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Royal Docks Enterprise Zone Market Demand

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Prepared on behalf of
Department of Communities & Local Government

14 July 2014

DTZ, a UGL company

Contents

1 Executive Summary

DTZ have been instructed to provide a review of the Royal Docks Enterprise Zone and report on the position and attractiveness against a back drop of UK, South East England and Fringe London market demand. The report provides a summary of UK and South East office market supply and demand and focuses on the potential take up analysis of the Enterprise Zone using the proposed development pipeline quantum as a basis for constructing and indicative take up profile for the area.

Overall, Newham is not currently an established commercial location and existing take up figures in do not reflect the quantum of B1 space in the development pipeline of circa 10 million (m) square feet (sq ft), equivalent to circa 900,000 square meters (sq m) having only achieved a 5 year average annual take up of 50,000 sq ft (4,600 sq m) of B1 space. Therefore, the take up profile applied to the proposed pipeline assumes the investment and regeneration in the area repositions the Royal Docks in the minds and actions of the occupier market in order that it can compete with pipeline development in Stratford totalling circa 4.0m sq ft (370,000 sq m) at the International Quarter and Westfield Stratford and other locations within the South East.

DTZ has modelled the average take up for the whole of the Enterprise Zone including office, retail and 'brand pavilion' space over a 14 year period at 0.5m sq ft (46,000 sq m) per annum. The take up profile for the office space only has been modelled at 0.33m sq ft (30,000 sq m) per annum over 13 years. This includes both start-up and SME space as well as larger scale HQ commercial office space.

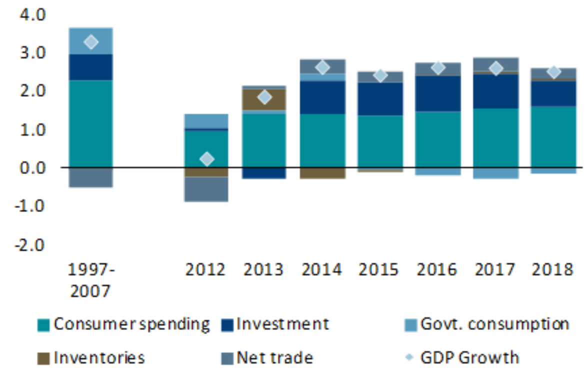
Given the significant number of variables involved, the scenario mapped out is highly unlikely to exactly match what comes forward but is a considered view based on the need to balance typical take up rates and wider demand in London/ South East with the purpose and drive of the Enterprise Area, namely to help create and foster a substantial increase in demand through public sector intervention and 'pump priming'.

This will be capital intensive development over a reasonable period of time where value will be generated in the medium to long term as opposed to more traditional development with a 2-5 year business model in established locations. Therefore, the successful development of the sites in the suggested time period, in such an unestablished location for offices, requires partnership with developers who are focused on the creation of 'long term' value as opposed to a trader developer model where full returns need to be achieved in the short term.

2 UK Economic Overview

The recovery of the UK economy is much stronger than initially predicted, with GDP growth for 2013 and 2014 revised up to 1.9% and 2.6%, respectively. Growth has been underpinned by robust consumer spending and housing activity, offsetting weaker investment and exports. However, the recovery is expected to broaden out and become more balanced, with both investment and trade making positive contributions to GDP (Figure 1). Numerous business surveys have reported increased confidence and investment intentions. Businesses also report improved export demand as the recovery in advanced economies has strengthened. World trade is forecast to accelerate markedly over the next couple of years. Consequently, UK GDP growth is expected to increase by 2.7% per year over the medium term, faster than the long term average and better than most other European countries.

