Economic Background

The UK economy continues to strengthen which means that a rise in interest rates will come sooner than originally expected. UK commercial property returns have responded to the stronger economy with yield compression driving improved capital values.

UK Economic Statistics

The UK economy grew by 0.8% in Q1 2014 and was the fifth consecutive quarterly increase. Throughout 2013 and in the first quarter of 2014, the UK has moved from having one of the slowest growth rates in the G7 to one of the fastest. GDP has risen by 3.1% over the year compared with growth of 2.3% in Germany and 2.0% in the US, according to the Office for National Statistics (ONS). The UK’s service sector rose by 0.9% in the first quarter and contributed 0.7 percentage points to quarterly GDP growth. Agricultural and construction industries had a marginal impact on GDP growth, while production contributed 0.1 percentage points to GDP growth in the first quarter of 2014. Within the production industries, manufacturing was the strongest performer growing by 1.4% on the quarter – its strongest quarterly growth since Q2 2010.

The labour market continues to perform well, demonstrating the flexibility and resilience of the UK jobs market. Labour market statistics for Q1 2014 showed the fourth consecutive quarterly rise in employment with the employment rate now standing at 72.7%, a record of 0.6 percentage points up on the quarter. Since Q4 2013, the unemployment rate has fallen by 0.6 percentage points to 6.6%.

The headline rate of inflation has continues to fall. The Consumer Prices Index (CPI) showed that prices grew by just 1.5% in the year to May 2014, down from 1.8% in April. Output price ‘factory gate’ annual inflation for all manufactured products rose 0.5% in the year to May, compared with a rise of 0.6% in the year to April. Month on month the output price measure for all manufactured products fell 0.1% between April and May, compared with a rise of 0.1% between March and April.

Although this benign inflation background would normally have eased pressure on interest rates and the Bank of England’s Monetary Policy Committee (MPC) has continued to maintain a historically low Base Rate, it is now clear from a recent statement by Mark Carney, the Governor of the Bank of England that Base Rate could be raised from their current level of 0.5% sooner than the City expects. House prices are the one part of the UK economy where inflation is a looming problem but the Bank’s new tools to constrict banks’ ability to make risky loans should enable it to cool down the property market without a significant rise in interest rates. Market commentators consider that any increase in Bank Base Rate is unlikely before October 2014.
UK House Prices

ONS figures showed that UK house prices increased by 9.9% in the year to April 2014, up from 8.0% in the year to March 2014. House price annual inflation was 10.4% in England, 3.3% in Wales, 4.8% in Scotland and 2.6% in Northern Ireland. House prices are increasing strongly across most parts of the UK, with prices in London again showing the highest growth. Annual house price increases in England were driven by rises in London (18.7%), the South East (8.9%) and the East (8.5%). In April 2014, prices paid nationally by first-time buyers were 10.7% higher on average than in April 2013.

Later figures from Nationwide show house price inflation in May 2014 at the higher rate of 11.1% following a month on month increase of 0.7%. Nationwide estimate that Help to Buy accounted for only around 4% of mortgage completions in London, the region with the strongest growth, in Q1 2014, lower than any other region. Help to Buy has accounted for a much larger share of transactions in regions such as the North of England where house price growth has been less marked.

Cost of Finance

Since our last update in January 2014, 3 month LIBOR has moved up 40bps currently running at 0.56%. With the improved economic outlook and potential earlier rises in Base Rate on the horizon, SWAP rates have risen since our January report with the 3 year SWAP now up another 32bps at 1.72% and 5 year SWAP up just 16bps at 2.20%.

The latest edition of De Montfort University’s Commercial Property Lending Report, published in May 2014, showed that new lending in the full year 2013 totalled £29.9 billion, up from £25.5 billion in 2012, and the report showed that 60% of organisations intended to increase the size of their loan books, compared with 46% in the previous year. The average LTV ratios of new loans slowly crept up from 64.2% to 65.9% in 2013, and for the first time in several years, lenders indicated that they would be willing to lend against speculative commercial development.

The gradual increase of LTV for new lending was supported by a separate study of requests for commercial mortgages from borrowers, also published in May. Laxfield Capital’s debt barometer, found that borrowers sought loans with an average LTV ratio of 58% in Q4 2013 and Q1 2014, compared to 51.8% in the first three quarters of 2013.

