D2 REAL ESTATE

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Channel Islands Annual Office Market Review

JANUARY

2020

JERSEY / GUERNSEY

www.d2re.co.uk

Contents

Introduction

2019 has certainly been an interesting year and with all the political uncertainty and BREXIT, it was going to be a challenge to match the unprecedented level of occupational and investment activity in the Channel Islands, witnessed during 2018.

However, I am pleased to report the Channel Island investment market has remained very resilient, with total sales volumes actually exceeding the record levels achieved in 2018, which is in marked contrast to the UK. Indeed, during the past 12 months we have seen yields compress further from around 6% to 5.75% for the very best assets, demonstrating a strong appetite from investors for quality buildings with long unexpired lease terms. Another positive feature is that investment activity has been consistent throughout both islands, whereas in 2018 Jersey accounted for all the significant investment sales.

In contrast, St Helier's occupational market has been challenging compared to the record levels of take up achieved in 2018. Given the unprecedented level of development over the past few years the majority of the significant enquires have been satisfied for the time being. On a positive note, most of the new Grade A space in St Helier has now been let and the overall vacancy rate is very low, so the timing of these new schemes has been opportune. In Guernsey, the outlook is particularly encouraging and after a dearth of development over the past decade, we are at last seeing activity at Admiral Park with No 1 The Plaza now under construction.

We expect that investment demand for prime assets will continue throughout 2020, although the number of transactions is likely to be down compared to 2019. Occupational take up in Jersey is still likely to be subdued as developers and occupiers take stock. However, hopefully momentum will continue to build in Guernsey and, in our view, there is a need for Grade A stock given a number of requirements are still unsatisfied. The challenge for developers and ultimately occupiers in both islands is the effect of building cost inflation and its impact on rents.

Phil Dawes
Managing Director | D2 Real Estate

Key Highlights

- Investment volumes in 2019 exceeded £220,000,000, an increase on 2018's 5 year record of £185,000,000
- Prime yields for the very best assets have compressed further over the past 12 months to around 5.75%
- Investment demand and activity has been spread evenly amongst both islands, which was not the case in 2018, where Jersey was dominant. The largest deal in 2019 was the sale of Dorey & Martello Court, Guernsey for over £60m, the best yield was achieved on IFC5, Jersey at 5.75%
- Appetite in Guernsey to develop new stock gathers momentum and negotiations to take a prelet of No 1 The Plaza, Admiral Park, Guernsey are well advanced. This will be the first new major office development to have taken place since the late 2000's
- Rents remain stable across both islands, however occupational "Take Up" is down due to lack of supply. The vacancy rate continues to remain low and there is minimal Grade A stock sitting vacant across both Islands
- In Jersey, given the strength of the residential market, more obsolete stock has been taken out of the market
- Given rampant building cost inflation in both Islands, developers are having to increase rents to keep pace.

"I am pleased to report the Channel Island investment market has remained very resilient, with total sales volumes actually exceeding the record levels achieved in 2018"

UK Investment Market Review

Investors seeking opportunities, particularly in the larger lot sizes, will be comparing returns from equivalent assets in multiple jurisdictions. Therefore, any yield shift in the UK could potentially impact on values throughout the Channels Islands. The UK market, in particular, is therefore highly relevant.

2019 Investment Volumes

2019 was very much defined by the uncertainty over the UK's withdrawal to the European Union. However, thanks partly to improved sentiment following the election results in December, Q4 transaction volumes reached £17bn, the highest quarterly volume in two years. Despite this buoyant finish, investment volumes reached £52bn, 18% below 2018 but still in-line with the 10-year average.

Given the large weight of capital waiting to enter the market however, we anticipate an uptick in activity in Q1 following the election result and ratification of the EU withdrawal agreement in January.

