



# THE COMMERCIAL IMPACT OF SUSTAINABILITY

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The impact of sustainability, as a business issue, on the commercial property market has been exaggerated. For sure, we can see which way the wind blows and we can be reasonably certain of the end result but, so far, we have seen little evidence that sustainability has had any impact on rental values, vacancy rates or capital values.

### Increasing importance of sustainability

Numerous surveys of concerned consumers and enlightened companies suggest that sustainability is increasingly important to companies wishing to protect market share and to recruit and then retain the best quality staff but, as yet, there seems to be a wide gulf between what people say and how they actually behave.

Some say that sustainable buildings will soon come to command premium rents whilst others believe that older, less sustainable buildings will suffer from an accelerated fall in value as occupier demand falls off, voids increase or the quality of tenant and length of lease are eroded. Ultimately, both views will probably be right but the killer question remains: when is this likely to happen and how far will values shift?

Whilst there are still too many uncertainties, there are a number of clear trends that

can be used to model some of the impact on investment portfolios together with a range of new risks that can be measured, monitored and, perhaps, even managed as part of an enlightened portfolio management strategy.

### Traditional drivers of value remain

Sustainability will not fundamentally change the importance of the traditional drivers of value: location, specification and the longevity and security of income. As always, the most valuable properties will be those that most closely match occupiers' requirements. Clearly, if all other factors are equal, a tenant will prefer a building with a better environmental performance. But all other factors are rarely equal. Increasing numbers of occupiers have published environmental policies, which commonly set targets for reducing carbon emissions. Since just under 20% of carbon emissions in the UK come from the use of commercial

## The commercial impact of sustainability

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buildings, occupiers will inevitably need to address the environmental efficiency of their operational estates in meeting these voluntary but often very public targets.

Some occupiers have already issued statements about the minimum standards required on the acquisition of new properties – often expressed in terms

**So far, we have seen little evidence that sustainability has had any impact on rental values, vacancy rates or capital values**

of Energy Performance characteristics or the Building Research Establishment's Environmental Assessment Method ("BREEAM").

This clearly has implications for property owners with vacant properties but, even if only in the short term, occupiers' environmental aspirations may end up being compromised due to the scarcity of qualifying stock in some locations and by the over-riding issue of affordability.

### Existing properties

The bigger challenge for most property owners is to decide what to do with their existing properties, a challenge that is shared by the government, as there is no hope of meeting carbon reduction targets unless emissions from existing buildings can be significantly reduced. If occupiers have been slow to translate environmental policies into leasing decisions, there is even less evidence that many organisations outside the public sector are getting to grips with existing estates on any meaningful scale.

Sustainability and, more specifically, energy efficiency do not seem to feature strongly in occupiers' decisions on whether to renew existing leases or to relocate, and the energy savings made from moving to more efficient premises simply do not justify the overall cost of relocating a business. This will change over time, of course, especially if the government introduces punitive taxes and imposes legal requirements to undertake improvements, all of which are almost guaranteed if carbon reduction targets are to be met.

### Client retention

For now, it is too soon to make accurate predictions on the impact of sustainability on occupier behaviour or to make more than a well-informed guess as to the exact nature of future legislation. In the meantime, property owners are well advised to examine the risk posed to existing assets from climate change and to develop regimes to monitor the growing influence of sustainability on the retention of key tenants.

## INVESTMENT VIEWPOINT

### Have base rate reductions had an impact on the B8 investment market?

The slowdown in investment market activity and the decline in capital values from their peaks in June 2007 were driven primarily by a reduction in the availability of debt and a fall in confidence in the underlying market rather than the prevailing level of base rates. You would not expect therefore that cuts in the base rate from 5.75% in July 2007 to 1.0% at February's MPC meeting would in themselves spur a return to higher volumes of activity and a stabilising in capital values.

Two types of investor who drove the shift in pricing up to the market peak are likely to remain on the sidelines: UK institutions will not become buyers of big sheds until their confidence in the economy and market outlook improves, while leveraged buyers cannot secure Loan to Value (LTV) ratios high enough to hit their geared IRR targets.

