Spotlight | 2018

Cambridge: A city state of mind?

Summary Cambridge needs to evolve to maintain its current level of success

- Cambridge continues to attract investment, notably in bioscience and technology research and development. It can maintain a competitive edge as labour costs are up to 52% lower than in the US
- Demand for commercial space is high, with only one year's supply in the pipeline. The city core remains strong, but developer confidence is also growing outside the city centre. There is appetite for value add opportunities on the edge of the city
- House price growth has stalled, due to stretched affordability and Brexit uncertainty. Median house prices in the city are 13 times more than median earnings, and buyers are looking increasingly to the hinterland instead
- Both the city and surrounding area need to continue to provide more housing at a range of price points, and in a range of tenures. Economic growth will be hindered if employees of all levels are priced out of the area
- Local and central government has a crucial role to play in planning and funding an expanding infrastructure network. Clusters of high value businesses need to be linked to a growing residential sphere of influence

A city state of mind?

Cambridge has been one of the success stories of the past decade, but there are signs emerging that it needs to adopt new strategies to remain in a position of strength

The Cambridge ecosystem that links entrepreneurs, investors and academics has resulted in the city becoming a leader in technology, life sciences and the emergent tech in between. Over the last ten years, the value of goods and services produced in the area has grown by 15%. But in tandem, pressures on the local property markets have continued to grow. Office rents are at £38 per sq. ft. per annum, a 52% increase over 10 years, while house prices have grown by 60% over the same period.

The question now is how well Cambridge can respond to these pressures. Are we seeing Cambridge spreading its wings and emerging as a new 'city state' dominating its surroundings, or will growth falter if supply can't keep up with demand?

On the face of it, Cambridge is still a rising star. It attracts investment from around the world, with £8.71 billion invested in 2017 alone, and the pay back is that it produces four times as many patent applications per capita as its nearest competitor in the UK. The Cambridge life sciences cluster alone is made up of more than 430 companies and organisations, and according to a recent report by AstraZeneca contributes about £2.9 billion to the British economy each year.

The draw of established knowledge intensive companies – the clustering effect – and pool of skilled graduates from the university has led to increasing numbers of companies choosing to be based in Cambridge. According to Cambridge Ahead, the number of businesses based in the city has increased by 31% since 2011. This has placed growth pressures on the supply of office and laboratory space.

In addition, the increased demand for housing as a result of these new arrivals has resulted in the least affordable market outside London, with median house prices holding steady at 13.3 times median incomes. This has led to a slowdown in the market, and increasingly those that can't afford such high prices are moving further out into a widening hinterland.

Looking ahead

For Cambridge to continue its success, it needs to maintain delivery of commercial space, and improve residential affordability. The relationship with the hinterland will become increasingly important, as it is beyond the city boundaries where the room to grow and deliver more affordable homes can be found. Cambridgeshire has already received a significant commitment from Government (£20m per annum over 30 years to kick-start economic growth alone) and has restructured itself significantly as a result as part of the March 2017 Devolution Deal.

The Greater Cambridge Partnership (GCP), the local delivery body for a more localised City Deal with central Government, will bring powers and investment worth up to £1 billion over 15 years. The focus in and around Cambridge is primarily on local transport, housing and smart technology initiatives.

Similarly, the new Combined Authority is keen to invest for the future; its proposed Cambridge Autonomous Metro mass transit system seeks to help address the area's notorious congestion problems. It is innovations like this that will be key to Cambridge's future, enabling the clusters of high value businesses to be linked to a growing residential sphere of influence.

A show of strength

Investment and innovation continues to support economic growth

Office & laboratory demand, supply and rents: The strength of Cambridge

Savills data shows the strength of the city centre market during the past 12 months. The majority of take-up, whether for offices and/or laboratories, has occurred in the city centre (Zone 1) around the central station and Hills Road. This area has accounted for 38% of take-up by square footage up to the end of Q2.

Supply is just over 100,000 sq. ft. of existing stock in this area currently, so the market has less than one years' supply at present. Positively, the city centre market has around 156,000 sq. ft. under construction, of which only 30,372 sq. ft. is pre-let.

