RESEARCH

Q4 2011
M25 OFFICES
Investment, development & occupier markets
Knight Frank

HIGHLIGHTS

- 2011 ended positively, with Q4 take-up in the M25 and M4 markets ahead of the long-term quarterly average. M25 take-up for 2011 as a whole was virtually identical to 2010, at 2.15m sq ft, while in the M4, 2011 take-up was down 10% on the 2010 total, at 1.56m sq ft.
- The vacancy rate fell during Q4 in both the M25 and the M4, to 8.3% and 10.7% respectively. In contrast, the M3 vacancy rate increased to 9.6%, its highest level since Q4 2006.
- Active named demand rose by 7% in Q4 to 6.15m sq ft, its highest level since mid-2010. Financial & Business Services accounts for 31% of demand, while Manufacturing & FMCGs demand now accounts for 22.6%, having grown significantly over the past year.
- In the South East investment market, PRUPIM's £400m sale of Green Park, Reading lifted transaction volumes to £854m in Q4, the second highest quarterly total on record. Prime yields held firm at 6.00% NIY, while yields for poorer quality stock drifted further outwards, and are expected to continue to do so in 2012.

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Demand and take-up

- M25 take-up was 743,157 sq ft in Q4 2011, taking the total for 2011 as a whole to 2.15m sq ft. While this is almost identical to the 2010 level, it included BskyB's lease restructure at Horizon West 1-6, Brentford (165,834 sq ft), where the tenant was out of contract. If this is excluded, take-up is effectively 8% below 2010 and 25% below the 10-year annual average.
- Q4 take-up was overwhelmingly focused on good quality accommodation, with New and Grade A space accounting for 85% of the total. Of Q4's 36 transactions in the M25, of particular note was Nestle's 126,523 sq ft acquisition at 1 City Place, Gatwick.
- In the M4, despite resilient Q4 take-up of 619,635 sq ft, 2011 closed 10% below 2010's level. Hammersmith, Maidenhead and Reading provided the focus of activity, together accounting for 16 of Q4's 29 transactions and 68% of total take-up. However, the largest M4 deal was at Heathrow, where BP acquired 67,856 sq ft at 1, 5 & 7 New Square, Bedfont Lakes, at a headline rent of £25.00 per sq ft.
- The M3 region saw total take-up of 736,045 sq ft in 2011, 6% above the 2010 total but 22% below the 10-year average. Following a number of significant deals in Q3, Q4 take-up of 167,953 sq ft was relatively subdued, with the largest of Q4's nine transactions comprising Computer 2000's lease of 47,821 sq ft at Redwood 2, Basingstoke.
- Active named demand edged up by 7% during Q4 to stand at 6.15m sq ft, its highest level since Q2 2010. Financial & Business Services retains the largest share of demand, at 1.59m sq ft, while Manufacturing & FMCGs has shown the strongest growth, rising by 67% from a year ago to 1.39m sq ft.

In Q4, Nestlé leased 126,523 sq ft at 1 City Place, Gatwick. The confectionery manufacturer will transfer 840 staff from its Croydon HQ to this site by the end of the year.

Supply and development

- Steady take-up of New and Grade A space and an absence of new completions saw the M25 vacancy rate fall from 8.7% in Q3 to 8.3% in Q4, reversing the rises seen since the middle of 2010. New and Grade A space makes up 61% of total availability, falling from a peak of 71% in Q2 2010.
- Similarly, the M4 vacancy rate fell from 11.1% to 10.7% in Q4 2011, its lowest level since Q1 2009. The fall largely resulted from the removal of Horizon West 1-6, Brentford from the market, following BskyB's decision to renew their lease.
- In contrast, the M3 vacancy rate continued to increase, rising from 9.2% to 9.6% in Q4, its highest level in five years. This is largely due to three major occupiers, Nokia, Oracle and BAE Systems, returning a combined 600,000 sq ft to the market in the second half of 2011.
- Speculative development activity has re-surfaced, albeit selectively in prime markets with expectations for rental growth. Recent starts include Blackstone's Building 6 at Chiswick Park (216,000 sq ft), Kames Capital's The Point, Maidenhead (78,000 sq ft) and two Rockspring developments; Velocity at Brooklands, Weybridge (104,000 sq ft) and The Stanza Building at Uxbridge (81,000 sq ft).

