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Report & Market Commentary

to inform a

Viability Refresh of the Community Infrastructure Levy

on behalf of

Central Bedfordshire Council

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Appendices

1. INSTRUCTIONS

Lambert Smith Hampton (LSH) has been instructed by Joe Welch, Financial Analyst at EC Harris LLP, acting as advisors to Central Bedfordshire Council, to provide a report and market commentary on the industrial & logistics market and office market within the Central Bedfordshire Administrative Area.

The report has been produced to inform a study into the viability of a refresh of the Community Infrastructure Levy with a particular focus on large scale logistics development

The report seeks to provide market commentary on the industrial & logistics and office market within the administrative area of Central Bedfordshire, providing specific advice on rental values, yields, incentive packages and recent land transactions within the key employment areas.

Where available to LSH, the report seeks to provide additional evidence of other non-typical residential land use values, in particular within Use Class C and D of the Town & Country Planning (Use Classes) Order 1987.

This report has been prepared by Lloyd Phillip Spencer, a surveyor and Fellow of the Royal Institution of Chartered Surveyors (FRICS), Head of the Luton and Milton Keynes Offices of Lambert Smith Hampton, with over 25 years experience in the commercial property market throughout Buckinghamshire, Bedfordshire and Hertfordshire.

It is important to acknowledge that Central Bedfordshire is spread over a relatively wide geographical patch and that unsurprisingly the main employment areas are concentrated alongside the primary infrastructure corridors being the M1, A421 and A1(M). Central Bedfordshire has a number of smaller, rural market towns for which direct market activity in the current climate has been relatively scarce. It is also important to recognise that values can vary significantly between the key employment areas alongside the major infrastructure routes and the less accessible, rural locations.

In arriving at our opinions of value the following assumptions have been made:

- Unless otherwise stated rental for industrial & logistics buildings assume a new building, in a prime location (relative to the motorway network), built to an institutionally acceptably standard with a minimum eaves height of 15 metres for buildings in excess of 200,000 sq ft, 12 metres for buildings of 150,000 sq ft +, 10 metres for buildings of 100,000 sq ft+, 8 metres for buildings of 25,000 sq ft+ and 7 metres for all other sizes.

- Unless otherwise stated rental values for office buildings assume a new, Grade A building in a prime location (relative to the motorway network), built to an institutionally acceptably standard, let for a minimum 10 year term certain on a full repairing and insuring basis.

- Opinions on yield assume prime buildings in a prime location (relative to the motorway network), let on an institutional lease, to an institutionally acceptable covenant, for a term of 15 years certain in respect of single unit industrial & logistics buildings of 100,000 sq ft+, or 10 years certain in respect of every other sector reported.

- Serviced land is defined as *Land primed and ready for development with phase 1 infrastructure and services to the boundary.*

2. INDUSTRIAL & LOGISTICS MARKET COMMENTARY

2.1 National Overview

Take up in the national industrial market throughout the UK recovered from the low levels recorded in 2012, rising by 24% to 94.2 million sq ft in 2013 on the back of a stronger economy, improving business confidence and the continued growth of ecommerce. Take up across the national industrial market was close to the 10 year average of 88 million sq ft per annum, peaking at over 101 million sq ft in both 2010 and 2011. LSH forecast 2014 would continue this trend and expectations so far indicate that take up could exceed the 100 million sq ft figure.

Due to the lack of supply of quality stock, occupiers have been driven to consider second-hand properties in order to satisfy their requirements. Lack of availability has constrained take-up of Grade A space which fell to 13.8 million sq ft in 2013, the lowest level recorded since 2005/2006. 2013 has seen investors and developers slowly respond to this decline with speculative developments starting to redress the imbalance in areas of acute shortage.

In terms of size ranges, the increase in demand for 2013 and 2014 has been across the range in size terms, but concentrated particular in the medium (50-100,000 sq ft) and large (100,000 sq ft+) unit sectors which are driving the recovery. These areas saw activity increase by 56% and 32% respectively.

Looking closer at the wider logistics or big shed market across the country, demand for space improved after a dip in 2012, with take-up rising by 32% to 30.2 million sq ft. The acquisition of Grade A space rose to its highest level in 5 years, with 11 million sq ft of Grade A space taken, accounting for 36% of overall activity.

The lack of choice available to occupiers requiring Grade A stock saw them increasingly turn to second-hand space and a growing trend for freehold purchases in order to take advantage of either perceived low capital values or advantageous sale and leaseback opportunities. Build to suit activity has also risen in response to the Grade A shortage and in 2013 accounted for 74% of all Grade A transactions compared to 18% in 2012.