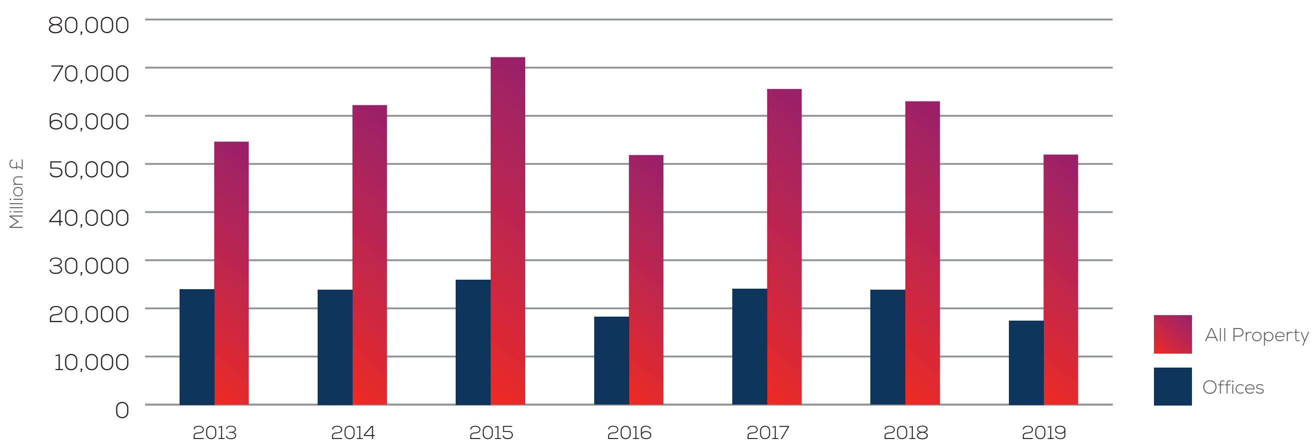
2019 Regional Office Performance

Office investment volumes outside of Central London reached £6.4bn in 2019; this is 32% below volumes reached in 2018.

Overseas investors increased their share of 2019 investment volumes, accounting for 36%, up on 23% the previous year. Boosted by Legal & General's two acquisitions in Leeds, Quarry House for £243m and Wellington Place for £211m, UK institutions accounted for 22% of total 2019 volumes.

Prime yields in the key regional cities remained at 2018 levels, standing at 4.75% in Birmingham, Bristol and Manchester and 5.00% in Leeds.

UK Investment *Source: Property Data/BNP Paribas Real Estate Research*



Looking forward to 2020, given the large weight of capital waiting to enter the market, we anticipate an uptick in activity; however, a lack of available stock could hinder volumes.

Occupier sentiment remained strong throughout 2019 with Big Six take-up reaching 4.7m sq ft, 5% ahead of the 10-year average. This is the sixth year of consecutive above average levels of take-up, demonstrating the resilience of the regional office markets.

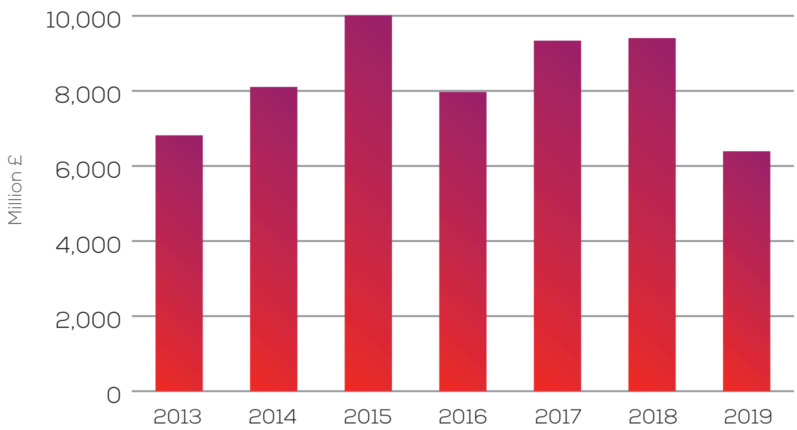
Large deals included BT's 200,000 sq ft acquisition of Assembly, Bristol, the Government Property Agency's 110,000 sq ft deal at Platform 21, Birmingham and Serviced Office provider, Spaces 117,000 sq ft acquisition at 125 Deansgate, Manchester.

Vacancy rates continue to fall across the key regional cities, the markets of Bristol and Leeds remain the most supply restricted and as a result experienced prime rental growth of 3% and 7%, respectively, in 2019.

Looking forward, with the development pipeline looking quite restrained, this year will be characterised by constrained levels of supply. In response, we are likely to see an uptick in speculative development schemes however rising construction costs could be an ongoing issue for some developers.

