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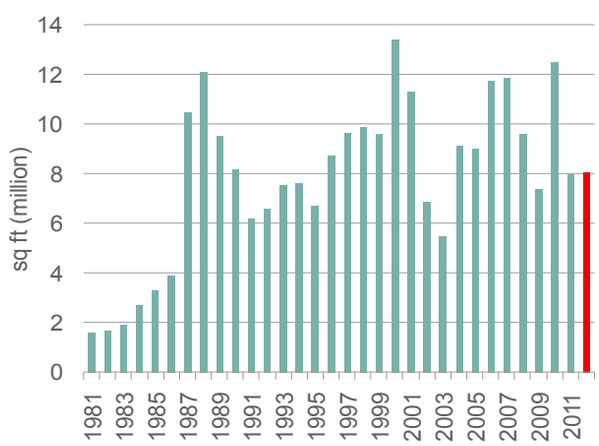
Savills World Research
UK Commercial

Review and Outlook
Central London office

February 2013

GRAPH 1

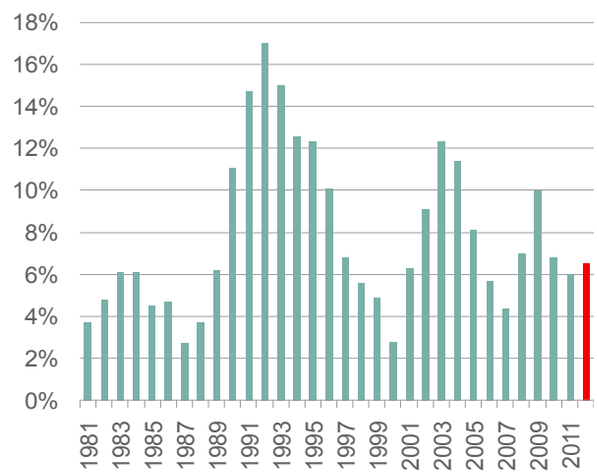
Central London office take-up picked up slightly in 2012



Graph source: Savills

GRAPH 2

The vacancy rate has risen to 6.7% due to development and refurbishment activity



Graph source: Savills

SUMMARY

■ Take-up in 2012 was broadly the same as the 2011 total. The City of London saw take-up rise to average levels, while the West End and Docklands had a below average year.

■ The overall central London vacancy rate rose due to a slight pick-up in development completions, and a more robust rise in refurbishment activity. Despite this there are pockets of undersupply in many size bands and locations, and these are where rents are beginning to rise.

■ Prime rents rose by 4-5% in central London last year. We are expecting slower but steady rental growth over the next five years

■ Investment in central London offices rose to over £15bn in 2012, with more than 65% of the purchases being by non-domestic investors. We expect this trend to continue in 2013, albeit with some non-domestic investors becoming more adventurous on location or security of income.

"We expect to see a steady rise in leasing activity in the more affordable fringes."

Mat Oakley, Savills Research

West End leasing

Take-up in Q4 12 reached 740,115 sq ft, up on both Q2 and Q3 12. Despite this end of year uptick in activity 2012 total take-up reached 3.1m sq ft, down on the long term average of 3.3m sq ft. More positively however, this was a better than expected outcome.

Pre-letting activity drove take-up levels last year, on average six pre-lets per annum are seen in the West End, whereas 2012 saw 12. The largest pre-let was at 1a Page Street, SW1 where Burberry took 127,000 sq ft.

Much has been made about the TMT boom and the rise in demand from this sector. Indeed, the TMT sector had the largest share of take-up in 2012, accounting for 24%, marginally up on the long-term average of 21%.

The sector to witness the biggest rise in share of take-up was the Retail & Leisure sector accounting for 18%, up on the average of 7%. 2012 witnessed a direct correlation between retailer expansion, particularly from luxury brands and office demand from high end brands like Burberry, Jimmy Choo and Michael Kors, who accounted for 52% of overall Retail & Leisure take-up. This will continue to be the case in 2013 as international retailers are keen to set up London headquarters as a spring board to European markets and beyond.

A combination of below average levels of take-up and an increase in development activity levels led to a rise in the vacancy rate. As at end December 12 the vacancy rate stood at 4.2% or 5.1m sq ft of supply, up from 4% or 4.8m sq ft in December 11.

Despite this rise, the West End is still firmly an under supplied market with just 1.5 years of supply. A return to average levels of development activity over the next three years (2013-15) will offer some reprieve, we estimate 1.7m sq ft of completions per annum over this period.

