Strutt & Parker/IPD Business Parks Index

A return to double-digit performance

Autumn 2014
Velocity, Brooklands, Weybridge
A new speculative development of two buildings totalling 106,400 sq ft by Rockspring Property Investment Managers Limited and Exton Estates.

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Introduction

Welcome to our annual Business Parks Index which tracks the performance of select UK business parks to enable us to benchmark the performance of the best parks versus the wider IPD universe, and understand the key drivers of return.

The Strutt & Parker Business Parks Index measures the performance of assets on a select sample of business parks from within the wider IPD sample. These parks have been identified to give investors an overview of how the best parks perform relative to the wider market. Typically they are characterised by the provision of good accessibility, amenities, car parking and site management.

The sample for 2013 consists of 129 assets across 51 parks, valued at £1.38 billion as at 31 December 2013.

In 2013 S&P Business Parks saw a return of 10%, driven by capital growth of 1.5%, a function of tightening yields, and an income return of 8.4%. The wider IPD sample outperformed at 11.5%, off the back of stronger capital growth. Similarly, superior capital growth led to IPD’s Standard Office sample (excluding Central and Inner London) mildly outperforming S&P Parks.

Monthly figures to end-June 2014, a smaller sample, suggest that performance is accelerating in 2014. The six-month total return of 10%, based on a 3.6% income return and 6.2% capital growth, suggests annualised returns of 20.9% for 2014.

Whilst a return to double-digit returns for the sector is a welcome move in the right direction, we should not lose sight of the fact that the sector has many challenges. Rental growth in 2013 on S&P Parks was flat and we cannot count on performance from yield compression over the longer-term. High yields against gilts and stable income suggest that the sector can achieve attractive return premiums. However, investors will need to bear in mind the attractive yield premium is no “free lunch.” Future requirements in terms of capital expenditure to maintain competitiveness, and perhaps, where parks are in multiple ownership, contributions to park-wide projects will need to be explicitly considered to truly understand the path of future returns.

I hope you find our research both informative and of genuine commercial use when considering this asset class, and would welcome your views on any of the subjects raised. If you would like to discuss the research and its implications in further detail, our research team would be delighted to hear from you.

Andy Martin
Senior Partner

1 All data in this report is sourced from IPD unless specifically sourced otherwise.
### Summary data

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* Excluding Central and Inner London
Headline performance

Total returns on S&P Business Parks came in at 10% in 2013, behind the wider IPD Business Parks sample and marginally down on the returns seen on IPD Standard Offices (excluding Central and Inner London). A positive yield impact of 3.3%, with only a marginal fall in rental value drove capital growth of 1.5%. Although it was strong income returns of 8.4% that really drove the performance. Equivalent yields now stand at 9.2%, having dropped circa 40bps since end-2012.

“Equivalent yields now stand at 9.2%, having dropped 40bps…”

In the ten years to end-2013, S&P Business Parks have out-performed both other segments – see Figure 2. Strong income returns being the main driver over this longer period, compensating for falling rental values and widening yields. The equivalent yield on the sample remains 345bps above its previous 2006 low of 5.8%.

“S&P Business Parks have outperformed both other segments over the medium and longer-term.”
Early indicators in 2014

This section provides performance data based on the IPD monthly sample of S&P Business Parks, which included 35 assets valued at £398 million at end-June 2014.

In the six months to end-June S&P Business Parks delivered a total return of 10%, or 20.9% on an annualised basis. A strong compression of yields in this sample from 8.8% to 8.4%, once again key to performance; although tentative green shoots of rental growth, at 1.9% over the six months, were seen. The wider IPD sample delivered marginally better returns of 10.3% in the period. This was, though, based on a larger yield impact, with the better rental growth numbers from the S&P sample suggesting that it may see more sustainable capital growth in the future.

Take-up in the South East office market was soft in the first half of 2014 – see Figure 4. Although a very strong end to 2013 played its role in this and the market is expected to see much higher activity in the latter half of the year. Our statistics for this region suggest that the out-of-town office market continues to attract occupiers despite the much trumpeted urbanisation of occupiers.

Of course, the South East office market is characterised by a lack of cities, with many of the larger towns not having sufficient large-scale office stock in-town to satisfy demand from major occupiers. Going forward we believe the parks that are not having to compete with large ‘cultural centres’, such as Edinburgh or Manchester, will continue to attract strong demand from occupiers, without a major rental discount. On the other hand, parks nearer major centres will need to be able to offer steep discounts to the in-town stock in order to persuade firms to keep their operations out-of-town. Those large-scale parks with either a strong existing amenity offer, or the wherewithal to improve it, will be able to compete more effectively with in-town markets – negating in some cases the need to compete too aggressively on cost.
Business parks are an important sector within the office property universe. Performance has been poor for some time, and levels of investment have fluctuated strongly – a function of both uncertainty regarding the sector and its small size contributing to a relatively illiquid investment market. Figure 5 illustrates trends in the business parks investment market since 2007. We don’t expect the volatile nature of this market to change, with big deals having the capacity to swing any year’s numbers wildly.