Regional Offices Investment

Source: Property Data/BNP Paribas Real Estate Research



Channel Islands
Investment Market Review

Investment Overview

The Channel Islands' investment market has proven its resilience during 2019. Despite the political turmoil in the UK and BREXIT fears, investment volumes have actually exceeded the record set in 2018 and yields have compressed further. This is in stark contrast to the UK, where investment volumes are down.

In total, over £220,000,000 (£185,000,000 - 2018) of stock was transacted over the past 12 months. This activity was evenly spread between both Islands, with £109,000,000 in Guernsey and £111,000,000 in Jersey. This is in complete contrast to the previous year when all the significant investment activity took place in Jersey.

Prime yields for the very best buildings have moved in to 5.75%. This can be demonstrated through the sale of IFC 5 for just under £47m which achieved 5.75% in August 2019. This compares to the sale of IFC 1 (£43.7m), achieving 5.94% in November 2018. Both buildings are BREEAM rated "excellent", constructed in 2017 and 2018, with a similar weighted average unexpired lease term (WAULT) of around 12.75 years to the tenants' lease break options.

For prime, second generation buildings, yields range from between 6.25% - 6.5%. For example, Dorey & Martello Court, Guernsey, built in 2004 but having a similar WAULT (11 years) to IFC, sold in April 2019 for over £60.6m reflecting 6.4%. In addition, 27 Esplanade, Jersey, sold for around £41m in November 2019 reflecting a yield of circa 6.2%, but with a longer WAULT compared to IFC.

Through the sales of IFC over the past few years, we are now able to demonstrate that investors are prepared to pay more for a premium product. They will focus on the building's quality, such as efficiency, natural light, amenities etc, in addition to WAULT and income security, and as a result we are starting to see a two tier market develop.

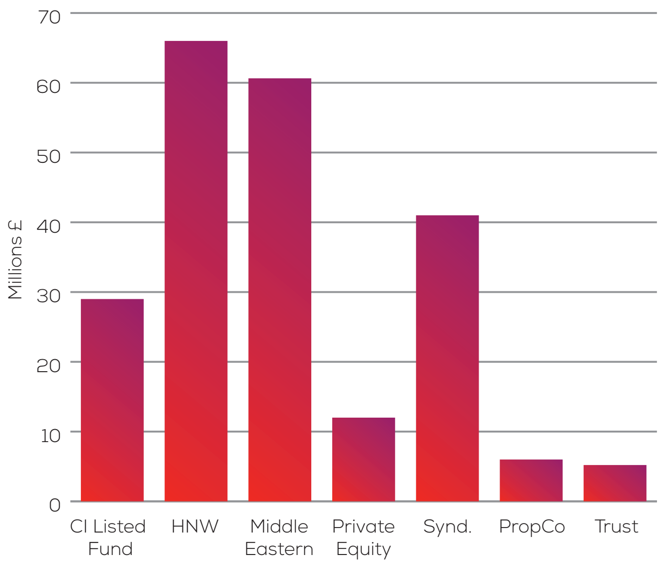
The investor pool for the larger assets is still dominated by high value residents. Middle Eastern investors and syndicates have also been active during 2019. For the smaller investments, particularly opportunities with asset management potential which accounts for around 25% of all investment transactions, it is not surprising that locally based property companies and local high value residents have been active. They have the expert local market knowledge to work the asset and maximise value.

Even with a narrowing yield gap between the UK regions, given the strong covenants, long leases, and limited Grade A office supply, the Channel Islands investment market still offers excellent value. Locally, the banking sector has a strong appetite to lend at competitive margins, so cash on cash returns in excess of 10% are achievable, albeit for the larger investments, debt is seldom required.

Over the past 5 years we have seen investment volumes increasing year on year. There have been some significant investment sales, such as IFC 4 & 5, Dorey & Martello Court and Gaspé House. The increased investment activity is mainly a result of the unprecedented level of development that has taken place over the past 5 years. Given the widening investor pool, we believe there is certainly scope for the yield of 5.75% to be improved, but we will have to wait until the next phase of new developments, which are still several years away. As a result we see 2020 being a quieter year on the investment front, although there are one or two significant prime second generation buildings earmarked for sale.

