King Sturge Research bulletin

City Offices

2004 QUARTER 4

Pre-lets fuel supply bypass

Austral House, Basinghall Street, EC2

- Investment activity increases by 43% with £5.6 billion invested during 2004
- Take-up demonstrated a 75% increase on Q3 2004 with 135,700m² space being taken
- Pre-lets return to the City for the first time in 3 years
- Take-up demonstrated a 75% increase on Q3 2004
- Supply decreased by 5.4% to 985,200m², which equates to a vacancy rate of 15.3%
- Headline rents continue to show resilience at £484m² (£45ft²)
- IPD Monthly data for December 2004 shows RVG for City offices over Q4 2004 to be -0.7%

Following earlier expectations some tenants have finally put their feet firmly back on the gas and chosen to bypass existing supply in favour of a pre-let. These deals (Willis Group Ltd at 51 Lime Street, EC3 and Legal and General at Austral House, Basinghall Street, EC2) are critical for this market as they demonstrate the commitment large occupiers still have towards the City. What should not be overlooked however, is that these deals have come alongside a significant improvement in sentiment and regular transaction levels.

There is a cost to these improvements. Pre-lets do little to correct levels of existing supply and the recovery of demand has been heavily biased towards prime, thus placing an increasing degree of pressure on the top end of the market. Tenant appetite for prime space is due to a combination of relative affordability and the type and size of tenant requirements in the market place. When combined with the slow-moving development pipeline, the market will eventually experience a shortage of prime single floors and single let buildings, furthermore a burgeoning over-supply of second-hand is developing as tenants release previously occupied space back on to the market.

Despite this, the market remains optimistic. With an improving outlook, some tenants will look towards withdrawing space to re-occupy. This will alleviate some of the "grey" element of second-hand supply that has been largely unquanitifiable throughout the past three years. Alternatively, some landlords are already seeking to withdraw second-hand assets to refurbish, returning them to the market after 2006 when it is expected that prime rental levels will have shown improvement. Overall the City does appear to be on the road to recovery despite the odd diversion on the supply bypass.

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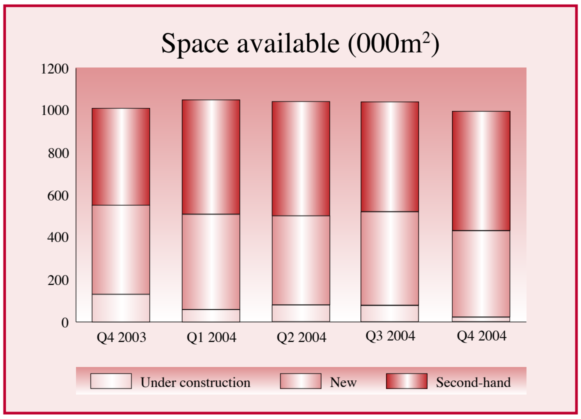
Supply



Availability begins to turn

Having peaked during Q1 2004, City availability has fallen for three consecutive quarters. Total supply at the year end was 985,200m² (10.6 million ft²) which represents a 5.4% decrease on Q3 2004.

The reduction in supply continues to be driven by transactions and lower levels of development completions. In addition, fewer tenant controlled assignments and sub-leases were placed on the market.

Another reason behind falling supply relates to a change in status for some properties. For example, at 200 Aldersgate Street, EC1 where Canary Wharf Group Plc has withdrawn the building from the market for refurbishment. King Sturge defines supply as space available for occupation within six months.

Vacancy rate falls to 15.3%

The current level of supply equates to a City vacancy rate of 15.3%, a reduction of 110 basis points since Q1 2004.

Supply dynamics

A key feature of supply in 2004 has been changes to grade composition. A year ago prime (new or space under construction) represented 55% of total availability, and there were worries that the market would be left with a number of "ghost-schemes". As of Q4 2004 the proportion of prime has now reduced to 43% leading to speculation that if demand for prime product continues and given the limited amounts of speculative development this figure will be eroded further leaving the market biased towards unrefurbished second-hand. Based on current levels of prime take-up current prime space could be exhausted within two and a half years. In comparison the equivalent statistic for second-hand is over four years.

Key availables (End Q4 2004)

- Hammerson and Henderson Global Investors landmark Moor House, 119 London Wall, EC2 (29,100m²/313,323ft²)
- Swiss RE's 30 St Mary Axe, EC3 (25,008m²/269,185ft²)

Development

The volume of City development completions continued to reduce in Q4 2004 with only 30,300m² (326,000ft²) completing.