That being said, two consequences of the drop in base rates are boosting activity from a low base: one direct and one indirect. Now that LIBOR and swap rates have followed base rates down – to 2.1% (3 month LIBOR) and 3% (5 year swap) respectively – all in borrowing costs are well below initial yields, even against December yields measured by IPD as shown below. Private property companies with sufficient equity to fund deals at

lower LTVs have therefore returned to a sector that has seen yields unwind from 5% to 8%+ in an 18 month period. Opportunistic buyers like Dwyer who have bought Tesco in Didcot, which offers 16 years of unexpired income off a yield of 8.1%, and Emersons Green in Bristol, with 14 years of Sainsbury's income off 8.2%, can benefit from this positive financing gap.

An indirect consequence for the market of the drop in base rates is the decline in sterling it has triggered.

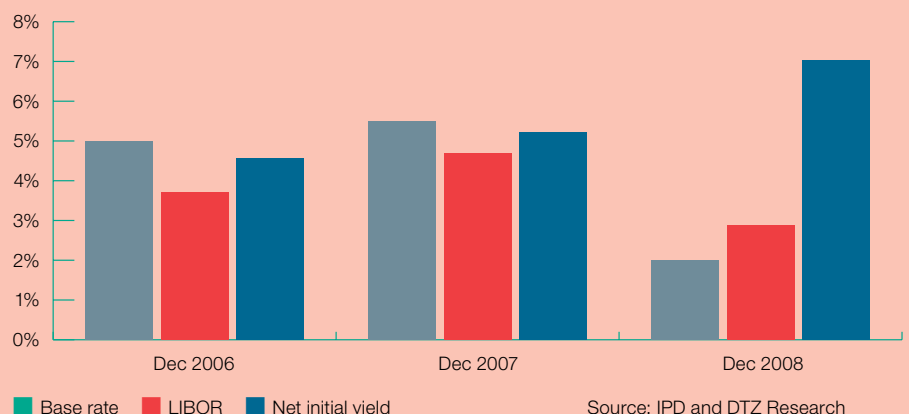
**The 20% slide in sterling against the euro makes the UK look better value for continental investors who are now entering the market along with the private property companies**

The 20% slide in sterling against the euro makes the UK look better value for continental investors who are now entering the market along with the private property companies. Examples include Deka's purchase of Sainsbury's at Waltham Point for 7.9% (21 years to Sainsbury's), and

Garbe's acquisition of Celestia in Milton Keynes for 8.6% (15 years to Jenks).

The positive financing gap and combination of good covenants and long leases have resulted in greater activity in big sheds than other sectors of the market at a time when income security and risk aversion are paramount. Further falls in base rates will only help the sector, but we do not expect any meaningful reversal of the softening in yields until confidence in the occupier market returns for the UK institutions and LTVs start to increase.

### Money rates



# UK Ports and Airports - Navigating the way ahead

“Congestion, whether it is on our roads or railways, is not just a nuisance to travellers, it is also a tax on the productivity of our businesses, and if left unchecked could become a brake on growth”

**Geoff Hoon** Transport Secretary  
24 November 2008

Transportation hubs are key drivers of logistics activity and have long been a focus of investor attention, both in terms of the property needed to operate the hubs and the resulting logistics activity in surrounding conurbations. As the capacity of established UK transport hubs and networks are stretched to breaking point and sustainability issues rise up the agenda, alternative transport modes, such as short sea shipping, are likely to become increasingly popular.

In a report to be published shortly, DTZ Research identifies the potential opportunities created by a modal shift such as this, and analyses the extent of the suitability of inland waterways for transporting commercial freight. Against the backdrop of an increasingly competitive European logistics market, the report also looks at current themes in the UK port and airport markets and provides a focus on Heathrow.

### There's something in the water

In the current economic climate, the development of opportunities seems a distant prospect. However, anticipating long term changes in supply chain dynamics – such as a move towards co-modality and the increased use of fuel-efficient transport – is crucial to strategic long term property investment in the logistics sector.

Road haulage is still the most dominant form of transportation within the UK. However, in comparison, water transport uses less than a third of the fuel and emits less than a sixth of the overall pollution per standard load. These environmental benefits, in conjunction with EU and UK policy encouragement of the use of water as a means of transporting freight, will mean that over the longer term the mode will become more attractive to companies. To date, however, largely due to the perceived higher costs and levels of bureaucracy, few companies have realised the potential of inland waterways as a means of transporting commercial freight.