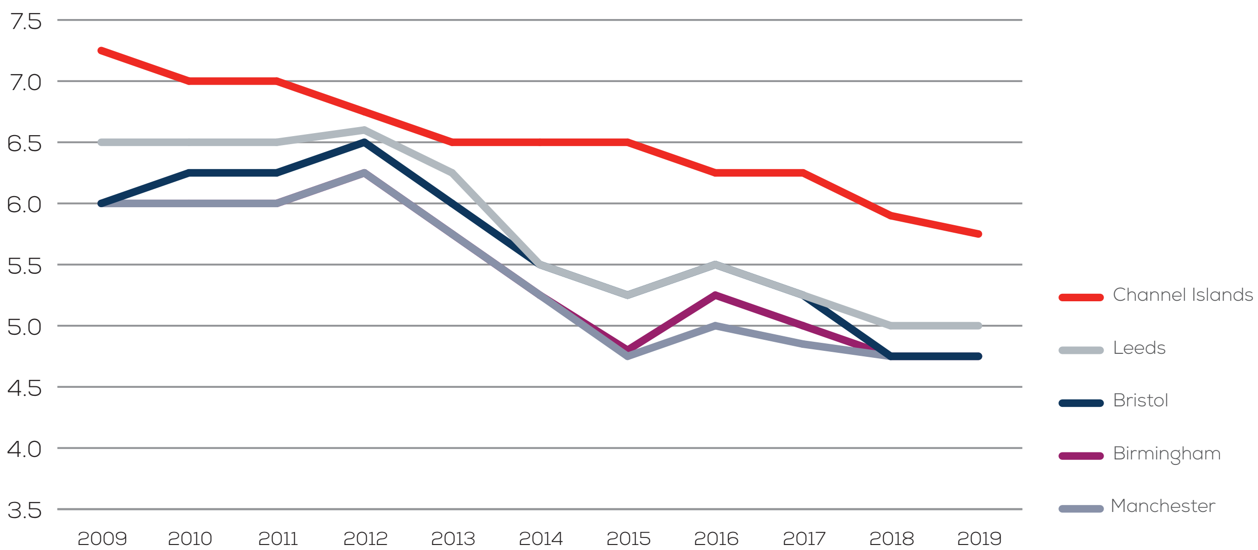
Active Investors 2019

Source: D2 RE



Prime Yields

Source: D2RE / BNPPRE



Jersey Occupational Office Market Review

Overview

Since 2016, there has been a huge change to Jersey's occupational market. New developments include Gaspé House, IFC 4 & 5, 27 Esplanade and 5 Esplanade, which has added over 400,000 sq ft of new BREEAM rated stock to the market, an increase of around 15%. This level of development has been unprecedented in the Channel Islands and has consolidated The Esplanade in St Helier as being the prime office location.

This increase in development activity was driven by the need to improve the quality of stock to satisfy the needs of corporate occupiers, seeking high quality, efficient office accommodation with larger floor plates. Prior to this, corporate occupiers had no option but to occupy multiple buildings throughout St Helier.

Whilst the likes of Royal Bank of Canada, UBS, BNP Paribas, JTC and Sanne Group PLC, to name a few, have relocated, the residential housing market has been strong, which has resulted in several of the obsolete buildings being converted to alternative uses. To date we estimate that 85,000 sq ft of offices has been converted to residential use with a further 120,000 sq ft under construction. We expect this trend to continue and with the States of Jersey exiting buildings such as Cyril Le Marquand House, that will in turn be redeveloped, much of the obsolete stock has been taken out of the market, whilst at the same time the quality of the remaining office stock has improved.

We estimate the total stock currently stands at around 3,000,000 sq ft and of this around 600,000 sq ft is Grade A BREEAM rated.

In terms of future development, the most active developers are the Jersey Development Company (JDC) and Dandara. JDC have developed Buildings 1 & 5 of the International Finance Centre (potentially comprising 6 buildings) and will start on Building 6 as soon as a significant prelet is secured. A planning application for Building 2 was submitted in December. This is a long term project and the buildings will be drip fed into the market as and when there is a need.

Prospects for 2020:

- Letting activity will focus on securing a prelet for the next phase of development, otherwise there is little prime stock available, so we expect take-up to be subdued.
- Several tenants are seeking to re-gear their leases and the challenge for developers will be to prove the cost benefit in paying a higher rent, by way of efficiencies and wellbeing standards.
- Rising building cost inflation is likely to drive rental levels on new schemes. This should eventually filter through to older stock located on the Esplanade.
- We expect the vacancy rate to remain at around 7.5%; much of the available stock is sub 5000 sq ft and in need of refurbishment.