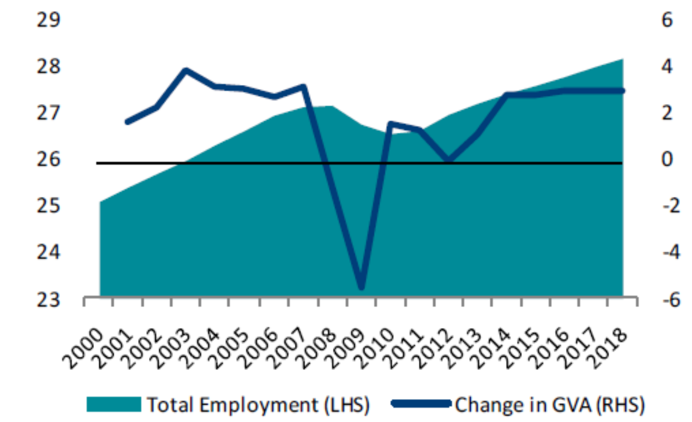
Figure 1 – UK GDP Growth and Components (% pa)



Source: Oxford Economics

The recovery is also finally spreading out from London and South East to the rest of the UK. Recent consumer and business surveys report that all UK regions are registering increased confidence and activity. Economic output (GVA) outside London is expected to have increased by over 1% in 2013 and is forecast to accelerate rapidly to 2.8% in 2014 (Figure 2). Thereafter, growth is expected to strengthen to about 3% per year. Similarly, employment outside London is expected to have increased by about a quarter of a million in 2013, and is back to 2008 levels. Moreover, employment is forecast to increase by nearly 400,000 over this year and next. Employment gains will continue to be underpinned by the expansion of the service sector, notably business services and TMT (Technology, media & telecoms). This will offset the ongoing contraction in public sector employment.

Figure 2 – Output Growth (%) and Employment Outside London (m)



Source: Oxford Economics

Despite the stronger than expected recovery and upgraded forecasts, current market sentiment is that the Bank of England (BOE) is unlikely to increase the official Bank Rate until later in 2014 or early 2015. This is despite the expectation of the ILO unemployment rate hitting 7%, the threshold at which the BOE will consider rate increases, in early 2014. The BOE has made it clear that it does not want to tighten monetary policy prematurely. Indeed, it has been mooted that the BOE will probably lower its ILO unemployment target to 6.5% in the near future. Inflation is also falling and is expected to plateau at less than 2% over the medium term. Nevertheless, 10 year government bond rates are steadily rising in expectation of the eventual unwinding of Quantitative Easing (QE) and tighter monetary policy.

3 UK Office Occupier Overview

The improving economic situation is underpinning rising occupier demand. There has been a marked pick-up in regional take-up in recent months, which is forecast to be maintained in 2014. Surveys suggest that many businesses are now phasing from 'consolidation' to 'growth', which has led to an increase in demand for additional space, especially for larger Grade A lettings. Furthermore, some occupier markets are entering a more active phase in line with 2014-17 lease events, which should support a progressive increase in aggregate take-up. Demand is likely to be driven by professional and business services, notably the TMT sector. Consequently, landlords will increasingly need to provide flexible space on flexible terms in order to satisfy TMT growth requirements. Over the medium term, however, we expect take-up to plateau because of pre letting and limited new supply. The changing London skyline reflects the current high level of development activity. However, take-up of grade A space has been more than adequate to absorb this level of development. Grade A space has fallen by nearly 20% over the past year. Furthermore, of the 7.5m sq ft scheduled for completion in 2014, 2.7m sq ft is already taken up. 2015 speculative completions, including probable schemes not yet started, total a much reduced 4.5m sq ft, of which only 3.4m sq ft is available. The biggest increase in new supply will be concentrated in the City. However, the volume of grade A availability will not increase significantly due to the continued pre-leasing of upcoming development completions. Of the 4.5m sq ft currently under construction for completion in 2014, 1.9m sq ft has already been let or placed under offer prior to completion.

There has been a dearth of new regional development projects, resulting in historically low levels of committed development completions in recent years. However, increased confidence in the outlook for regional markets and the growing shortage of Grade A space is encouraging investors to acquire assets for development and refurbishment. Development is seen as a way to access large prime property assets, which provide good returns, that otherwise would not be available. Also an increasing proportion of stock will become obsolete in respect of environmental regulation and institutional best practice. This will create opportunities for developers and landlords. Committed and probable regional development for 2014- 2017 totals 4.6m sq ft. Nevertheless, financing of new developments is likely to remain challenging and pre-lets will be a prerequisite in many cases.