### The links effect

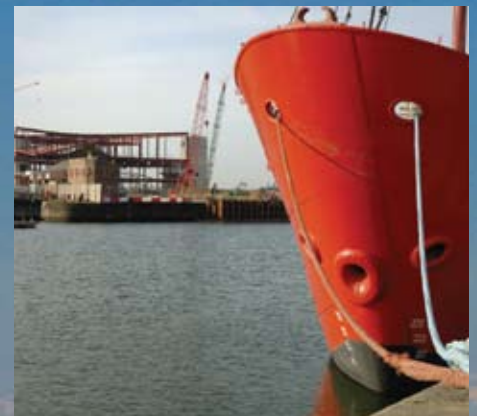
As a result of the combination of the global downturn in trade and increasingly stringent energy efficiency policies, more and more companies will seek to increase supply chain effectiveness, both in terms of cost and energy efficiency. Rail and water are anticipated to be the beneficiaries of this increased scrutiny. As inland waterway ports become busier, the demand for industrial property in the areas surrounding these expanding transport hubs is likely to increase. The report examines the development prospects in these locations.

### Heathrow – up in the air

The use of water is given further encouragement through the polemical arguments surrounding the expansion of airport capacity, especially regarding the third runway at Heathrow. The

environmental credentials and the importance of the aviation industry to the economy are topics currently under the spotlight, and all this is set against a backdrop of looming European emissions targets. As it is anticipated that future growth in freight cargo will be at specific airports (a combination of freight 'specialists' and airports handling wide-bodied long-haul flights) rather than across the board, a heightened awareness of current airport developments could identify future opportunities for logistics development.

Accordingly, DTZ Research's report also assesses the capacity constraints and development plans of UK ports and airports and provides commentary on EU and UK industrial property performance. The relative strengths and weaknesses of short sea shipping as a viable mode of transport are also examined.



If you would like to order a copy of 'UK Ports and Airports – Navigating the way ahead' contact Anna Kelly - [anna.kelly@dtz.com](mailto:anna.kelly@dtz.com)

# Scotland

Contact: Ross Sinclair  
+44 (0)141 304 3256

As Scotland is currently not affected by the empty rates legislative changes introduced in 2008, it would normally expect to have seen some form of competitive advantage from its English and Welsh counterparts. However, the current economic downturn has effectively eradicated any such advantage.

With static headline rents, rising investment yields and difficulties in borrowing, the last six months have seen a virtual stagnation in speculative development activity. St Modwen are speculatively building some 80,000 sq ft of space in four separate units at Pegasus Business Park in Hillington and Eurocentral Partnership are building six units ranging from 40,000 to 122,000 sq ft at Eurocentral in Lanarkshire, but they are certainly in the minority of developers.

The only positive is that construction costs are levelling out somewhat due to the lowering margins that contractors have to use in order to win business, together with a drop in steelwork prices due to a reduction in global demand.

On the occupational side there has been a gradual shift back to leasing, caused primarily by the difficulties of funding freehold purchases. Enquiry levels are considerably lower than they were some six months ago, although there are still some sizeable requirements in the market.

It is difficult to give an accurate assessment of land values as there are so few transactions taking place. However, we estimate that they have dropped somewhere between 10% and 20% over the last six to 12 months as the viability of schemes has deteriorated.

The concern shared by most property advisers is that we are now beginning to see several 'distressed' sellers, exacerbating the decline in values. This will further lengthen the time before a viable development market returns.

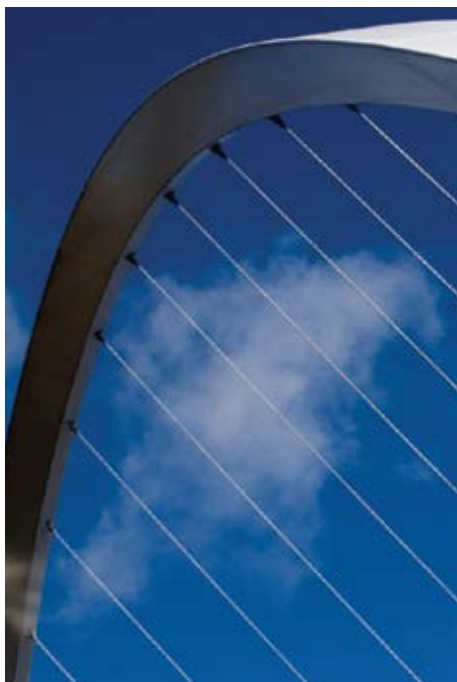
On a more positive note, there have been a number of significant deals in the past six months including:

- Kuehne + Nagel took a 10 year lease on a 50,000 sq ft modern building at Hamilton International Park at a headline rental of £5.25 per sq ft
- Centrica Plc paid £5.30 per sq ft for a 25,000 sq ft unit on Hamilton International Park
- St Modwen have pre-sold one of their four new buildings in Pegasus Business Park to Toolbank, at a reported price of £85 per sq ft.