Significant developments to complete is 2013 include; 260,000 sq ft at Land Securities 62 Buckingham Gate, SW1, 310,000 sq ft at British Land's 10 Brock Street, NW1 (175,000 sq ft of which is pre-let to Debenhams) and 100,000 sq ft at Development Securities/Scottish Widows 10 Hammersmith Grove, W6.

Grade A availability rose significantly in 2012, it stands at 68%, up from 54% in December 11. This rise is the result of 1.5m sq ft of development and refurbishment completions entering the supply figures over the course of 2012.

Rents

What did this mean for rental growth last year? Shortages of Grade A stock in <10,000 sq ft size bands in the West End's core continued to drive rental growth. Over a 24 month period the number of this type of property available has decreased by 50%. This supported rental growth of 5% in 2012 with the top rent reaching £107.50 per sq ft in Q4 12 where Gulfstream Management took circa 5,500 sq ft at 15 Sackville Street, W1.

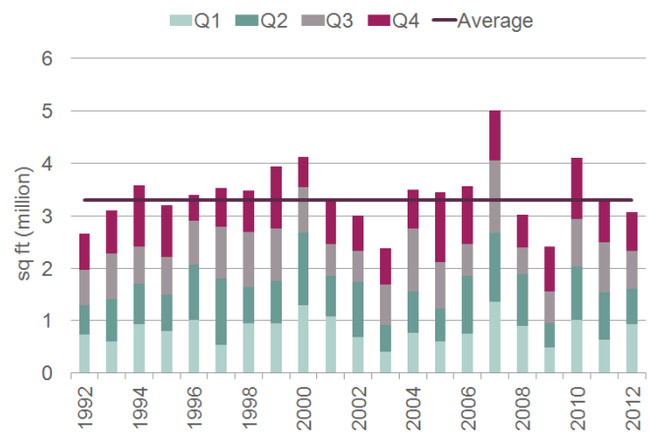
Outlook

What can we expect from 2013? The market fundamentals of the West End market look healthy. The overall vacancy rate remains low (one of the lowest in Western Europe) and Google have provided an early boost to 2013 take-up figures and more importantly, occupier sentiment by committing to nearly 1m sq ft at King's Cross. Furthermore, several deals in excess of £100 per sq ft have completed or are under offer.

Rent frees have seen no movement over the past 12 months and stand at 8-9 months on a 5-year lease, up on the average of 6 months.

GRAPH 3

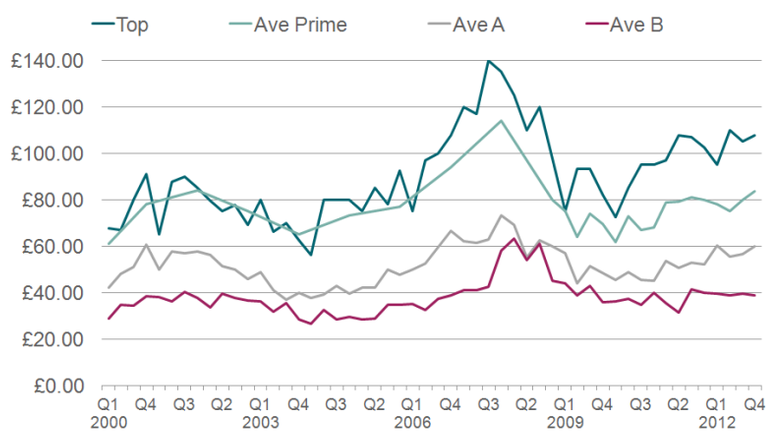
West End take-up



Graph source: Savills

GRAPH 4

West End rental levels



Graph source: Savills

West End investment

The West End investment market had its third consecutive year of turnover of more than £5.5bn in 2012 (£6.1bn). Indeed, last year was one of only four years ever that investment turnover was over £6bn.

Once again, the main driver behind the high level of turnover was non-domestic investor interest in the market, with 67% of the purchases by value being by international investors. The most active non-domestic investors in the West End last year were from Europe, who accounted for £1.55bn of purchases, though they were also active sellers, with Deka in particular disposing of several West End assets in 2012.

UK investors were more active in the West End than in the City last year, acquiring 33% of the investments sold reflecting £2bn. Indeed, while the UK institutions were net sellers in 2012, the final quarter of the year saw a strong pick-up in requirements from the domestic funds - perhaps a recognition that the West End might be one of the few markets where they can expect to give their investors above average returns?

