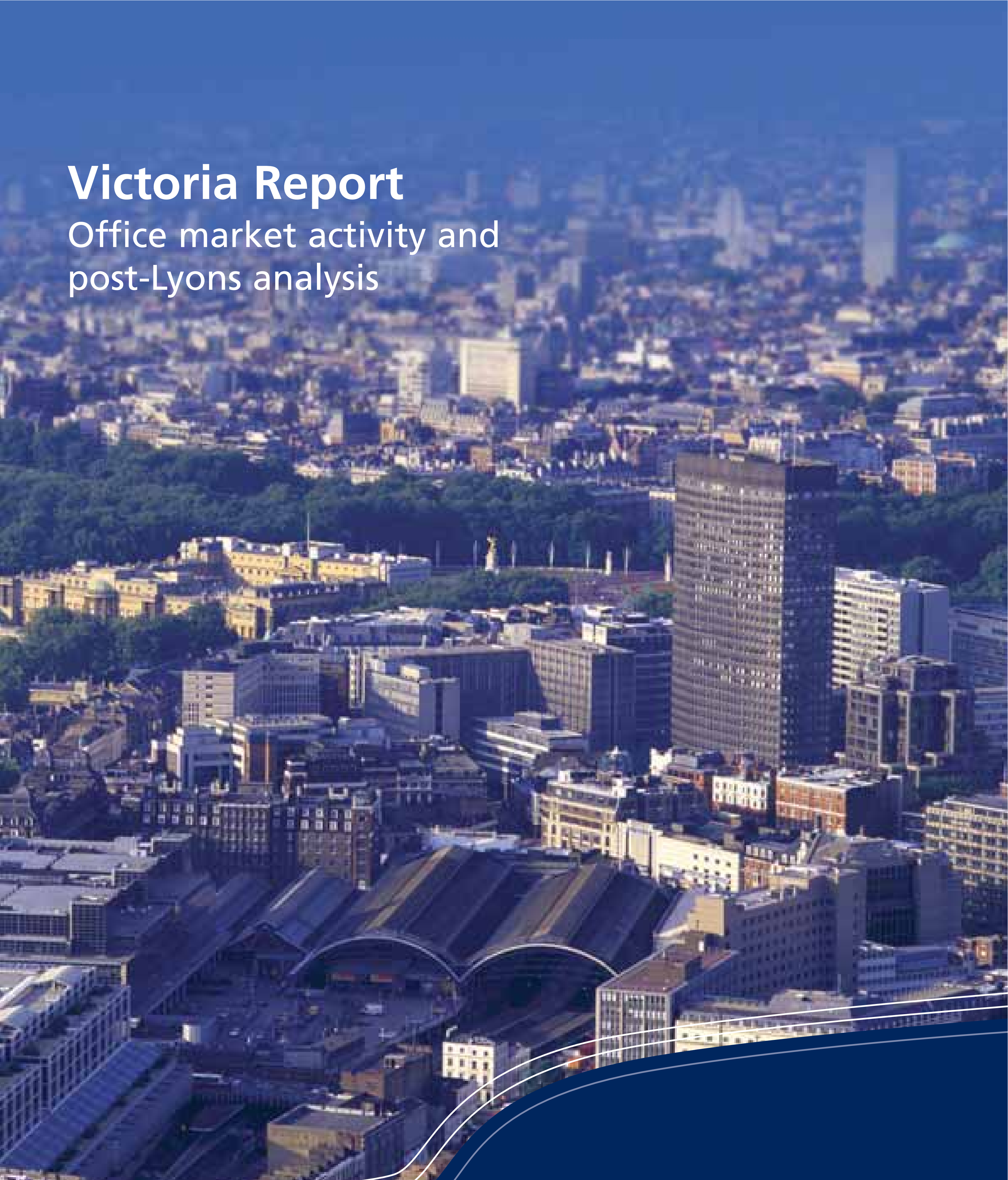
Victoria Report

Office market activity and post-Lyons analysis



Chesterton

Quarter Two 2004

Victoria Market - 12 Month Review

- Quarter Two 2004 take-up totalled 108,000 sq ft
- In the 12 months to end June 2004 take-up was 21% below average
- Availability has risen to 7.2% of stock, but still reflects a reasonably balanced market
- Three developments completing in the next 15 months will increase availability further.
- The consequences of the Lyons report, advocating the relocation of 20,000 civil service posts, and the Gershon report on efficiency savings will be significant for Victoria
- The most likely scenario will see the vacancy rate increasing to almost 14% and rents falling by 2007.

Take-up[1]
623,200 sq ft

Vacancy rate[2]
7.2%

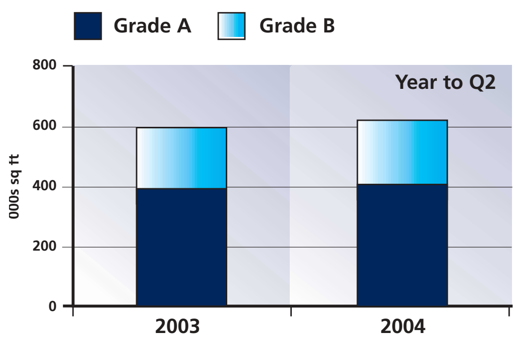
Spec Completions[1]
567,000 sq ft

1 Year to Q2 2004 2 Q2 2004

Take up

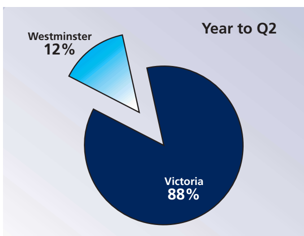
- Q2 take-up totalled 108,000 sq ft.
- Take-up has fallen below average in the last three quarters.
- Take-up in the last 12 months was similar to the previous year, as the government continued to hold back on acquisitions.

Take up by grade