The market for big shed buildings remains dominated by retailers who maintain their leading positions as the most active tenant type, accounting for almost 7 million sq ft of take-up in the logistics sector or 30% of total activity. Manufacturing occupiers account for a further 6.1 million sq ft of large unit take-up during 2013, some 25% of total activity in the sector.

Third party logistics operators are showing signs of returning to the market, increasing their take-up of space to 4.1 million sq ft during 2013, up from 2.6 million sq ft in 2012. Parcel operators also increased their presence within the large unit sector, acquiring 2.1 million sq ft of space in 2013 compared with 1 million sq ft in 2012. This reflects the continued evolution of ecommerce.

2.2 Regional Overview

Consistent with the market nationally, the regional market including the Central Bedfordshire Administrative Area has experienced improving market conditions, particularly along the M1 corridor, fuelled by a stronger economy, increasing business confidence and proximity to London and the Greater London area. Significant infrastructure investment and planned infrastructure projects have improved accessibility to London and begun to address key congestion hotspots, opening land for development and improving the appeal of the location generally.

Whilst demand historically has been consistent, there is evidence to suggest that enquiry levels across all size ranges have improved in the last 3-6 months, whilst the availability of existing built stock has continued to diminish leading to an overall shortage in supply but particularly of good quality or Grade A buildings.

Consistent with the national market, demand within the size ranges 50-100,000 sq ft and 100,000 sq ft+ has been particularly active.

Improving levels of demand against a backdrop of diminishing supply in particularly of Grade A product has led to rental growth within certain size sectors together with a general hardening of terms and incentive packages.

Whilst a lot of the activity has been concentrated along the M1 corridor, focus does now seem to be turning to the perceived secondary locations along the A421 and A1(M) as occupiers look to secure value for money.

Historically, new development along the M1 corridor has been difficult to deliver against a backdrop of falling demand and unstable economic conditions. Few developers, investors or owner-occupiers have been in a position to raise debt to purchase sites or fund development, whilst occupier demand has been subdued. Land transactions that have taken place have largely been opportunistic with purchasers taking advantage of the then perceived “buyers market”.

Over the past 12 months however market conditions along the M1 corridor in particular have started to change as developers seek to redress the imbalance between supply and demand, whilst occupiers seek to capture value against a backdrop of rising prices. The shortage of existing Grade A stock, coupled with relative economic stability, has not only led to increased demand for build to suit facilities but also seen the return of speculative development, albeit so far limited to a single building of 310,000 sq ft at Prologis Park, Dunstable. Gazeley are rumoured to be considering speculative development at their flagship scheme, Magna Park, Milton Keynes, of 185,000 sq ft with a further 240,000 sq ft proposed on a 16 acre site at G-Park, Bedford.

In preparation to meet growing occupier demand and the increased availability of funding, developers have sought to align themselves with strategic sites, particularly sites for big shed development and in particular along the M1 corridor. Despite this however only a limited number of transactions have been outright purchases with a larger number of opportunities having been secured through options or joint venture partnerships.

Whilst there is evidence of new development activity at the larger end of the market, there is no evidence to suggest speculative development at the smaller end of the market where occupier activity is constrained by a lack of supply. Limited land opportunities of sub-10 acres are likely to further constrain new development within this sector in the short to medium term.

3. OFFICE MARKET COMMENTARY

3.1 National Overview

2013 was considered a successful year for the office market, with take-up and investment returning to levels not seen since the start of the global financial crisis.

The rebound in the market has been fuelled by an improvement in business confidence and growth in employment which has encouraged the corporate sector to expand and invest for the future in a meaningful way. As the economy continues to improve, we forecast that 2014 will be another good year for office activity and that take-up could top 30 million sq ft. Unsurprisingly, Central London and the larger key markets, such as Manchester, Birmingham, Glasgow and the Thames Valley, are forecast to lead the way.

The conversion of office stock into other, more profitable uses, was a notable trend during 2013. LSH Research reveals that the number of applications for the conversion of offices into residential accommodation increased by 500% since temporary permitted development regulations came into force in May 2013. Combined with a notable increase in the purchase of office buildings for change of use, this has contributed to a 7% drop in available stock.

The outlook for 2014 was forecast to be more positive at the beginning of the year than at any time since before the recession. Availability levels are firmly on a downward path and are below the long term average with many regional centres starting to see an under-supply of Grade A space, although it is noticeable that this activity is largely concentrated within the key regional markets mentioned earlier.

The under-supply of Grade A space could impact on take-up statistics in the short term but the prospect of speculative development in key markets is expected to improve as prime rents continue to grow and incentives harden.