Another group of domestic investors that were fairly active in 2012 was the property companies. In general, most of these acquisitions were to refill their longer term development pipelines following a spate of recent completions and lettings. Six London REIT's alone accounted for over £500m across 14 deals; with the same group accounting for £340m and 10 deals in 2011.

Another factor behind the high level of turnover last year was a rise in the number of larger deals towards the end of the year, with six transactions of £100m or above completing in the final quarter. This brought the total to 19 deals over £100m for the entire year and accounted for nearly £3bn of turnover. Of these, only two UK parties (British Land and Almacantar), were domestic buyers.

Yields

Our monthly index of prime West End office yields has remained stable at 3.75% throughout 2011 and 2012. However, the final few months of last year saw a change in the temperature, and as a result of this we have hardened our typical prime yield to 3.50%.

This is the lowest level that the prime West End yield has been since 2006, and is a reflection of the strength of demand in this market for small, prime assets that offer both wealth preservation and upward rental growth prospects.

Away from the prime and secure end of the market, there has also been a pick-up in investor activity, and this is reflected in the steady hardening of the IPD average initial yield which ended 2012 at 4.25%; a 37bp improvement on the year.

Outlook

The West End investment market in 2013 will at worst be a rather boring "more of the same" with the market characterised by improving values, strong competition and limited quality opportunities. There seems little scope for questioning this hypothesis especially when one reviews the West End's 2012 performance in the context of the wider economic uncertainty and then reflects on the positive end outcome.

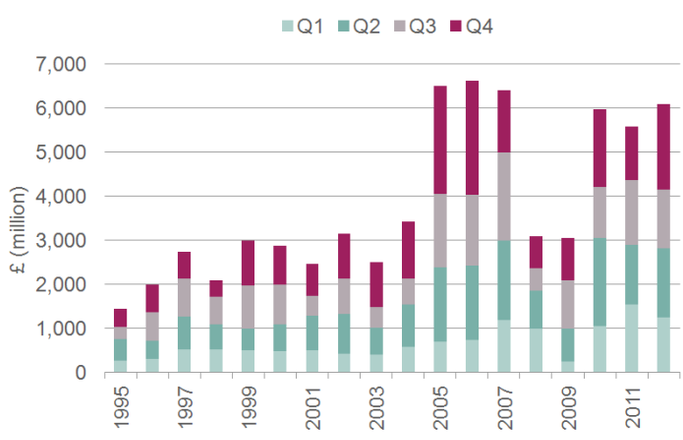
With Euro-worries easing and the leasing market seemingly as robust as ever it's arguable there is even more upside risk considering rents have to date failed to take off, other than across the retail sector.

In terms of buyers non-domestic investors will continue to account for the majority of purchases, particularly at the lower yielding end of the market. However scarcity, and an improvement in wider business confidence and rents, will encourage some of move up the risk curve and compromise on location or income security.

If the pick up in requirements from the UK institutions that we saw at the end of last year is sustained, then they too could be net acquirers of West End offices this year for the first time since 2010. Further, even with UK property companies likely to be less active overall but still hunting opportunistic deals, then the market could be even more crowded than before!

GRAPH 5

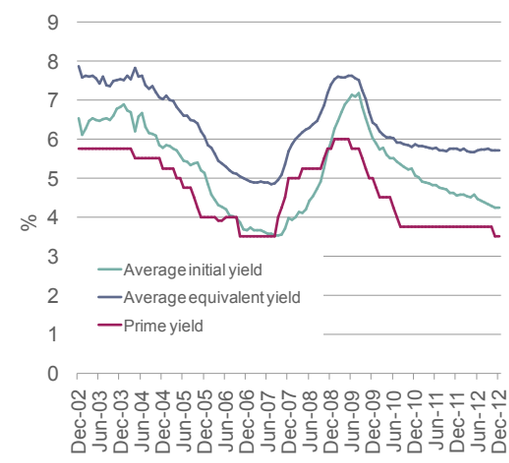
West End investment volume



Graph source: Savills

GRAPH 6

West End office yields



Graph source: Savills, Investment Property Databank

City leasing

Take-up returned to the ten year average during 2012, the 4.63m sq ft total being 18% up on 2011. However, a number of factors indicate that although performance improved, occupiers continue to act cautiously.

Firstly, there was an increased preference for small units. Typically six or seven transactions for over 100,000 sq ft can be expected to complete in the City annually, representing around 1m sq ft. But during 2012 only three such deals completed; the cumulative total of these being 568,000 sq ft. In contrast, space taken at units no more than 15,000 sq ft was 27% above trend, and the average amount of space acquired in a single transaction was just 13,100 sq ft. So, although the overall number of deals done in the City was high, more often than not units transacted were small.