Occupational Take up

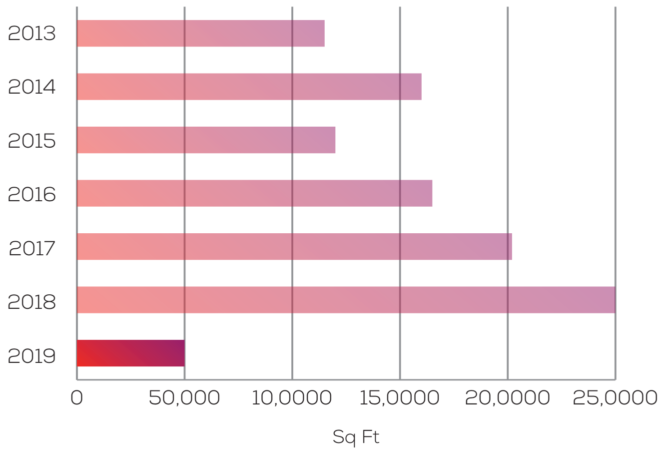
Year on year take up has increased significantly over the past 3 years, culminating in a record of 250,000 sq ft being let in 2018. Given the size of the market, this level of take up was unsustainable so we expected the rate to fall significantly during 2019. This has been the case during 2019 and the figure of 50,000 sq ft is significantly below the 5 year average.

The fall in take up has partly been a result of the success achieved in previous years and, during the course of 2019, there has simply been a lack of good quality space available in either prime or secondary locations. Developers are unlikely to start on site without a prelet and the majority of the large requirements were satisfied in 2017 and 2018. Given the cyclical nature of the market, there is a need to be patient and wait for the next round of letting opportunities to arise. In the meantime, developers have been active in securing planning on their sites.

In addition, we sense that the uncertainty surrounding BREXIT and other global events has had an impact. During the course of the year we have seen an increasing amount of tenants seeking to re-gear as opposed to committing to a prelet. The rental differential between prime "second generation" and "super prime" on the Esplanade is now significant and in some cases there is a 50% rent differential between such buildings which are otherwise adjacent to each other. Therefore we expect to see rental growth filtering through to prime "second generation" buildings.

In 2019 the majority of the enquiries have been circa 10,000 sq ft, albeit not all of these tenants are prepared to pay the top rents. There have been very few requirements sub 5000 sq ft and the smaller enquiries are also being targeted by serviced office operators who have been active.

St Helier Take Up *Source: D2RE*



Vacancy Rates

Given that take up has been subdued, with tenants opting to re-gear, it is perhaps not surprising the vacancy rate as at December 2019 has remained similar to 2018, at around 7.5% of total stock or 250,000 sq ft. Both years are considerably below 2017 when the vacancy rate hit 12% of total stock as the new developments on the Esplanade, that were part prelet, reached practical completion.

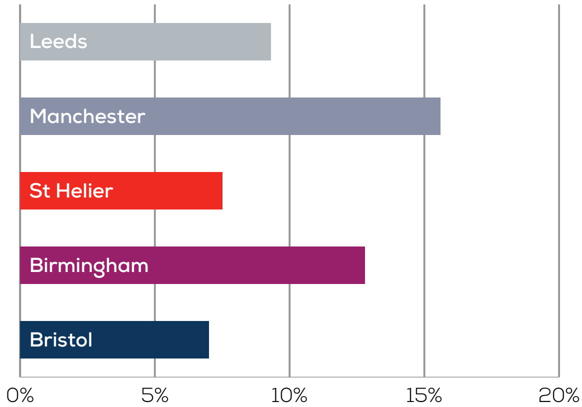
We estimate that about 25% of the existing vacant stock comprises suites below 5000 sq ft, where there is currently a lack of active requirements, plus they will be competing with the serviced office operators. With a few exceptions, many of these suites have not been refurbished, with landlords unwilling to invest unless a tenant is lined up, so the suites present poorly from the outset and will remain difficult to let.

On the Esplanade, the vacancy rate is very low and there is very little choice, unless a tenant is prepared to take ground floor space, however in this case natural light is often severely compromised. In terms of good quality prime space on the Esplanade there is circa 25,000 sq ft available but again in suites of sub 6,000 sq ft. Tenants wanting a large floor plate above 10,000 sq ft therefore have no option but to wait until the next phase of development comes on stream, which will take at least 2 years post planning and signing a prelet.