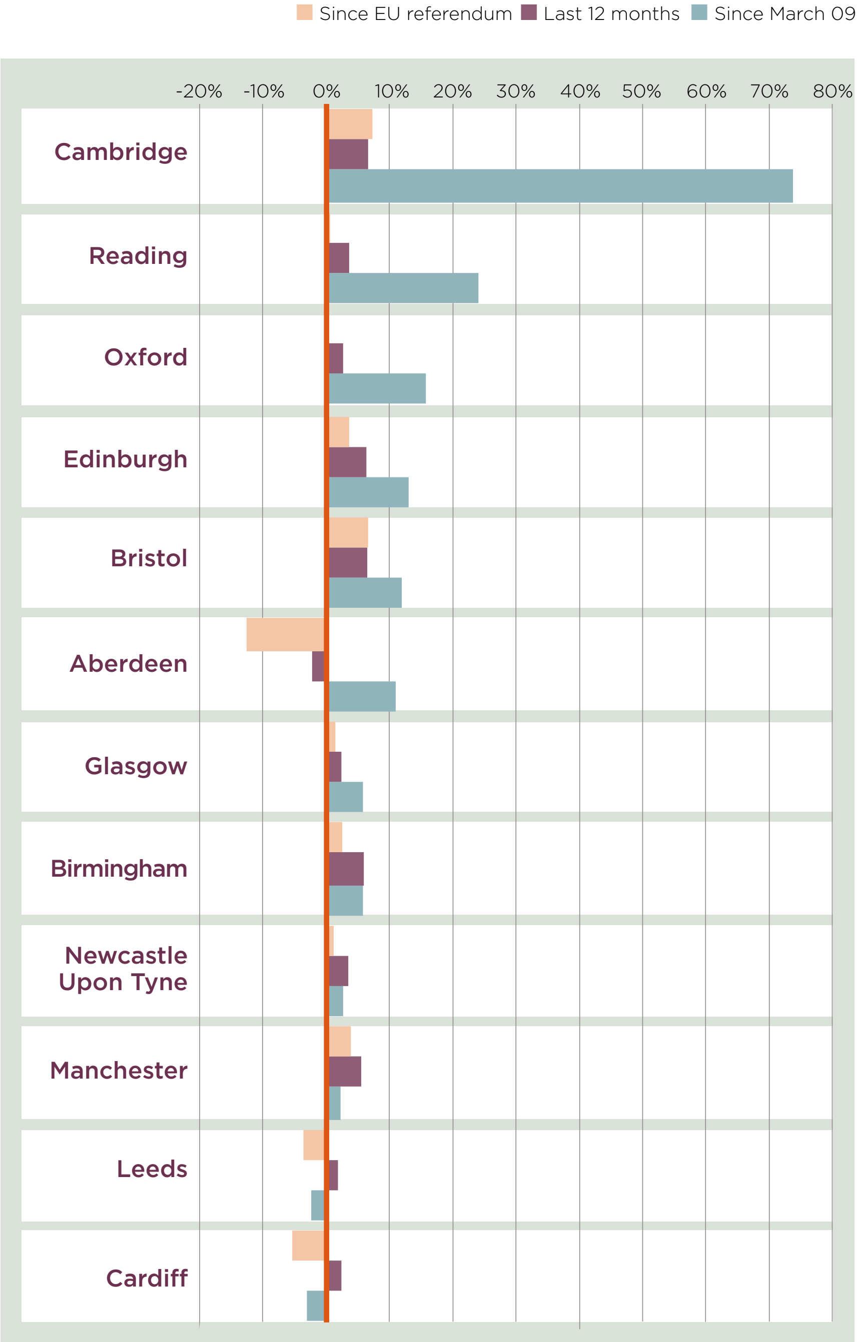
The UK commercial real estate investment market has seen an insatiable appetite from overseas investors for UK opportunities, particularly the larger lot sizes in London, despite the decision to leave the European Union. The Cambridge office market has seen £201 million of deals during the last five years (2013-2017); so far, 2018 has seen £139 million; more than half of this total has been within the office sector.

A major investment this year, involving an overseas investor, was the Trinity College and Tus Park joint venture. This £200 million deal involving the Cambridge Science Park development and Tsinghua University, a highly ranked university globally, highlights the attraction of overseas capital to redevelop the earlier parts of Cambridge Science Park as well as collaborate across a range of bioscience and healthcare sectors.

Since the last deep recessionary period for commercial property in 2009, the 'Cambridge Phenomenon' has driven capital value growth that has exceeded all other key regional cities.

Following the EU referendum, Cambridge has seen average capital values grow by 7.3%, which is the highest of the key cities shown in Figure 1. Investor confidence, supported by a strong occupier market and enhanced future corporate growth, has driven this. The majority of this growth has emerged during the last 12 month.

Figure 1 Changes in capital values are positive



Source: MSCI

A spreading of business geography for Cambridge?

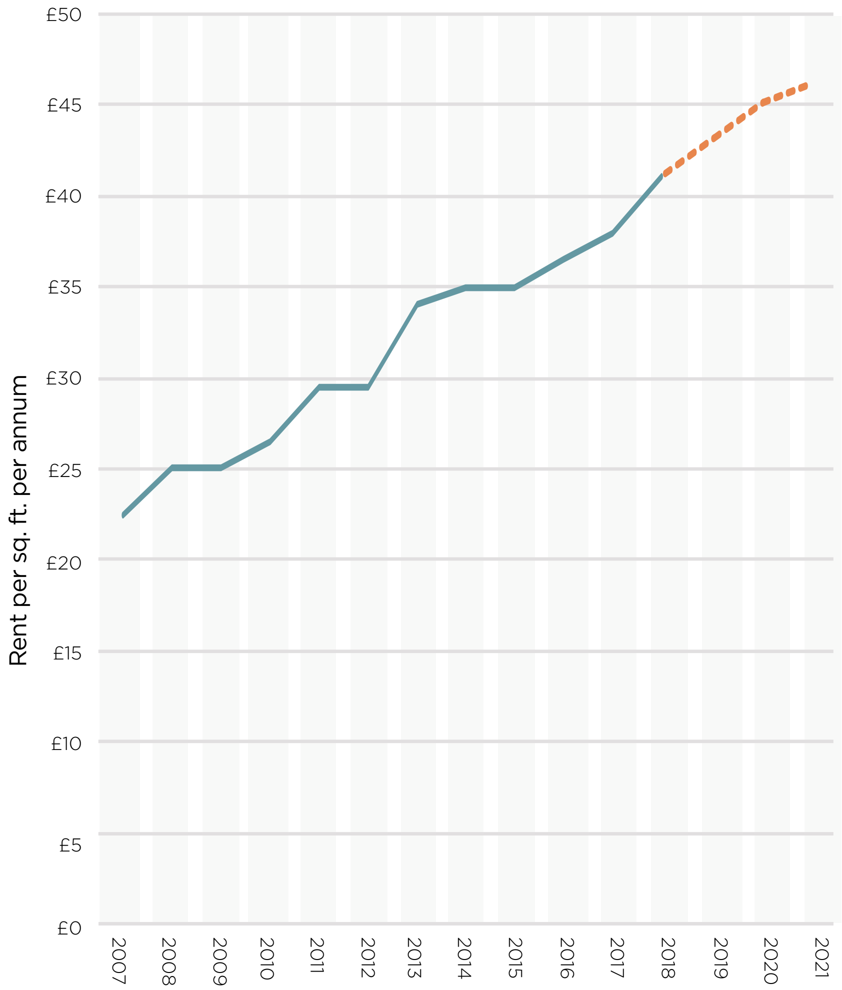
A key question for the future is the ability for the innovation economy to evolve and expand within Cambridge and its hinterland. Balancing cost of space with accessibility to the city centre is what corporates need to consider; and they do, carefully. Access to capital, transport, labour and knowledge are vital considerations and the question evolves in to how does Cambridge prosper and what is the potential for the hinterland to deliver real estate to achieve economic and social success.