Secondly, letting activity resulted from shifts in the pattern of sectoral take-up rather than real recovery in the sectors most susceptible to economic challenges. Whereas Banks leased a predictably low 2% an increased share was taken by the Insurance & Financial Services sector, those companies taking a third more space than usual (1.5m sq ft). Notably robust to cyclical changes in the economy were insurers, such companies being responsible for multi-floor acquisitions at the "Walkie-Talkie", the St Botolph Building and 70 Mark Lane. Large acquisitions such as those by Skype (89,000 sq ft at 2 Waterhouse Square) and Pushbutton (48,000 sq ft at Glasshouse Yard) meant the TMT sector also took a higher than usual share (20%), and it was only increased activity from these sectors that helped to compensate for lack of Banking activity during 2012.

Thirdly; many high rents and large deals were induced by an increase in tenant incentives; whereas in a very good year like 2007 the average of all rent free periods at Grade A premises lies at nine months, the average for 2012 was 16 months (a figure which is also up on 2011's 14 months), and an even higher average rent of 25 months could be expected at prime office space. This increase in tenant friendly terms does not signal an indubitable recovery.

Lastly, the effects of increased take-up have been limited by a steady stream of availability. The periodic entry into supply figures of refurbished offices (such as 33 Holborn and 10 Aldermanbury) along with continued availability at large units (such as the Shard) mean the vacancy rate went up successively during the first three quarters of 2012, and supply currently stands at around 8m sq ft. It therefore clear that, despite the City's relatively restrained development pipeline for 2012 (the 2.05m sq ft of new completions fell 33% below long term average levels), even large deals were only capable of making a short term dent in supply figures.

Rents

The highest rents in 2012 were paid by the Insurance & Financial Services sector (they agreed 64% of all rents over £50 per sq ft). However, there were only two recorded instances of TMT sector companies negotiating rents over £50 per sq ft, and just two instances of Banks doing the same.

Although there was no growth in average Grade A rents during 2012, top and prime rents were enhanced by pre-completion lettings and deals for tower space in the City core. In fact, with the exception the Payden & Rygel at 1 Bartholomew Lane, the top ten rents (none of which fall short of £62 per sq ft) were negotiated for tower space in either EC2 or EC3. As a result, the top rent achieved during 2012 was 4.4% above that achieved during 2011 and the average prime rent was £54.30 per sq ft, also representing growth (of 2.8%) on the previous year.

Outlook

Searches that translated into deals during 2012 are yet to be replenished by new demand. As a result active demand fell by 23% in Q4 2012 to 2.5m sq ft. However, at the time of writing, there is evidence that a number of large requirements are starting to appear, and it is hoped that some impending sub-40,000 sq ft transactions at landmark buildings will bolster occupier confidence during 2013.

Further development activity (such as at the Place, Alban Gate and Sixty London) mean 2013's completions will be 11% above average. This continued supply of Grade A offices, along with relatively subdued demand, means any rental growth in the first half of 2013 will be muted. As a result, prime rents are expected to rise by just 0.8% and top rents are likely to remain flat.

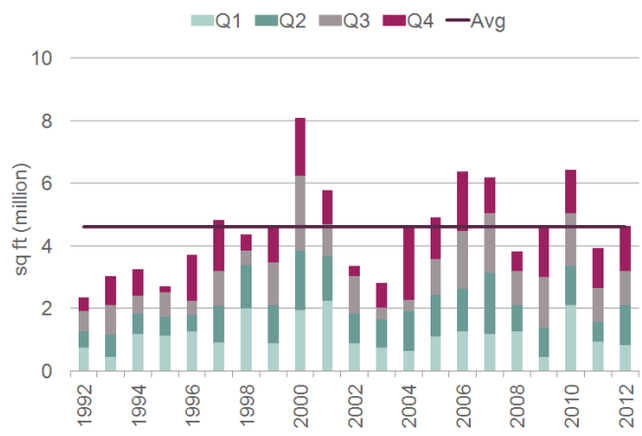
GRAPH 7

City of London office rents

Graph source: Savills Research

GRAPH 8

City of London take-up



Graph source: Savills Research

City investment

The second half of 2012 saw the City of London investment market continue to attract strong interest, particularly from international investors. This translated into £4.3bn of transactions, which though it was lower than the first half of the year drove the market to a significantly above average year with a total of £8.9bn of turnover.