To apply some context, St Helier's vacancy rate compares favourably to the UK:

St Helier Vacancy Rate Compared to UK Regions (December 2019)

Source: D2RE / BNPPRE



Rental Tone

Taking into account the subdued letting activity in 2019, rental evidence is naturally in short supply. For the best Grade A suites headline rents of over £40 psf are realistic *(see prime rent comparison chart on page 13)*.

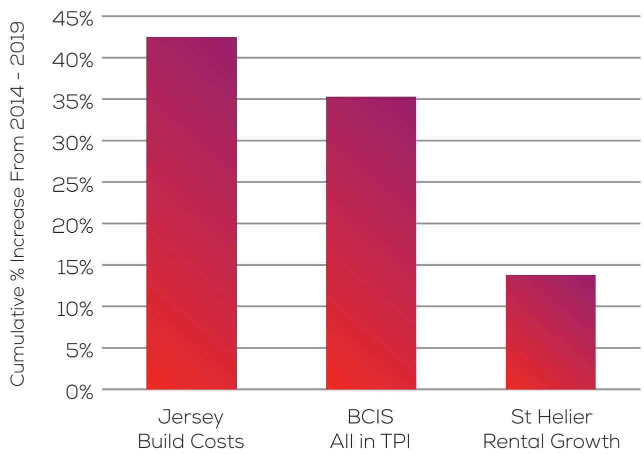
For larger lettings, particularly prelets, rents vary significantly especially where developers are in competition and can range from anywhere between £35 psf to over £40 psf depending on quality, configuration and efficiency. What is also becoming increasingly apparent is that building cost inflation is having an impact on rental levels. Fortunately, for the best developments, yields have compressed further, however there is constant pressure on developers for rents to keep pace with the inexorable rise of building cost inflation, testing a project's viability. There are also several major infrastructure projects on the horizon, such as the new hospital, that may exacerbate the situation. In order to demonstrate the true value to occupiers, other factors will inevitably need to come into play aside from rental level, such as service charge rate, BREEAM rating, wellbeing standards, space and energy efficiency. The disparity between building cost inflation versus rental growth is a concern that could frustrate the next phase of development.

This theme has become increasingly relevant in 2019 as several tenants occupying prime, second generation buildings are considering re-gearing their leases as opposed to signing prelets at significantly higher rents. Headline rents on these non BREEAM rated buildings on the Esplanade tend to range from £28 psf to £30 psf, so are at a significant discount. Outside the Esplanade the headline rental tone ranges from anywhere between £20 psf to £25 psf depending on location and specification. Given the significant rental differential landlords owning second generation buildings in prime locations, which are let off significantly lower rents, should be in a strong position when renegotiating leases, whereas developers will need to be able to demonstrate the true cost benefit to occupiers if they are to persuade these tenants to relocate.

"For the best Grade A suites headline rents of over £40 psf are realistic."

Construction Costs vs Rental Growth

Source: Colin Smith Partnership & D2 RE



Guernsey Occupational Office Market Review

Overview

After 10 years without any significant development, No 1 The Plaza, Admiral Park, will start the next phase of development and hopefully this will be the catalyst for further activity. The outlook is generally positive and over the past 12 months investors and developers, including a specialist syndicate and local high value residents, have all be actively investing. Sites that have previously lain dormant have been acquired and there is now an air of confidence that will hopefully bring forward new developments in all sectors.

The last phase of development in St Peter Port took place in the 2000's, with the development of Admiral Park, a 230,000 sq ft out of town business park and in St Peter Port a number of high quality buildings were developed along St Julian's Avenue and Glategny Esplanade. These two areas are now recognised as the prime office locations in Guernsey.

No 1 The Plaza, is part of the first phase of new development comprising approximately 30,000 sq ft of offices located on Admiral Park. The developer, Comprop, who is active in both Guernsey and Jersey, aims to achieve practical completion by Q4 2021 and are currently in negotiations with a tenant to take a significant prelet. They have also agreed a prelet to Premier Inn, and will build out a restaurant and a 387 space car park, which will further enhance the location and benefit other users occupying space on the business park. Given St Peter Port's topography and the Island Development Plan identifying Admiral Park as the Office Expansion Area, development of new stock is a challenge, although there are some smaller sites within St Peter Port itself, such as St James Place, again owned by Comprop.