Figure 1
M25 take-up

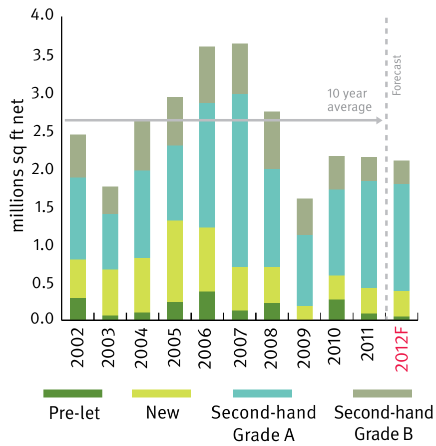


Figure 2
M4 take-up

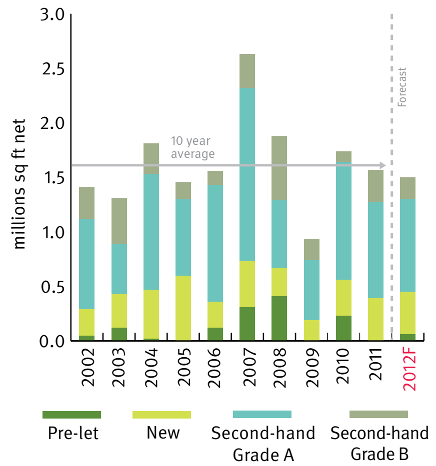
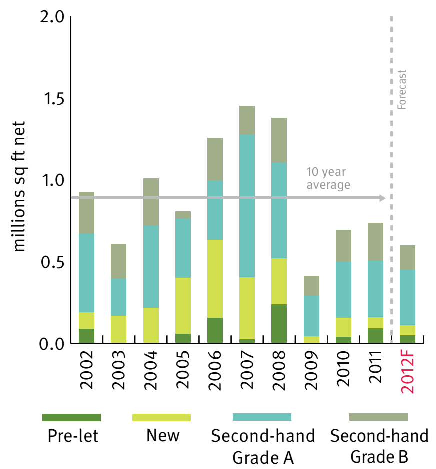


Figure 3
M3 take-up



Source: Knight Frank Research

Market statistics

Table 1

Key town prime rents & forecasts

Town	Q4 prime rent (psf)	Rent free (months)
Basingstoke	£17.50 ▼	33 ▶
Bracknell	£20.00 ▶	39 ▶
Brentwood	£21.00 ▶	24 ▶
Chiswick	£41.00 ▲	21 ▶
Croydon	£22.00 ▲	24 ▼
Gatwick	£21.50 ▲	30 ▶
Guildford	£27.50 ▶	24 ▶
Hammersmith	£37.50 ▲	21 ▶
Heathrow	£27.50 ▶	30 ▶
Maidenhead	£30.00 ▶	24 ▶
Reading	£30.50 ▲	24 ▶
Slough	£21.00 ▶	30 ▶
Staines	£28.50 ▲	21 ▶
St Albans	£22.50 ▶	24 ▶
Uxbridge	£29.00 ▲	24 ▶
Watford	£22.00 ▶	27 ▶
West Malling	£20.50 ▶	30 ▶