Availability across the UK regions fell over 2013 and this trend is forecast to continue over the short and medium term, in line with the increase in take-up. Tenant default is now very much reduced and new development completions and refurbishments have been very subdued. Consequently, regional markets remain polarised, with limited Grade A availability. We estimate that there is only 1.6 years of Grade A supply at current take-up rates, compared with 2.9 years of Grade B. Going forward, Grade A availability is likely to fall as new lettings continue and limited new stock is delivered to replace the space absorbed. In contrast to the regions, availability in London has risen over the last year, thanks to the delivery of new space. But continuing strong demand means that availability is expected to erode in 2014 and 2015.

For all markets, increased occupier demand coupled with the subdued level of new development and refurbishments means that the demand and supply balance at the prime end of the market is set to tighten. London will see the strongest growth in rents over the next few years. Similarly, prime headline rents in most cities are forecast to see a marked rebound. Rental growth in Edinburgh, Leeds and Manchester will be underpinned by the quantum of lease events coming up. Incentives are also likely to erode in markets such as Birmingham. Higher rents will create cost challenges for occupiers, although this will be partly offset by lower general inflation. In addition, rental prospects for non-prime space are likely to be subdued due to the high level of second hand space available. This will help support the expansion of small and medium sized enterprises which typically take up non-prime office space.

4 East Fringe London & Newham Supply & Demand

Fringe London markets remain the biggest beneficiaries of the recovery in leasing activity in the capital since the downturn in 2008. In the South East fringe, take-up totalled 0.43m sq ft in Q1, compared to only 0.1m sq ft in the same period last year. The supply of floor space increased slightly in the first quarter, from 1.5m sq ft to 1.6m sq ft. This is owing to 0.17m sq ft of second hand space becoming available at Bankside, SE1. The volume of grade A space, however, remained broadly unchanged at around 1m sq ft. As an undersupply becomes increasingly apparent across the core markets, increased competition for good quality space is expected to place upward pressure on demand in the emerging markets.

The Docklands market in particular has improved; Q1 2014 take-up reached just over 0.4m sq ft, the highest quarterly total since Q4 2010. This led to a 26% fall in available supply from 1.6m sq ft at the end of 2013 to 1.2m sq ft at the end of Q1 2014. New or newly refurbished availability in the Docklands is at the lowest level recorded since Q4 2008. The 5 year average annual take up in Docklands is 0.8m sq ft and the majority of this period has seen demand limited by the severe recession.

4.1 NEWHAM LOCAL MARKET

Historically, Newham has been an area dominated by industrial uses, however this is beginning to change given the huge investment in the Olympic Park site in Stratford which has triggered investment in to the regeneration of Canning Town and the Royal Docks and a step change in infrastructure provision within the Borough.

Average office take up in Newham over the last 5 years has been 50,000 sq ft per annum and rose to circa 80,000 sq ft per annum in 2013. This is exceptionally low when considering the volume of office space that is set to enter the market in the next 10-20 years which reflects the level of current and forecast investment and regeneration expected in Newham. Table 1 illustrates the indicative volume of B1 space in the Newham pipeline not included in the subject Enterprise Zone and the type and likely rent where the information has been released. The table does not include the 4.3m sq ft of commercial office space proposed within the Royal Docks EZ which increases the development pipeline to 10.8m.

By far the largest office led development (existing or under construction) east of Canary Wharf, is the International Quarter (Lend Lease and London & Continental Railways JV), located adjacent to Stratford Station and Westfield Stratford. The development is in the early phases of construction and the first phase of commercial office space is not expected until 2017. The development proposes 4.0m sq ft of commercial office space with residential, hotel and ancillary retail space. There have been two office pre-lets secured to date including the Financial Conduct Authority who will relocate 450,000 sq ft from Canary Wharf and Transport for London who committed to the development over Canary Wharf with a pre let of 250,000 sq ft. Another large occupier that could potentially relocate from Canary Wharf is Thomson Reuters. The company has a 700,000 sq ft requirement and is believed to also be considering the International Quarter in Stratford, as well as options at Wood Wharf in Docklands, which has permission to be redeveloped.