UK Commercial Property Market Trends

The IPD Quarterly Index for Q1 2014 showed a total returns for UK commercial property of 3.7%, which is more than triple the rate of return at same point in 2013. Overall returns totalled 13.3% for the 12 months ending March 2014. Q1 rental growth was also at the strongest level reported since December 2007. Overall returns remain underpinned by strengthening investor appetite for UK property assets. The top performing sector was offices with 4.9% for Q1, marginally ahead of industrials with 4.8% for the quarter. Overall capital values were up 2.2% in Q1 driven by lower yields, with average initial yields at 5.6% at the end of the quarter.

Central London Office Market

Although Central London office take-up in Q1 2014, as reported by Knight Frank, at 3.2 million sq ft Q1 was down on Q4’s figure of 3.7 million sq ft, it was still marginally higher than the long-term average. However, take-up in Q1 2013 was only 2.6 million sq ft, and this comparison with one year earlier highlights the significant change in demand levels As in previous quarters, TMT (technology,
media and telecoms) was the largest source of take-up with the largest deal of the quarter being Google’s lease of 160,000 sq ft of additional space at King’s Cross Central. There was increased activity in the financial sector with 626,000 sq ft taken up in Q1 2014, compared with just 165,000 sq ft in Q1 2013.

Knight Frank reported an increase in total supply to 16.7 million sq ft, up from 16.1 million sq ft at year end 2013. However supply is down substantially on a year earlier when it stood at 17.9 million sq ft. The Central London vacancy rate of 7.2% is below the long-term average figure of 8.3% and there are also some submarkets with very restricted supply, such as Victoria (with a vacancy rate of 3.3%), Bloomsbury (3.3%), and Holborn (just under 5.0%). Available new build supply for the next 12 months is below last year’s annual office take up, which suggests that Central London rents will continue to rise and leasing incentives such as initial rent free periods will reduce over the year ahead.

The Core West End is increasingly uncompetitive compared to other submarkets in central London, both in terms of cost and available property, not helped by Westminster’s planning policy which has allowed for the easy conversion of offices to residential use.

The biggest growth areas in % terms are Midtown/Clerkenwell/Farringdon and these areas together with other ‘fringe’ areas such as Aldwych, Shoreditch and Hoxton are becoming increasingly popular locations with property in short supply. These areas will have to be rebranded as what were once labelled ‘fringe’ areas become destination locations in their own right.

Interestingly on the back of this the core City area is one of the best places to try and acquire office space, with good availability and choice by comparison to the other areas outlined above, and this has resulted in landlords offering very competitive deals to attract tenants.
City of London

Although City office take-up fell to 1.1 million sq ft in Q1 2014, a drop of 42% from the strong Q4 2013, CBRE suggest that slow starts to the year are not unusual. They say that in comparison with the corresponding level in 2013 (900,000 sq ft), the Q1 figure is well ahead, but 11% below the 10-year average of 1.2 million sq ft. Pre-letting accounted for 300,000 sq ft or about 30% of total take-up, including the largest deal of the quarter with a 130,300 sq ft pre-let to Dutch bank ING at The Banking Hall, 8/10 Moorgate. There were three other deals of over 50,000 sq ft in Q1 2104, matching similar level of larger deals in Q4 2103.

On the supply side, the number of buildings able to accommodate a requirement of over 100,000 sq ft has fallen from 14 in the previous quarter to nine in Q1, of which six were marketed ahead of the space becoming available for occupation. Aldgate Tower, which is currently under construction, with 313,800 sq ft, provides the largest amount of available space in a single building while Cannon Place was the largest ready-to-occupy building with 233,700 sq ft still available at the end of the quarter.

The volume of space under construction in the City fell 19% to 4.7 million sq ft during the quarter, although 2.2 million sq ft is already committed. On the new development front Helical Bar, in a joint venture with the Healthcare of Ontario Pension Plan Trust Fund, is to start construction of 273,000 sq ft at Creechurch Place, EC3 in August, which it is scheduled to complete in September 2016. M&G Real Estate has agreed to forward fund a 301,000 sq ft redevelopment of the London Fruit & Wool Exchange, E1, where Exemplar will continue as the development manager.

West End

Take up in Q1 2014 was 674,330 sq ft (below the three year average of 775,400 sq ft) but marginally up from 654,835 sq ft in Q4 2013, according to Strutt & Parker. The highest take up was again North of Oxford Street at 191,015 sq ft, up by over 26% on the 151,345 sq ft leased in Q4 2013. Take up in Mayfair fell from 157,450 sq ft last quarter to 89,620 sq ft the first quarter, representing a 43% drop. Take up of 36,795 sq ft in St James’s was also low as consequence of a lack of supply, rather than lack of demand.