How far from the city centre are commercial occupiers, of office and/or laboratory space, willing to be? Whilst the city core is still king, developer confidence is growing outside of the city centre. St Johns College and Turnstone completed the 65,000 sq. ft. Maurice Wilkes Building at St John's Innovation Park in July. The building was let to seven occupiers prior to practical completion. Biomed Realty are speculatively developing 108,000 sq. ft. of laboratory space at Babraham Research Park across two new buildings and Churchmanor Estates are speculatively developing 40,000 sq. ft. whilst simultaneously masterplanning for additional capacity at Chesterford Research Park. In addition the Howard Group are to speculatively construct over 60,000 sq. ft. of office/R&D space at Pampisford adding to the weight of activity on the southern side of Cambridge.

The continued lack of supply in the city core and the strong pre-letting activity in the Northern cluster and Cambridge Biomedical Campus has resulted in limited supply available. Royal London acquired Cambridge Research Park in Waterbeach for £78 million in H1 2018. This has highlighted the appetite for value add opportunities to the edge of the city, most recently the 75,000 sq. ft. speculatively built Enterprise industrial/hybrid scheme has experienced good levels of interest and enquiry since its recent completion.

The overall impact of current and future supply in the Cambridge market will be positive on future rental growth. The limited development pipeline and lack of available space in the city centre and northern fringe combined with the consistent good levels of occupier demand will result in headline rents increasing in the short term. We expect record rents to be achieved in the city centre at 50 & 60 Station Road. By the end of 2020 prime rents could reach in excess of £45 per sq. ft.

Figure 2 Prime Cambridge office/laboratory rental forecasts



Source: Savills Research

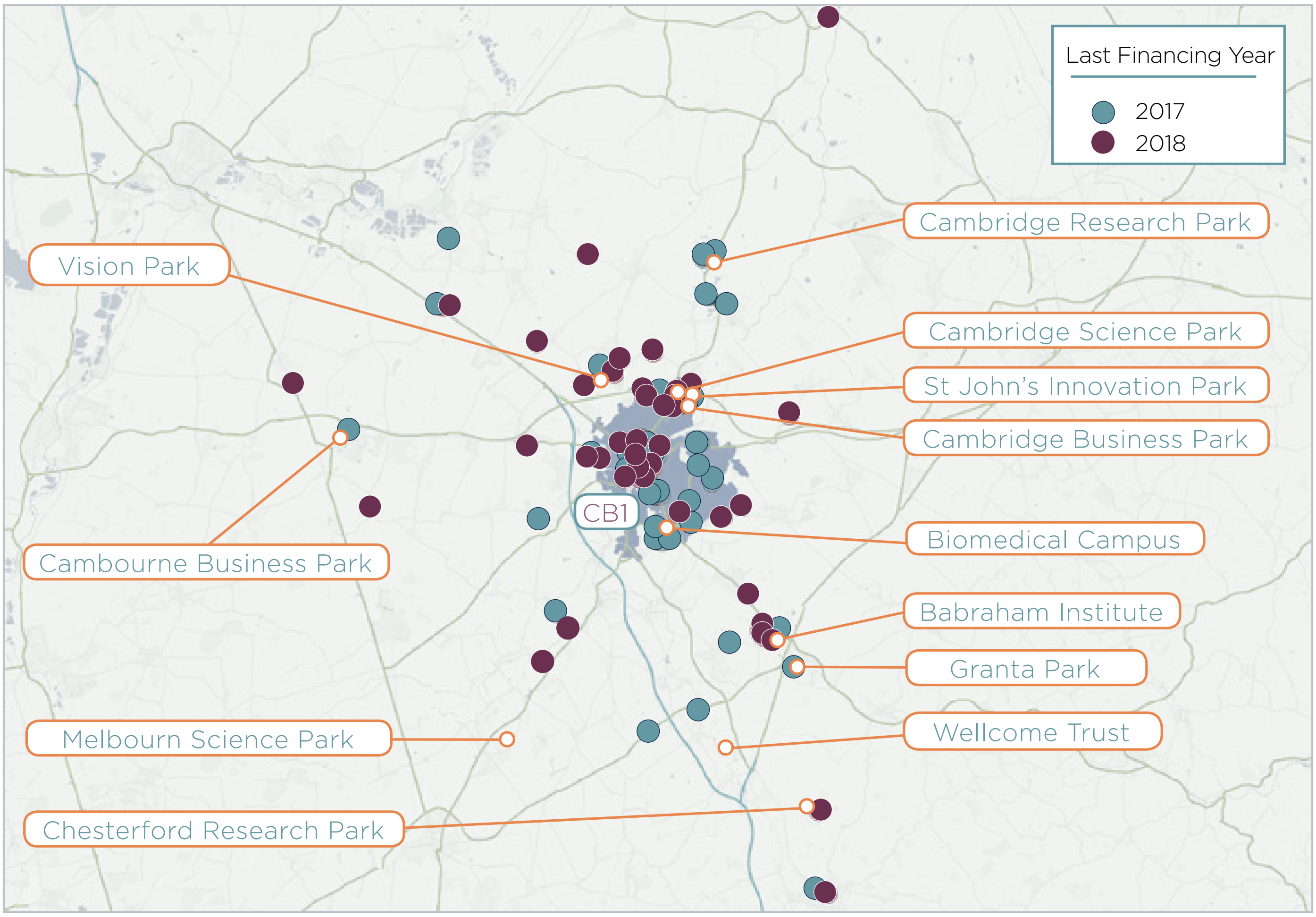
Corporate investment: shaping the future of Cambridge

The strong levels of corporate investment into Cambridge seen since 2012 continued in H1 2018. There has been over £8.45 billion invested into and by businesses in Cambridge in 2018. The majority of this investment (£8.25 billion) are by companies headquartered in the Cambridge area.

