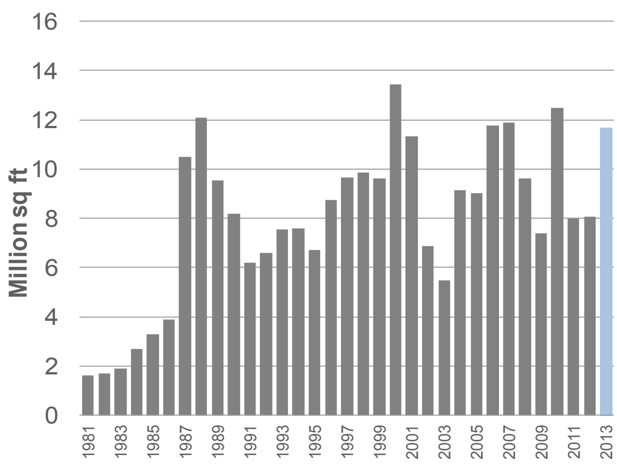
Review and Outlook
Central London Offices

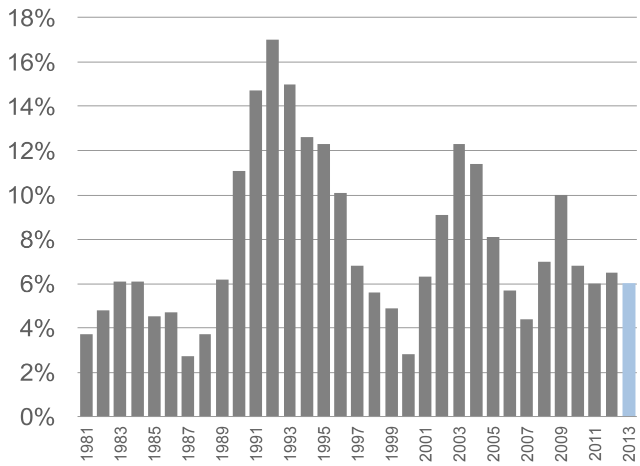
February 2014

GRAPH 1
Take-up rose to its highest level since 2010



Graph source: Savills

GRAPH 2
The central London vacancy rate fell to 6.0%



Graph source: Savills

SUMMARY

■ Take-up of office space across central London rose by 45% in 2013. This was driven by strong demand in both the City and West End. We expect that 2014's total take-up will be marginally down on this level.

■ The overall vacancy rate fell to 6.0% at the end of 2013. This year will see a pick up in development completions, which will mean that the vacancy rate stays broadly stable over the year.

■ Average prime rents in the City and West End rose by 20% in 2013. Our latest forecast is for average annual rental growth of between 3% and 6% per annum over the next five years.

■ The volume of investment transactions in the City and West End rose to a record £20bn in 2013, and yields in both markets fell by 25bps. Investor demand will remain strong in 2014, with some investors widening their strategies from core to value-add or opportunistic.

"The central London office market has definitely moved from recovery into growth."
Mat Oakley, Savills Research

West End leasing

2013 take-up reached 4.1m sq ft, 22% ahead of the 10 year average annual take-up figure of 3.3m sq ft and 33% ahead of 2012's total. Although take-up was inflated by Google's 800,000 sq ft pre-sale at King's Cross, the number of transactions is 13% above 2012 levels.

As predicted in last year's report, the West End's fringe submarkets saw increased levels of transactional activity, in particular Hammersmith, Victoria and King's Cross. These submarkets all experienced take-up growth of 20% and above when compared to the 10-year average. Conversely, the core market of Mayfair & St James's saw 2013 take-up down 11% on the average.

Take-up levels in the core have failed to reach average levels for the last three years (2011-13). A combination of restricted supply of prime Grade A product and rising rents has seen 'traditional' core occupiers relocate east. 2013 relocations to Midtown and the City included private Swiss bank Julius Baer, magazine publisher Hachette and asset manager Brookfield.

The migration of traditional West End occupiers east is a reversal of a historic trend and not restricted to just the core. Other high profile occupiers that have moved east in 2013 included Amazon and Publicis from Noho and The Co-Operative from Paddington. We estimate that in 2013 the West End has lost approximately 750,000 sq ft of potential take-up to the City and Midtown markets.

The dominant business sector in 2013 was the Technology, Media & Telecoms (TMT) sector, accounting for 22% of total take-up (excluding Google). The Media sector accounted for 14% of this. The Business & Consumer Services sector took the next largest share of take-up accounting for 15%, significantly up on the long term average of 9%.

Unsurprisingly, the biggest decline in sector demand comes from the Banking sector, which accounted for an average of 4% per annum over a 10 year period. In 2013 the sector accounted for 1% of total take-up.