West End availability excluding buildings under construction was 3.15 million sq ft at the end of Q1 2014 reflecting a vacancy rate of 5.02%. Availability including properties under construction stood at 5.65 million sq ft showing a vacancy rate of 7.81%. Within this current availability figure, Total currently available Grade A stock, including both new and second-hand, totalled 2.45 million sq ft or 77% of available stock.

The highest headline rent achieved in the West End in Q1 2014 was £115.00 per sq ft at Grosvenor & Stow’s 33 Davies Street, W1, where Golden Tree Asset Management signed a 10 year lease of 5,998 sq ft on the 4th floor. After the end of the quarter, this rent level was beaten at Grosvenor’s 19-20 Grosvenor Street where KPMG leased the entire 36,900 sq ft on a new 15 years lease at £125.00 per sq ft.

Midtown

Midtown has been one of the strongest performing Central London markets of the past year. CBRE reported that this trend continued in Q1 2015, with take-up at 400,000 sq ft. Despite this being a 28% fall from the previous quarter it was still above the 10-year average of 300,000 sq ft. The high levels of take-up caused availability to fall in consecutive quarters, with supply falling by 19% in Q1 to a below-trend 1.2 million sq ft, an availability rate of just 4.9%.
New development in Midtown is expected to deliver 1.0 million sq ft in 2014 compared with a 20-year average of 400,000 sq ft. From 2014 to 2018, 4.8 million sq ft is scheduled for delivery, of which 2.7 million sq ft has been pre-leased. Of the remaining 2.1 million sq ft of speculative space in this period, many projects will only proceed subject to pre-leasing or stronger market conditions.

High demand and limited availability resulted in strong rental growth of 9.5% in 2013. In Q1 2014, prime Midtown rents increased by 4% to £60.00 per sq ft.

**CENTRAL LONDON TAKE-UP BY SECTOR - 2013**

Docklands

Take-up in Docklands was 400,000 sq ft in Q1 2014, showing significant growth from a weak Q4 2013. This uplift was supported by a pre-lease during construction of 205,000 sq ft at 25 Churchill Place to accountants EY, which was also the largest deal in Central London in Q1.

CBRE report that availability in Docklands has fallen in consecutive quarters, with supply falling by 28% in Q1 to 1.1 million sq ft, of which 800,000 sq ft was in Canary Wharf. This resulted in availability rate falling to 5.9%.

There is an argument that the new area based around the Olympic village in Stratford is taking tenants that in the past might have gone to Docklands/Canary Wharf. Two government quangos have ‘opted’ for Stratford taking between them some 675,000 sq ft - Financial Conduct Authority (FCA) 425,000 sq ft and Transport for London (TFL) 250,000 sq ft. The detail on these transactions has not been made public, but rents here are circa £35/40, so a little below prime Canary Wharf. We are going to have to insert the Stratford ‘island’ on our location maps.
South Bank

In Q1, take-up increased marginally by 2% over the quarter to 300,000 sq ft, also remaining above trend (0.1m sq ft). There were three deals over 20,000 sq ft in Q1 compared with five in the previous quarter. HCA International took 70,000 sq ft at The Shard in the largest deal of the quarter and serviced office space provider, WeWork committed to a pre-let of 37,500 sq ft at the South Building of Sea Containers House.

CBRE forecast accelerating prime rental growth in Southbank over the next two years, with low double digit growth in 2014 and high single digit growth in 2015.

M25 & Thames Valley Office Markets

The M25 take-up over the year to Q1 2014 reached a six year high of 2.7 million sq ft with 57 transactions completed in Q1 2014, the most in a single quarter since Q2 2007, as reported by Knight Frank. Supply levels in the M25 region are increasingly under pressure while occupier demand is strengthening. The vacancy rate for New and Grade A space in the region has fallen to a 10-year low of just 5%. Knight Frank say that there are a growing number of key markets in the M25 region that have less than three years of office supply left, which is expected to stimulate refurbishment and new development activity.

In addition to the improving occupier market, the Permitted Development Rights for conversion of offices to residential use has resulted in a reduction of the supply of existing buildings for office occupiers. This is most likely to affect older properties at the lower end of the rental market, where...
UK Property Market
London & South East

residential values outstrip the value for refurbishment for office use. Knight Frank report that prior approval notices for conversion to residential total 3.2 million sq ft, equivalent in size to the entire Slough office market.