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

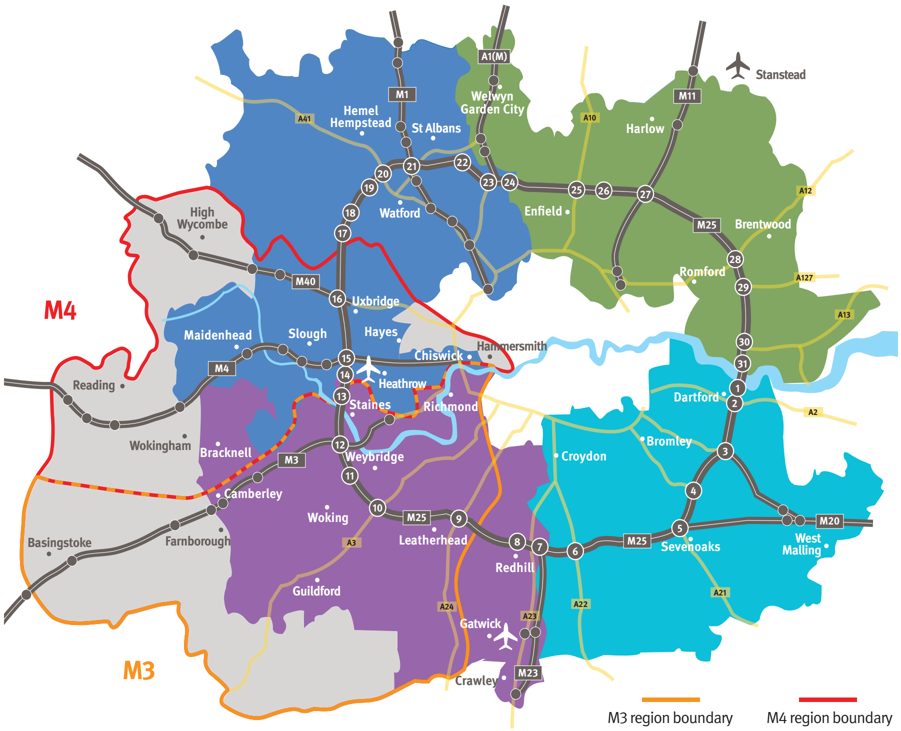


Table 2

Demand & Supply

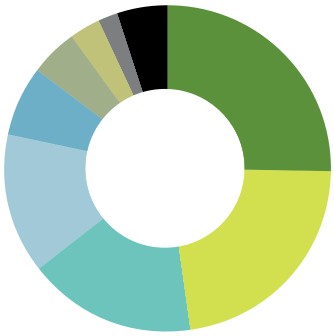
Take-up	M25	NW	SW	NE	SE	M3	M4
Sq ft	**743,157**	454,269	256,595	21,390	10,903	**167,953**	**619,635**
Change Q4 11 vs Q3 11	**17%** ▲	87% ▲	-34% ▼	100% ▲	244% ▲	**-51%** ▼	**47%** ▲
Change Q4 11 vs Q4 10	**46%** ▲	123% ▲	-14% ▼	100% ▲	108% ▲	**-42%** ▼	**116%** ▲
Q4 pre-let (sq ft)	**0**	0	0	0	0	**0**	**0**
Q4 % take-up new & pre-let	**84%**	95%	66%	0%	0%	**38%**	**88%**
Forecast 2012 take-up (m sq ft)	**2.1**	–	–	–	–	**0.6**	**1.5**

Availability	M25	NW	SW	NE	SE	M3	M4
Sq ft	**10,781,934**	4,726,367	4,206,596	527,684	1,321,287	**4,062,457**	**6,993,745**
Change Q4 11 vs Q3 11	**-5%** ▼	-5% ▼	-7% ▼	8% ▲	-3% ▼	**5%** ▲	**-4%** ▼
Change Q4 11 vs Q4 10	**-1%** ▼	-7% ▼	-5% ▼	9% ▲	39% ▲	**19%** ▲	**-6%** ▼
Q4 % new	**12%**	12%	16%	10%	5%	**10%**	**22%**
Q4 % second-hand Grade A	**49%**	57%	50%	29%	22%	**55%**	**58%**
Q4 % second-hand Grade B	**39%**	31%	34%	61%	73%	**35%**	**20%**
Q4 vacancy rate (▲/▼ movement from Q3 11)	**8.3%** ▼	9.4% ▼	10.3% ▼	3.0% ▲	6.5% ▼	**9.6%** ▲	**10.7%** ▼