Table 1 – Major Business Space Development Pipeline (excluding subject Royal Dock EZ sites)

Scheme	Proposed Business Space (B1a,B1b,B1c) (sq ft)	Type of Space	Indicative Asking Rent per sq ft
International Quarter, Stratford	4,000,000 (370,000 sq m)	Grade A Commercial office	£35
Westfield Stratford, Stratford	1,000,000 (93,000 sq m)	Grade A Commercial office	£35
Here East, Olympic Park, Stratford	450,000 (42,000 sq m)	Technology & Media Office/Studio (refurb)	£32
Royal Wharf, Silvertown	150,000 (14,000 sq m)	TBC	TBC
Thames Rd Industrial Estate, Silvertown	200,000 (18,500 sq m)	TBC	TBC
Canning Town Regeneration Project	350,000 (32,500 sq m)	TBC	TBC
Sugar house, Stratford	350,000 (32,500 sq m)	TBC	TBC
Total	**6,500,000 (600,000 sq m)**		

Primary factors in both pre lets at the International Quarter are likely to have been cheaper rent (and overall occupation costs) than Canary Wharf and strong transport links (Crossrail arriving in 2017) as well as the customisation advantages of a pre-let deal. Major occupiers (the sort which are required to fill significant long term office provision) of office space have exacting requirements when looking for new office space in unestablished locations. Requirements would typically include:

- Good accessibility to transport hubs
- High quality environment
- A strong pool of similar industry/sector occupiers nearby
- New and efficient office space
- Cheaper occupation costs than core locations
- Both traditional commercial as well as creative SME work space

5 Enterprise Zone Site Dynamics

The Enterprise Zone is comprised of 5 main sites:

- Royal Albert Docks
- Silvertown Quays
- Great Eastern Quays
- Gallions Quarter
- Gallion Park

The area is part of London Docklands – the Royal Docks themselves effectively ceased operation in the early 1980's (more centrally located docks closed earlier) and the area was then made available for redevelopment by the London Docklands Development Corporation. Access was enhanced via the opening of a spur to the Docklands Light Railway (DLR) in the mid 1990's (Gallions Reach Station) and by road infrastructure improvements.

This section focuses on analysing the demand profile of the commercial elements of the development schemes, particularly the business space elements and applying an annual take up figure for the proposed pipeline of development assuming a significant increase in demand can be achieved from the investment in the area.

5.1 ROYAL ALBERT DOCK

The site is 38.5 acres in total and is located between Royal Albert Way and the Royal Albert Dock. To the east is land proposed for an extension of the University of East London and to west is the Regatta Centre, a hotel, vacant sites and the land bridge linking the dockside and West Beckton. The site has extensive dockside to its southern edge and wraps around the existing building of 1000 Dockside and extends beyond to the west. The site slopes gently from north to south and vehicular access is from a ramp leading off of the elevated Royal Albert Way, over Beckton Park DLR station, and from the western edge of the site via existing highways at Dockside Road and Royal Albert roundabout. There is currently no pedestrian access to the site.

Chinese developer ABP have submitted a hybrid planning application for a business-led mixed use development comprising of circa 3m sq ft (280,000 sq m) of business space (B1), 0.18m sq ft (167,000 sq m) of retail (A1-A5) as well as D1, D2 uses and around 800 residential units.

The developer plans to create a third London business district, primarily targeting Chinese businesses with ambitions for European Headquarters. The demand from Chinese business cannot be measured although the high volume of Chinese investment over the last 24 months in to London gives an indication as to potential demand and there is significant interest from Chinese firms according ABP. Recent news that China is to invest up to £18bn in UK infrastructure also strengthens the justification for the large quantum of office space proposed.

