OUR MARKET

London is one of a few truly global cities: a position that has strengthened in the last few years. It is the UK's largest single economic market and is enjoying relatively strong growth.

The impact of strong growth is clearly positive on our London villages where there has been strong occupier take-up and high levels of investment activity. This has been reflected in rising rents, falling yields and continuing outperformance against the rest of the UK.

Economic growth has also seen a change in occupiers' aspirations as they balance the most efficient use of space with an attractive working environment. The relative strength of some new digital/creative industries has triggered a 'war for talent', and the workplace has become one of its arenas. This has reinforced the trend of demand spreading beyond the traditional core to some border areas, and an increasing interest in flexible buildings which allow tenants to be more creative and reflect the company brand in their office surroundings. Derwent London's focus on improving London villages and design-led development means we are well-placed in this regard.

Improving economic backdrop

London leads a broader UK recovery. The UK's economic outlook steadily improved during 2013, with GDP growing by 1.9%. The UK base rate remained unchanged at 0.5%, but gilt yields have been rising with the prospects of an end to Quantitative Easing as the UK economy improves. Unemployment continues to fall, and was 7.2% of the workforce in December 2013, yet CPI inflation was also lower, falling from 2.7% to 2.0% over the course of the year.

The outlook is for increasing growth as the recovery takes hold. The Bank of England expects UK GDP growth of 3.4% in 2014. The London economy is expected to continue to outperform the rest of the UK, benefiting from its international links and as the preferred centre for many of the new growth industries. Oxford Economics estimate that London's average GDP growth will be 3.1% pa over the next five years, which compares to average projected UK growth of 2.3% pa over the same period.

A recent study from Deloitte found that London employed 1.5 million people in 22 high-skill, knowledge-based sectors. Its nearest rival is New York with 1.2 million working in the same industries. The study found that London led other cities in 12 out of these 22 chosen sectors (New York led in seven). The fact that London is seen as 'a crucible for creativity and commerce' helps to support its favourable outlook.

West End office development pipeline

Source: CBRE

"We have the universities… we've got the lunar pull of London. People just want to be here. They're attracted by the sheer agglomeration of talent. They come for the vibe in London – the vibe, which not even we politicians can do anything to spoil."

BORIS JOHNSON, MAYOR OF LONDON
13 MARCH 2014

Flourishing central London office occupier market

The provision of desirable office space is a key part of central London's economic success story. It is also our focus. Total office stock is estimated at 221 million sq ft (20.5 million m²) of which 49% is located in the City, 42% in the West End and 9% in Docklands. This basic division hides a dynamic trend of the last few years, which is the growth of new office neighbourhoods on the borders of these traditional zones driven by young businesses and improving infrastructure.

Last year we highlighted the growing attractions of a less well-established office district running in an arc from King's Cross to Whitechapel including Clerkenwell, Old Street, and Shoreditch. We labelled it the 'Tech Belt', and this has rapidly become an established subsector. We estimate that the office stock in this thriving mixed-use area is c.24 million sq ft (2.2 million m²) or 11% of central London's total. It is also where Amazon, Google, and Publicis committed to major lettings during 2013. We have just started our next major development, the White Collar Factory, next to Silicon Roundabout in the heart of this area. Recent research from Tech City UK estimated that the tech/digital sector created new jobs 2.7 times faster than other London industries in the period 2009-12, and that in 2012 the total London workforce in this sector was 0.6 million people.