As Graph 9 shows, this made 2012 the third most active year in our history. Given the relative weakness of the leasing market, as well as the overall pessimism about the banking and financial services sectors throughout the western world, this is a pretty surprising out turn.

A number of factors combined to deliver this strong level of activity. The first, and by far the most important, was the continued belief amongst international investors that the UK and London property markets represent a safe-haven. Only 24% of the purchases of office investments in the City last year were by domestic investors, with the Asia-Pacific region alone accounting for 25.7%.

The second reason why trading volumes were so strong last year was the average size of deal, which rose to £57m. Non-domestic investors were generally more active at larger lot sizes, with the average deal size for non-european investors being in excess of £100m.

The UK fund and property companies were more focused on fringe and value-add opportunities, and this is probably the area of the market that has seen a biggest rise in investor interest over the last six months.

The availability of both prime and value-add investments remained tight throughout the year, and tightened further in the final quarter. This limited stock supported pricing, and may well be a factor that will contribute to a lower investment volume in 2013.

Yields

The end of 2012 saw the first change in our City prime yield index for more than 12 months. The combination of strong demand and restrained supply has led to several new benchmark deals being transacted in the final quarter of the year, and as a result of this we have moved our prime yield benchmark down to 4.75%

The most notable transaction of the final quarter was the sale of 1 Threadneedle Street by SEB to a client of Deutsche Bank for £63m. This represents a net initial yield of 4.5%, one of the keenest yields on a significant deal in the City since the sale of 30 St Mary's Axe in early 2007.

The City has also seen a recent flurry of owner-occupation deals, with ITV and Southwark Council both buying their own headquarters buildings on the South Bank. We believe that this is primarily a function of the comparatively low cost of money at present.

Outlook

The City investment market in 2012 clearly demonstrated that investor demand is currently less motivated by rental growth prospects than by income protection.

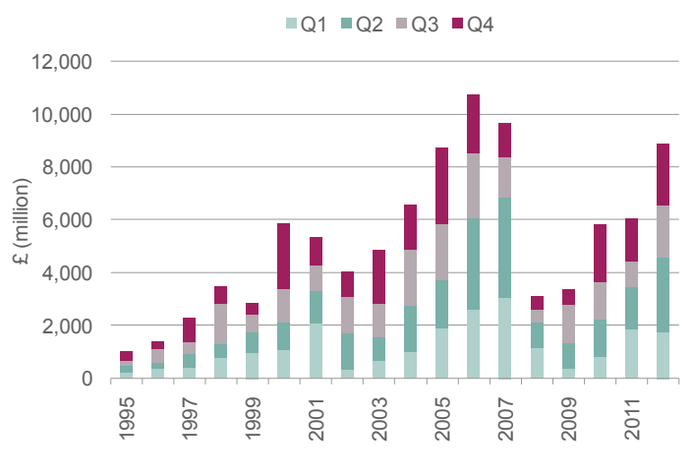
Given that our outlook for the City leasing market in 2013 is broadly flat in terms of take-up, supply and rents, we don't expect many investors to be attracted to the City by its strong rental growth prospects. However, continued turbulence in the Eurozone and Middle East, as well as rapid growth in Asia-Pacific will support similarly strong demand for office investments across London in 2013.

Once again we expect that bulk of purchases will be by non-domestic investors, with a heavy bias towards prime. However, this type of asset will remain in short supply. We do expect to see a steady stream of sales by the banks and special servicers, particularly as some of the CMBS deals start to mature. But, it is questionable whether these sources will release the type of stock that the typical, risk-averse international investor is looking for.

Falling yields and the inability to find 'dry' deals may well push some non-domestic investors towards fringe locations, or value-add assets, and these may well be the next segments of the market to see a slight hardening in yields.

GRAPH 9

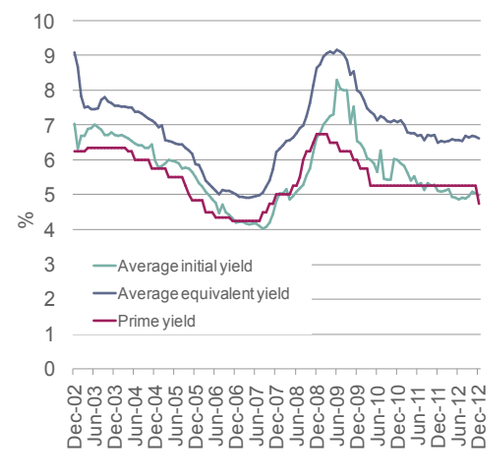
City of London investment volume



Graph source: Savills

GRAPH 10

City office yields



Graph source: Savills, Investment Property Databank

Docklands

Levels of take-up in the Docklands have been decreasing rapidly since the close of 2010 and the 351,000 sq ft reached during 2012 was well down on the 1m sq ft average, as well as being 50% down on 2011.