Demand from UK based businesses is likely to seed from existing inner and outer London larger commercial occupiers who consider the location to add value to their business. In particular, businesses currently located at Canary Wharf who are looking to reduce occupation costs but still be well connected to Central London could be typical target occupiers. Alternatively, it may be possible to attract businesses located east of London who are looking to invest in a London business location if they can be persuaded of the uplift in value of the location to their business.

Office occupiers typically prefer to be located close to businesses of a similar type and sector and therefore the Chinese influence over the development may restrict the demand of UK based companies depending on unknown information on volume of initial take up from Chinese occupiers. The competition to the development from both Silvertown Quays as well as the International Quarter at the Olympic Park offers alternative options to prospective occupiers which will impact on both aggregate demand for the development as well as the profile of occupiers that the development could attract.

The proximity of the site to City airport provides a strong competitive advantage for attracting international market facing businesses. Rail links are not currently as comprehensive as Stratford as the DLR is the primary mode of access. The arrival of the Custom House Crossrail station will improve the sites access considerably and have a significant impact upon the demand and take up that the business park is likely to achieve.

The build out rate of the development is not representative of the existing or historic take up rates in Newham as the development is the first of its kind for the area (not including the IQ which is under construction). The development has a particularly aggressive first phase quantum of business space and the extent to which the space will be constructed speculatively vs pre-let is currently unknown. The specific nature of the Chinese market focus distorts the potential take up profile of the scheme and doesn't allow for simple comparison with other major office led mixed use schemes. In addition, the 'place-making' element of the development effectively creates a new local office market, similar in creation to Canary Wharf.

An office district of this quantum and untested location must provide a relatively large quantum of office space in the first phase in order create the initial stages of a new district and is unable to build out at lower rates should pre-let commitment be limited.

5.2 SILVERTOWN QUAYS

The site is 50 acres and occupies a waterside location on the south side of the Royal Victoria Dock opposite the ExCeL Centre. The development will comprise of circa 1.8m sq ft of 'brand pavilions' where brands can showcase their latest products and interact with customers in a new and innovative way as well as circa 1m sq ft (93,000 sq m) of commercial office space and 0.28m sq ft (26,000 sq m) of incubator flexible workspace for technology and media SME's. Other uses include residential (circa 1,500 units), restaurants and leisure facilities.

It is likely that the development will 'feed off' the regenerational benefit and office market exposure of the ABP development and will certainly become more attractive to all types of occupiers once the Custom House Crossrail station is established. The new Crossrail station will offer express services to the City (10 mins) and the West End (17 mins) and allow the site to operate as a genuine office and leisure/retail destination.

Whereas the ABP site has a pre-determined target occupier market, the office commercial office space will be in direct competition with the International Quarter for businesses seeking improved value from their office premises within an innovative and sustainable working environment.

However, the commercial office space has the potential feed off the incubator/start up space at the scheme. The incubator space is a rapidly growing market in London and the former flour mill (Millennium Mills) may provide the right combination of affordability, accessibility and creative environment to attract occupiers. Start up and SME's are very sensitive to locational aspects of office premises and prefer opportunities for collaboration and skill sharing with other entrepreneurial SME's. Co-location of start-ups and the creativity of an innovative environment is key in seeding a thriving start-up and SME community. The indicative quantum of space dedicated to start-up in the Millennium Mills scheme offers an opportunity to create an entrepreneurial hub for technology and media.

In addition, occupiers could benefit from the ability to locate leisure, retail and residential facilities close by, catering for the growing population of technology start ups who look to maximise efficiency with regards to their time and lifestyle, offering the ability for workers to live at the development and provide a full range of services. The commercial office space projected to be delivered in the second phase offers the opportunity for larger, more established technology companies to locate on site, enabling them to scout for talent and promising start-ups while the more immature companies benefit from the potential collaboration and funding established companies can offer.

Competition for such space in Newham currently exists at Here East, the former broadcast centre for the Olympic Games located on the Olympic Park. However, the building offers only relatively large units on a flexible but traditional style lease – i.e. there is no serviced office offer.