- Almost 623,200 sq ft was let in the 12 months to Q2 2004, which is 3.6% up on the year to Q2 2003.
- There were no prelets during the last 12 months.
- 409,000 sq ft, or 66% of let space was of grade A quality and 50,700 sq ft was new.

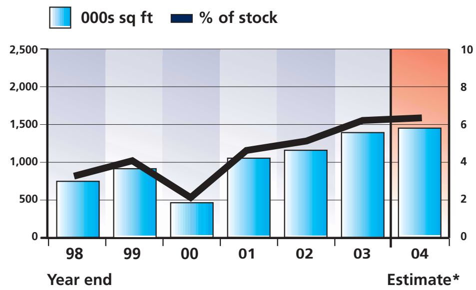
Take up by location



- 545,400, or 88%, of the space let was in the Victoria area, down 1.4% on a year earlier.
- 77,800 sq ft was let in Westminster, up 59.4% on the year to Q2 2003.

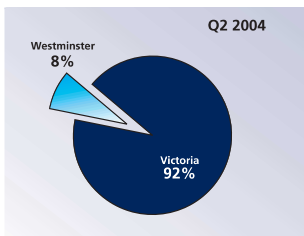
Supply

- The market is reasonably well balanced despite the sharp rise in supply this quarter due to the completion of Belgrave House, 76 Buckingham Palace Road.
- There is plenty of grade A space available.
- 92% of the space available is in Victoria.



- There was 1.7 million sq ft of available space at the end of June 2004, up 16.5% on March 2004.
- A vacancy rate of 7.2% of total stock is low compared with other London markets.
- Of the space available, 1.1 million sq ft or 65% is of grade A quality.
- There is 584,000 sq ft of grade B space, down 1.8% over the quarter.

Available space by location



- July 2005 will see a further 110,000 sq ft of government space released.