The five-year annual average, for headquartered companies, is £7.87 billion highlighting the relative strength of this year and continued confidence in Cambridge, and indeed, UK companies despite the uncertainty over Brexit.

There have been four deals worth over £100 million in 2018, highlighting the strong investor interest in Cambridge's tech cluster. This new investment into Cambridge companies will lead to expansion from existing occupiers in the market and therefore developers need to be able to respond to this latent demand. 81% of the companies which have received investment since 2012 have been headquartered in Cambridge. This is positive for the market as it is likely that Cambridge will directly experience the benefits of any expansion rather than if the businesses were headquartered elsewhere.

Figure 3 Distribution of corporate investment transactions



Source: Company data

Figure 3 shows the distribution of corporate investment for companies that are headquartered in Cambridge. In total, 89 transactions were recorded in 2017, and to date 74 transactions have been recorded in 2018. This shows, again, the continued strength of Cambridge in terms of confidence in the city and the ability for corporates to grow.

What type of 'next' sectors?

The obvious growth area for the Cambridge economy is the increase in technology businesses who are developing artificial intelligence (AI) software. Samsung has recently committed to opening a new AI research hub in Cambridge, which will add to the already growing cluster of mature and start-up AI developers. Microsoft also have a research base covering AI at 21 Station Road. A newer company, Darktrace is moving to The Maurice Wilkes' Building at St John's Innovation Park. Darktrace is one of Europe's most promising billion dollar technology companies.

The University of Cambridge will play a role as they have received £10 million of funding to develop a new supercomputer, which will enhance the research capabilities of AI companies. There is also a limited supply of AI experts across the UK, so the supply of new talent from the University of Cambridge, particularly those undertaking PhDs, will attract AI developers. The UK government's AI Deal is worth over £1 billion and Cambridge is well placed to capitalise on the increased investment into the sector.

New workspace provision is assisting with the evolution of new sectors. The start-up community in Cambridge is buoyant and is supported by the highly talented graduates who want an alternative to working for a corporate.

The Bradfield Centre at Cambridge Science Park is a new 40,000 sq. ft. facility dedicated to accommodating start-ups and scale-ups. This is a welcome addition to the "flagship" St John's Innovation Centre, which has been providing this type of space for over 30 years and is still in high demand. Savills is also aware of 100,000 sq. ft. of requirements from serviced office operators and envisage stronger demand from this sector in the future.

Employment growth prospects

Companies in Cambridge are expected to grow by 7% per annum for the next ten years according to Cambridge Ahead. When solely focusing on office based employment, Oxford Economics forecasts that in the next five years employment could reach 76,600 in South Cambridgeshire and Cambridge, a 6% increase on the current level which will drive demand for office space. The strong growth of the life sciences and technology sector in Cambridge notably AI technology development will be a key driver for job creation in the next few years. These forecasts will be further boosted by the proposed investment into employment from the "City Deal" and the "Devolution Deal."

The recently agreed City Deal will see £500 million invested by the Greater Cambridge Partnership until 2035 in supporting infrastructure. With extra funding from central government this will reach in excess of £1 billion. This investment will improve local transport infrastructure, accelerate housing delivery and provide new employment opportunities. The investment into employment will include 1,556 apprenticeships which will be in local growth sectors. There will also be additional support to small and medium sized enterprises. The Devolution Deal also aims to substantially increase employment as it is committed to accelerating the delivery of 90,000 new jobs.