The ‘brand pavilion’ is an untested concept and therefore the demand and take-up profile is particularly opaque and difficult to predict. The take- up rate has therefore been applied at a conservative level, notwithstanding the significant quantum of space proposed for the first stage of development. It is likely the concept will seek a pre-determined level of pre-let commitment from the market before construction commences.

5.3 GALLIONS QUARTER

The site is 8.3 acres located adjacent to Gallions Reach DLR station is a residential led mixed use scheme of circa 800 units. The primary transport node of the development will be Gallions reach and therefore the commercial element of the scheme must serve the majority of the retail needs of the development as the localised area is not subject to residential focused infrastructure and services.

The site must also consider the Great Eastern Quays (GEQ) site in terms of the commercial offer and is better suited to retail rather than employment and business space uses which will be located at GEQ. The intention is that GEQ will be served in the main by the Gallions Quarter retail offer and the natural route to take to the development from the DLR will be along the parade of shops that span Atlantis Avenue and fronting Royal Docks Road.

The retail strategy for the Gallions Quarter will involve attracting a strong anchor occupier, namely a convenience foodstore (circa 5,000 sq ft (465 sq m)) close to the DLR station to create footfall and demand for further 4,000 sq ft (470 sq m) of retail units in the first phase and around 20,000 sq ft (1,850 sq m) in the second phase of development. Occupiers in the target range could include a Chemist, News Agent, Deli, Mobile Phone retailer, Independent or small-chain Bakery, Kitchen or Bathroom designer, lawyer, Accountant, Estate agent and cafe/pub which may serve as a secondary anchor.

Given the quantum of residential units being developed both at Gallions Quarter and GEQ, there is likely to be adequate demand for the retail space being proposed, particularly if a convenience foodstore anchor can be secured.

5.4 GEQ

The site at Great Eastern Quays (GEQ) extends to just over 15 acres and proposes a residential led mixed use development of around residential 800 units with circa 40,000 sq ft (3,700 sq m) of employment space and 15,000 sq ft (1,400 sq m) of ancillary retail.

As discussed in section 4.3 above, the retail offer will consider the Gallions Quarter and the residential units will provide adequate demand for the quantum of retail proposed.

Given the location, transport links and the quantum of business space planned in the rest of the EZ, the employment element of the development poses a higher risk to the developer in terms of demand and take-up. In light of a commercial strategy review by Savills, the scheme has been designed to be flexible to a wide range of employment uses including offices, light (clean) industrial/workshop and ‘hybrid Hi-Tech uses’ with smaller units provided for start-up companies. There is an opportunity to cater to the local, market and businesses based around the docks and the adjacent marina as well as possible ventures connected to University of East London (UEL).

The proposed differentiation and targeting of local businesses through flexible workspace maximises the likelihood of attracting occupiers and creating a new employment community in the area.

6 Enterprise Zone Take Up Profile

Assuming the ‘step change’ in demand can be achieved through investment and regeneration, the take up profile for the 5 sites within the zone has been modelled as illustrated in Figure 3. The graph includes all commercial, brand pavilion and retail space. The average take up over a 14 year period is circa 0.5m sq ft (46,000 sq m).