Under construction	M25	NW	SW	NE	SE	M3	M4
Sq ft (net approx)	**609,441**	376,556	232,885	0	0	**232,885**	**454,556**
Change 12 months	**277%** ▲	362% ▲	482% ▲	–	–	**51%** ▲	**457%** ▲
Pre-let (sq ft)	**0**	0	0	0	0	**0**	**0**

Source: Knight Frank Research

Figure 4
M25 active named enquiries by sector



Active demand is 6.15m sq ft at Q4 2011	
Financial & Business Services	26%
Manufacturing & FMCG's	23%
ICT	17%
Retail, Distribution & Transport	14%
Construction & Engineering	7%
Public Sector	5%
Utilities	3%
Pharmaceutical, Healthcare & Medical	2%
Other	5%

In Q4 2011, Urban Science leased 8,191 sq ft on the 12th floor of the Blade in Reading, at an agreed headline rent of £30.50 per sq ft. Knight Frank acted for the tenant.

FORECAST AT A GLANCE

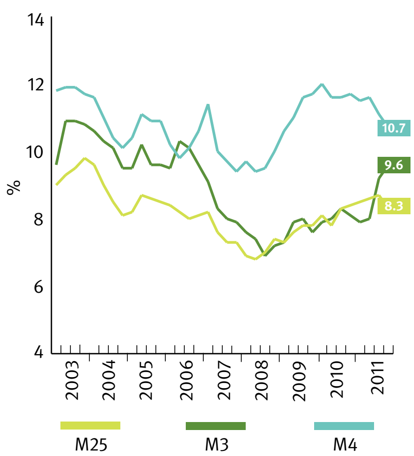
Take-up:

- With the short-term economic outlook remaining uncertain, occupier activity will be largely driven by lease events as opposed to business growth. Knight Frank forecasts 2012 take-up in the M25 and M4 corridor to be broadly consistent with 2011, at 2.1m sq ft and 1.5m sq ft respectively. However, in the M3 region, we forecast lower take-up of 600,000 sq ft in 2012, as its principal occupier sectors of communications and IT remain in consolidation mode (see Figures 1, 2, 3).
- New and Grade A space has dominated the demand profile as occupiers have upgraded their accommodation on competitive terms. We expect the more resilient locations, focused to the west of London, to continue to provide the focus for 2012 activity, with examples including Hammersmith, Maidenhead and Reading. We also anticipate heightened activity in Bracknell, given the competitive pricing of a range of good quality accommodation.
- Looking beyond 2012, Knight Frank's transaction analysis shows that a spike in lease event-driven demand is anticipated in 2013-15, at the expiry of a raft of historic leases. This, combined with a firmer economic recovery, should provide a boost to activity, which is expected to remain focused on the key locations west of London.

Supply and rents:

- 2011 saw positive rental growth return in specific markets with strong fundamentals, and we expect these markets to show further growth in 2012 as Grade A supply diminishes. Rental performance over the following 12 months is likely to become more polarised, with continued growth occurring in the favoured markets of the Thames Valley, while rents and incentive packages remain under pressure in secondary locations
- The recent re-emergence of development activity also reflects this market polarisation. The final quarter saw c.500,000 sq ft of new development and refurbishments commence, with a further 450,000 sq ft expected to proceed in Q1 2012. This activity is confined to prime locations such as Chiswick, Hammersmith, Maidenhead and Uxbridge, and the delivery of this product will coincide with a marked rise in lease event-driven demand in the next 24 months.
- Given the cost and timing advantages over new-build development, we believe developers and landlords can benefit from considering opportunities for refurbishment in specific key centres, which will be undersupplied with New and Grade A space by the end of 2012.