There were two speculative development completions in the Thames Valley region in Q1 2014, providing 135,000 sq ft. The Point in Maidenhead is a 77,940 sq ft development by Kames Capital / Capella Estates and 5 Pine Trees in Staines, is a 57,180 sq ft development by Aberdeen. Speculative development activity remained limited over the past 12 months, with about 1.3 million sq ft under construction, mainly within the Thames Valley markets. Reading is has five office buildings under construction, the largest being M&G/Bell Hammer's development of the 186,000 sq ft Forbury Place.

Prime M25 and Thames Valley office rents were generally slightly firmer that at year end 2013 with Chiswick achieving £50.00 per sq ft in Q1 2014 with Uxbridge, Staines, Heathrow and Maidenhead all at about £32 per sq ft. Guildford and Reading prime rents are £30.50 to £31.50 per sq ft while in Slough, Croydon, Gatwick and Watford rents are £24.00 to £24.50 per sq ft. Bracknell and Basingstoke provide some of the lower rents in the region at £21.50 and £18.00 per sq ft respectively.

Investment Market Activity

After a very strong second half of 2013, investment in UK commercial property was just £9.5 billion in Q1 2014, down 55% on Q4 2013. However, the Q1 volume was similar to same quarter in the previous year. Investors were more active outside of Central London in Q1 2014, reflecting the lack of investment opportunities in the capital rather than a lack of demand.

Central London investment volume was significantly down on Q4 2013 with transaction volumes totalling £2.7 billion in Q1 2014 according to CBRE. This was the lowest level of Central London investment activity since Q3 2010 (£2.2 billion). Large transactions (over £100 million) have dominated the investment market in recent years, but the lack of stock has significantly reduced the number of suitable assets available to investors. In Q1 2014, there were only seven deals of over £100 million compared with 13 in the previous quarter. The size of the transactions has also reduced with Legal & General's purchase of Telereal Trillium's Hyperion Portfolio for £261m being the largest deal in Q1 2014 compared with seven deals over £250m in Q4 2013.

UK purchasers accounted for the majority of investment in Q1 2014, with 54% of the total. UK institutions accounted for 22% of Central London turnover and UK property companies next with 16%. These figures were boosted by Legal & General’s acquisition of the Hyperion Portfolio and London & Regional Properties’ purchase of 99 City Road for £101.5 million. The proportion of overseas investors fell from 82% in the previous quarter to 45% in Q1 2014. Asian investors accounted for 12% of investment volumes. However, the average price paid by Asian investors fell from £1.8 billion in Q3 and Q4 2013 to only £340 million in Q1 2014.

Prime City of London yields remain at 4.5% in Q1 2014 but there is continued downward pressure on prime West End offices yields of 3.75%.

Investment demand for M25 and South-East office investments continues to outstrip the supply of investment opportunities coming to the market, which is constraining the total volume of deals. Despite this, Knight Frank reported that Q1 2014 volume reached £494 million, 7% ahead of the ten-year quarterly average, but down on Q4 2013, which were distorted by the £780m sale of Chiswick Park.

The relative lack of buying opportunities continues to put downward pressure on yields with prime long income yields in Q1 at 5.25%. The strongest price increases over the past six months have been for good quality secondary office buildings, with rental growth prospects improving in the tightly supplied markets. The UK Funds remain the dominant buyer in the South East market, and their

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appetite for well-located multi-let buildings and office parks is exceptionally strong. Overseas buyers seeking to invest in UK property are now competing with domestic buyers for single-let investments, and increasingly for secondary assets showing more attractive initial yields.

Outlook

With the UK economy continuing to perform well in comparison to mainland Europe and the USA, UK property markets are well set for a further period of strong growth. Offshore capital inflows continue to seek a home in the Central London markets. The main constraint to increased investment activity continues to be the relative lack of stock available on the market.

Outside London, South-East and prime regional city offices attract capital from UK based fund managers and increasingly overseas investors with renewed rental growth potential offsetting the lower yields available now.

Looking forward the imminent Scottish Independence Referendum to be held in September 2014 and the run up to the UK General Election in May 2015 may result in some uncertainty in the latter part of the year but the underlying strength of the UK economy points to solid overall property returns for 2014 as a whole.

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