Given the age of the existing office stock the running costs are generally high, particularly the utility costs and with the very limited supply of Grade A office stock, the total occupational cost compared to other jurisdictions will be a consideration for occupiers. There is also an increasing focus from corporate occupiers on their environmental responsibility and at the moment there are no BREEAM rated buildings in Guernsey. As a result new office stock is needed, particularly as several unfulfilled requirements remain since we reported last year.

This shortage of prime space has resulted in rental growth over the past 12 months, albeit there has not been the volume of transactions we saw in 2018, so evidence is still quite limited. We have also seen demand for good quality, refurbished, secondary space, as not all occupiers are prepared to pay top rents. However, the space needs to present well and suites that are not refurbished from the outset will be difficult to let.

Of the vacant secondary stock, many buildings are listed and often the configuration does not enable conversion, consequently there is an oversupply. Protecting the island's heritage is obviously crucial, but it is also important to try and regenerate older buildings where possible.

We estimate that total stock currently sits at around 1.8m sq ft, with around 500,000 sq ft being considered as Grade A, however hopefully we will see this figure rise over the coming years.

Prospects for 2020:

- Given the lack of stock, those Landlords who have invested in their buildings and refurbished to provide good quality space at competitive rents have reaped the rewards and we believe this theme will continue
- Take up is likely to be higher next year. Discussions on prelets are ongoing and there are several prime refurbished suites coming to the market, as well as several unfulfilled requirements
- Given the increased take up and new prime stock coming to the market, we expect modest rental growth over the next 12 months
- The vacancy rate as a percentage of total stock is likely to remain high, albeit once again, in the prime sector vacant space will be limited.

Occupational Take Up

2019 was a reasonable year for take up in Guernsey, although several of the larger requirements that we identified in our previous report are still live given the challenges in finding suitable premises. We estimate that take up over the past 12 months was in the region of 55,000 sq ft, which is below 79,000 sq ft achieved in 2018 but above the figure achieved in 2017.

Again, the larger lettings were a result of mergers and acquisitions and that has been a consistent theme across both Islands in recent times. The majority of the transactions have been under 10,000 sq ft which is similar to 2018.

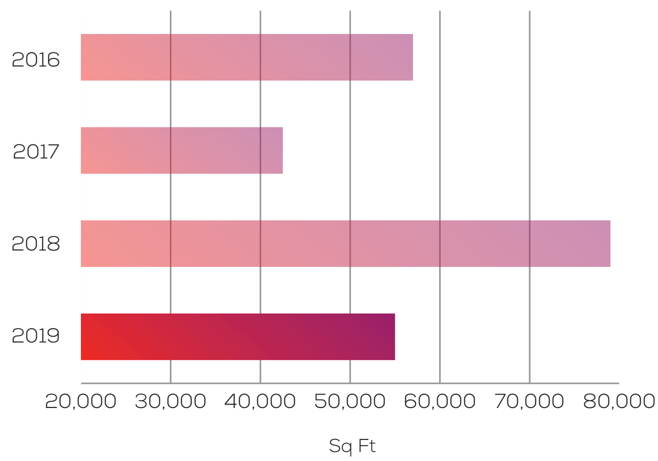
Landlords offering high quality refurbished space in older buildings, but at competitive rents, have been successful in creating competitive tension between potential occupiers. It also demonstrates that not all tenants are seeking the very best space, where rents are significantly higher. Many occupiers run their back office operations from the Channel Islands and are not client facing, so a high quality working environment, offering a competitive rent, in an older building is sufficient for their needs.

Unfortunately, this is not the case in all instances and occupiers seeking the best suites in the prime buildings have very limited choice and there are several requirements from 2018 still outstanding. These occupiers have few options, particularly if they need to accommodate all their staff on one floor.

Although take up only represents 3% of the island's total stock, there isn't a glut of good quality vacant office space and the reason for the relatively low take up is a result of lack of suitable stock as opposed to demand.