The largest new letting was a 165,000 sq ft acquisition by the Financial Ombudsman Service at the Exchange Tower. But, aside from the Economist's acquisition of 45,000 sq ft at 10 Cabot Square, all remaining transactions were for no more than 30,000 sq ft, the average size of units leased in the sub-30,000 sq ft size bracket being 8,100 sq ft.

It is positive that the Bank of New York Mellon decided this year to remain at their 152,000 sq ft 1 Canada Square offices and cost conscious occupiers such as Renaissance Capital and the Ministry of Justice are focussing their requirements on the Wharf. It is clear, however, that tenants will find feasible alternatives in affordable City Fringe locations. This is evidenced by at least one large occupier - advertising and marketing agency Ogilvy & Mather – who is planning to exit Canary Wharf upon expiry of an existing lease.

The release of space by Clifford Chance, LOCOG, MF Global and Citigroup means the amount of vacant offices on the market in the Docklands has risen from 1.2m sq ft to 1.7m sq ft over the last 12 months. Tenant controlled space now accounts for 57% of total supply on the Canary Wharf Estate itself, and the overall vacancy rate in the Docklands has increased from 9.1% to 12.2%.

The amount of space available at 1 Canada Square and 25 Canada Square has risen by over 20% to 250,000 sq ft and 230,000 sq ft respectively since mid-2012, and 205,000 sq ft remains on the market at 30 North Colonnade. It is estimated that no less than 80% of space available is of Grade A quality.

Despite planning permission being in place for 2.39m sq ft offices at North Quay, 4.9m sq ft at Wood Wharf, 1.28m sq ft at Heron Quays West and consent for a 37-storey tower at the adjacent Newfoundland site, there are yet to be any advances on JP Morgan's instruction to proceed with final construction of their new 1.9m sq ft HQ on Canary Riverside South and 25 Churchill Place remains the sole building under construction (pc mid 2014).

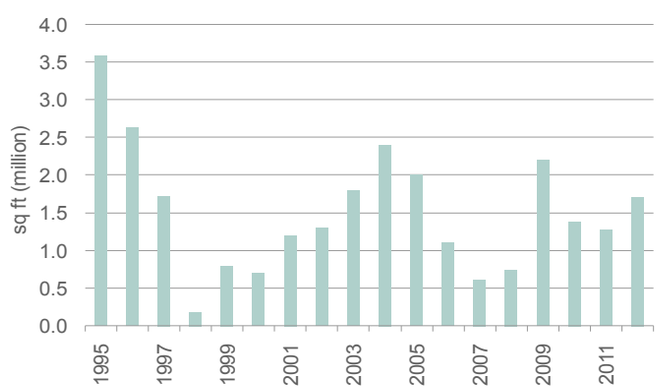
Although 48% of space at 25 Churchill Place has been pre-let to EMA and various companies, including Deutsche Bank, have shown an expression of interest in the remaining 525,000 sq ft it is positive that the development pipeline remains controlled. This is especially pertinent when considering the adverse effect oversupply will have on rents; top rents have already fallen by 7.5% in the last twelve months, and prime rents for tower floors - which are currently between £41.50 and £42.50 per sq ft - are on the more modest side of the £40.00-£45.00 per sq ft range described in the latter half of 2011.

Grade A rents range from £28 per sq ft at refurbished buildings in fringe areas to £43 per sq ft at landmark skyscrapers situated within the Canary Wharf Estate. And there is currently a widening gap between rents achieved in the City and rents achieved in the Docklands; at 39% the gap between top rents is the widest we have ever recorded and the gap between prime rents is currently around 24%.

Although a restrained development pipeline and low rents capable of attracting budget-conscious tenants may go some way to controlling vacancy rates, the biggest challenge for this market will continue to be on the tenant supply side. Take-up at either current or annual average rates will take time to absorb even existing supply, and this leaves the prospects for short term rental growth limited.