# North East

Contact: Nick Atkinson  
+44 (0)191 223 5714



The last six months have seen a significant reduction in the volume of enquiries, particularly for units less than 3,000 sq ft and greater than 50,000 sq ft. However, properties between 5,000 and 20,000 sq ft in particular continue to trade well – indeed at a similar level to the last 12 to 24 months.

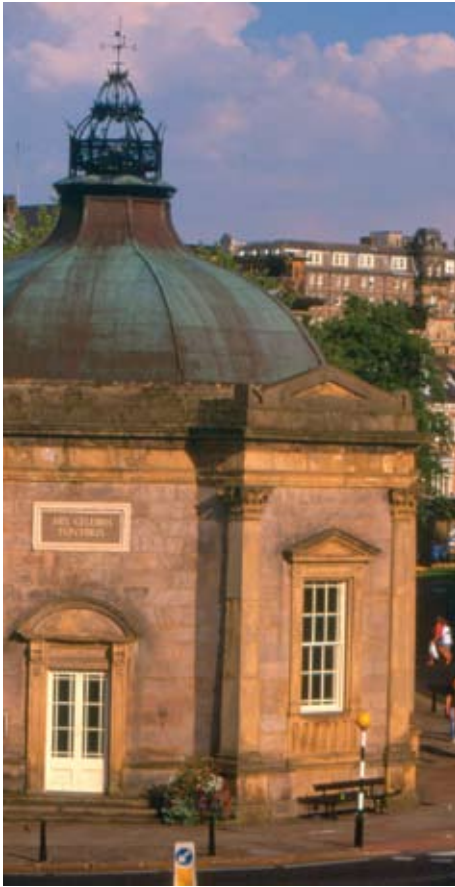
There are a number of niche sectors within our market bucking the trend and looking to take advantage of the good deals on offer. Two examples are offshore engineering and the new emerging markets of recycling and renewable energy. The former Neptune shipbuilding yard on the Tyne has been earmarked as a possible renewable energy centre to service the proposed offshore wind farms. This is a potential silver lining to a cloud that hangs over the remainder of the manufacturing industry in the North East following high profile closures such as LG Phillips Displays, Black & Decker and Electrolux, to name a few.

Nissan is the one to watch in the North East. The car manufacturer and its associated supply chain are widely reported to represent in excess of 20,000 jobs in the region. The automotive industry is facing tough times, and whilst Nissan is one of the most efficient car plants in Europe, they are constantly striving for further efficiencies to compete with the Far East and indeed have recently announced staff losses.

New industrial development is not currently viable without gap funding so the diminishing supply of new properties is shoring up rental values. There are only seven new units in excess of 60,000 sq ft in the entire region, including Teesside, although competition is emerging from second-hand units as a result of business failures.

Finally, deals on tertiary accommodation are becoming ever more competitive with landlords keen to offset the rating liability and security risks of vacant buildings.

Contact: Mike Baugh  
+44 (0)113 254 3112



The outlook for the Yorkshire industrial market remains steady going into 2009. There continues to be demand and take-up of units below 30,000 sq ft in main centres, and although transactions on larger units are taking longer to complete and demand has reduced as a result of the economic climate, transactions are still occurring across the region.

There are currently about 7 million sq ft of units over 100,000 sq ft available on the market. This number is expected to increase as companies go bankrupt or seek to survive the difficult economic situation through consolidation.

2009 has begun with an encouraging level of enquiries, relative to the economic climate. Reluctantly landlords are becoming more and more flexible on deals on offer and equally tenants are putting forward more aggressive proposals. Occupiers are tending to prefer second-hand, cheaper buildings that are already fitted out with lighting, heating and racking.

## Yorkshire

A few large transactions have taken place recently. They include the disposal of 210,000 sq ft at Gascoigne Wood, Sherburn in Elmet to British Gypsum; the acquisition of 105,000 sq ft at Benyon Park, Leeds on behalf of Encon Insulations; and the acquisition of 87,000 sq ft at Adwick Park, Rotherham on behalf of Cert Octavian Logistics.