"Hype" the pipe

Despite the current anxiety surrounding the pressure on prime space there has been much enthusiasm in development circles, as planning consents returned with a vengeance during Q4 2004.

After a year long absence, five influential schemes were awarded consent which, if built, will provide some comfort should a two-tiered disposal market develop over the next year.

The schemes awarded consent total 183,000m² (1.9 million ft²) of which 21,450m² (230,900ft²) is under offer to Standard Chartered Bank who wishes to purchase 35 Basinghall Street, EC2 for their own occupation.

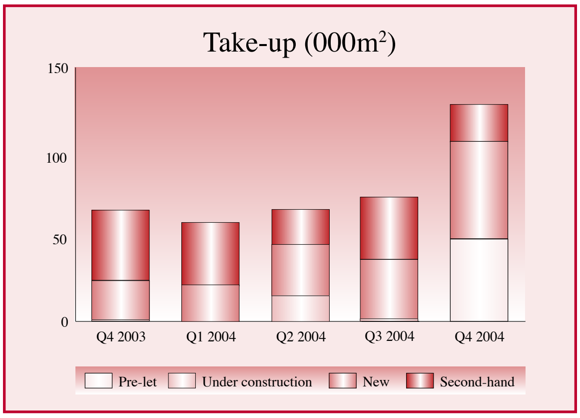
Other schemes include:

- Mitre House, Cheapside, EC2 18,452m² (198,616ft²)
- 21 Moorfields, EC2 44,395m² (477,867ft²)
- 122 Leadenhall Street, EC3 66,178m² (712,337ft²)
- Walbrook House, Walbrook, EC4 32,516m² (350,001ft²)

City Availability

000m²	Q3 2004	Q4 2004	Year ago
New space	441.0	403.7	418.0
Second-hand	519.6	560.6	457.0
Available U/C	80.6	20.8	139.5
Planning permission	98.1	183.0	69.6
Completions	45.1	30.3	115.0

Demand



Take up - positive - at last!

12 months ago, it was hoped, that 2004 would bring a much needed return to health for the City office market. And judging by the evidence it would appear that this has indeed been the case.

During Q4 2004 City take-up totalled 135,700m^2 (1.4 million ft^2) representing a 75% increase on Q3 2004. Crucially, year-end take-up totalled 342,600m^2 (3.6 million ft^2), 66% up on 2003. This is extremely positive news for the City office market, after three years of hesitancy, tenants appear to be finally confident enough to reassess financial commitments. This level of annual take-up is only 7% below the long-term (20 year) average of 362,200m^2 (3.9 million ft^2).

Pre-lets return, sub-Lime!

After an absence of two and a half years and following nine months of anticipation, pre-lets returned to the City office market in Q4 2004 as Willis Insurance took 42,270m^2 (455,000ft^3) at 51 Lime Street, EC3 and Legal and General took 11,426m^2 (123,000ft^2) at Austral House, Basinghall Street, EC2.

The return of pre-lets, combined with the type of companies taking them, is hugely reassuring for the City office market. It confirms that international companies still consider a City of London presence to be essential and that companies remain convinced of the benefits of a City address. Further companies will follow suit in terms of more pre-lets and regular transactions. As with any positive news there is a flipside, with pre-lets it is the fact that whilst these transactions bolster take-up they have no positive impact on availability. They do not eliminate any of the current over-supply and there are still plenty of empty buildings requiring occupiers.

A changing complexion

Throughout 2004 the City office market looked towards diversification and a greater sense of sophistication amongst occupiers as a means of development. Could it be, therefore, that the complexion of the City may be changing? Forecasts from Experian Business Strategies Ltd certainly suggest that it will be the Business Services sector which will drive City output over the next four years with Lawyers, IT companies and perhaps even property companies becoming key to the continued success of the Square Mile; through their provision of support to the traditional financial services sector.

Already there is evidence to suggest this; in the last twelve months thirty Lawyers have taken a total of 55,750m^2 (600,000ft^2) of space in the City with a number of others including Kennedy's, MacFarlane's and Evershed's looking to exercise requirements during 2005.

Furthermore, 2004 has seen a selection of hoteliers and leisure providers seeking to enter the City market looking to modify the use of a number of former office properties.