Figure 5
Vacancy rates



Source: Knight Frank Research

Figure 6
Space under construction in the M25

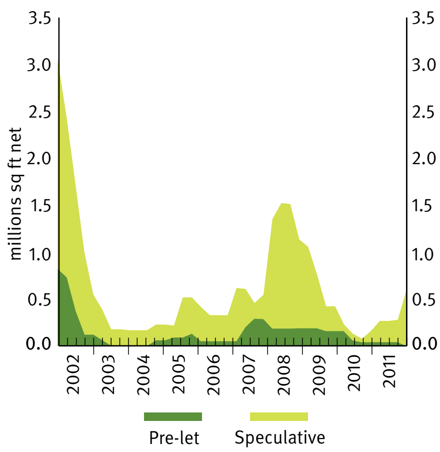
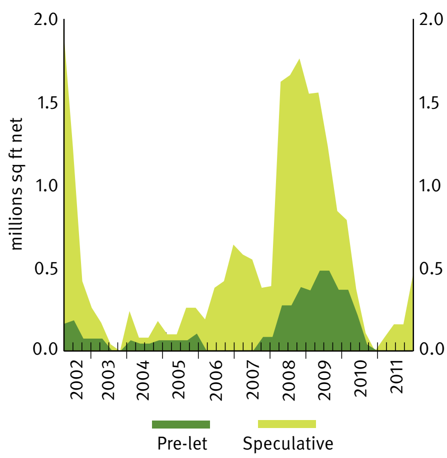


Figure 7
Space under construction in the M4



Investment market

Table 3
Key investment transactions Q4 2011

Building	Size (sq ft)	Price	Net initial yield	Vendor/ Purchaser
Green Park, Reading	1,297,475	£400.00m	8.00%	PRUPIM / Oxford Properties
Watson House, Reigate	73,936	£19.70m	7.22%	SWIP / PRUPIM
Reading International, Reading	405,872	£140.15m	7.00%	Goodman / RREEF
Hayes Park, Uxbridge	183,468	£56.25m	9.16%	Receiver / USS
1 City Place, Gatwick	126,523	£39.00m	9.30%	RREEF / L&G

	Transaction volume	Mean lot size	Mean NIY
Q4 2011	£854.31m	£40.68m	8.22%
Change 3 mths	467% ▲	359% ▲	47bps ▼
Change 12 mths	359% ▲	153% ▲	6bps ▲

INVESTMENT VIEW

- Despite only 21 deals, several major transactions propelled Q4 2011 volumes to £854.3m, the second highest quarterly total on record (Figure 8). In Reading, PRUPIM's long-awaited £400m sale of Green Park to Oxford Properties and RREEF's £140m purchase of Reading International collectively made up two thirds of total Q4 volume.
- The above transactions demonstrate the strong appetite which exists for large lot-sizes which offer secure income, increasingly from overseas investors attracted to the relatively higher yields available outside central London. To the vendors, the sales are providing an opportunity to generate significant capital to re-invest in smaller, more liquid property assets.
- In the more resilient occupier markets, investment demand for good quality secondary and shorter income prime stock is relatively buoyant, particularly among UK Funds seeking opportunities for active asset management. Yields of between 7.50% and 9.50% are typical for this sort of product, with prime 15 year income holding firm at 6.00% in Q4.
- The yield gap between prime and poorer quality secondary and tertiary stock is expected to continue to widen in 2012 (Figure 10). However, increasing transactional activity is now being seen for poorer quality stock, as the banks and other vendors are now starting to become more realistic on pricing for this type of product.

In Q4, Oxford Properties purchased Green Park, Reading from PRUPIM for £400m, reflecting a net initial yield of 8.0%. It was the second largest office investment transaction ever seen in the South East market, following the sale of Chiswick Park in Q1 2011.