GRAPH 11

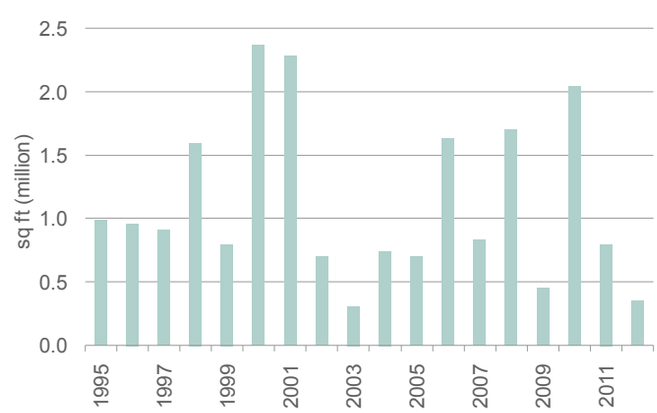
Docklands availability



Graph source: Savills

GRAPH 12

Docklands take-up



Graph source: Savills

Outlook

The biggest surprise about the central London office market in 2012 was probably not how strong it was, but how subdued it was.

A few basic statistics on the market and the economy help support this slightly counter-intuitative theory:

- The FTSE 100 is at its highest level since 2007;
- British companies are holding more cash on their balance sheets than they have done for more than 30 years;
- Both City and West End office-based employment has regained all its losses from the downturn of 2008/9;
- The central London vacancy rate is lower now than it has been at the start of any the last three market recoveries.

So, why aren't rents rising faster? If we look at average annual rental growth in the recovery phase post the dotcom boom, and after the early 1990's recession, the rates of growth in both the City and the West End office markets were more than double what we have seen over the last few years.

While the leasing market is by no means buoyant, the low levels of vacancy that we are seeing across the West End, as well as in some submarkets and size bands of the City, should be making landlords feel more confident, and tenants feel more under pressure to make decisions as the market tightens.

The key, we believe is the word "confidence". Graph 13 shows the recent trends in the national service sector confidence survey, and it is clear from this that while businesses might be less pessimistic than they were in the 2008 and 2009, there is still some way to go before they return to optimism.

Thus, while employment might be rising, many CEO's and property directors are still mirroring the consumer's newly acquired habit of "precautionary saving", and avoiding deploying any of their capital on any new investment such as a new offices.

So, what will it take to change business's minds from pessimistic to optimistic? For those businesses whose own company is performing ok, all that might be needed is a cessation in the regular supply of bad news about internal and external shocks to the UK. This will probably not be in 2013, as we believe the UK economy will be pretty flat this year. This will combine with concerns about the rating of our sovereign debt, the US debt ceiling, and the lack of a credible solution to the Eurozone crisis, to ensure that businesses remain cautious well into the second half of 2013.

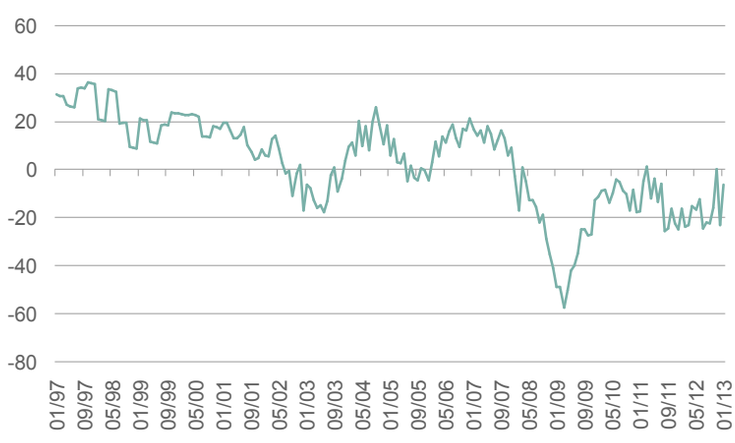
However, by early 2014, the newsflow on the domestic and global economies will have started to improve, and this should result in an improvement in business confidence. This could translate fairly quickly into a rise in leasing activity (at least outside the Banking sector), as companies realise that not only are they facing an impending lease event, but they are occupying their premises at its highest possible density.

Furthermore, as the economy recovers, the desire to control property costs will give way to a focus on growing the business. For many service sector companies in London this will lead to a pick-up in hiring. As unemployment falls, and competition for the best staff intensifies, we will see a return of office moves being driven by the desire to attract and retain staff.

This economic and property market recovery will undoubtedly be weaker than those we have seen before, with the word austerity weighing heavily on both. We believe that the next five years will see a rise in austerity-led office moves, with companies looking to achieve great working environments at less than prime rents. This doesn't mean that the core markets of Mayfair and St James's will be deserted, but as the rents rise in these and other core submarkets, we expect to see a steady rise in leasing activity in the more affordable fringes. CEO's will be looking for clever property deals, and what could be better than a prime building at a less than prime price?