Figure 3 – Overall Enterprise Zone Take Up Profile

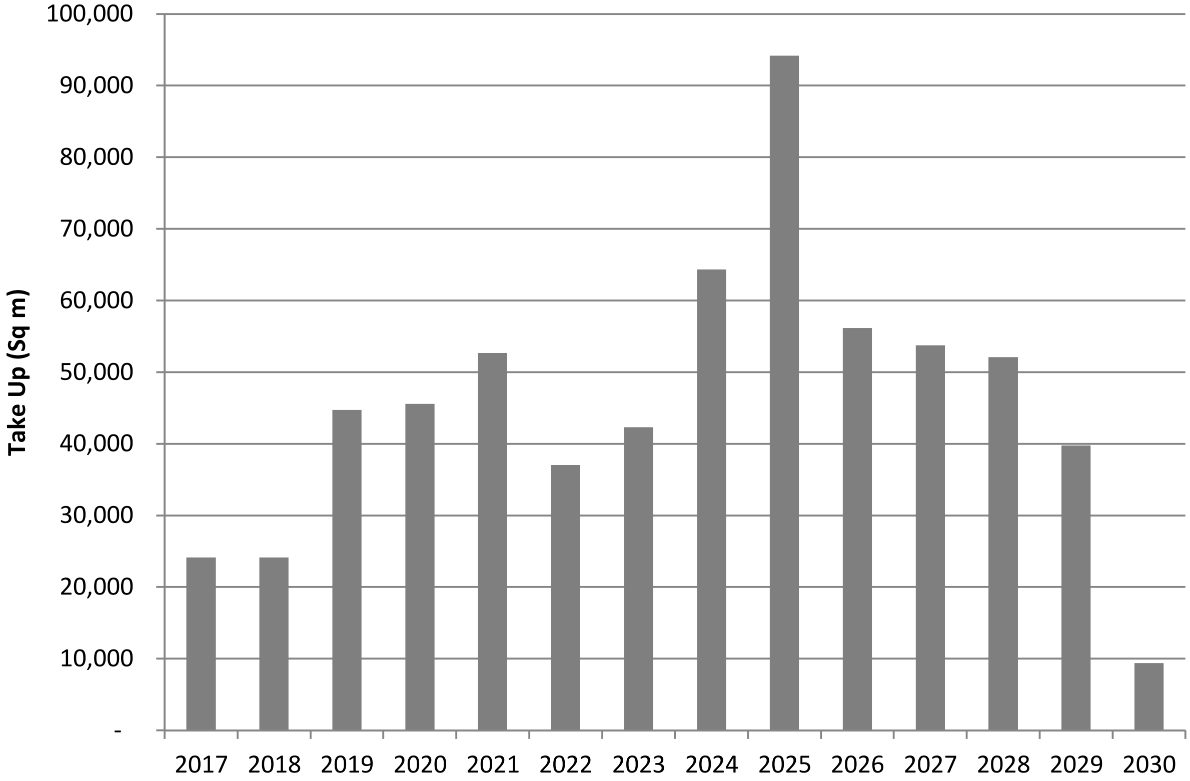
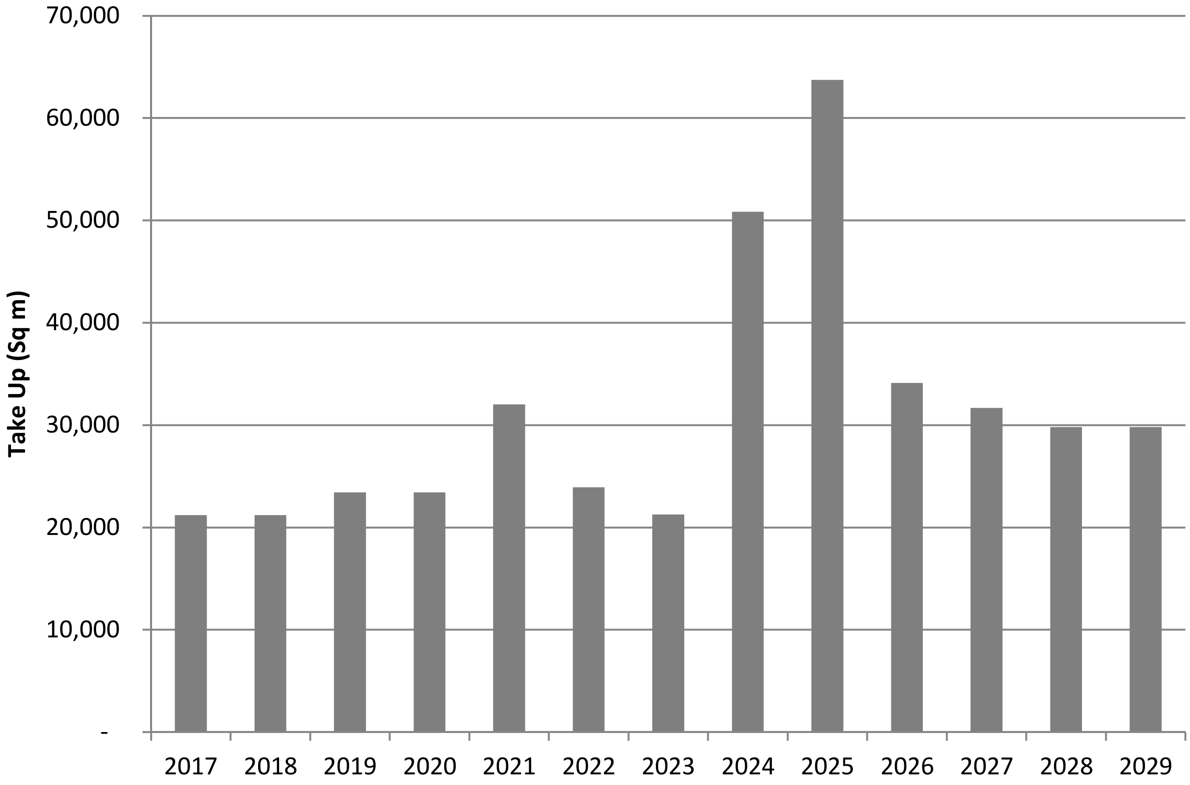