The Insurance & Financial and the Professional sectors, historically dominant business sectors in the West End, have both experienced falls in share of take-up. Oxford Economics, however forecast a return to positive GVA growth in the Insurance and Financial sector in the City of Westminster this year and average growth of 3.4% per annum over the next five years (2015-19). Furthermore, the Professional sector is estimated to grow by 4.4% this year. We therefore expect to see, increased demand from these two sectors as a result.

With several new >100,000 sq ft requirements circulating, demand stands at 3.4m sq ft, 11% above the 12 month average.

Developments

The addition of several developments and major refurbishments due for completion in 1H 2014 resulted in a small increase in year end supply to 4.6m sq ft in December 2013, a vacancy rate of 3.8%. As at end December 2012 the vacancy rate stood at 4.2%.

Developments and major refurbishments due to complete in 1H 2014 include 225,500 sq ft at Aviva and Exemplar's 1 & 2 Fitzroy Place, W1, 67,500 sq ft at Green Property's 8 St James's Square, SW1 and 93,000 sq ft at British Land's 39 Victoria Street, SW1.

We estimate that 1.7m sq ft of new developments and major refurbishments will be delivered in 2014, just below the long term average annual figure of 1.8m sq ft. This will offer some reprieve to the tight supply currently being experienced in the West End. However, we expect the majority of this to be absorbed fairly quickly; indeed 397,000 sq ft (24%) of the 2014 pipeline is already pre-let and 173,000 sq ft is currently under offer.

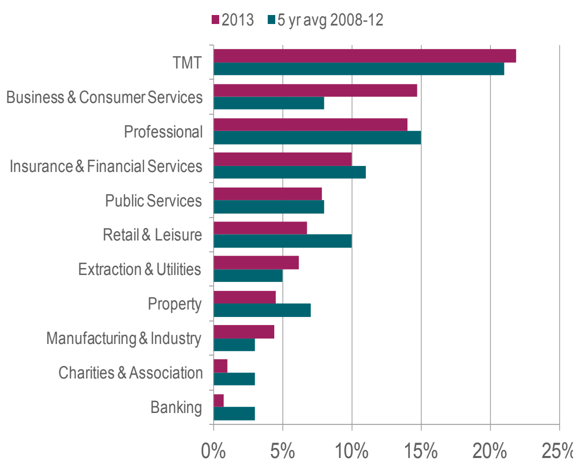
Looking further ahead, 2015 and 2016 will see above average levels of development completions, totalling 2.1m sq ft and 2.2m sq ft respectively. 15% of this pipeline is committed.

Rents

The highest recorded rent in 2013 was £120 per sq ft at Devonshire House, W1. This contributed to average prime rental growth of 20% in 2013.

GRAPH 3

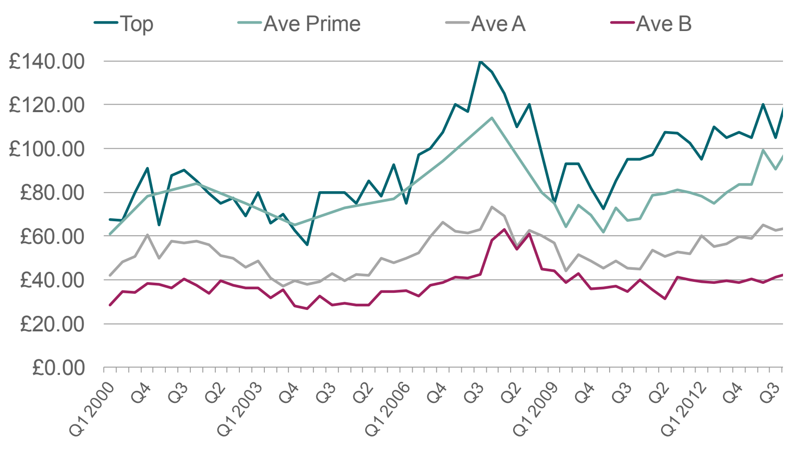
West End take-up by business sector



Graph source: Savills

GRAPH 4

West End office rents



Graph source: Savills

West End investment

The second half of 2013 saw a considerable pick-up in investment activity in the West End, with £5.8bn transacted, of which £1.4bn was in December alone. This brought the total for the year to £8.4bn, the highest level of turnover in this market since our records began in 1995.

It would be all too easy to attribute this volume of turnover in the market to the safe-haven characteristics of London and their appeal to non-domestic investors, and buyers from outside the UK accounted for 64% of the purchases. However, 2013 saw a significant increase in acquisitions by domestic investors, who purchased £2.9bn of assets over the course of the year. This pick-up in activity was driven both by private investors, who were more active due to the improving availability of debt, and of property companies who acquired some major sites e.g. British Land's £470m purchase of the 1.2m sq ft office-led Paddington Central scheme. Both also identify with the robust case for real rental growth in the coming years.