Cambridge, UK versus Cambridge, MA

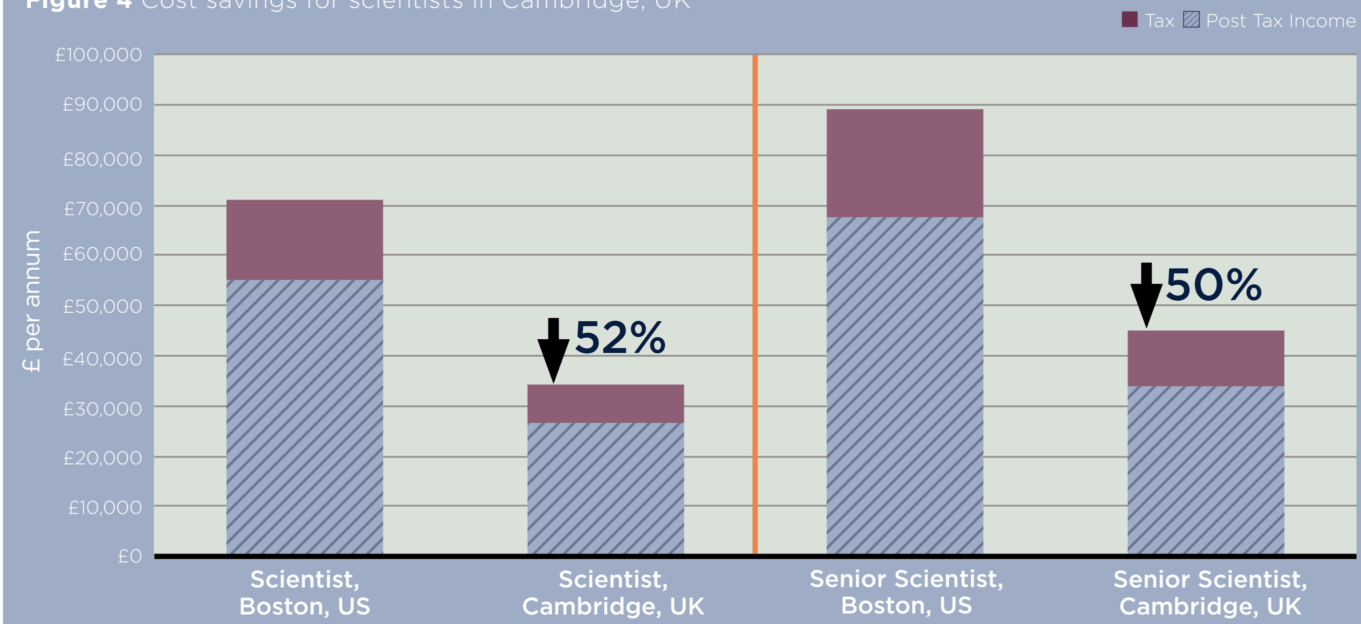
The future of Cambridge rests on its ability to continue to establish the growth sectors and deliver a real estate environment to enable companies to compete and thrive, but at the same time to be highly connected to sources of capital. Cambridge, therefore, competes at the highest global level within the bioscience and technology fields. So Savills has asked the question of how Cambridge measures up, for some variables, against its US namesake – also a centre of global significance within the same sectors.

When the UK's Cambridge office/laboratory rents hit the £41 per sq ft level by year end, they will only be 6% lower than the highest rents seen in Cambridge, MA this year. However, it is well known that salary costs are by far the biggest cost and differentiating financial factor in locating a corporate.

The impact of Brexit has, of course, delivered uncertainties for the UK and for those companies located here. However, the impact from a weaker Sterling/Dollar exchange rate is now a significant driver. Personal taxation and these Sterling impacts have impacted on the latest analysis. In 2016, Savills highlighted a 40% discount for UK scientists compared to the same roles in the US (and for the same companies).

As shown in Figure 4, this differential has widened. For the UK scientist, the salary level was similar between 2016 and 2018; the Senior Scientist level has increased by 4.7%. However, compared to the US sample, the UK discount sample is now 50-52% lower. The case for Cambridge, UK employees has strengthened significantly compared to the US.

Figure 4 Cost savings for scientists in Cambridge, UK



Source: Savills Research

Changing focus for residential development

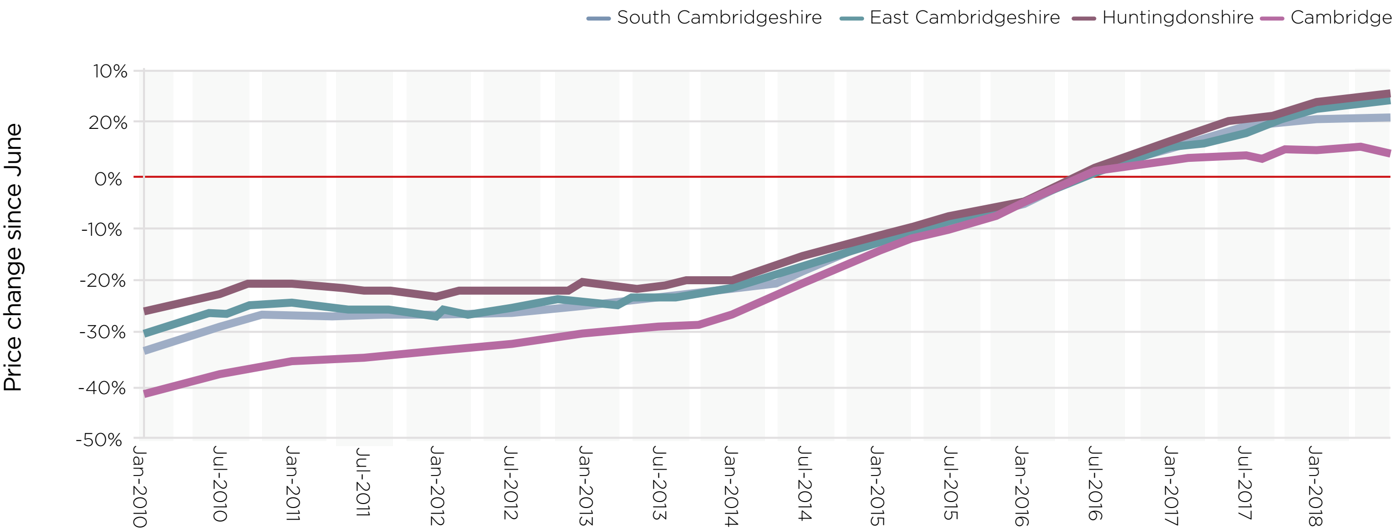
House price growth is slowing but lack of affordability remains a challenge

Cambridge saw a 1.7% decline in house prices in the year to May 2018, mirroring the London market's response to political uncertainty, stamp duty hikes, and the targeting of buy-to-let mortgages. Price contractions have been most strongly felt in the new build market, with reductions in asking prices averaging between 5% and 8%. 4 and 5 bed houses have seen the largest price falls. Despite these falls, affordability remains a challenge for many buyers, with Cambridge house prices nearly twice the national average at £421,250 in Q2 2018.