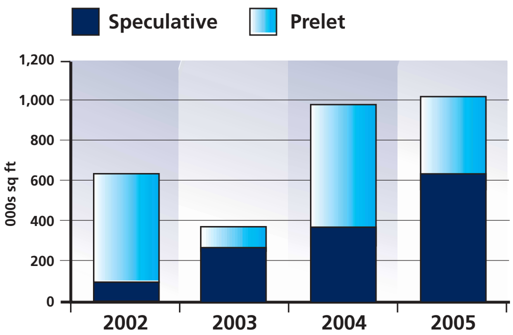
Supply pipeline

- 277,000 sq ft was completed in the second quarter, including the 272,188 sq ft redevelopment of Belgrave House.
- Completions were up 12.4% in the last 12 months.
- Prelets have declined significantly compared with 2002/3
- A big increase in completions is expected by the end of 2005

Expected completions

- There was 567,000 sq ft of speculative space completed in the 12 months to Q2 2004.
- A further 620,000 sq ft of speculative developments will complete by June 2005.
- At the end of Q2 2004, outstanding applications amounted to just 8,500 sq ft.
- In contrast, there is over one million sq ft in schemes with planning permission.

Expected completions



Construction pipeline

The development of three buildings known as Cardinal Place, Victoria Street will complete in 2005. This development has a combined size of 572,000 sq ft with Building 1 being 75,000 sq ft; Building 2: 385,000 sq ft and Building 3: 112,000 sq ft. These schemes are committed to, and have confirmed delivery dates.

Sites already with planning permission include 171 Victoria Street (220,000 sq ft), Romney House, 49-53 Marsham Street (170,000 sq ft), and the former Westminster Hospital, Dean Ryle Street (166,000 sq ft). It is likely that developers with outstanding consents will be closely monitoring letting activity on the schemes shortly to complete as well as the effect of proposed government relocations from Victoria. Romney House, with both an office and a residential consent, has just been sold for £32 million to a joint venture between Frogmore and Galliard Homes, who are to implement the residential consent. More reviews of consents for alternative and mixed-use schemes are expected to follow.

There is also a number of large schemes with potential, including the Victoria Interchange site on Wilton Road capable of providing 250,000 sq ft, controlled by London Transport and Howick Place Post Office where a potential 100,000 sq ft scheme could be sited. Selbourne House in Victoria Street and Elliott House on Breston Place are both occupied by government and if vacated, could produce 400,000 sq ft and 100,000 sq ft schemes respectively. Abel, Cleland and Horseferry House, totalling 363,000 sq ft, will be vacated in the next two years creating further opportunities.

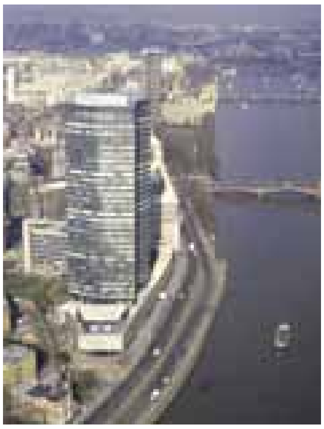
Rents and investment yields

At the end of Q2 2004, prime headline rents in Victoria were £42.50 per sq ft to £45 per sq ft. This excludes any rent-free period. Rents in excess of £50 per sq ft are being mooted for new developments. For a ten-year unbroken term to a quality covenant, rent-frees of between nine and 12 months are frequently seen.

Prime yields are 5.75%, however, this can alter depending on the covenant strength and the specific lease. In Victoria, there are a number of long leases to government departments (such as 151 Buckingham Palace Road) with fixed increases which are viewed as 'bond-style' investments and lower yields have been paid for this type of investment.