3.2 Regional Overview

Given the ongoing changes to the nature of occupier demand - centralisation, fewer office locations, less floor space and implementation of modern workplace strategy – there are some concerns as to the future of small regional markets. Despite this and consistent with the national picture, the regional markets in and encompassing the Central Bedfordshire Administrative Area have stage a relatively strong improvement after a weak 2012.

The biggest increase in take-up has been seen along the M1 corridor in the regional markets of Luton, Milton Keynes and Watford, with all centres experiencing a modest decline in availability.

Local market intelligence suggests there is now an extreme lack of Grade A availability, particularly in centres such as Milton Keynes and Luton. In all markets, the trend for office to residential conversion has contributed to the fall in available space. Where the market is over-supplied with secondary and tertiary space this is welcomed as it removes the overhang of available stock which, although largely obsolete, can act as a drag on the rest of the market.

This has particularly been the case in Luton, where 125,000 sq ft of Grade C space was taken up over the course of 2013.

Prime rents in the regional centres along the M1 corridor in particular have displayed a relative high degree of stability. This does however hide the movement in secondary and net effective rents, both of which have fallen in the years following the global financial crisis.

As market conditions improve, there is evidence to suggest a hardening of lease incentives and rental terms offered, however the only upward movement in prime rents experienced along the M1 corridor is in Watford, where rental values have increased to £23 per sq ft on the back of new lettings at Croxley Business Park.

4. INVESTMENT MARKET COMMENTARY

Quarterly investment activity in the commercial property market totalled £11.9 billion in Q2 2014 up 10% on the first quarter of the year.

The all property transactional yield has fallen to 6.06%, which is the lowest level recorded since Q2 2008.

Offices, and especially Central London offices, remain the most heavily invested in sector with just over 40% of the quarterly total invested in office property.

Even though investment volumes have increased this quarter, the real story is the thirty five point inward shift in the transactional yield. On this measure, property is the most expensive it has been since Q2 2008, the tail-end of the last boom. One of the reasons for the inward shift experienced during this quarter is the strong demand for good quality shopping centres.

With more and more money flowing into property funds from retail investors, investment from the UK institutions has picked up again in Q2 2014. They now represent the biggest net investors into the market since mid-2013 and as a result total net investment has increased significantly from -£0.5 billion in 2012 to just under £5.7 billion in the last 12 months.

This is reflected in the increase investment in UK regions, where the institutions are most active. Regional investment totalled £18.6 billion in the last 12 months, as compared to £11 billion in the previous 12 months and in Q2 accounted for its largest share of the quarterly investment total Q1 2011.

The pick-up and shift in investment market activity over the last 12 months has resulted in a real change in the market. Investment volumes are up, as are capital values; investors – especially UK institutions are much more active in the regions; and prices outside London are now on the rise.

The rise in prices has been investor driven as vendors have benefitted from 12 months of yield driven increases in capital values. The main question now is for how much longer can this inward in shift be sustained. Certainly, the prospect of an increase in the base rate could act to slow it down as the impact in rising rates from such a low level is an unknown quantity. We anticipate another 6-12 months of hardening yields; however from mid-2015 onward rents will have taken over from yields as the main driver performance.

Despite a number of large shopping centre deals, the office sector is still attracting the lion share of capital deployed by investors in the UK commercial property market.

In the regions, office investment in the south east and rest of the UK totalled £1.4 billion which is a 35% quarter on quarter increase. Having averaged 8.3% over the course of 2012 and 2013, the regional office yield shift has come into around 6.5% in the first half of 2014 which demonstrates the turn around in investor sentiment.

Q2 was also another strong quarter for industrial property. Long term investors with liability matching obligations, like the pension and insurance funds, continue to be in the market for long let distribution units. In Q2 2014, Legal & General forward funded Waitrose's new distribution centre in Milton Keynes for £114 million at a yield of 4.64%. This is the largest single asset industrial transaction since Legal & General's purchase of a big shed let to Tesco in Reading in Q1 2012 for £115 million at a yield of 5.4%.

It is immediately apparent that there has been a real shift in investors' attitude towards regional property in the last 12 months. Regional investment volumes in the last three quarters total £15.1 billion which is the same as in the previous six. There are a number of reasons for this:

- London is expensive
- Capital values in the West End are back to the peak levels seen in mid-2007. This is pushing investors into other markets
- The economic recovery is well entrenched and even though London's economy continues to out-perform the regions they are all forecast to grow at around 2.5% per annum over the next 5 years.

The domestic institutions, who are experienced regional players, have money to invest after net inflows into their retail fund.

Credit availability to investors and developers, as shown by the Bank of England Credit Conditions Survey, has improved over the last 12 months.