In recent years UK institutions have tended to pick off individual assets, located on well-known business parks, with secure and long-term income. The big deals of the past 18 months have been driven by foreign buyers, with China Investment Corporation acquiring Chiswick Park for £780m and a joint venture between Oaktree Capital Management and Patrizia purchasing IQ Winnersh from Segro for circa. £245m.

Post second quarter, we have seen further business park investment pushed through. With Oaktree and Patrizia’s joint venture acquiring three parks from MEPC for £430m, after a very competitive bidding process, and AEP Investment Management purchasing Trident Place in Hatfield Business Park for circa. £190m.

Looking forward, we anticipate investment in 2014 to comfortably exceed £1bn, but remain short of the strong volumes seen in 2013. Buyers remain very attracted to opportunities that allow them to acquire whole business parks, without conflicting ownerships, and apply a more holistic ownership style akin to that seen on shopping centres. We expect assets such as these to attract strong interest when they come to market, albeit wholly owned parks constitute the minority of the UK’s investable stock. This lack of wholly-owned parks will prove to be the main drag on investment in the sector going forward.

“Foreign buyers are dominating the large lot sizes.”
Figure 6 gives us the yield profile across the S&P Parks and our two comparator segments. It demonstrates the degree to which lease length is still dominating pricing of real estate assets, with the yield differential between the segments pretty mild within any particular lease length banding. It is worth noting that there are insufficient assets within the S&P Parks sample with lease length of 16-25 years for a figure to be released. The lack of differential may change on the short lease sample going forward, as we see investors begin to take on assets they believe to have strong reletting potential within the better quality S&P Parks sample.

2013 was still a year, however, where investors preferred long-income. Exemplified by the strong returns seen on the longer-let samples in each segment; with yields falling strongly on the long-let assets – see Figure 7. Looking forward, the short-lease segments have the capacity to generate very strong income returns, assuming further sustainable improvements in the occupational markets and a stabilisation of yields.

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Figure 6 - Equivalent yield at end-2013, by term to expiry

![Graph showing equivalent yield at end-2013, by term to expiry](image)

Figure 7 - Annual performance by term to expiry - 2013

![Graph showing annual performance by term to expiry - 2013](image)

“Lease length continues to be the main value driver.”
Since the sector’s rental peak in 2001, it has seen a long period of stagnation. As Figure 8 starkly illustrates, rents on the S&P Parks and IPD Parks samples remain some way off previous peaks, having fallen 12% and 14% respectively since 2001. This rental stagnation has though not been unique to offices on business parks. The wider IPD Standard Offices sample, excluding the central part of London, has shown a rental fall of 9% over the same period. On the positive side the evidence of recent years suggests that rents have now bottomed out, with occupiers no longer able to exert notable downward pressure on market rents.

Looking at Figure 9 we can see that S&P Parks had seen yields compressed to an equivalent of 5.8% by end-2006. However, rents at this point had shown no real sign of growth and have fallen further since. Low yields and no rental growth contributing to a very poor investment performance. Considering where we are now, yields are at least at a level that reflects an asset with a need for notable capital expenditure – both at an asset and a park level.

Looking forward, we believe that the sector has reached the end of a long period of weakness. The storm of weak demand since the early noughties is now over. And the glut of supply it left behind has been slowly absorbed. Rents remain soft and speculative development is a limited occurrence. As the economy improves, we anticipate that demand and supply will reach an inflection point where rents will rise and development becomes feasible again. The key to the sector’s success will be to avoid a glut of development in response to only steady improvements in demand.

“Yields now reflect the need for notable capital expenditure.”
Both S&P Parks and the wider IPD sample have had an excellent year performance wise, both having lagged the wider IPD All Property index since 2009, and yields still look very attractive against the risk-free rate. However, despite this year’s return to form, we believe that the sector has a plethora of challenges ahead to ensure that it remains relevant in 21st century Britain. Consequently we have laid out what we believe to be the main solutions and changes the sector will see in the next decade as it adapts to shifts in the wider economy.