The greatest affordability pressures come in the city itself, where median house prices are 13.5 times greater than median annual earnings. In comparison, in the neighbouring local authorities of South Cambridgeshire, Huntingdonshire and East Cambridgeshire, house prices are 11.0, 8.7 and 9.8 times earnings respectively. Although this still makes housing affordability a concern for many would be buyers, they are not as stretched as those seeking to buy in Cambridge itself.

The result of the disparity in affordability between the city and areas surrounding Cambridge is that large numbers of domestic buyers are looking instead to neighbouring towns. Consequently, market activity is higher in Cambridge's hinterland; in 2017, residential transactions in Huntingdonshire were equivalent to 4.2% of stock, while in Cambridge turnover was only at 3.1%.

Figure 5 Residential growth has stalled since the EU referendum



Source: Land Registry

The impact of Brexit

Uncertainty is likely to be the driving force in the market for the next couple of years as the UK negotiates its exit from the European Union. This is most clearly seen in the number of overseas buyers in the market. According to Savills dealbook data, the proportion of non UK buyers in Cambridge has fallen from 38% in 2015 to 28% in 2017. International buyers are more unwilling to commit to a purchase while their immigration status post March 2019 remains unclear. However, Cambridge is still attracting an international workforce, who are instead looking to the rental market. In 2016 and 2017, 29% of new Savills lettings were to European tenants.

Confidence is likely to return to the market once the future of the UK's relationship becomes clearer, and with the recent adjustment in pricing, there should be room for a return to growth. However, this is an evolving situation encompassing a wide range of possibilities. Oxford Economics' Brexit forecast is split equally between two opposing scenarios; continued regulatory alignment with the EU (Brexit in name only) or the UK falling back onto World Trade Organisation rules (no deal).

The first scenario would likely result in a quicker bounce back after March 2019, while the latter, in combination with steadily rising interest rates, would act as a drag on growth rather than anything more severe.

Meeting housing need

Despite the slowing market, Cambridge has still delivered high volumes of new homes, with new build transactions accounting for 20% of all sales recorded by Land Registry in the year to May 2018, albeit this has fallen from 30% in the same period last year. The city also has a strong residential development pipeline; we have identified sites with capacity for over 17,000 homes, either in planning or currently under construction in the city.

However, much of the new development is aimed at the top end of the market; the average transaction value in the year to June 2018 for a new build house was £814,865, 33% higher than the average value for secondhand houses. In contrast, in South Cambridgeshire, new build values were 1.8% below secondhand values.

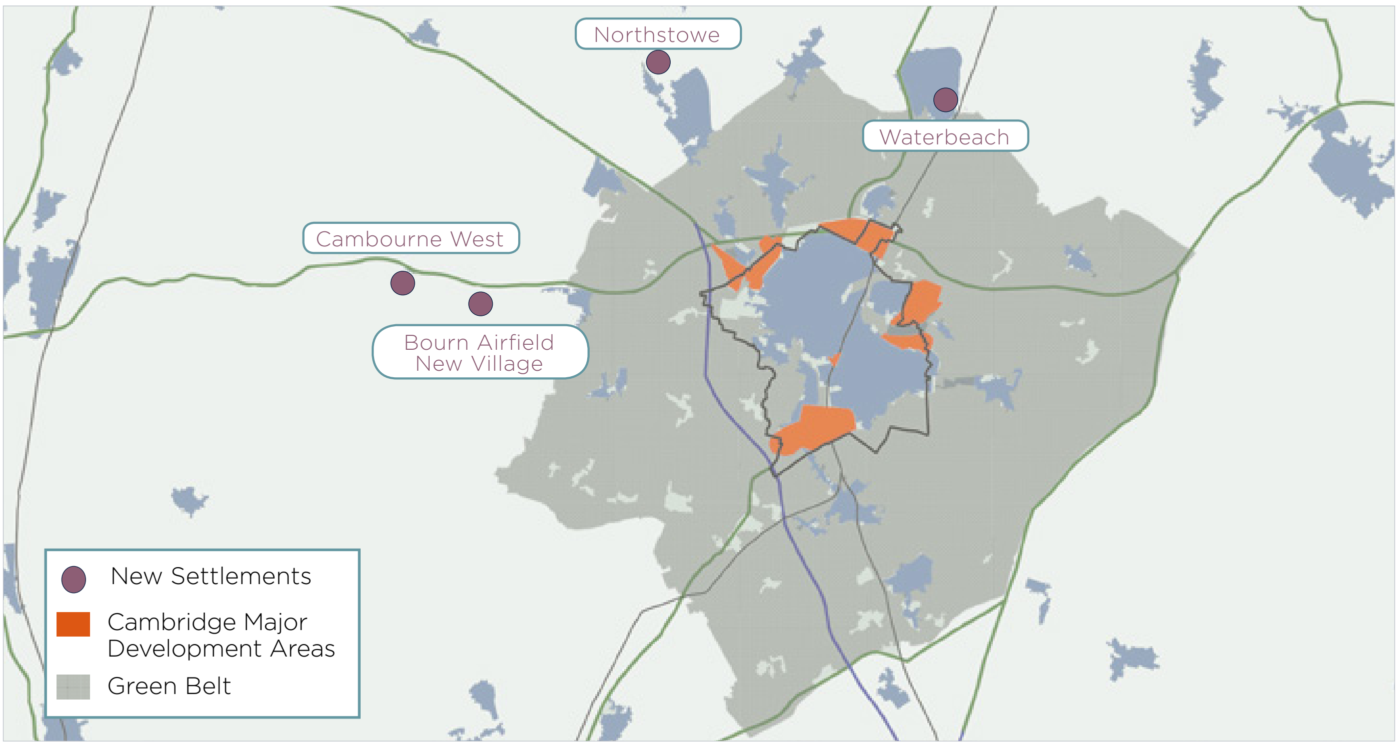
The local plans for Cambridge and South Cambridgeshire were given approval at examination in early September. This sets the housing requirement for the two authorities at 33,500 new homes by 2031. This is equivalent to 950 homes per year in South Cambridgeshire and 700 in Cambridge over the plan period.