Speculative developments under construction

Address	Completion date	sq ft	sq ft gain
172 Buckingham Palace Road	3/2005	47,996	–
Cardinal Place Scheme	6/2005	572,000	155,797
Total		619,996	155,797



Victoria Market - Past Trends, Future Expectations

Lease expiries in 2004 and 2005

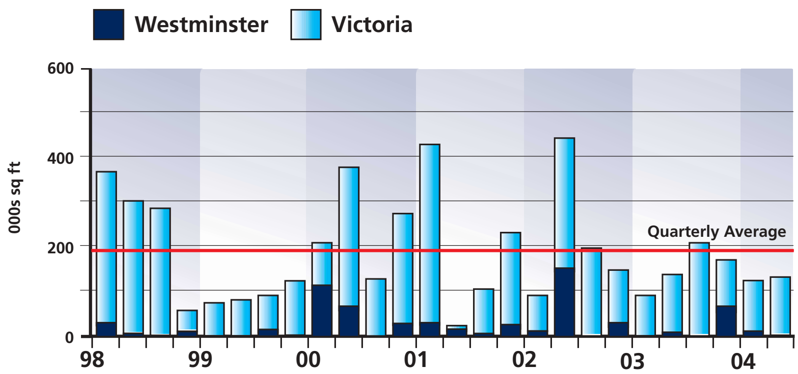
Lease expiries are expected to total 940,191 sq ft in 2004/05. Non-government lease expiries/breaks will total 663,740 sq ft.

Of this, some 254,612 sq ft (38.4%) is not expected to be renewed, according to the tenants.

The following four scenarios consider various patterns of government relocation from the area and all have these basic assumptions:

- The government is seeking to relocate 20,000 civil servants out of London and the south east occupying over three million sq ft.
- The government occupies 6.9 million sq ft (leasehold) and 1.2 million sq ft (freehold) in Victoria.
- The government will vacate buildings as leases expire and will action all break clauses.
- The government will not lease any new space, utilising spare capacity in its portfolio where necessary to maintain local service delivery.
- Over the last five years 32% of lettings have been to government or to government-related agencies. Therefore the average annual amount of space let would fall to 532,000 sq ft from 785,000 sq ft.

Average take-up



- Second-hand space will come onto the market as a result of lease expiries/breaks. This will include all government leases and 38.4% of non-government leases (based on expected/stated intentions from tenants with lease expiries in 2004/05).
- A vacancy rate below 5% would trigger new development.
- To allow for 'hidden availability' – (that space that is pre-let or re-let without being recorded as available at a quarter end), we have removed pre-lets from the projections. We estimate that remaining hidden availability may push up availability forecast by between 0.5% points and 2% points.

Projected Availability Scenarios

Scenario 0:

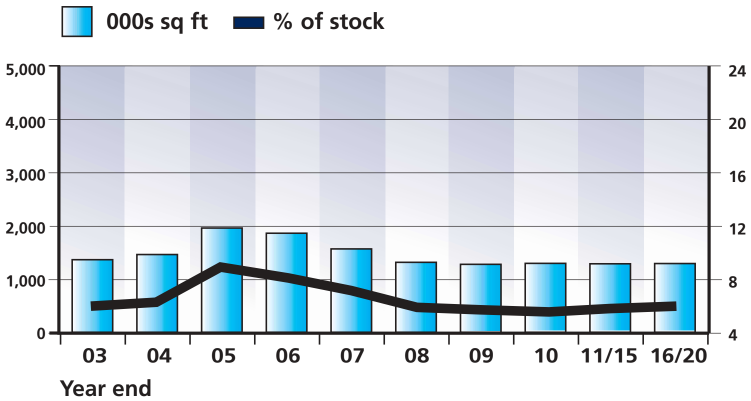
No government relocation (includes existing commitments to lease exits):

If the government does not implement Lyons, and remains the predominant occupier in the area, continuing to lease new space at its average rate per year, the impact on available space would appear as in the chart alongside.