St Peter Port Take Up

Source: D2RE



Vacancy Rates

The vacancy rate in Guernsey has fallen over the past 12 months to around 10% of the total stock. However, this is slightly misleading as there is a two tier market, with an over supply of poor quality secondary and tertiary stock, much of which has been vacant for a number of years. These office buildings are often listed, which can hinder redevelopment and comprise small cellular offices. The floor to ceiling heights are often minimal which restricts the retrospective installation of modern M&E equipment and makes their occupation impractical. In essence, they fail to meet the requirements of modern occupiers.

In terms of the prime market, it is a very different story. There is very little stock available and the vacancy rate is around 2.5% of total stock. There are several refurbishments currently underway, such as Royal Bank Place and Regency Court, which will provide much needed Grade A space. However, there are virtually no opportunities for an occupier to take a single floor plate over 10,000 sq ft at the current time.

Rental Tone

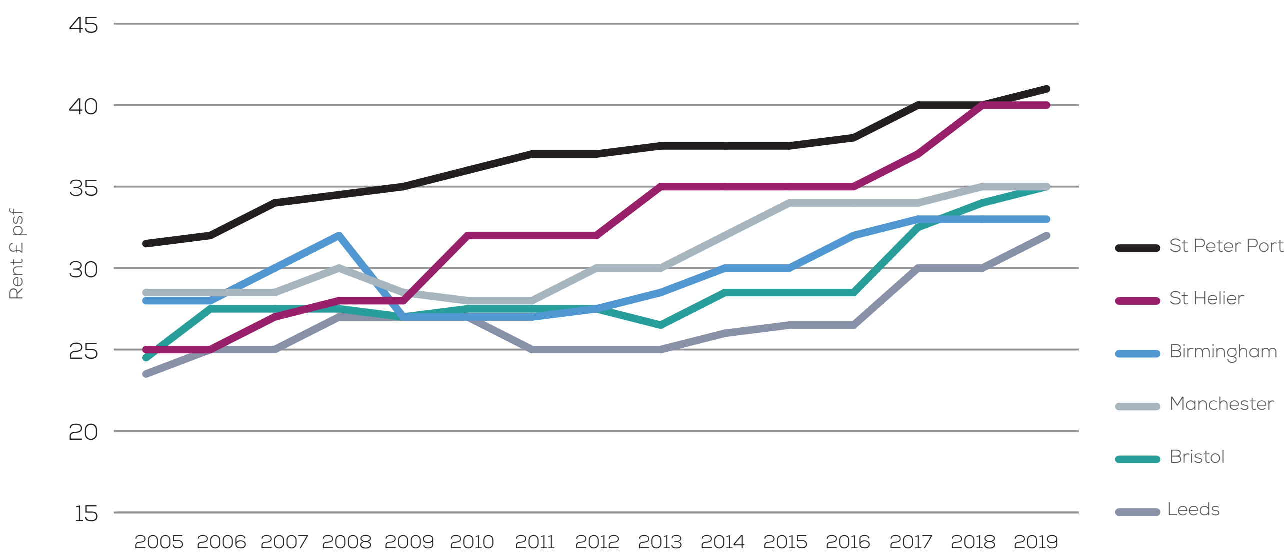
2020 should see rents rising, with prime stock on Glategny Esplanade for example, achieving headline rents of close to £40 psf. Once again, those tenants wanting prime space have limited choice and during the course of the year we have certainly seen modest rental growth during rent review negotiations. Dorey Court (£42 psf) set the tone in 2018 and Royal Chambers (£44 psf) in 2017, albeit generous incentive packages were offered.

Similar to Jersey, rising build cost inflation throughout the Channel Islands is a concern and will undoubtedly impact on rents in due course. It will then be a case for developers to demonstrate the cost benefit to tenants to relocate, offering lower service charge costs, utilities, efficient use of space, improved output through enhance working environment etc.

For the good quality, refurbished stock, rents have risen and are now in the region of £33 psf. Once again this is for good quality refurbished space with car parking, which is an essential requirement in St Peter Port and we have seen car parking rates rise over the past 12 months.

Certainly, from a landlord's perspective, the outlook is promising particularly where rents are below £40 psf on prime buildings. In some cases, we feel the market would benefit from a degree of transparency, and rents that have been distorted through granting significant incentives above the market rate which will ultimately be reflected in the yield. For older buildings, landlords who are prepared to invest and refurbish, have been rewarded with significant capital gains.

Prime Rents Source: D2RE / BNPPRE



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