Non-domestic investors however still continued to be the most active buyers of very large lot sizes in the West End, with 80% of the purchases by values of West End lots of £100m and above being by investors from outside the UK.

Investor interest in residential conversion opportunities accelerated in the second half of 2013, perhaps as a result of the rising expectation that Westminster Council could soon produce their much talked about consultation paper on this subject. Prices for any office building that has the potential for conversion to residential have risen considerably over the last year. This even applies to assets with well secured income as investors identify value in the differential between the entry price and residential resales on the finished product. The next wave of conversion opportunities is likely to be driven by the sales of small embassies and consulates, as well the headquarters buildings of various trusts, institutions, charities and associations.

Many of these parties are currently looking at the value and their recent rise of their central London properties and considering whether moving to a fringe location would free up significant amounts of capital that could be reallocated elsewhere.

Yields

We predicted in our August 2013 report that prime office yields in the West End would harden from 3.50% to 3.25% by the end of the year, and prediction proved correct.

This hardening has also been seen in the IPD average office yields for the West End and Midtown, with the average equivalent yield hardening by 44bps over the last six months (to 5.28% in January 2014), and the average initial yield hardening by 55bps to 3.49%.

Purchasers are increasingly turning to the equivalent yield as a more useful indicator of pricing, as they have become more convinced that the rental recovery in the West End leasing market is sustainable.

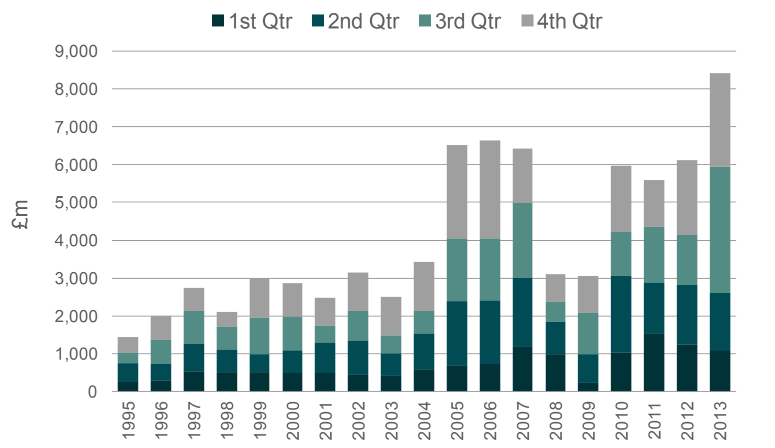
Outlook

We expect that investor demand for West End offices will be steady over the next 12 months, though the actual volume of transactions is unlikely to reach 2013's record high.

The big question has to be whether yields will continue to shift downwards, particularly since they are currently nearly 200bps lower than their 25 year average of 5.0%. Improving rental growth prospects will undeniably help to support current yields, but could the prospect of rising base rates from 2015 and the recent strengthening of sterling temper some of the downward pressure on prime West End yields? Non-prime yields are however likely to see pressure and fall, consistent with this phase of the cycle, as investors seek enhanced returns and show a willingness to take greater risk.

GRAPH 5

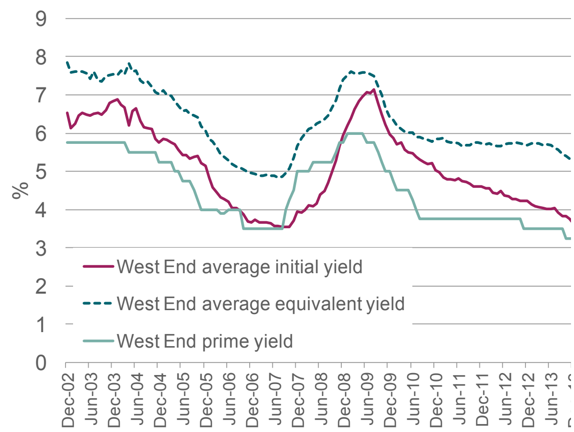
West End investment volume



Graph source: Savills

GRAPH 6

West End office yields



Graph source: Savills, Investment Property Databank

City leasing

Take-up of office space in the City of London rose for the second consecutive year in 2013, with the total level of leasing activity for the year reaching just over seven million square feet.

This was 53% higher than 2012's total, and 46% above the long term average. Indeed, 2013 was the strongest year for the City leasing market since 2000.

The main reason for this strong recovery in take-up the return of larger requirements to the market. 2011 and 2012 were characterised by very low levels of lettings of 50,000 sq ft and above. Indeed, 2011 saw the lowest level of large unit demand in the last 20 years.

