd for £19.01m, reflecting a net initial yield of 5.89%. Knight Frank acted for the buyer.

FIGURE 8

Investment volumes and lot size



Source: Knight Frank Research

FIGURE 9

Mean initial yield & finance

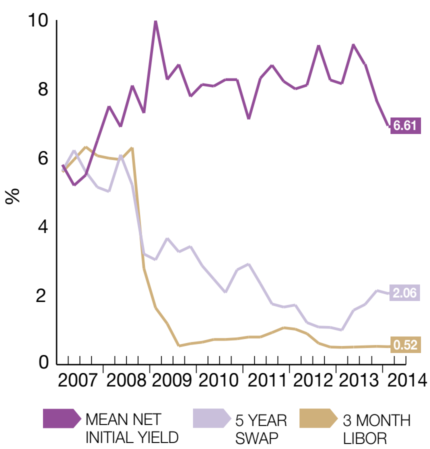
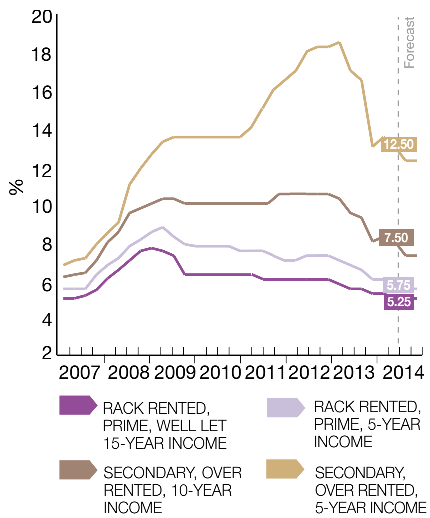


FIGURE 10

Yield forecasts



TECHNICAL NOTE

- Knight Frank define the M4 market as extending from Hammersmith, west to Newbury, incorporating Uxbridge and High Wycombe to the north and Staines and Bracknell to the south. Reading is also included. Existing built office stock in the M4 market totals 69.4m sq ft.
- The M3 market incorporates the main South West London boroughs and encompasses Leatherhead, Guildford and Basingstoke extending north to the M4 boundary described above. Farnborough and Camberley are also included. Existing built office stock in the M3 market totals 42.0m sq ft.
- The figures in this report relate to the availability of built, up-and-ready office/B1 accommodation within the M25 market. Vacant premises and leased space which is being actively marketed are included.
- The market definition used, shown in the map on page 3, is based on Local Authority District boundaries.
- All floorspace figures are given on a net internal area basis (as defined by the RICS).
- A minimum 10,000 sq ft (net) cut-off has been employed throughout. Major and minor refurbishment have been treated as new and second-hand respectively. Data is presented on a centre and quadrant basis. Classification by centre relates to the locational details contained within the marketing material for available properties. Classification in this manner is clearly somewhat arbitrary. Vacancy rate data is based on a total M25 stock measure of 130m sq ft (net), an M4 market stock of 69.4m sq ft (net) and an M3 market stock of 42m sq ft (net).
- Second-hand floorspace has been sub-divided into A and B grade accommodation, reflecting high and low quality respectively. Whilst subjective, this categorisation is based on an assessment of each property's age, specification, location and overall attractiveness.
- Pre-let = The letting of proposed schemes not yet under construction and those let during the construction process.
- All data presented is correct as at June 30th 2014.

Front cover image: The Blade, Reading

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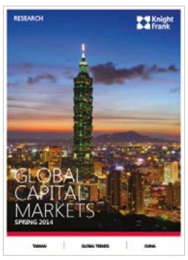

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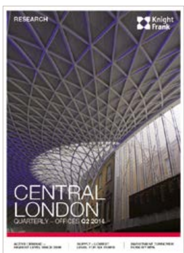

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