Speculative development of industrial accommodation has ground to a halt across the region due to a combination of funding difficulties, an oversupply of product in some size ranges and the increased cost risk associated with empty rates.

There have been no significant land sales in the area. However we believe that in the current market, prime motorway-orientated, industrial land would probably achieve in the region of £200,000 – £250,000 per acre.

Contact: Anthony O'Keefe  
+44 (0)161 236 9595

Last summer was a pivotal moment, seeing the end of the 'phoney war' in the North West and the effects of the credit freeze came to the fore in the occupational market.

Occupier enquiry levels are now approximately 25% down on this time last year. Occupiers have been reticent to commit to new accommodation, and the freehold market has unsurprisingly fallen away with an associated negative influence on capital values.

Landlords are adapting their leasing proposition accordingly and, whilst headline rents have remained largely static, values are expected to follow incentive packages which have improved significantly for occupiers – shorter lease terms and increasingly longer rent-free incentives are being offered by the most pragmatic landlords.

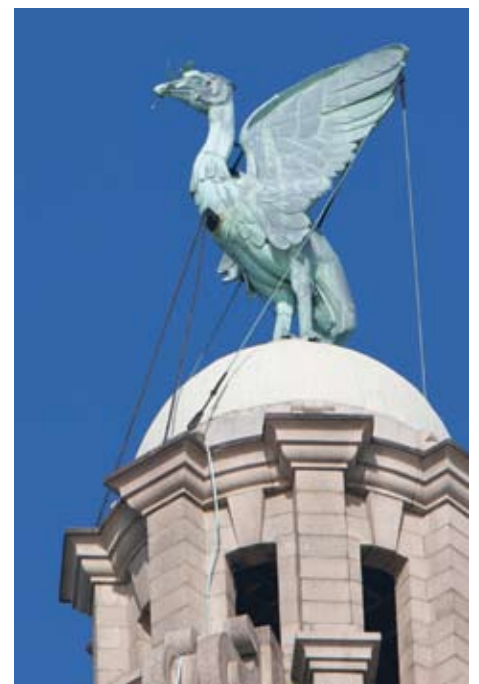
Developer activity has halted, save for a limited number of schemes by Langtree and Easter Developments, and this is likely to remain the case for the foreseeable future.

Despite this, there have been a number of notable transactions suggesting that there is still life in the North West industrial market:

- Prowell Limited have recently leased a 210,000 sq ft unit in Ellesmere Port, which had been speculatively built by Goodmans
- Royal Mail have taken F & C Reit's 180,000 sq ft unit in Warrington.

However, these seem to be the exception to the rule and the current economic malaise has introduced an uncertainty into the occupier market and caution is the order of the day.

## North West



# West Midlands

Contact: Simon Lloyd  
+44 (0)121 697 7392

The second half of 2008 saw a 30% reduction in industrial enquiries in the West Midlands compared to the same period in 2007.

Viewings are still taking place but decisions are taking longer to be reached.

Owing to the difficulties in securing credit, occupiers are opting for short-term leases rather than freehold. As a result, freehold values are continuing to drop.

Floor space take-up was good in the third quarter of 2008. Deals included the letting of 270,000 sq ft to Norbert Dentressangle at Big Tel in Telford; and 240,000 sq ft to Centre Soft at XL240, Swadlincote.

As a result of the current economic climate and void business rate charges, developers and investors are taking a far more flexible

approach to the letting of larger buildings and good incentives are available to occupiers. This is a significant marker for the way the industrial market will continue this year.

Headline rents are continuing to be achieved. PHS Datasafe recently leased 22,000 sq ft at SEGRO's Meteor Park on a 20 year lease with a 15 year break at a new headline rent for Birmingham of £6.00 per sq ft. Furthermore, Opus 9 achieved a headline rent of £5.50 per sq ft in a letting of 105,000 sq ft.

Speculative development has halted as developers wait for the market to improve and vacant stock to reduce. Developers are now seeking pre-lets from occupiers and this is likely to prevail over the next 12 months.



# East Midlands

Contact: Helen Longstaffe  
+44 (0)115 901 5111



The second half of 2008 saw a reduction in monthly enquiry levels compared to the previous two years. This is generally the case across all size ranges. Viewings were also significantly down, particularly during December.

Despite the reduction in the number of enquiries, the quality is much improved. Companies who are actively looking, tend to have a specific need for new premises and a desire to commit once a suitable property has been identified. However, potential occupiers are well aware of the strength of their position and are using this to negotiate highly competitive deals.