2013 however was clearly the year that confidence returned to the City's larger businesses, and this led to a 113% rise in the volume of lettings of 50,000 sq ft and above. This was driven not only by traditional City-type businesses, but also by tenants who historically might have chosen the West End.

It is clear that the structure of demand for City of London office space has changed during the global financial crisis. The Banking sector, which accounted for 10% of take-up in 2006, only accounted for 1% of take-up in 2013. Insurance and Financial Services remain a stalwart of the City occupier market, driven by insurers in particular in 2013, but it was the Technology and Creative sectors that continued to outperform their historic trends in this market. While these two sectors only accounted for 8% of the space leased in the City of London in 2006, this rose to 27% of take-up in 2013. Deals such as Amazon's acquisition of 60 London are typical of this new more footloose occupier who had been attracted to the City both by the cheaper rents than in the West End, and the emerging technology corridor to the north of Holborn and London Wall.

The strong recovery in take-up in 2013 led to a corresponding sharp fall in availability in the City. The vacancy rate fell from 10.4% at the end of the second quarter of 2013, to 8.3% at the end of the year. This means that the total amount of available office space at the end of 2013 was 6.76m sq ft, which is less than the total take-up in 2013.

Rents

Top rents in the City remained broadly stable during the second half of 2013, oscillating around the £70/sq ft at the City's three new tower buildings. However, it was the rather more representative average prime rent that showed a dramatic recovery last year, rising by 20% over the 12 months to £64.45/sq ft.

This is the kind of growth rate that we would normally expect to see early on in a City market recovery, and while there is no chance that this rate will be sustained, it is a clear sign that the supply/demand balance is tilting firmly in favour of the landlord.

Another indicator of rising tenant concern about localised shortages of Grade A space is the recent trend in the length of leases being signed in the City. 2013 saw the largest number of leases of 15 years or more signed in the City since 2006. Indeed, our records show that 66% of all the leases signed last year in the City of London were for ten or more years, which is the direct opposite of the trends that are being seen outside London.

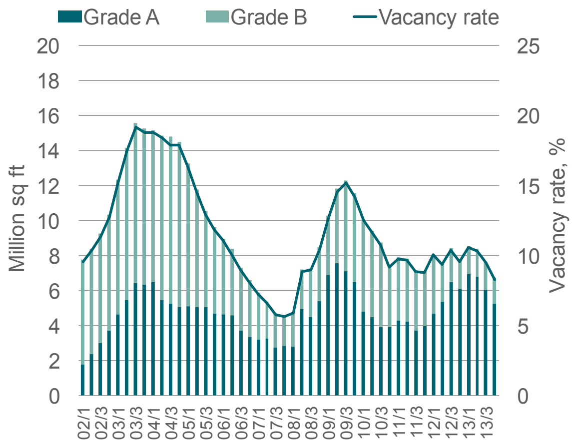
The longer leases and rise in pre-letting might both be reasons why net-effective rents have not risen as much as headline rents over the last 12 months. Previous market cycles have tended to see net-effective rents rising before headline, but this time around the typical 24 months rent free on a ten year lease has remained stable. This means that the gap between prime headline and net-effective rents has remained stubbornly wide, at around 20%.

Development

The major challenge facing the continued recovery of City rents in 2014 is the state of the development pipeline. While there is by no means a development boom underway, there are 4.7m sq ft of developments and refurbishments due to complete in 2014. While this might sound like a large number, even in the context of 2013's strong take-up, the devil is as always in the detail. First of all only half of this space is made up of new developments, the rest being small to medium-sized refurbs. Secondly, just over one third of the space is already pre-let. Finally, even if some of this space doesn't let up fast, 2015 is only scheduled to see 2.9m sq ft of completions.

GRAPH 7

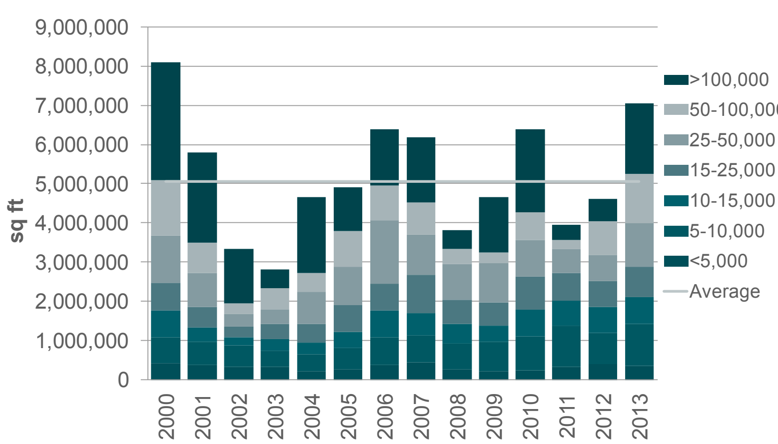
City of London availability



Graph source: Savills Research

GRAPH 8

City of London take-up by size band



Graph source: Savills Research

City investment

The volume of investment into the City of London office market boomed to just over £12bn in 2013. As Graph 9 shows, this is its highest ever level.