The vacancy rate would rise to 8.5% by the end of 2005 as Cardinal Place comes on stream. It would then fall sharply over the next five years, unless new developments added to the stock available. In a stable market such as this, any potential undersupply would be filled by new developments. As a result we have assumed that new completions would maintain the vacancy rate at circa 5.5% after 2006, implying an average of 445,000 sq ft completions per annum (compared to the average of 398,531 per annum between 1998 and 2003).

Consequences for the market: The market in Victoria would become very active, as developers deliver accomodation that would be required to keep pace with demand. With a large number of obsolete 1960s and 1970s buildings in Victoria, there is no shortage of re-development opportunities. Rents are likely to rise and pre-lets become essential for many large deals.

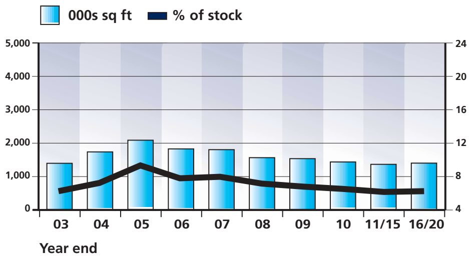
Scenario 0: Projected available space and vacancy rate



Scenario 1:

Passive Withdrawal: No leases renewed, but no buy-out or sub-letting of leases before break or end of term.

Scenario 1 Projected available space and vacancy rate.



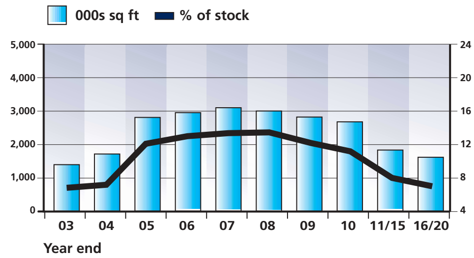
The result of these assumptions sees the vacancy rate pushed up to 9.5% by the end of 2005, mainly due to the Cardinal Place scheme coming to the market, the Cleland/Abel/ Horseferry buildings being made available and a number of government leases expiring. The vacancy rate then declines over the remainder of the period.

Consequences for the market: Little significant threat, as government withdrawal is slow. However, the market will need to absorb the extra space available in the absence of demand from its largest tenant – the government.

Scenario 2:

Lyons fulfilled: With assumptions as Scenario 1, plus the government buys out or sub-lets 25%, or just over two million sq ft of leaseholds. It is assumed that the government will exit leases that have the fewest years to run from 2007 and that the exit period happens over 2005-2010.

Scenario 2 Projected available space and vacancy rate.



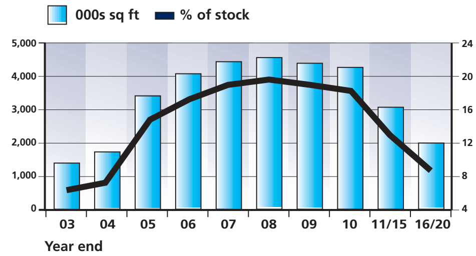
If the government exits 25% of its leases the vacancy rate rises to 13.6% by 2007. It will then slowly decline, but even by 2010 it will still be over 11%. Over the next ten years it will fall further, ending 2020 at around 7%.

Consequences for the market: Significant rise in available space will push rents down and lead to a number of change-of-use proposals to residential or hotel use for developments across Victoria. Some occupier demand may transfer from other London markets, attracted by the large size of buildings and rental levels.

Scenario 3:

Lyons plus Gershon: Assumptions as Scenario 1, plus the government exits 50%, or just over four million sq ft of leaseholds. It is assumed that the government exits leases that have the fewest years to run from 2008 and the exit period covers 2005-2010.

Scenario 3 Projected available space and vacancy rate.



Exiting 50% of its leases would result in a 20% vacancy rate by 2008, falling to 18.7% by 2010. By the end of 2020 the vacancy rate would still be above 8%.