Whilst quarterly investment volumes by region can be rather volatile, it is clear that aside from London, the South East is the most active regional market. Investment in the South East totalled £2.5 billion in the first 6 months of 2014.

A more comprehensive overview of the performance of the UK investment market is captured within our UK Investment Transactions Bulletin for Q1 and Q2 2014, contained in Appendix 1 of this Report.

5. RENTAL AND CAPITAL FORECASTS

5.1 Industrial & Logistics

Underlying market dynamics in the industrial & logistics market reveal a relatively buoyant period with increased investor and developer appetite, increasing levels of take-up and reducing levels of supply.

A more detailed investigation of the market reveal varying levels of activity within different size sectors, with some sectors still having a reasonable level, whilst others experience acute shortages of supply. The lack of supply of existing buildings is no more acute than within the size sector 50-150,000 sq ft where the availability of buildings has fallen to record lows across the region not only of Grade A stock, which is virtually non-existent, but also of secondary stock which in turn is beginning to fuel rental growth.

As a general observation development activity on the whole has largely been fuelled by investor and developer confidence and an increase in investment activity, albeit against a sometimes modest and inconsistent backdrop of demand. As commented earlier within this Report, rental growth is expected to become the main driver for property performance from 2015 onwards and whilst some sectors within the market are demonstrating growth this cannot be adopted as a blanket assumption across the market as a whole.

The lack of Grade A or even good quality modern premises means the market is relatively short of transactional evidence to support rental forecasts and the lack of supply of existing buildings or speculative development is unlikely to change this situation in the short to medium term.

As suggested earlier within this report, it is important to acknowledge that the Central Bedfordshire Administrative Area is spread over a relatively wide geographical patch, which can result in a wide variation of values between the prime and secondary areas and in particular the prime and more rural locations.

The big shed market specifically, in particular along the M1 corridor, has experienced relatively high levels of activity and booming investor/developer confidence, evidenced by a decision from Prologis to develop speculatively a unit of 310,000 sq ft at Boscombe Road, Dunstable. Despite this, interest in the unit which completed in August 2014 has been slow and whilst there are some ongoing negotiations, we understand from a representative of Prologis that there is still some way to go before terms are likely to be agreed.

As forecast by Lambert Smith Hampton some 12-18 months earlier, a rental differential is now beginning to emerge between existing built stock and design and build opportunities, which largely reflects the supply situation. Availability of existing stock is extremely limited, fuelling rental growth and hardening of incentives whilst the availability of design and build options, in particular along the M1 corridor concentrated around Junction 13 of the M1, is by comparison relatively plentiful leading to competition between developers.

It is therefore important to recognise that an existing new build unit of 150,000 sq ft is likely to let for a higher rental level, with a smaller incentive package than a building delivered on a design and build basis.

A schedule of transactions for industrial & logistics buildings ixo 100,000 sq ft is incorporated within Appendix 2 of this Report.

Having regard to prevailing market conditions, levels of supply and market dynamics, a matrix of rental values for the key employment areas within the Central Bedfordshire Administrative Area is incorporated within Appendix 3.

Assuming new development of a Grade A product, built to an institutionally acceptable standard in the locations reported within the Industrial & Logistics Rents Matrix, we are of the opinion that for a 10 year term certain an allowance for 9-12 months' rent free incentive should be made and for a term certain of 15 years this should be increased to 15-18 months' rent free.

5.2 Offices

As highlighted earlier within this Report although take-up of offices within the region has increased during 2014, this has largely been fuelled by a significant increase (up to 500%) of take up in office to residential conversions which has removed a large percentage of secondary, Grade B and C stock. Availability of Grade A product is relatively low, although there still remains some reasonable, good quality Grade B product in some of the prime locations such as Capability Green, which is likely to inhibit speculative development of new buildings in the short to medium term.

Demand is relatively inconsistent and as a result in many of the secondary markets land allocated for office development is largely unviable and is being developed for alternative uses, with a particular pressure from demand for residential sites.

Market dynamics are such that speculative development to redress the imbalance of Grade A stock in the office market is unlikely to return for the foreseeable future and viability issues still remain against a backdrop of increasing build costs.

A matrix of office rental values within the key employment markets of the Central Bedfordshire Administrative Area is contained within Appendix 4.

Assuming a Grade A building, developed to an institutionally acceptable standard, let for a term of 10 years, situated in a prime location, we would anticipate a rent free package of between 18-24 months.