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<thead>
<tr>
<th><strong>Increased densification</strong></th>
<th><strong>Out-of-town parks to begin the long-march towards mixed-use</strong></th>
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<td>We believe that a major trend going forward will be the increased densification of business parks. This will be both from the perspective of squeezing more income from the acreage by building upwards (offices and car parks) but also by increased site coverage. Alongside this change, however, parks will need to make sure that the newly dense space has the characteristics of a high-quality urban centre. This means high quality pedestrianised streets and public squares, and a variety of high quality amenities – not all of them major brands.</td>
<td>For those parks that are truly ‘out-of-town’, and have no easy access to in-town amenities, the future is likely to see a gradual shift towards a much greater mix of uses. This is likely to include healthcare and education facilities, residential accommodation (student, elderly or mainstream), water parks and other ‘big box’ leisure facilities, and retail. Of course, the form each park takes will depend on local need, the geographic and size particulars of any one park, and the extent to which the local authorities support planning change out-of-town.</td>
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<tr>
<th><strong>Collectivised car-parking</strong></th>
<th><strong>Use of Business Improvement Districts</strong></th>
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<td>In order to accommodate the gradual densification of parks, and in some cases the shift towards mixed-use, car-parking will become collectivised as opposed to being assigned to particular buildings/tenants. This will enable the parking to be more efficiently accommodated together, and enable building upwards. In order to optimise the level of parking, monitoring systems will be increasingly used to understand the traffic flows and parking usage throughout the day, with some parks already having such systems in place.</td>
<td>On those parks with multiple ownership, achieving park-wide changes is likely to prove somewhat difficult. It is our view that forward-looking landlords will seek to implement something akin to the Business Improvement Districts, although the focus is likely to be a levy on landlords within a business park as opposed to the occupiers. The idea being that a majority of landlords are motivated to contribute to necessary capital expenditure, and legislation to force ‘free-riders’ to contribute is necessary for the kind of initiatives we have laid out to move forward.</td>
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Appendix: definition of key terms

Business park
According to Strutt & Parker, a business park is a large scale development conceived from a master plan and developed through the control of single entity. Among its attributes are low density developments in a highly landscaped environment with sufficient car parking to meet occupational needs. Further, an overall management structure applies across the development to maintain standards and be administered by a central body. In distinguishing the property within this index, Strutt & Parker considered a number of factors. No single factor was sufficient to characterise a development.

Total Return
The annual compounded rate of monthly capital appreciation, net of capital expenditure, plus monthly net income received expressed as a percentage of monthly capital employed. Note that annual capital growth plus annual income return may not sum perfectly to annual total return due to the cross product that occurs when capital and income returns are combined within compounded total returns.

Income Return
The annual compounded rate of net income receivable per month expressed as a percentage of the capital employed over the month.

Capital Growth
The annual compounded increase in monthly values, net of capital expenditure, expressed as a percentage of the capital employed each month.

Capital Values
Are those supplied by the Fund’s external or internal valuers, in accordance with the RICS definition of Open Market Value, net of purchasers’ costs.

Equivalent Yield
IPD estimation of the discount rate which equates the future income flows to the current capital value. IPD projected cash flows are estimated from records of current tenant rents, ground rents, open market rental values, rent review and lease expiry dates, and tenant options to break, assuming upward only rent reviews to expiry of the lease and that options to break are exercised when the tenant rent exceeds the market rent. Vacant or void units are assumed to be let over a period of eighteen months.

Changes in the End-Year yield reflect changes in the composition of the portfolio covered by the IPD, resulting from the effects of trading and development activity.

Yield Impact
An indicator of the change in capital values due to changes in the Equivalent Yield on standing investments through the year. Calculated as the Yield Shift expressed as a percentage of yield at the end of the year, with the sign reversed to show the impact on values.

ERV Growth or Rental Value Growth
The annual compounded increase in monthly estimated rental values expressed as a percentage of the rental value at the beginning of each month.

Estimated Rental Value (ERV)
The rent the valuer estimates could be charged if the unit were let in the open market on the valuation date.

Over-Renting
Tenancies where the open market rental value is below the rent actually paid by the incumbent tenant.

Residual
That part of the annual change in capital values not explained by movements in rental values and yields and attributable to lags between changes in rental values and income due to rent reviews, or non-linear impacts of yield movements over the valuation cash flow produced by over-renting.

Reversionary Potential
Index of total ERV with Rent Passing = 100.

Reversions - ERV
Rent passing in occupied tenancies with ERV at or above rent passing.

Unsecured Income
Rent Passing - ERV in tenancies where rent passing is above ERV.
4 The Square, Stockley Park, Heathrow
80,000 sq ft owned by Legal and General Assurance Society Limited.