Looking ahead

Despite earlier government statistics it is not anticipated that there will be a substantial increase in the Square Mile's workforce in the coming years. It is likely however, that the City will experience a moderate increase in take-up during this recovery phase. Competing markets should also be considered, although the City now faces less competition from Canary Wharf than 10 years ago, the South Bank and Paddington are proving to be attractive alternatives for some occupiers.

City Take-up

000m^2	Q3 2004	Q4 2004	Year ago
New space	38.1	59.1	19.4
Second-hand	38.9	22.8	44.4
Under Construction	0.7	0.0	0.7
Pre-let	0.0	53.7	0.0
Under offer	70.7	64.9	34.0

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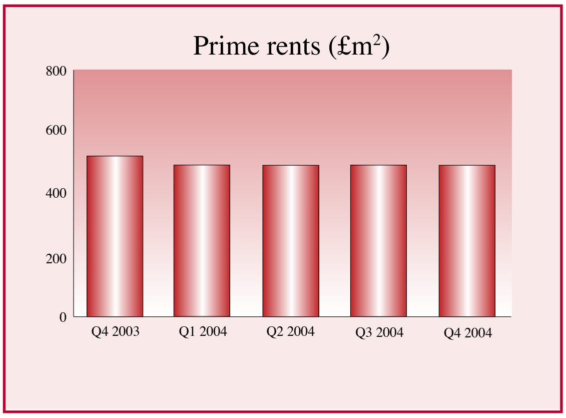
Rents



Rental review

Prime City office rents remained resilient at £484m² (£45ft²) throughout 2004. Whilst market sentiment and performance is improving it has not yet transferred through in terms of rental growth. Looking ahead, transactions at Moor House, London Wall, EC2 and Plantation Place, Fenchurch Street, EC3 are expected to be the market barometers for 2005. Transactions include HypoVereinsbank, who is believed to be taking in the region of 9,290m² (100,000ft²) at Moor House - with a rent in the region of £484m² (£45ft²) expected in early 2005.

Rent incentives

Tenants continue to enjoy long rent-free periods at the start of new leases. Typically current expectations are still for up to three-years rent-free for a 15-year term. Looking ahead it is likely that incentives will reduce slightly during 2005 with a more significant correction in 2006.

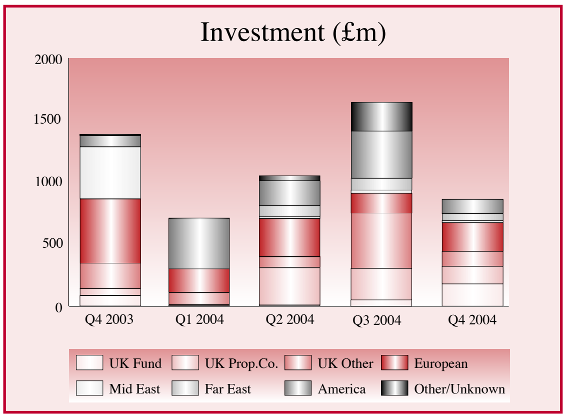
Rental value growth (IPD monthly data)

IPD Monthly data for December 2004 shows RVG for City offices over Q4 2004 to be -0.6%. Over the lat 12 months (Q1 to Q4) RVG was -2.9%.

Rental outlook

For 2005 we expect limited rental growth, however, as the year progresses and pressure on prime increases further we anticipate some growth returning in 2006 and accelerating in 2007.

Investment



Investment increases by 43% in 2004

£1.4 billion was invested during Q4 2004 taking 2004's total to £5.6 billion.

Investment comment

Stable interest rates and the continued performance of property resulted in strong trading in Q4 2004. Debt buyers are still able to leverage at competitive rates, whilst there is also an abundance of cash from institutional investors. A mixture of products have been purchased with greatest demand was for the higher yielding, short to midterm, asset management stock which investors are buying off IRRs of typically 7-8%. Long-term income, trophy buildings and vacant possession assets are still popular due to the perceived opportunity to create value in the recovering leasing market. UK funds dominated due to their ability to buy with cash and transact quickly. Property companies and private investors have also proved to be aggressive e.g. the Irish purchase of 5 Royal Exchange Buildings, EC3, and the German purchase of 60 Queen Victoria Street, EC4. Limited stock continues to affect demand, fuelling strong prices and as the UK funds still have large sums to invest we expect them to now look at a broader range of products. In 2005, it is expected that a large amount of stock will come to the market on the back of positive yield shifts. This may calm the aggressive nature of prices and bidding, however, prime initial yields are likely to remain firm at 5.50%-5.75% due to the unprecedented range of buyers and weight of money in the market.