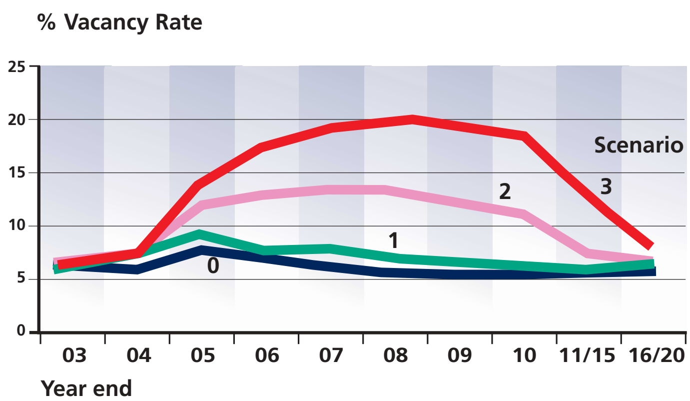
Consequences for the market: A major rise in availability that will have significant effects on all aspects of the Victoria market. With other London areas suffering a withdrawal of government occupation as well, it is unlikely that there will be demand from other parts of London at or near existing rental levels. Rents would fall significantly until the vacancy rate returns to more historically 'normal' levels.

Scenario Comparison

The following chart summarises the impact on the area's vacancy rate under the above scenarios.

The "No Relocation" scenario leaves Victoria as a market that will require above average rates of completions to ensure that demand is met. With the government's high-level commitment to relocation and the loss of government posts, this scenario is very unlikely to happen. With Scenario 1, the "Passive Withdrawal" scenario, the non-renewal of expiring leases by the government will reduce the scope for redevelopment, but should have little effect on vacancy rates as the market absorbs the vacant space. This scenario could occur if the treasury baulked at the short-term cost of relocation, or was unable to satisfactorily negotiate its way out of leases.

The "Lyons fulfilled" scenario, will leave the Victoria market with an excess of space rising to over 13% of stock and falling rents. How the government deals with its early exit from leases has not been clarified. Freeholds are likely to be sold first. Buying out from leases will be expensive with little motivation on the landlords' part to release the government without significant compensation. Even sub-letting will be problematic and costly with such large blocks of space released on the market in quick succession. The government is unlikely to achieve rents equal to its existing commitments and would suffer long void periods. Relocation will be expensive in the short to medium term. To achieve the acceptable re-negotiation of numerous leases over a seven-year period will require significant staff and financial resources from the government.



The Gershon report requires a further reduction in government jobs and the "Lyons plus Gershon" scenario gives an indication of the potential damage to the Victoria market, and to the problems that will face the government in trying to reduce its costs in London.

Alternative Uses

If the recommendations contained in the Lyons review are fully implemented over three million sq ft of office space, or more than 13% of the stock, would become empty in the Victoria area leaving the market significantly over-supplied and resulting in falling rentals and rising yields.

Relocation activity on this scale would be phased over several years, but even this is unlikely to give the market adequate time to adjust.

With large amounts of office space to be vacated, options include conversion to residential or mixed use schemes, which would be well received by Westminster Council. In its Unitary Development Plan (UDP), and endorsed in the new draft, the council places housing at the top of its agenda and encourages mixed use development.

Where proposed commercial development results in an increase of office space in excess of 2,150 sq ft, the UDP stipulates that there should be a pro-rata increase in residential space. The residential element can be developed off-site provided it had previously been in business use. The UDP also proposes that outside the Central Activities Zone (CAZ), commercial space can only be converted to residential.

Recent examples include:

- Cardinal Place where off-site housing will be provided at Neville House, Page Street, SW1P
- Belgrave House where 36 units were provided

Clearly planning approval for residential development or conversion might reasonably be assured in all but extreme cases. Westminster proposes a requirement for 30% of affordable housing against the Mayor's 50% (London Plan). This must be tempered with the council's requirement in the Strategic Planning Guidance to retain small offices "where they contribute to the character and function of the area (CAZ)".