To deliver this level of new housing in a more challenging market, developers will need to adopt new strategies. There have already been pricing adjustments which should help tackle the affordability challenge, but an increased focus on delivering smaller units at prices that are eligible for Help to Buy support would also help increase the numbers of buyers able to access the new build market.

Our research last year demonstrated that in less affordable markets like Cambridge, highest sales are achieved where pricing is in line with or at a discount to the secondhand market. In Cambridge itself, limited land supply and demand for variety of uses, such as hotels and student accommodation alongside residential, makes it harder for developers to deliver new homes at this price point, and therefore, rapid delivery of homes for open market sale is most likely to be found on sites in the city's hinterland.

There is also the opportunity to deliver more purpose built rental stock. Cambridge is unusual in comparison to similarly sized regional cities as it currently has no build to rent schemes under construction, although there are proposals at an early stage for 600 PRS homes at Cambridge North. In contrast, there is a pipeline of over 1,500 PRS units in Bristol. Delivering alternative tenures will also help market absorption, and in Cambridge there is strong rental demand both from young professionals to live in the city centre and increasingly from families looking for homes in more suburban or rural locations.

Figure 6 Delivery will come from new settlements beyond the Green Belt, requiring infrastructure support



Source: Savills Research

Shifting focus

The focus of new housing delivery in the city will shift. Since 2012, the Southern Fringe has contributed significantly to Cambridge's supply of new homes, with Trumpington Meadows and Clay Farm together representing 30% of all new build transactions within a 10 mile radius of the city. Over the next five years, delivery from the Southern Fringe is projected to total around 500 units, as the remaining homes on these sites are built out.

Instead, the bulk of delivery for Cambridge will shift to other urban fringe areas, predominantly North West Cambridge. The site has capacity for 5,800 homes in total, and is anticipated to deliver 1,500 homes by 2023. In the longer term, there is likely to be a growing emphasis on delivering major new sites between Cambridge and Bedford, to support ambitions for 1.1 million new jobs and 1 million new homes by 2050 in the Oxford-Cambridge corridor.

New opportunities will emerge as the new transport routes are defined, with confirmation of the new rail route expected in 2019 following a series of public consultations.

Housing requirements could shrink in response to new household projections

Although the local plans for Cambridge and South Cambridgeshire have gained approval at examination, this is subject to the local authorities agreeing to beginning an early review of the plans in 2019. This will involve reassessing housing requirements, and is likely to produce very different figures, as it will use the new standard methodology for calculating housing need introduced by the revisions to the NPPF in 2018.

The new methodology takes household projections as the baseline, and applies an uplift based on housing affordability. New household projections are due to be published at the end of September, and we anticipate they will be much lower for Cambridge than the 2014 projections, in line with latest population projections.

The 2026 projected population has dropped 10%, from 138,000 to 125,000 people. International migration which was expected to contribute significantly to Cambridge's population is now projected to cease contributing by 2020 and by 2023 will represent a net negative for Cambridge's population growth.

As a consequence, the standard methodology for calculating housing need, which draws on these household projections will likely produce a much lower housing target for Cambridge when the local plan is reviewed. In light of the new household projections, the government is planning to review the standard methodology, but any revisions are not expected until the end of the year, so the potential changes to Cambridge's housing requirements will remain unclear for several months.

It is important to consider that local authorities are able to apply an uplift to the standard methodology figure based on local industrial strategies or planned economic growth. Given the affordability pressures facing Cambridge and its position in a strategic area for economic growth, it will be important to continue to plan for enough housing to ensure the city's continued success.

Figure 7 Average transaction values, year to May 2018

	New build flat	Second hand flat	New build house	Second hand house
Cambridge	£422,966	£334,583	£814,865	£578,228
South Cambridgeshire	£260,000	£213,185	£429,390	£437,478
East Cambridgeshire	£218,947	£157,703	£354,783	£316,757
Huntingdonshire	£211,154	£160,034	£346,800	£306,685

Source: Land Registry

The future of farmland

There are signs that values are settling, but the outcome of Brexit negotiations will be key

The Cambridge region is of national significance within the agricultural industry, due to the scale of many farm business' and diverse cropping. Brexit is the greatest issue for farmers to consider at present, be it the impact this will have on support payments; the implications arising from trade negotiations; and the availability of seasonal labour.

Whilst businesses are preparing for the impact of Brexit, crucial aspects such as our future trading arrangements with the EU remain uncertain. The prospect of departing the EU with no deal in place appears to have become more likely, although the Government remains confident tariff free access will be secured. For agricultural policy we do at least know the direction of travel. Future policy and any support schemes will have an increased focus on public money for public goods, especially environmental enhancements.

The Government recently published the long-awaited Agriculture Bill. The Bill represents a significant departure from the approach that we are accustomed to under the Common Agricultural Policy. Crucially, unlike the CAP, there will be no income support element to the payments planned under the Agriculture Bill. The transition away from the current system of payments based on the area of land farmed is planned for 2021 onwards for a period of seven years. This transition phase is likely to expose arrangements in rent, tenancy and tax planning that will require careful consideration.

The outcome of trade negotiations is probably more important than domestic agricultural policy. It is a 'no deal' scenario which poses the biggest short-term challenges to the UK economy. Trade flows between the EU and the UK will be subject to tariffs and rules constrained by the WTO default position. The effect of the imposition of new tariffs and procedures with a key trading partner is the main concern here.

There are three separate areas to consider: the effect of tariffs, the effect of border inspections, and the implications for UK agricultural policy as a result.