5.3 Land

Since the global downturn in 2007 and subsequent economic slump, new development within the Central Bedfordshire Administrative Area has been difficult to deliver and unviable against a backdrop of falling demand and unstable economic conditions. Few developers, investors or occupiers have been in a position to raise debt to purchase sites or fund development, whilst occupier demand has been subdued. Transactions that have taken place have largely been opportunistic with purchasers taking advantage of the buyers market.

Over the past 12-18 months improving market conditions, economic stability and a diminishing supply of existing buildings has fuelled an increase in demand for land and build to suit facilities.

In preparation to meet growing occupier demand, in particular within the big shed sector, a number of developers have sought to align themselves with strategic sites along the M1 in particular, although the number of actual transactions is still relatively limited, constrained by the availability of land.

Enclosed within Appendix 5 is a schedule of sites currently being promoted or about to be promoted for big shed development.

Enclosed within Appendix 6 is a schedule of recent employment land transactions.

It is noticeable from Appendix 6 that activity has increased significantly in the last 12 months, with 12 land transactions having been concluded or agreed compared to 3 within the corresponding 12 month period in the preceding year.

There is also evidence to suggest increasing land values as owner occupiers and developers compete against a backdrop of improving market conditions.

One transaction worth highlighting during this period was the acquisition of 4.66 acres by CM Downton in December 2013 at a purchase price of £536,500 per acre which is now under offer due to be sold with a small adjoining site at a purchase price equivalent to £677,000 per acre, although this transaction does need to be treated with care as the proposed use is not an employment use and could therefore arguably attract a premium value.

A more direct comparison to reflect increasing land values would be the acquisition of 31.1 acres by Prologis in September 2012 at Boscombe Road, Dunstable, for a reported figure of £530,000 per acre compared to the transaction currently under offer at Grange Park, Northampton, which equates to a net land value closer to £645,000 per acre. This transaction in particular highlights the increase in demand and investor appetite for the big shed sector.

There is a marked difference, as is to be expected, between land prices paid by owner-occupiers compared to prices paid by developers and this is in evidence with the relatively small transactions at 250 Toddington Road where plots of between 1-2 acres have been changing hands at values at or in excess of £700,000 per acre. The market for small plots of between 1-5 acres, much like the market for large sites capable of accommodating big shed development is relatively buoyant, whereas arguably values for sites between 5-10 acres lag behind.

For a big shed development site in excess of 20 acres along the M1 corridor in the current climate, we would anticipate achieving values in the order of £700-£750,000 per acre for a fully serviced site in the Luton/Dunstable area, compared to £600-£650,000 per acre for a fully serviced site at say Junction 13 of the M1.

These forecasts suggest land values may have risen in the big shed sector by as much as a third since the acquisition of Boscombe Road by Prologis in September 2012. As indicated previously, the increase in values has been driven largely by increasing investor appetite and developer demand rather than hard evidence of rental growth which will become increasingly important over the next 12-24 months.

5.4 Yields

A comprehensive commentary of the investment market is provided in section 3.3 of this Report and Appendix 1, within our UK Investment Transaction Bulletin for Q1 and Q2 2014.

The Schedule contained within Appendix 6 provides an opinion of yields for the industrial & logistics and office sectors within the Central Bedfordshire Administrative Area.

6. CONCLUSION

Relative to previous post recession periods the commercial property market, in particular along the M1 corridor, has recovered relatively quickly with the rate of recovery in the industrial & logistics market, taking many people by surprise.

This recovery has been fuelled by improving occupier confidence, increased investor/developer demand and a diminishing supply of existing built stock.

Improvement in the industrial & logistics market has been more noticeable than the office market, evidenced by a return of speculative development (albeit limited in the regions to big shed development), rental growth and a hardening of incentives. The office market, whilst also experiencing a recovery, has seen a more modest recovery in part fuelled by a demand for office to residential conversions which has seen a 500% increase in the last 12 months.

Demand across both sectors can at best be described as inconsistent with periods of prolonged activity followed by periods of inactivity and these characteristics harbour some concern as to whether the anticipated rental growth in certain sectors will necessarily follow, particularly within the design and build market.

Unlike the industrial & logistics market, there is no evidence of speculative development of offices which is unlikely to occur in our opinion in the short to medium term.

Hardening of yields is forecast to continue for a further 6-12 months beyond which we anticipate rental growth will have taken over as the main driver of property performance.

The scarcity of land transactions and the lack of development land generally makes it difficult to evidence current forecasts, although underlying evidence would suggest an increase in land values of up to 33% over a period of 12-18 months as investors/developers and owner-occupiers compete to secure a limited number of sites.

Land values currently being paid, particularly within the big shed sector, reflect recent yield compression and will undoubtedly be relying upon a continued shortage of supply fuelling rental growth.