IS THERE STILL VALUE TO BE FOUND?

SOUTH EAST OFFICE MARKET - MAY 2017

RESEARCH

BNP PARIBAS REAL ESTATE
INTRODUCTION

In the years post-Global Financial Crisis the South East region as a whole has experienced a substantial recovery. However, recovery is only part of the story. Development and regeneration, both at a regional and town level, are provoking a structural change within these markets, meaning that historic performance can no longer be relied upon to provide an accurate benchmark for future growth. With these factors in mind, can the South East office market record further growth going forward, and from an investor perspective are there still opportunities to be found?

THE HEADLINES

- Markets across the South East are undergoing a structural change, partially driven by substantial infrastructure investment, which has led to significant rental growth.
- The region’s strong market fundamentals mean that investor interest remains high.
- However, whilst some markets are starting to look expensive, there are still attractive risk adjusted returns to be found.
SPOTLIGHT ON THE SOUTH EAST

In the immediate aftermath of the Global Financial Crisis, South East development levels fell back as the market adjusted to reduced occupier demand. Noticeable levels of speculative development began to return to the market in 2013, bringing forward much needed prime supply.

This speculative development cycle has, however, been far from widespread, with development very much focused in the Thames Valley market and within this those core towns in closer proximity to London and the larger urban hubs in the Thames Valley.

The delivery of these new prime schemes, alongside falling vacancy, helped prompt a return to rental growth. Again, whilst the Thames Valley has always commanded higher prime rental levels than its North and South M25 counterparts, this sub-region saw a quicker return to growth. At Q1 2017, the majority of South East markets have seen prime rental levels match or surpass their pre-recession peak, and in some cases current prime rents have surpassed historic all-time peaks set during the dot-com boom of the late 1990s and early 2000s.

Within a handful of development starved markets, the delivery of new Grade A office schemes has instigated a step increase in headline rents – this has been the case in Maidenhead with The Pearce Building commanding rental levels of £38.50 psf (10% above previous historic all-time peak) and Watford where the newly developed 36 Clarendon Road saw rental levels reach £31.50 psf.

With prime rental levels reaching new peaks across a number of towns in the South East, and secondary rents also recording significant growth, this could indicate that further growth may be fairly muted. However, our forecasts indicate that, although not continuing at the pace recorded over the last two-year period, the South East will record further rental growth. Our forecasts, which look at average rents, place the South East office market as an outperformer in relation to both London and the UK, over the next two-year period.

The South East office market has and continues to undergo something of a structural change. Therefore judging future growth by previous rental levels is perhaps less relevant than it has been historically. This structural change is being driven by a number of factors ranging from regional infrastructure investment, conversion of obsolete office stock to alternative use through Permitted Development Rights to rejuvenation and development at individual town level.

![Fig. 1: Development Pipeline](source: BNP Paribas Real Estate)

![Fig. 2: Average Prime Rents](source: BNP Paribas Real Estate / Note: * as at end April 2017)
STRUCTURAL CHANGE

The South East is currently witnessing significant investment in infrastructure projects, which is altering not only the structure of individual towns, but also the way in which these markets are connected to both each other and London.

As in Paris, with the advent of the Grand Paris project, London and the wider South East area have recognised the need for infrastructure to support population growth and the benefits that increased connectivity brings. Key developments comprise the currently underway Elizabeth Line and the Electrification of the Great Western Route alongside the planned ventures of HS2, the Expansion of Heathrow Airport and the Western Rail Access to Heathrow (WRATH). These projects feed into the growing desire for increased connectivity and flexibility of movement, factors which have become increasingly important in the ever growing global workplace.

In some towns, such as Slough and Reading, the development of the Elizabeth Line has engendered a renewed development focus centred on the town centre and particularly the station area – breaking up the traditional “zonal” elements of these town centres and encouraging a mixed development focus with retail and leisure schemes cohabiting with new office buildings and PRS developments. In Ealing, also on the Elizabeth Line, whilst large-scale office development is yet to come to fruition, the retail and leisure offer in the town has undergone substantial change. As a sign of the structural change taking place in this market, prime rents here now stand c. 35% above the post-recession trough.

For towns not directly benefitted by infrastructure investment, regeneration has still taken place, aided by the implementation of Permitted Development Rights. The conversion of obsolete office stock across the South East to alternative use, predominantly residential, has rejuvenated the office stock profile of a number of markets across the South East, squeezing secondary vacancy and improving the overall grade of available stock.

To date this has been more keenly felt in the Thames Valley sub-region, with Grade A stock comprising 57% of availability at end-2016 compared to 32% in 2010. Whilst the North and South M25 sub-regions have also recorded some speculative development and secondary stock conversion, this has so far lagged behind the Thames Valley. There are, however, clearly variations at town level, with the South M25 market of Croydon seeing over two million sq ft of obsolete office stock converted to alternative use over the last five years.

A combination of an improved market stock profile, good transport links and increased leisure offerings has been a key catalyst for rental growth within the South East in recent years. This is evident in markets like Croydon where the headline rent sits 51% above the level recorded before the introduction of PDR in 2013, with future growth on the horizon.

Simon Fitch, Director of South East Agency

Fig. 3: Supply - Changing Stock Profile

Source: BNP Paribas Real Estate
With the South East region as a whole continuing to record strong market fundamentals, aided by significant investment in the region’s infrastructure and the rejuvenation occurring at town level, this has led to healthy investment volumes and yield compression over recent years.

Across 2016 investment levels for the South East remained healthy, despite the uncertainty generated by the EU-Referendum. Overseas Investors remained active, particularly within the Thames Valley, accounting for 41% of investment activity here and clearly indicating the South East’s continued investment appeal. Arguably the year’s key transaction comprised the sale of Green Park in Reading to Singaporean investors Mapletree for £563m, reflecting a yield of 6.5%.

UK Local Authorities have also accounted for a significant share of the South East Investment market having acquired c.18% of the investment stock traded in 2016. Notable deals include the purchase of the BP Campus by Spelthorne Borough Council for £360m.

Looking ahead across 2017 and beyond, where can investors find value?

If we were to position the major South East markets on the risk return spectrum, the combination of the attractive demographics, current and future infrastructure provision and the real estate supply and demand dynamics would position them in the core category. However we believe there are still attractive risk adjusted returns to be found by selectively accepting additional levels of risk whilst maintaining a disciplined focus on the key drivers of performance.

In a market typified by historical low levels of stock, enhanced returns can be achieved by taking leasing or refurbishment risk in established, liquid markets or even location risk in markets such as Slough or Ealing where pricing is yet to fully reflect the impact of strong infrastructure links and the wider social environment. Enhanced returns could also be achieved in markets such as Watford and Hemel Hempstead where pricing is still at a significant discount to the wider South East office market.

For example, in the North M25 market of Watford, over the last 6-12 month period investors have capitalised on the acquisition of secondary assets in a core location with a number of sales along Clarendon Road achieving c.7% yields, a significantly higher return than the current South East prime yield of 5.25%.

The latest INREV Investor intentions report highlights several themes that reinforce this view. Firstly, there is still substantial capital seeking allocation to real estate, and secondly the UK remains one of the most attractive markets. Finally, given the challenge in identifying acceptably priced core real estate, there is an increasing requirement for core plus to value added strategies.

Finding value is contingent on a number of factors: knowledge of a market area at a macro level alongside in-depth knowledge of individual town characteristics and fundamentals, which at BNPP RE we pride ourselves on.

Hugh White, Head of National Investment

With certain aspects of the South East starting to look expensive, asset selection is key, with prime assets in secondary locations or secondary assets in core locations with the potential for repositioning providing better value than prime.
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