Land sales and values

As a result one might have expected a reduction in the number of farm sales, particularly given the challenging weather we have experienced since last autumn.

However, our research shows that across England supply in the first seven months of 2018 was up 14% on the same period of last year. However, there were significant variations in activity across the English regions. In the East of England activity was significantly higher – up 52% on the same period of 2017.

The scale and profile of demand has remained largely unchanged over the past three years, with farmers accounting for around 40% of purchases. In 2017, there was increased interest from institutions, while the return of the lifestyle buyer has continued. Expansion of existing farm businesses remained the primary reason for buyers and accounted for just over half of total transactions.

Personal circumstances, such as retirement and death, account for a significant number of sales – around 40% during the past three years. However, the number of sellers citing debt as their principal motivation has increased from about 8% in 2015, to around 20% since 2018.

With future farm income potentially under pressure, and the cost of serving loans set to increase, we believe debt will continue to be one of the material factors driving supply and could also temper demand.

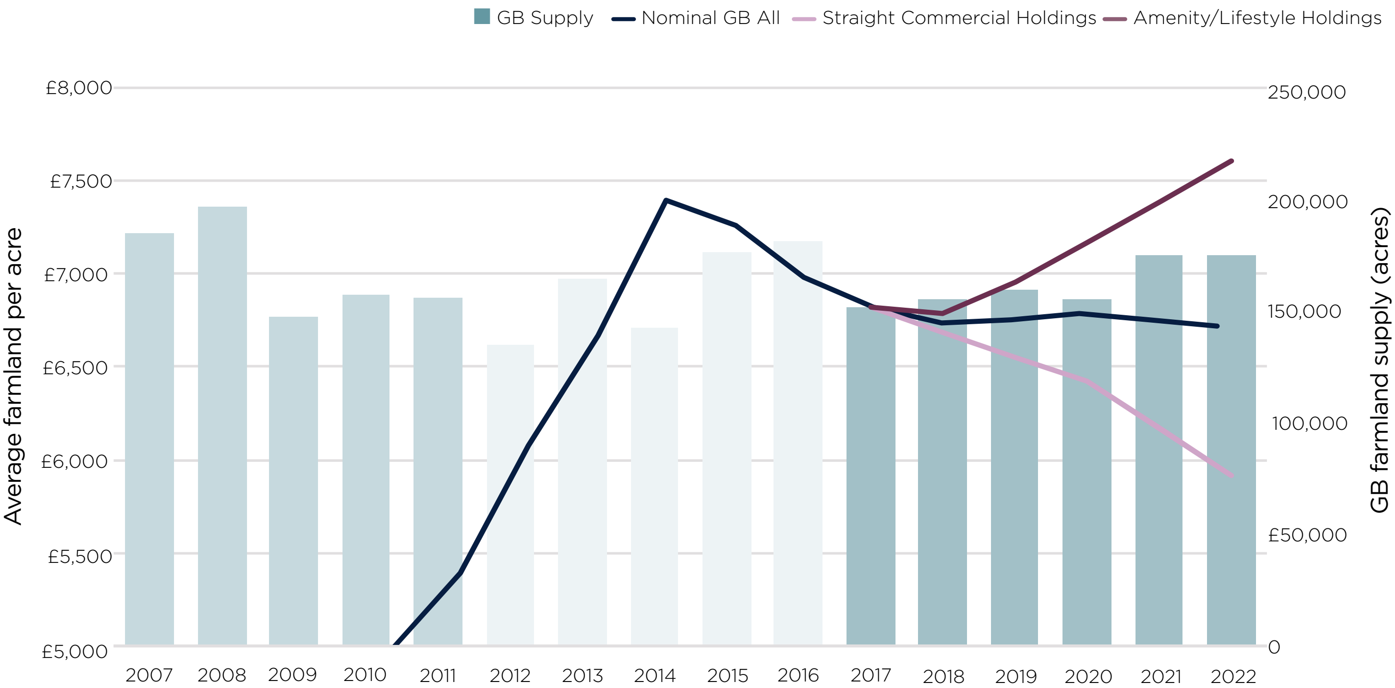
The decline in average farmland values over the past three years is well documented and there are now clear signs that values for most regions and land types are settling with only minor price adjustments. The latest results of our Farmland Value Survey show that average values across GB are relatively stable, falling by just -0.6% during the first half of 2018.

There is also widening disparity between pure commercial productive ground and holdings with higher amenity value. This is clearly seen in average arable values in the eastern regions. In the East of England average prime arable values are around £9,000 per acre although the actual prices achieved are dependent on local demand.

Figure 8 Strength of key demand factors

Source: Savills Research

Figure 9 Farmland values against supply



Source: Savills Research

Future opportunities

The shape of future agricultural policy is currently uncertain although the evidence is building and we know that after 2022 any subsidy system will be on a very different basis to the direct BPS payments.

Farmland is different from other assets in that it is tangible; you can live on it, play on it, bring up your family on it and at the same time it also offers a range of income generation opportunities from food to energy. In addition, it is transferable to the next generation in a tax-efficient way.

Long term capital appreciation is the prime attraction for holding agricultural land as an investment, as income returns are historically relatively modest compared to commercial property. Its performance is relatively recession proof resulting in a low or negative correlation with other traditional asset classes such as stocks and bonds and therefore it is a valuable asset to hold as part of a diversified investment portfolio.

Many factors contribute to the performance of farmland values and it is the balance between them that determines the outcome for each sector of the market. The current strength of commodity prices and the weak pound are positive influences for arable farm profitability at a time when the future of agricultural trade and policy is uncertain.

Our outlook for the next five years shows an overall recovery to positive growth, albeit at a pace below historic trends. However, much will depend on the outcome of trade negotiations and revisions to agricultural subsidy.

Savills team

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