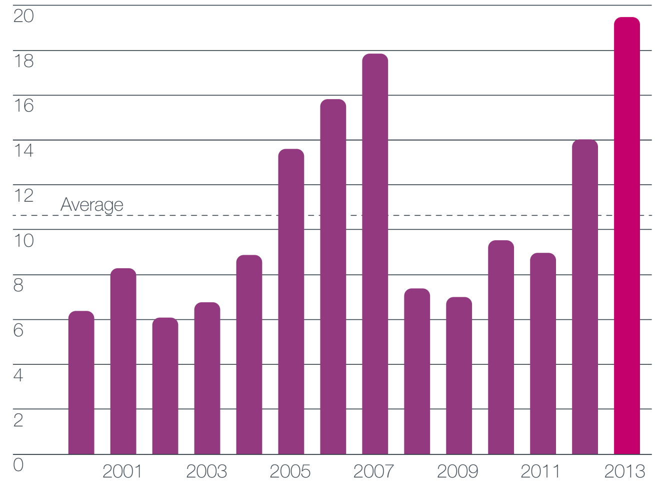
Tech Belt and TMT/creative demand stand out, but we are also seeing demand from a variety of other sectors across London. We stressed earlier London's diversity and broad base. Improving business confidence has benefited most central London office markets and many businesses. CBRE is reporting good rental growth in the West End core where prime rents are up 8.1% pa to £100.00 per sq ft (£1,076 per m²). In Fitzrovia and Victoria, where half our portfolio is located, prime rents are up 12.5% pa to £67.50 per sq ft (£727 per m²), and 12.0% pa to £70.00 per sq ft (£753 per m²) respectively. The City of London core is also seeing growth with prime rents up 4.5% pa to £57.50 per sq ft (£619 per m²).

CBRE central London office take-up rose 39% last year to an estimated 13.6 million sq ft (1.26 million m²), of which 30% was in the West End. TMT take-up comprised 33% of the total, followed by Banking and Finance which made up 18% and Business Services at 13%. There was still strong active demand for 8.4 million sq ft (0.78 million m²) of central London office space at the year end, which was 24% higher than the previous year (according to Jones Lang LaSalle). It is estimated that 32% of this derived from the TMT sector and 20% from each of the professional services and financial services sectors.

Some of last year's central London take-up was met by developments, which supplied 3.5 million sq ft (325,000m²) of new space, of which 1.3 million sq ft (121,000m²) was in the West End, and 1.1 million sq ft (102,000m²) in the City. West End delivery is running marginally above trend and these levels are expected to be maintained over the next four years. City delivery was slightly below trend in 2013, but is expected to pick up in 2014.

In the short-term, central London office vacancy levels are still falling (5.1% to 4.7% in 2013) and we expect our portfolio ERVs to rise by around 5% to 7% in 2014. The positive economic outlook and increased business confidence should see letting demand strengthen further to absorb the expected levels of new supply, auguring well for the foreseeable future.

Central London office investment transactions £bn



Source: CBRE

Thriving central London office investment market

Our guidance last year was for London office yields to remain broadly stable. It was correct for most of the year, but in the last few months yields have tightened significantly. This reflected strong demand in the last quarter, which saw London annual transaction volumes jump to £19.4bn. These levels are even ahead of those in 2007, with the major difference being that equity is financing the bulk of the demand. Overseas investors continue to dominate, representing 68% of the total with increasing demand from Asia. Continental European investment has remained a significant component notwithstanding the improving Eurozone outlook. More recently there are signs of increased bank debt availability for commercial property.

These high levels of demand explain why prime office yields hardened by 25 basis points in the West End to 3.75%, and by 50 basis points in the City to 4.50% during 2013.

Current demand has spread broadly across central London, which has benefited some emerging locations such as those within the Tech Belt. Crossrail has also had a positive impact ahead of its opening in 2018. 80% of our portfolio is located either in the Tech Belt or close to a Crossrail station.

Central London office market values have also been supported by the high values of alternative use. Both central London residential (capital values +11.2% in 2013 according to the Land Registry) and retail (capital values +13.5% according to IPD) continue to be strong.

Rising rents should protect current property yields from the likely further rise in gilt yields in the next twelve months. We expect property yields to be stable, and may even tighten in some markets, while the rental outlook is good and inflation stays low.

"Our competition is only going to be in other cities that have similar kinds of characteristics. And the city that comes to mind is London."

MICHAEL BLOOMBERG, MAYOR OF NEW YORK
EVENING STANDARD, 14 OCTOBER 2013