The Opportunity

Not all of the three million sq ft will convert to residential but, assuming a balanced market implies a 5% vacancy rate this still leaves some 1.9 million sq ft that could be developed, possibly all of which lies within the Central Activities Zone. As we point out in Scenario 2 some occupier demand may transfer from other parts of London attracted by the large size of buildings and rental levels, but this will only partly solve the problem.

The bottom line is that occupier demand post Lyons will not support the level of stock currently in Victoria and maintain the integrity of rental and yield levels. The problem is exacerbated if the recommendations in the Gershon Report are also implemented.

This potential dilemma could, however, be turned into an opportunity for the government, Mayor, Westminster Council and landowners, working together, to draw up a new blueprint for inner city regeneration, including:

- Setting high standards for urban space to enhance the quality of life for residents, workers and visitors to the area.
- Redefining the Central Activities Zone.
- Increasing and/or bringing forward the residential targets.
- Changing the building use profile within the Central Activities Zone to reflect the new occupier demand structure. In particular the reduction of office space and an increase in residential, leisure and retail.

If the opportunity is grasped then Victoria will survive the relocation of government office workers replacing it with a model for urban regeneration which could be copied by other inner cities.

Lyons report summary

Summary of the Lyons report and consequences for Victoria…

The final report by Sir Michael Lyons was accepted by Gordon Brown in his March 2004 budget statement and will lead to:

- Relocation out of London and the south east of nearly 20,000 civil service and government agency posts.
- The loss of over 7,000 posts as part of the, as then unpublished, Gershon Efficiency Review
- Total reduction around 11% of current establishment
- Main departments to see a fall are: DWP (4,200 posts); MoD (3,900); Chancellor's Deptartments (3,000) and the Home Office (2,300).

The reduction in space requirements in London and the south east is estimated to be three million sq ft at 150 sq ft per post, with some 2.2 million sq ft to go in Victoria over the next seven years.

This scale of reduction – an average of 330,000 sq ft per annum is significant and if achieved, will increase vacancy rates to 13% as described in Scenario 2 opposite.

Gershon Report

The Gershon report recommends a 70,600 reduction in the number of public sector jobs UK-wide in addition to the relocations recommended by Lyons This will have further damaging consequences for Victoria, and Scenario 3 provides an insight to the potential for vacancy rates to reach 20%.

Neighbourhoods

The greater Victoria area defined for this report (please see map) can be split into two distinct neighbourhoods: Victoria and Westminster/Whitehall.

Victoria - Centred on Victoria Station, this area has a mixture of 1960s in-fill with a number of smaller period buildings such as those found on Grosvenor Gardens. There has been little new development until recently and perhaps the most notable example is the award-winning 40 Grosvenor Place.

Although seen by many as the home for civil servants, there are a number of large corporates located in the area, such as PA Consulting, Channel 4, John Lewis, Amex, Korn Ferry, Yahoo! and London Electricity.

Whilst much of the 1960s stock has been recycled, the remainder is largely obsolete and redevelopment is probably the only viable option. This is demonstrated by the redevelopment of the former Esso and Glen Houses by Land Securities, fronting Victoria Street and Palace Street known as Cardinal Place, and the former BP offices at 123 Buckingham Palace Road by the Grosvenor Estate in a joint venture with JER Roberts.

Westminster/Whitehall - Government departments and agencies dominate Westminster, along with a few institutions such as RICS, Church Commissioners and lobbying bodies. There is a wide mixture of buildings including the new Marsham Street development for the Home Office. The main government ministries and departments including Downing Street are located in Whitehall. The building stock tends to be institutional and in large blocks from the Treasury Building at the southern end of Parliament Street all the way through to Admiralty Arch at Trafalgar Square.

Victoria Area

Definitions

Victoria is defined in this report as SW1 excluding SW1A (outside Whitehall) and SW1Y. See map opposite. 'Government' includes all central government and directly funded organisations.

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