The main factor that contributed to this high level of activity was the continuing global risk-averse institutional demand for large property investments. Funds who are coming to Europe looking for prime lots of £200m and above generally have few other choices than to buy in the City of London, and it was two such deals that led to last year's strong activity.

However, even without GIC's £1.7bn purchase of a 50% stake in the Broadgate Estate, and St Martins' similarly large lot size at More London, 2013 would still have seen an investment turnover of £8.6bn. This would have been £2bn over the ten year average for this market.

The continued rise in importance of non-domestic investors to the City and central London investment markets has been well documented, and 2013 saw no end to this trend. 78% of all purchases in the City in 2013 were by non-domestic investors, and this rises to 91% when we look at all purchases of £100m or above.

UK purchasers only accounted for 22% of the acquisitions by volume in the City of London last year, but the actual amount of capital that they deployed in this market rose considerably to £2.7bn in 2013. Indeed, UK investors were the third most active purchasers of lot sizes of £100m and above.

Domestic investors tend to be focusing more on value-add and core plus investments than some of their global peers, though international investors are active even in the most opportunistic markets. Indeed, the competition for development opportunities in the City of London has intensified, with site values pushed up to £300/sq ft in 2013.

So, where are all the sales coming from? While many opportunistic investors have spent the last few years complaining about the lack of distressed selling, the last three years has seen a steady stream of bank or receiver led sales. This trend continued in 2013, with £1.1bn of the sales (12.5% of the market by number of transactions) being bank or receiver-led. While these assets may not be priced as distressed sales, they are still contributing to the availability of product in the City. We expect this trend to continue in 2014.

Another area that stimulated some sales in 2013, and that will continue to do so in 2014, is profit-taking. The City investment market did not go silent during the GFC, and £12bn of assets were transacted in 2008-2010. Many of those investors who purchased City of London office investments over that period are now in a position to realise increases in capital values of 20-30%. While there is no particular cyclical reason to sell out of the City of London in 2014, we do expect to see more profit-taking this year than last.

Yields

Prime City office yields remained stable at 4.75% for the whole of 2013. This is well below the twenty year average of 5.56%, and the ten year average of 5.31%.

This stability in the prime yield has not been mirrored by the recent trend in the IPD average initial and equivalent yields, which have hardened by 15 and 25bps over the last six months. Interestingly the IPD average initial yield for City offices stood at 4.84% at the end of January 2014, only around 10bps higher than our prime yield for the same month.

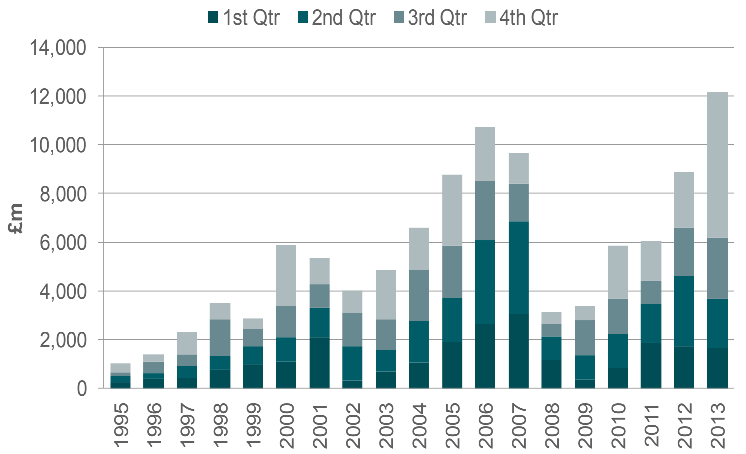
The market is definitely seeing more emphasis being placed on equivalent rather than initial yields at present. This is a reflection of an increasing acceptance that the rental recovery is not only underway, but that it is likely to be sustained for the foreseeable future.

Outlook

While City yields are lower than their long-term averages, the gap between City and West End prime yields remains at a historically wide level. With the City looking comparatively cheap, as well as being the only market that offers sufficiently large lot sizes to satisfy the global funds, we expect investor demand to be sustained in 2014. There will be more profit-taking, as well as bank-led sales, but we still expect prime yields to harden by 25bps by the end of 2014.