Figure 4 illustrates the take up profile for the commercial office space only with an average of 0.33m sq ft (31,000 sq m) over a 13 year period.

Figure 4 – Enterprise Zone Commercial Office Take Up Profile



These take up rates are based on a very aggressive development plan and business model. We have retained the stated phasing plan of the ABP development without alteration, which is a significant part of the overall take up assumptions. For the other sites, we have sought to take an approach where a critical mass of development is delivered relatively early.

7 Conclusion and Summary

As described earlier in Section 3.1, Newham as a Borough is an un-established commercial location and the successful development of the area in line with the timeline we have adopted is predicated on significant investment by developers (and the public sector) to create a step change in demand, perception and market dynamics in the area.

There is likely to be a wide range of outcomes for business space take up in the Enterprise Zone area based on the actions of a myriad of private developers with different strategies and drivers. The scenario mapped out is highly unlikely to exactly match what comes forward but is a considered view based on the need to balance typical take up rates and wider demand in London/ South East with the purpose and drive of the Enterprise Area, namely to help create and foster a substantial increase in demand through public sector intervention and 'pump priming'.

To this end, the timeline is dependent on the success of the two major schemes identified in the Zone:

- The ABP development on the Royal Docks site and its business model of facilitating the established of a European hub for Chinese and Far Eastern business. As well as standard property market risks, this is obviously tied into a number of exogenous risks such as the performance of the Chinese economy, the regulatory environment in the UK and the EU and the attractiveness of London as a business hub. We have phased this element over 18 years. If this scheme does not manage to secure significant 'buy in' from Chinese and Far Eastern businesses the project rates will be very difficult to achieve.

- Silvertown Quays business plan for Brand Pavilions is a very bespoke area on which we are able to obtain limited evidence in terms of occupier demand. The 1.8m sq ft (170,000 sq m)of space is significant for the 15 year phasing period that we have allowed but considering the need to create scale at an early stage (to get the critical mass required for a Brand Pavilion concept to work as a destination) we consider this to be the most reasonable estimate available to us.

Whilst the commercial development of Great Eastern Quays and Gallions Quarter is of a reasonable quantum, these are primarily residential led schemes and the commercial elements are unlikely to be the key drivers of value. Therefore, the bringing forward of these development should be considered in term of the residential demand in the area which is currently very strong (based on a developer pricing the commercial elements at an accordingly low rate to secure occupiers).

There is a significant risk in these figures of an oversupply from adjoining commercial/office locations which needs to be kept in consideration. There are major developments at Canary Wharf (circa 6.0m sq ft (560,000 sq m) at Wood Wharf and North Quay) and Stratford (International Quarter and Westfield Stratford) which will impact on the demand and take up rate in the Royal Docks.