The leasehold market continues to be active due to the lack of available funding for freeholds. The second-hand market is particularly benefitting from this trend with occupiers perceiving this to be of better value, particularly as landlords are generally willing to be more flexible with lease terms

and other incentives.

There have been a number of significant lettings of units over 100,000 sq ft in the last six months:

- Primark have leased 637,000 sq ft at the former IKEA building at Thrapston
- Environcom have taken 157,000 sq ft at the former Corus building in Grantham
- NFT have acquired 222,752 sq ft at East 1, DIRFT
- Willis and Gambier took 188,295 sq ft at ProLogis Park in Peterborough

Speculative development has seen a severe decline, with very little in the pipeline for 2009. This will result in low levels of good quality stock once the market does recover.

A number of developers are attempting to sell sites in order to raise capital, but there are very few land buyers in the market and certainly not at previous land values.

**Contact: Rob Russell**  
**+44 (0)117 910 5264**



The industrial market in the South West is underpinned by low stock levels and lack of employment land, and as a result it is one of the few places in the country where demand currently still exceeds supply. The question on everyone's lips, though, is: 'How long will this continue?'

There is no doubt that the property market is going to get more difficult as we move further into 2009. In the South West, freehold prices have fallen by more than 20% and we anticipate that they will fall further as vacant possession values still exceed investment values. In respect of rents, both primary and secondary rents are falling rapidly, as landlords are keen to let space whilst there is still activity in the market. In addition, incentives are an important bargaining tool right now and these are in the guise of both rent free and capital contributions.

The past 12 months have witnessed some of the largest warehouses being built in

## South West

the South West; Constellation Europe completed a 850,000 sq ft distribution facility and Warburtons and Nisbets signed significant deals. Despite this, enquiry levels have halved in the past six months, and the majority are now for mid-range properties.

With the exception of the speculative warehouse developments by ProLogis and Gazeley, which total over 1 million sq ft in Bristol, development is limited. Furthermore, many pre-lets / pre-sales do not stack-up, unless occupiers are willing to pay a premium or require a bespoke facility. In turn, this has led to land values falling by up to 50%.

Forced sales and receiverships have led to some good opportunities appearing in the market, and value can still be created by good asset management. Furthermore, the relatively low supply levels of the South West could mean the region will fare better than some others in the UK.

**Contact: Robert Ladd**  
**+44 (0)29 2026 2254**

In recent years the Welsh industrial market has been dominated by regional developers that have built units of c. 10,000 sq ft aimed at the SME freehold market and indigenous investors who have predominately bought large secondary accommodation that they have refurbished into smaller units and let. Now, small freehold acquisitions are increasingly difficult to finance. In addition, those SMEs that are able to raise funding appear to be reluctant to enter into long-term financial commitments and are instead preferring to look at leasehold options. As a result, there have been no significant speculative developments over the past six months.

With the continuing impact of void rates, speculators have moved away from large secondary stock. Rents are being reduced and larger incentives being offered, especially by smaller owners and investors, to try to negate this added cost. Together with the shift in investment yields, this has impacted significantly on the freehold value of large vacant industrial properties.

Whilst several manufacturers are reporting strong order books as a result of the cheap pound, Wales has seen a raft of large manufacturers announcing significant job losses including Hoover, Corus, Budlepack Cosi and Calsonic Kensei. Others, including Bosch, Novelis and Castle Cements, have advised that they are considering significant consolidation. Whilst these closures will undoubtedly impact on the availability of industrial space within South Wales, the region can report some significant take-up of well-located, second-hand industrial properties in the last nine months including the 1,000,000 sq ft for former Alpha Steel in Newport; TEC's acquisition of 130,000 sq ft in Bridgend; 215,000 sq ft by Stanco in Abercan; and CMC's letting of 180,000 sq ft at Trident Park in Cardiff.

Whilst tough market conditions will continue during 2009, there are a number of investors looking to come back into the freehold market for quality accommodation in the right location.

## Wales



## London & South East

Contact: Rob Hall  
+44 (0)20 7643 6488

Considering the economic environment, letting activity in the South East's 'Big Shed' market has been reasonably healthy over the past six months. A couple of notable transactions completed in Milton Keynes: River Island acquired approximately 25 acres for the construction a purpose built distribution facility of up to c. 500,000 sq ft, and Jenks acquired Frontier's 318,000 sq ft speculatively built warehouse, Celestia. The other significant deal of note was the acquisition of 190,000 sq ft in Peterborough by Samsun.