GRAPH 9

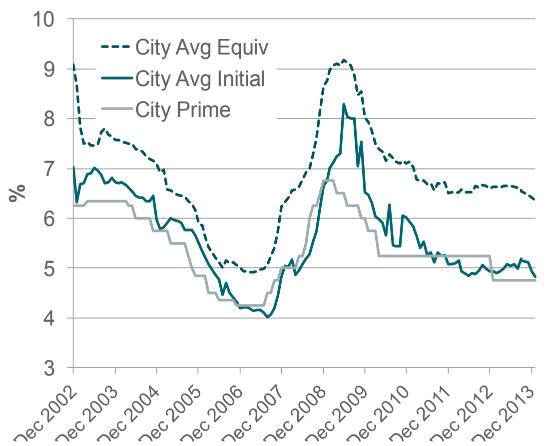
City of London investment volume



Graph source: Savills

GRAPH 10

City office yields



Graph source: Savills, Investment Property Databank

Docklands

The second half of 2013 was an altogether better six months for the Docklands office market, with just under 500,000 sq ft leased on the Canary Wharf estate alone. This positivity has continued into 2014 with the announcement that professional services company EY has taken 207,000 sq ft on the 14th to the 21st floors of 25 Churchill Place. This announcement has come on the back of KPMG's acquisition of 216,167 sq ft on floors 6 to 13 of 30 North Colonnade in Q3 of 2013.

The pick-up in leasing activity in the second half of 2013 means that the total take-up for the year reached just under 637,000 sq ft, a 54% increase on the previous year's total.

Leasing activity outside the core was muted, with the largest letting being 6,430 sq ft to Zamir Telecom at Greenwich View Place.

The total availability at the end of 2013 was 5% lower than the previous year, at 1.6m sq ft. This is equivalent to an overall vacancy rate of 11.6%. The core market vacancy rate is now much lower at 7.1%.

One of the characteristics of the letting activity in the second half of the year was the widening occupier base in this submarket.

The paucity of Banking sector demand across central London has to a certain extent been compensated for a pick-up in demand from other sectors. As well as the EY deal mentioned above, the second half of 2013 saw acquisitions of office space at Canary Wharf by Total Gas & Power, Shell, Infosys and Skrill. The later two of these companies could be described as being from the Financial Technology (FinTech) sector, a type of business that Canary Wharf are actively targeting through their Level 39 and other initiatives. Given that 27% of the office space leased in the City of London in 2013 was to the Telecommunications, Media and Technology sectors, this is undoubtedly a potential growth area for the Docklands as well.

Rents

Rents in the Docklands were broadly stable in the second half of 2013, with £41/sq ft achieved on a letting at One Canada Square. Rents outside Canary Wharf were also stable, with the current tone for good quality secondhand space being £22-£24/sq ft.

Interestingly the press release for the EY deal in February 2014 stated that EY were taking a 25 year lease at £48.50/sq ft. This would be the highest rent paid in the Docklands since 2007, and a clear indicator that this market is recovering in line with the rest of central London. However, it is important to note that the EY deal involved Canary Wharf Group taking responsibility for EY's lease at Beckett House which runs until 2026 at a rent of £35/sq ft.

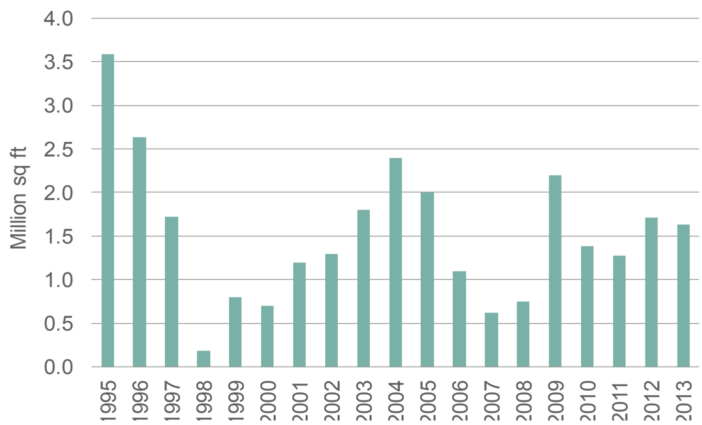
Outlook

The prospects for the Docklands office market are generally pretty closely linked to the City of London, albeit sometimes with a slight lag. The strong recovery in tenant demand for City office space in 2013 should feed through into a pick-up in take-up in the Docklands in 2014.

This is particularly likely given the widening rental gap between the two markets, and the increasingly footloose nature of central London requirements. Historically, the average differential between prime rents in the Docklands and the City has been 28%. This currently stand at 43%, the widest gap since 1997. This should ensure that the Docklands remains on the radar of more cost-sensitive occupiers, and we expect that 2014 will see rising take-up and falling supply.