GRAPH 13

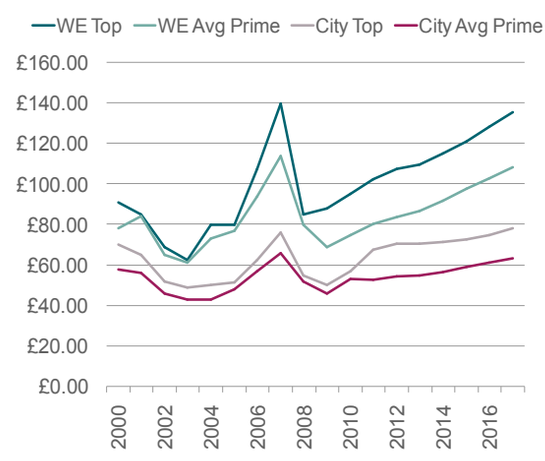
Service sector business confidence



Graph source: Thomson Reuters

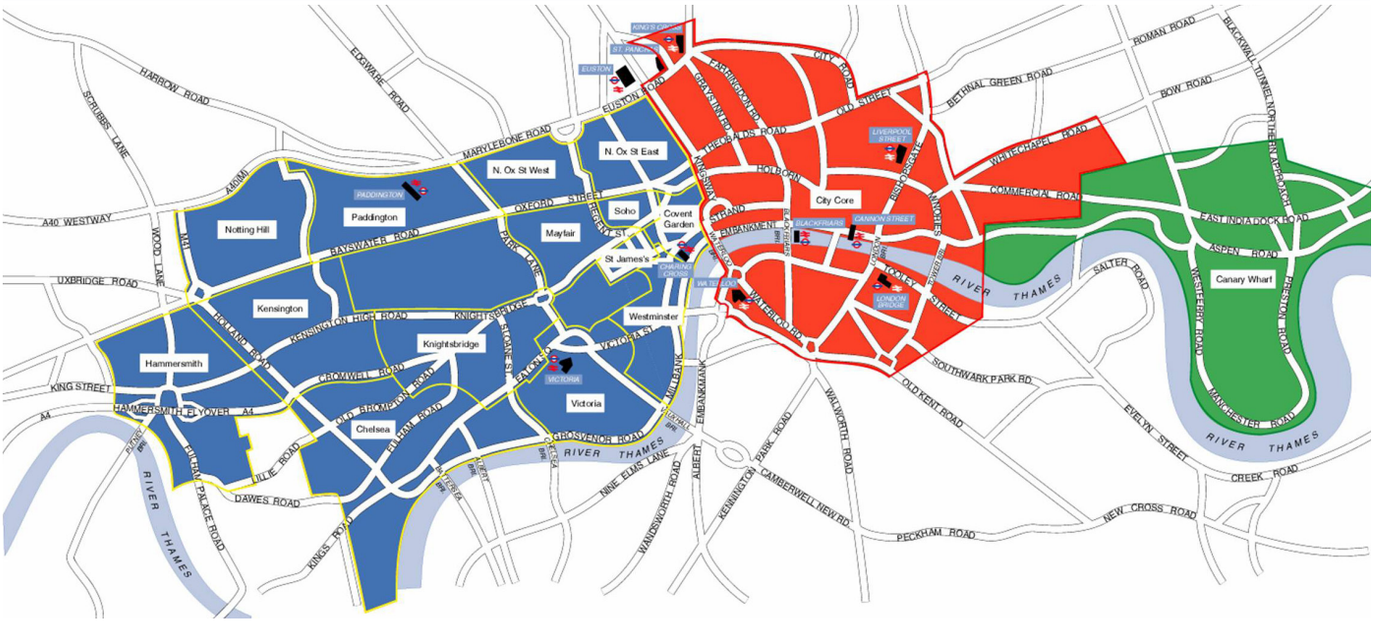
GRAPH 14

Outlook for prime headline office 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

Savills Central London Offices

Please contact us for further information

Stephen Down
Investment
(0)20 7409 8001
sdown@savills.com

Philip Pearce
Leasing
(0)20 7409 8917
ppearce@savills.com

Tracy Collins
Leasing
(0)20 7409 8958
tcollins@savills.com

James Crawford
Investment
(0)20 7409 8927
jcrawford@savills.com

Paul Cockburn
Investment
(0)20 7409 8788
pcockburn@savills.com

Mat Oakley
Research
(0)20 7409 8781
moakley@savills.com

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