In the West London region, there have been a couple of significant deals involving the retail sector. In Greenford, both H&M and Jack Wills have recently acquired new warehouse accommodation, measuring 86,000 sq ft and 60,000 sq ft respectively, to support their south east retail network. The tenants were able to secure break options after three years, without having to pay a premium headline rent.

Waste management is another sector where transactional activity remains reasonably active. Greenstar recently acquired a speculatively built 190,000

sq ft warehouse building in Edmonton to establish a waste recycling and management facility. There are a number of other similar enquiries from this sector, although they are yet to be satisfied.

Speculative development is virtually non-existent. Very few new developments have commenced during the second half of 2008, the notable exception being a 100,000 sq ft north London scheme by Canmoor. Land transactions are also limited, with none of the main industrial developers completing a land purchase of any significance in 2008.

With the problems of illiquidity in the economy, freehold owner occupier transactions have reduced significantly, and flexible leasehold transactions have become more commonplace. In an effort to sustain the freehold occupier market, a number of developers have introduced finance packages to fund the purchase of units. Overall, there continues to be a reasonable level of occupational activity in the market largely as a result of a combination of flexible lease terms and attractive incentive packages.



## UK round-up

	Sales/lettings (%)				Enquiries (%)				Rents (%)				Availability (%)			
	Q1 '08	Q2 '08	Q3 '08	Q4 '08	Q1 '08	Q2 '08	Q3 '08	Q4 '08	Q1 '08	Q2 '08	Q3 '08	Q4 '08	Q1 '08	Q2 '08	Q3 '08	Q4 '08
<b>Scotland</b>	33	0	-50	-100	0	0	-67	-50	33	20	0	0	-50	0	0	50
<b>North East</b>	0	-86	-78	-57	11	-86	-89	-43	-17	-43	-78	0	-14	0	67	43
<b>North West</b>	-29	-33	-67	-67	-18	-50	-52	-71	-41	-44	-57	-48	24	39	30	54
<b>Yorkshire</b>	-8	-33	-33	-55	31	-67	-25	-64	0	-28	-17	-73	54	17	67	45
<b>West Midlands</b>	-37	-42	-46	-80	-37	-42	-38	-69	-44	-42	-54	-56	50	33	15	44
<b>East Midlands</b>	-50	-42	-63	-75	-44	-54	-79	-88	-25	-21	-50	-75	13	22	8	13
<b>South West</b>	-11	-35	-56	-45	-8	-35	-52	-36	-7	-62	-48	-68	8	23	52	45
<b>Wales</b>	-20	-40	-60	-100	-20	-80	-80	-67	-20	-100	-80	-100	40	80	80	83
<b>London</b>	-10	-53	-36	-88	-25	-44	-46	-76	-10	-44	-42	-76	-20	11	-17	42
<b>South East</b>	-16	-34	-39	-55	-3	-40	-47	-51	-3	-15	-31	-53	10	-6	6	56

RICS industrial data

### Demand - over Q4

- Change in sales and lettings of commercial space to occupiers over the past quarter
- Percentage balance, seasonally adjusted
- Declined at fastest rate in 10 years in England and Wales
- Decline more moderate in London and North East
- Declined in Scotland and Wales at fastest pace since Q4 2007
- London worsened in Q4 significantly (ditto enquiries and rents)
- South East not declining as acutely as London

### Enquiries - over Q4

- Change in occupier enquiries for commercial space over the past quarter
- Percentage balance, seasonally adjusted
- Declined close to fastest rate in 10 years in England and Wales
- Decline in level of enquiries more moderate in South East, South West and North East
- Sharpest decline in enquiry levels over year was seen in Yorkshire

### Expected rents - over Q4

- Surveyor expectations for the change in rents for the next quarter
- Percentage balance, seasonally adjusted
- Expectation in Scotland and North East of stable rents
- No change in latest quarter in Scotland and North East
- In other areas, expectations of rental fall has increased - especially in Yorkshire

### Availability - over Q4

- Change in available commercial space for occupation over the past quarter
- Percentage balance, seasonally adjusted
- England and Wales increase at fastest level in 10 years
- Change in availability greatest in London and South East and Scotland over past quarter