GRAPH 11

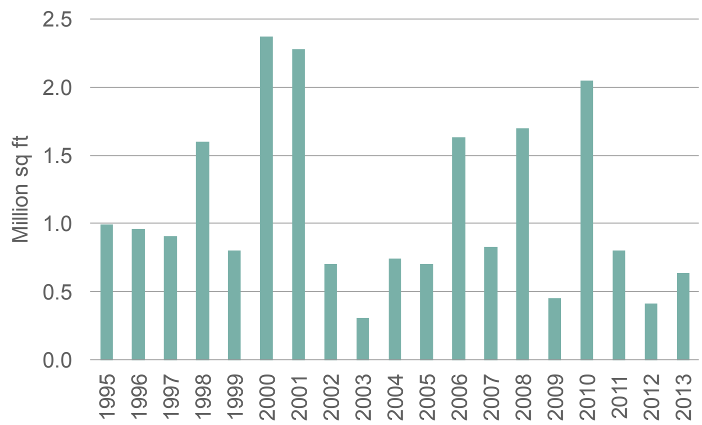
Docklands availability



Graph source: Savills

GRAPH 12

Docklands take-up



Graph source: Savills

Outlook

Strong take-up, falling vacancy rates, and 20% rises in average prime rents are all strong indicators that the central London office market is now firmly past the point of recovery and well into its growth phase. Somewhat inevitably this has led to a rise in questions about whether the market is overheating, and whether the investment market might be too far ahead of the leasing market.

The first question has to be whether the demand for office space in London can be sustained, particularly in the face of tenant austerity and rising occupational densities. The simple response to this question is an economic one – London is growing and will continue to grow. London's population is forecast to grow from 8.4m in 2013, to 9.2m in 2023 – this is the equivalent of moving the whole population of Birmingham and Hartlepool over the next decade.

Will there be jobs for all these new residents? In the early phase of the economic recovery the relatively low wage growth will support headcount growth, but once more robust growth of 2.5% pa and above is locked in, it will be the expansion of higher value industries such as those in the TMT and Financial Services sectors that will support a sustained period of above trend growth in office-based employment in London. So, with Oxford Economics forecasting nearly 82,000 more office-based jobs in the City and Westminster over the next five years, we can probably be assured normal levels of take-up growth, particularly since we believe that occupational densities will stop falling as staff morale become of increasing importance to many employers.

The next key question has to be over the supply-side. Is the development market booming or about to enter a boom? Certainly the level of development and refurbishment completions in the City of London this year is well above average at 4.7m sq ft, though the pipeline in the West End is still firmly below average. Just under one third of 2014's completions in the City have already been pre-let, and only 40% of the remainder are actual new developments. Against a background of even average levels of take-up, this is likely to be absorbed in 2014 and 2015. Furthermore, the development pipeline in 2015 and 2016 remains significantly below average.

The supply-side risk rises in the medium term, and the timing of this will depend heavily on how quickly lender's aversion to speculative office development diminishes. Previous downturns have always been preceded by a three to four year period of above average lending to commercial property, and this cycle will probably be no different. However, while the London lending market is becoming increasingly competitive, the volume of debt targeted at 100% speculative development projects remains limited at the moment.

What will trigger a rise in lending activity? Probably a sustained period of above average rental growth. The longer that goes on, the easier it becomes to believe that this cycle is more stable than the last, and the lower risk development seems. Certainly all of the last three downturns have preceded by a period of three to four years of above average prime rental growth. Our current rental growth forecasts for both the City and West End only have one year of above average rental growth in the next five years, and this comes at the back of the forecast period.

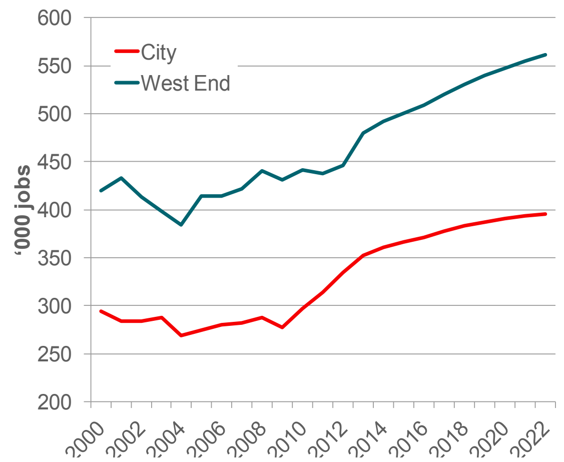
The final question hanging over the central London office market is whether the investment market is too far ahead of the leasing market. Prime yields are firmly below average, and 2013 saw a record high level of transactional activity. Will the current wave of non-domestic investment targeted at central London drift away as the global economy recovers? Our view is that some of it might start looking for more opportunistic purchases elsewhere, but that generally London's attractiveness to non-domestic investors has been on a steady upward path for the last 30 years. Back in the 1990's the norm was for around 35% of total investment to be from non-doms, this has since risen to 45% in the early 2000's, 60% in 2005-2010, and nearly 70% in the last four years.