Figure 8
£m investment volumes and lot size

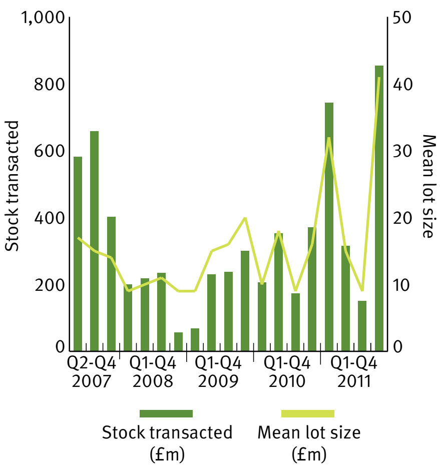


Figure 9
Mean initial yield & finance

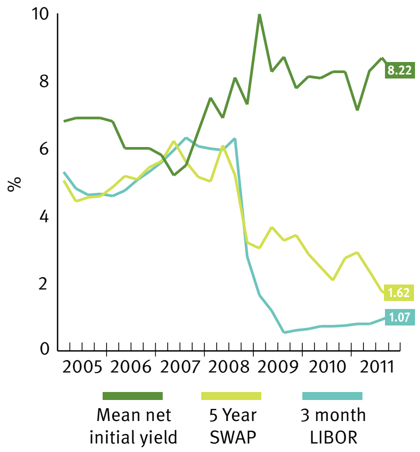
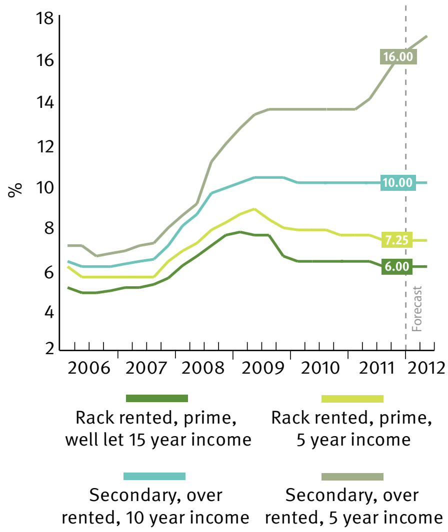


Figure 10
Yield forecasts



Source: Knight Frank Research

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Technical Note

- Knight Frank define the M4 market as extending from Hammersmith, west to Newbury, incorporating Uxbridge and High Wycombe to the north and Staines and Bracknell to the south. Reading is also included. Existing built office stock in the M4 market totals 62,392,070 sq ft.
- The M3 market incorporates the main South West London boroughs and encompasses Leatherhead, Guildford and Basingstoke extending north to the M4 boundary described above. Farnborough and Camberley are also included. Existing built office stock in the M3 market totals 41,927,373 sq ft.
- The figures in this report relate to the availability of built, up-and-ready office/B1 accommodation within the M25 market. Vacant premises and leased space which is being actively marketed are included.
- The market definition used, shown in the map on page 3, is based on Local Authority District boundaries.
- All floorspace figures are given on a net internal area basis (as defined by the RICS).
- A minimum 10,000 sq ft (net) cut-off has been employed throughout. Major and minor refurbishment have been treated as new and second-hand respectively. Data is presented on a centre and quadrant basis. Classification by centre relates to the locational details contained within the marketing material for available properties. Classification in this manner is clearly somewhat arbitrary. Vacancy rate data is based on a total M25 stock measure of 130m sq ft (net), an M4 market stock of 65m sq ft (net) and an M3 market stock of 42m sq ft (net).
- Second-hand floorspace has been sub-divided into A and B grade accommodation, reflecting high and low quality respectively. Whilst subjective, this categorisation is based on an assessment of each property's age, specification, location and overall attractiveness.
- Pre-let = The letting of proposed schemes not yet under construction and those let during the construction process.
- All data presented is correct as at December 31st 2011.

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