Pricing is undoubtedly keen, and this has as much to do with the strength of demand as the fairly steady supply. Indeed, while the investment volumes reached record levels in 2013, the actual number of transactions has been on a gently declining trend since the mid 1990's. Thus, with a relatively illiquid market, the current yield levels are probably supportable, so long as the outlook for rental growth remains positive.

In conclusion, we believe that the central London office market has definitely moved from recovery into growth. The supply and demand balance looks promising for some years to come, and this should support average, though relatively unexciting, levels of rental growth.

GRAPH 13

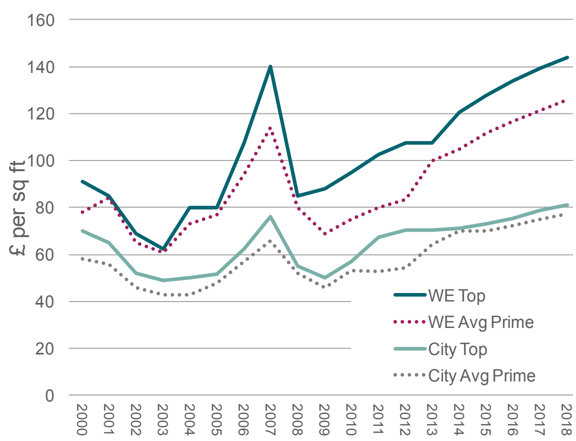
City & West End office-based employment



Graph source: Savills, Oxford Economics

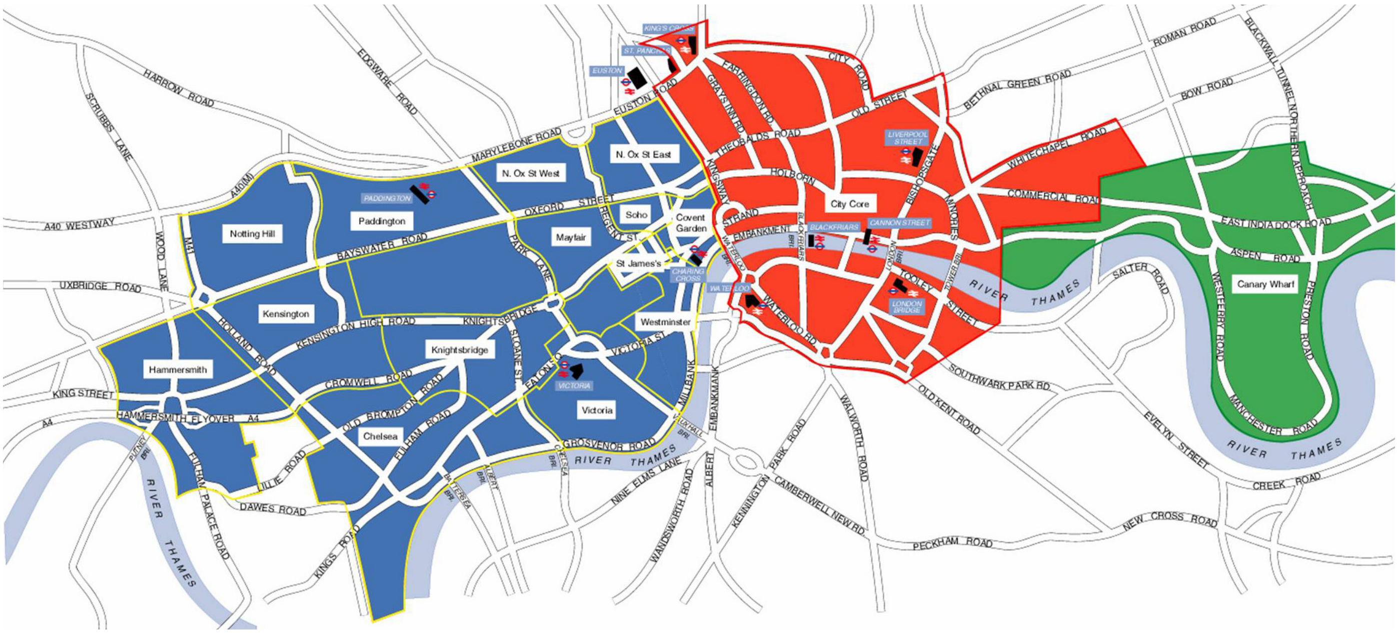
GRAPH 14

City and West End top and prime rents



Graph source: Savills

Survey Area



Monthly market data

We also produce monthly reports on the City and West End leasing and investment markets that include key statistics and comparables on each of these markets. If you would like to be added to the mailing lists for these, or any other research reports, then please e-mail your request to moakley@savills.com

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